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THE LETTER OF CREDIT AS SECURITY FOR COMPLETION OF STREETS, SIDEWALKS, AND OTHER BONDED MUNICIPAL IMPROVEMENTS

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I. INTRODUCTION

When approving a land development project, municipalities require assurance that developers will construct the required public improvements, and that in the event of default, the surety will be responsive, so that the project will be completed promptly, without risk to the municipal treasury. A form of guarantee sometimes used is the letter of credit. The case law involving public improvement letters of credit is sparse, yet the contingent liability to municipalities from defaulted land developments, with illusory sureties, should not be underestimated.[1]

The developer, the surety, and the municipality have mutual interests in clearly understanding the terms of the developer's performance agreement and the procedures for presenting the necessary drafts or documents by which the right to payment is asserted. This Essay gives a basic introduction to letters of credit and addresses some of the issues presented by the use of this instrument as a performance guarantee for land development public improvements. After a discussion of the legal principles relevant in the land development context, suggestions will be made for the effective use of the letter of credit, so that the best interests of the developer, the surety, and the municipality concerned may be served.

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1. For example, between 1970 and 1982, Fairfax County, Virginia, spent approximately $2.4 million from its general fund (construction costs of $3.7 million less collections from sureties of $1.3 million). OFFICE OF PURCHASING AND SUPPLY MANAGEMENT, FAIRFAX COUNTY, VA., CONTRACT NO. 3-0050-20-30, ANALYSIS OF LAND DEVELOPMENT BONDING PROCEDURES IN FAIRFAX COUNTY at I-5 (1983).

II. The Subdivision and Site Plan Approval Process; Defaults

The municipality operates within a framework of statutory authority requiring guarantees at the time of project approval. The "bonded" improvements generally include streets, sidewalks, drainage facilities, parking lots, curbs, gutters, and erosion and siltation controls. The typical subdivision enabling act provides that the governing body may accept a bond, cash escrow, certified check, or letter of credit as a performance guarantee.[2] Accompanying the surety is an underlying developer's agreement that describes the improvements to be completed, either expressly or by reference to the approved plat, and the time within which the improvements are to be constructed. The amount of the surety is based on the estimated cost to complete the improvements. Partial releases and reductions of the bond are requested and granted according to legally prescribed procedures as the construction of the improvements progresses.

When a project is in distress, affected persons urgently demand corrective action to alleviate inconvenience, vandalism, or damage from unpaved streets, incomplete houses, or siltation and erosion problems in excavated areas. Prompt remedial action in these situations is needed. Depending on the configuration of lots, the parties may consider vacating a portion of the subdivision, effectively reverting an incomplete portion to unplatted status. The platting and approval process may begin anew for the vacated portion.[3]

As the default unfolds, various fact patterns can occur: (a) a developer may abandon a project before the expiration date of the bond and developer's agreement, in which case the declaration of a default presents a legal issue;[4] (b) the municipality may not have incurred costs to complete the project, and the developer and surety defend that the municipality is seeking to collect an excessive amount, without adequately proving the extent of completion costs;[5] (c) the municipality may engage a successor-contractor and attempt to assign the proceeds of its claim against the original developer in exchange for an agreement by the assignee to complete

2. *See, e.g.*, Va. Code Ann. § 15.1-466 (Cum. Supp. 1988).
3. *See, e.g.*, Va. Code Ann. § 15.1-481, -482 (Repl. Vol. 1981 & Cum. Supp. 1988).
4. *E.g.*, Board of Supervisors v. Ecology One, 219 Va. 29, 245 S.E.2d 425 (1978).
5. *E.g.*, Board of Supervisors v. Safeco Enters., 226 Va. 329, 310 S.E.2d 445 (1983).

the improvements;[6] (d) the municipality may assert the absolute right to collect the full amount of the bond, arguing that the developer should be subject to a penalty for noncompletion and that an inquiry into actual damages would be irrelevant.[7] Defenses against the municipality include failure to mitigate damages, extension of time to the developer without notice to the surety, release, and factual and interpretive issues regarding the extent of obligation created or performed.

In anticipation of one or more of the foregoing patterns, the commercial letter of credit is viewed favorably as a performance guarantee, because it provides for automatic payment. Automatic payment avoids disputes over the status of the project, the cost to complete, the option to assign proceeds, and the measurement of actual expense to the municipality.

III. The Letter of Credit Transaction

A letter of credit is an engagement by a bank or other person, made at the request of a customer, that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit.[8] In the common letter of credit transaction, there is an "underlying transaction" for the purchase and sale of goods. Performance by the seller is conditioned upon the issuance of the letter of credit on behalf of the buyer, so that the seller will not risk shipping goods to a foreign port without an assurance of payment once the goods arrive. Upon the receipt of documents certifying the arrival of the goods, the issuing bank makes payment to the seller.

The buyer is termed the "account party" or "customer." The buyer also is designated the "applicant for the credit." The financial institution granting the credit is termed the "opening bank" or "issuing bank."[9] In the development context, the municipality will be the beneficiary and the developer is the account party.

Ordinarily, there is a reimbursement agreement, or indemnity agreement, between the account party and the issuer. By this

6. *E.g.*, Morro Palisades Co. v. Hartford Accident & Indem. Co., 52 Cal. 2d 397, 340 P.2d 628 (1959); County of Will v. Woodhill Enters., 4 Ill. App. 3d 68, 274 N.E.2d 476 (1971); Board of Supervisors v. Ecology One, 219 Va. 29, 245 S.E.2d 425 (1978).

7. *Safeco Enters.*, 226 Va. 329, 310 S.E.2d 445.

8. U.C.C. § 5-103(a) (1977).

9. *Id.* § 5-103(c)-(g).

agreement, the account party agrees to reimburse the issuing bank for any payments made to the beneficiary by the bank. The transaction is designed to avoid underlying factual disputes, thereby assuring that payment expectations will be realized.

There are three kinds of letters of credit: "documentary," "clean," and "standby." A letter is "documentary" if documents are required in addition to a draft or demand for payment. The commercial letter of credit is paid upon presentation of the appropriate documents. A letter of credit is "clean" if no documents are required in addition to the draft or demand for payment. A standby letter of credit is more in the nature of a loan or reimbursement agreement, by which the account party is obligated to repay the issuing bank after payment has been made to the beneficiary. The bank has greater risks in the standby letter of credit, because it does not involve presentation of any underlying documents. Instead, payment is conditioned upon the mere presentation of a draft by the beneficiary, without any evidence of nonperformance on the part of the account party.[10]

Most development surety agreements use the standby letter of credit. Defenses raised against payment of standby letters include characterization of the instrument as a contract of guaranty, in which case the bank would be liable only as a secondary obligor. Cases on point indicate, however, that an issuer of a standby letter can be liable as a guarantor even if payment has not been realized from the "primary" obligor. Thus, the issuer cannot require a beneficiary to proceed first against the account party.[11]

IV. Applicable Codes and Problem Areas

In order for the letter of credit to be effective in the land development context, the parties should draft the letter according to their mutual best interests, giving due regard to code provisions.

Two parallel sets of rules apply to letter of credit transactions: the Uniform Commercial Code (U.C.C.) and the Uniform Customs and Practice for Documentary Credits[12] (U.C.P.) (the latter is used

10. Annotation, *What Is a Letter of Credit Under UCC §§ 5-102, 5-103?*, 44 A.L.R. 4th 172 (1986).

11. *In re* Printing Dep't, Inc., 20 Bankr. 677 (E.D. Va. 1981) (applying Virginia law); Brummer v. Banker's Trust of S. C., 268 S.C. 21, 231 S.E.2d 298 (1977).

12. International Chamber of Commerce, Pub. No. 400, Unif. Customs and Practice for Documentary Credits (1984) [hereinafter U.C.P.] (available from I.C.C. Publishing

primarily in international trade). Under the U.C.C., an instrument conspicuously entitled "letter of credit" will be considered such, rather than a contract of guaranty, for example.[13]

Perhaps the most significant U.C.C. provision is that the engagement of the issuer is separate from the underlying transaction or obligation to perform by the developer. "An issuer must honor a draft . . . with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and beneficiary."[14]

A. *Presumption of the Issuer's Strict Liability*

The letter of credit serves primarily to certify the occurrence of an underlying transaction, for example, delivery of goods. Courts, therefore, have been strict in requiring payment upon presentation of documents, without reference to extrinsic facts. Courts have been equally strict, however, in adhering to the precise conditions for payment and in requiring precision in the recitals of the documents themselves.

If a draw against the credit requires the occurrence of one of several events of default, the letter of credit should require the certificate accompanying the draw to state the specific event of default which occurred. Otherwise, payment could ensue for any or all of several events.[15] The terms "completion of streets, drainage facilities, and erosion controls" could result in forfeiture of the face amount of the credit when only one of the items is yet incomplete, or upon the temporary failure of an interim item such as erosion control.

In two important cases, courts held that the municipality was entitled to the full amount of the credit without regard to the completion status of the project. In *East Girard Savings Association v. Citizens National Bank & Trust Co.*,[16] the Fifth Circuit held that there was no requirement in a standby letter of credit for a certifi-

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Corp., 156 5th Avenue, New York, N.Y. 10010), *reprinted in* F.P. DE ROOY, DOCUMENTARY CREDITS 171 app. A.1 (1984).

13. U.C.C. § 5-102(c) (1977).

14. *Id.* § 5-114(1).

15. Fair Pavilions, Inc. v. First Nat'l City Bank, 19 N.Y.2d 512, 227 N.E.2d 839, 281 N.Y.S.2d 23 (1967).

16. 593 F.2d 598 (5th Cir. 1979).

cate that a project was in default, and that the mere presentation of the demand was sufficient. Ambiguities were to be resolved strictly against the issuer of the draft. The municipality had no responsibility to demonstrate nonperformance, nor did the bank have any right to demand evidence of nonperformance by the developer.

Similarly, in *Colorado National Bank v. Board of County Commissioners*, the Colorado Supreme Court awarded judgment to the municipality.[17] The bank claimed that the "defaulted" project actually had been discontinued before it began, and that no work of any kind had been performed. Therefore, the bank argued that the county would receive a windfall which would not be used for construction at all. The court rejected these arguments and held that performance of the underlying agreement was not relevant, and that evidence of the possible windfall was inadmissible. The municipality, in effect, utilized the letter of credit as a penalty by avoiding an inquiry into its actual losses.

B. *Documentation Requirements*

The codes do not address the issue of compliance with documentary requirements, but courts have been strict in requiring precise documentation. Courts are inclined to facilitate the commercial advantages of the letter of credit,[18] but also to recognize the extraordinary trust the buyer places in the issuing bank.[19]

Because the issuer's liability is strictly enforceable, the beneficiary has a concurrent obligation to present documents exactly as required in the credit. Courts have used the technical term "identicality" when describing this obligation. Thus, the beneficiary must present the required documents,[20] and the documents must conform in detail to the specifications of the credit.[21]

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17. 634 P.2d 32 (Colo. 1981).

18. *E.g.*, Wichita Eagle & Beacon Publishing Co. v. Pacific Nat'l Bank, 343 F. Supp. 332 (N.D. Cal. 1971), *rev'd on other grounds*, 493 F.2d 1285 (9th Cir. 1974).

19. *See, e.g.*, Dubose Steel, Inc. v. Branch Banking & Trust Co., 72 N.C. App. 598, 324 S.E.2d 859 (1985) (seller's substantial compliance with the terms of the credit insufficient to force bank's performance; strict compliance with terms of letter of credit required).

20. Ufford, *Transfer and Assignment of Letters of Credit Under the Uniform Commercial Code*, 7 WAYNE L. REV. 263, 264-65 (1960).

21. Far Eastern Textile, Ltd. v. City Nat'l Bank & Trust Co., 430 F. Supp. 193 (S.D. Ohio 1977); *see also* Mentschicoff, *How to Handle Letters of Credit*, 19 BUS. LAW. 107 (1963).

In development cases, the underlying documents consist of a developer's agreement, which will make reference to an underlying plat and set of development conditions. Variations between the letter of credit and these underlying documents may occur. Recognizing the strict liabilities and requirements for precision in letters of credit, the drafter should recite all specific events of default. For example, the letter of credit should specify that a default will exist unless there is completion of the entire project before the expiration date. The amount of the credit should be the face amount, less any reductions actually approved. In the event the approved plans do not specify which items are "bonded," there may be complications in the attempt to draw. Culverts under individual driveways, grading of yards, installation of septic fields, and other borderline items can engender controversy. Coverage of these items under the letter of credit will be unclear if the documents themselves are not clear.

C. *Revocability; Expiration*

Two material differences between the U.C.C. and the U.C.P. are the provisions relating to revocation and expiration. The U.C.P. provides that "[i]n the absence of such indication the credit shall be deemed to be revocable;"[22] that "[a]ll credits must stipulate an expiry date for presentation of documents for payment, acceptance or negotiation;"[23] and that "documents must be presented on or before such expiry date."[24] If the letter of credit cites the U.C.P. as the governing rule, the beneficiary should be careful to specify irrevocability of the credit. Failure to heed governing revocation or expiration provisions can be fatal.[25]

The U.C.C. provides that unless otherwise agreed, a letter of credit is "established" as to a beneficiary "when he receives a letter of credit or an authorized written advice of its issuance."[26] Once a letter of credit is "established," unless otherwise agreed, as regards a beneficiary, it "can be modified or revoked only with his consent."[27] Whether a letter of credit is presumed irrevocable under the U.C.C. has been addressed in case law, with the rule prevailing

22. U.C.P. art. 7(c) (1984).
23. *Id.* at art. 46(a).
24. *Id.* at art. 46(b).
25. *See, e.g.*, Beathard v. Chicago Football Club, Inc., 419 F. Supp. 1133 (N.D. Ill. 1976).
26. U.C.C. § 5-106(1)(b) (1977).
27. *Id.* § 5-106(2).

that under the U.C.C., "establishment" and revocation "only with . . . consent" means that the U.C.C., unlike the U.C.P., favors irrevocability.[28]

The U.C.C. does not require an expiration date to be stated in the letter of credit, but does make provisions for the time of payment.[29]

D. *Assignment and Transfer*

Negotiations prompted by a default may lead the parties to consider an assignment of the letter of credit. The right to draw under a letter of credit differs from the right to be paid the proceeds of a letter of credit. The right to draw is the right of the beneficiary or of certain transferees to draw the draft or make the demand for payment that triggers the issuer's obligation to pay. The right to proceeds is a security interest analogous to the right of a party with a security interest in an account.

Both the U.C.C. and the U.C.P. allow the right of the beneficiary to assign the proceeds of the credit. The U.C.C. requires that notice of the assignment be given.[30] The U.C.P. provides that proceeds of a letter of credit are assignable, regardless of whether the right to draw is stated to be "transferable."[31] The U.C.P. forbids transfer of the right to draw unless the credit expressly provides for transferability.[32] Precision of terminology is required for letters which recite the U.C.P. as controlling: "a credit can be transferred only if it is expressly designated as transferable by the issuing bank. Terms such as 'divisible', and 'fractionable', 'assignable' and 'transmissible' add nothing to the meaning of the term 'transferable' and shall not be used."[33]

Restrictions on the right to draw exist because the issuing bank is strictly liable for dishonoring the draft, and is neither required nor entitled to inquire into the underlying transaction. Under these circumstances, the issuing bank is protected by being obligated only to its customer, unless otherwise stated in the credit.

28. *See* Data Gen. Corp. v. Citizens Nat'l Bank, 502 F. Supp. 776 (D. Conn. 1980).
29. U.C.C. §§ 5-112, -114(3).
30. U.C.C. § 5-116(2) (1977).
31. U.C.P. art. 55.
32. U.C.P. art. 54(b).
33. *Id.*

In the event of a transfer of the right to draw, or an assignment of proceeds, a new party comes into the picture in relation to the issuing bank. Because the bank is one step removed from its original customer at that point, disputes have arisen over the obligations of the issuer and transferee. For example, a transferee may attempt to assert that he takes free of "defenses" which could have been asserted against the original beneficiary. An issuer may honor the draft despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents.[34] But the customer may seek an injunction against the bank.[35]

In the context of a land development default, where a municipality engages a contractor to complete a project in exchange for drawing rights on the letter of credit, the contractor would attempt to assert that such rights are free of the original developer's defenses against the municipality's enforcement action. Accordingly, upon completion of the project, the issuer should pay the contractor from the original developer's letter of credit, notwithstanding any "wrongdoing" by the municipality. The original developer could claim, for example, that the municipality failed to mitigate damages by neglecting to bring a prompt enforcement action, which caused the project to deteriorate unnecessarily. The ability of the original developer to enjoin payment to the transferee contractor in this situation is uncertain.[36] Therefore, whether the contractor receives any payment may depend on what transpires in the negotiation process.

The U.C.C. gives some protection to the issuer by providing that the original beneficiary, when presenting a draft of demand for payment to the issuer, warrants compliance with all the conditions of the credit.[37] By virtue of these warranty provisions, an issuer may honor the draft of an original beneficiary with little or no risk. When the right to draw involves a transferee, the unfamiliarity of the issuer with the transferee can make the transfer situation more prone to problems. Assignment of proceeds, rather than transfer of

34. U.C.C. § 5-114(2)(b).

35. *Id.*; *see, e.g.*, Rockwell Int'l Sys., Inc. v. Citibank, 719 F.2d 583 (2d Cir. 1983).

36. *Compare* Cromwell v. Commerce & Energy Bank, 464 So. 2d 721 (La. 1985) (transferee takes payment free of defenses good against the original beneficiary) *with* Pubali Bank v. City Nat'l Bank, 777 F.2d 1340 (9th Cir. 1985) (assignee of the credit takes subject to defenses against the assignor if the assignee participated in the assignee's misconduct). *See also* Ufford, *supra* note 20, at 288; Brown v. United States Nat'l Bank, 220 Neb. 684, 371 N.W.2d 692 (1985) (assignor's misconduct not relevant unless assignee participates in the misconduct).

37. U.C.C. § 5-111(1).

drawing rights, appears to be the more effective method of arranging for a substitute entity to complete a defaulted project.

E. *Insolvency of the Developer*

In an insolvency situation, the municipality's right to draw against the letter of credit is determined by reference to applicable bankruptcy rules, which provide that:

> [a] petition . . . operates as a stay, applicable to all entities, of—
>
> . . . .
>
> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
>
> (4) any act to create, perfect, or enforce any lien against property of the estate.[38]

This "estate" is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case," wherever located and by whomever held.[39]

Generally, the stay does not preclude drawing rights under a letter of credit, because letters of credit are property of the issuer, not property of the estate.[40] Although there is authority supporting an injunction against honoring a beneficiary's demand,[41] commentators have criticized such a result.[42]

V. CONCLUSION

Letters of credit are advantageous to the municipality seeking a means of prompt payment to guarantee performance of a land development agreement. In order to serve the mutual interests of all parties, the lender issuing the credit should recognize that a standby letter of credit is not a secondary obligation contingent upon the failure of the developer to perform. The credit is strictly

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38. 11 U.S.C. § 362(a)(3)-(4) (1986).

39. *Id.* § 541(a)(1).

40. *In re* North Shore & Cent. Ill. Freight Co., 30 Bankr. 377 (N.D. Ill. 1983); *In re* Leisure Dynamics, Inc., 33 Bankr. 171 (D. Minn. 1983).

41. *In re* Twist Cap, Inc., 1 Bankr. 284 (D. Fla. 1979).

42. *See generally* Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. CHI. L. REV. 130 (1982); Chaitman & Sovern, *Enjoining Payment on a Letter of Credit in Bankruptcy: A Tempest in a Twist Cap*, 38 BUS. LAW. 21 (1982).

enforced against the issuer, and the issuer has no obligation to inquire as to the underlying transaction. Any presentment under the credit requires strict adherence to sight draft or documentary requirements.

The drafter of a letter of credit should keep the following principles in mind:

1. The underlying agreement must not conflict with the terms of the letter of credit. Expiration dates should be coordinated, allowing the municipality to ascertain the default and to exercise its drawing rights before the letter of credit expires.

2. The letter of credit must not call for documents that the municipality cannot supply. The letter should specify in detail the nature of the default and the precise events giving rise to the right to draw. The underlying documents and the letter of credit should correspond exactly.

3. Irrevocability and transferability of the right to draw must be expressly stated.

4. To avoid disputes over the accuracy of required documents, the parties should use the standby letter of credit, which is available by sight drafts and does not require a specific documentary presentation.

With the foregoing principles in mind, the well-drafted letter of credit in a land development agreement with a municipality nearly eliminates the possibility of litigation, and thereby serves the best interests of the parties by assuring the project's undelayed completion, without risk to the municipal treasury.