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INFORMALITY AS A BILATERAL ASSURANCE MECHANISM

Comments on Ronald Mann's 'The Role of Letters of Credit in Payment Transactions'

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Ronald Mann's study of documentary defects in the presentation of commercial letters of credit[1] is a valuable contribution to the commercial law literature in at least three respects. First, it offers a detailed and thorough empirical survey of an important though specialized aspect of commercial practice. Mann collected and coded a data sample of 500 randomly selected letter-of-credit transactions, personally evaluating each transaction to determine whether the documentary presentation by the beneficiary of the letter of credit (i.e., the seller) complied with the letter's formal terms. Then, for each case in which he found one or more documentary defects, Mann went on to classify the defects and to evaluate their commercial and practical significance. He also measured how quickly and readily the issuing bank and the applicant (i.e., the buyer) responded to — and ultimately waived — the defects, in addition to collecting various other information about the transaction and the parties involved. The creation of this data set required significant time, effort, and both professional and scholarly judgment; and the result is a level and quality of information that goes substantially beyond the qualitative information gleaned from his interviews with bank officers, not to mention the anecdotal information that motivated the study in the first place.

Second, Mann has not just produced a dry collection of business facts. Rather, in showing that the beneficiaries of letters of credit routinely fail to present documents that comply with the terms of the underlying letter and that the applicants and issuing banks just as routinely waive the resulting defects, he has convincingly documented an important and counterintuitive empirical regularity about commercial letters of credit — one that substantially undercuts the conventional teaching in the area that the purpose of the letter of

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1. *See* Ronald J. Mann, *The Role of Letters of Credit in Payment Transactions*, 98 MICH. L. REV. 2494 (2000) [hereinafter Mann, *The Role of Letters of Credit*].

credit is to provide the beneficiary with a guaranty of payment that is legally enforceable against the issuing bank. His findings are striking, provocative, and persuasive enough to demand explanation and, thus, to force a revision of the conventional scholarly wisdom in this area.

Third, Mann has put forward a theoretical account of letters of credit, grounded in the modern economics of information and based on his prior work in other areas of commercial law, that is both more nuanced and conceptually more sophisticated than is the conventional scholarly view. His explanation is that the value of letters of credit in assuring beneficiaries of payment does not lie primarily in their legal significance, but rather in their practical significance. More specifically, the willingness of a bank to issue a letter of credit serves as a credible signal, enforced by an implicit reputational bond, of the issuer's private information that the applicant is a reliable creditor; and this signal is more important to the beneficiary in practical terms than is any right to collect directly from the bank. To use Mann's own terminology, the letter of credit is primarily a verification institution, not a guaranty institution.[2] This explanation is creative, interesting, and as far as I know, original. It may be that Mann's explanation, as he suggests at various points, will be regarded as old news by practicing commercial specialists in the letter-of-credit area. Even if this is so, however, and even if his explanation is incomplete or incorrect, he has significantly advanced the state of the scholarly literature on this topic.

In these comments, I argue that the theoretical account of letters of credit that Mann offers, while instructive and suggestive, is indeed incomplete. In particular, Mann's theory does not explain why parties contracting at a distance would want to use a commercial letter of credit as their mechanism for verifying information relevant to the extension of credit, as opposed to some other device. Similarly, his account does not explain why, given that the parties have chosen to use a letter of credit to signal the buyer's reliability, they would avoid the presumably stronger signal of making the letter legally binding. Indeed, as Mann himself tells us, if the parties' main purpose is to provide the seller with assurance that the buyer will pay, there are easier and cheaper means through which to provide such assurance. Thus, his information-verification theory fails to explain all of the facts he uncovers in his empirical research, and to the extent it is consistent with his findings, it would be equally consistent with other findings if not more so.

The reason why Mann's explanation is incomplete, I also argue, is that he focuses on only half of the incentive problem inherent in the stereotypical commercial letter-of-credit transaction. When parties

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2. *See generally* Ronald J. Mann, *Verification Institutions in Financing Transactions*, 87 GEO. L.J. 2225 (1999) [hereinafter Mann, *Verification Institutions*].

deal at a distance, there is risk on both sides. The seller faces the risk that she will ship goods for which the buyer will not pay, leaving her with the relatively ineffective remedy of a lawsuit in a distant and unfamiliar jurisdiction; this is the problem on which Mann focuses. But the buyer faces the corresponding risk that he will pay for goods that are defective or that the seller does not even ship.[3] Either party could reduce or even eliminate this risk by insisting that the other party perform first; for instance, the seller could insist that the buyer prepay, or the buyer could insist that the seller ship on open account and that payment be due only after the buyer is satisfied that the goods conform to the underlying contract. Intermediate arrangements will give less protection to one party and more to the other. But there is no arrangement that will provide complete assurance to both; the difficulty lies in the very fact that the parties deal at a distance, which both makes it impossible for them to perform simultaneously, and renders the usual legal remedy for breach of contract — a lawsuit for damages or specific performance — ineffective in practical terms.

What Mann omits, in his focus on the seller's need to verify the reliability of her buyer, is that the commercial letter of credit is a bilateral assurance mechanism — one that, more or less, splits the difference between prepayment and shipment on open account. When the bilateral nature of the risk inherent in long-distance transactions is taken into account, the use of letters of credit, as well as the fact that in most instances they are honored despite technical noncompliance with their documentary conditions, becomes substantially more understandable.

1. WHY USE A LETTER OF CREDIT AT ALL?

As a vast theoretical and empirical literature in law and in economics makes plain, imperfect information is a primary institutional consideration in credit markets. According to the standard economic theory of risk bearing, creditors who lack individualized information about their debtors' risk profiles or post-credit behavior will be unable to price credit terms correctly or provide incentives for optimal precaution and risk taking by debtors over the life of the loan. As a result, the price of credit will generally include a premium for anticipated suboptimal behavior by the debtor (moral hazard) as well as a cross-subsidy from low-risk to high-risk debtors that inefficiently discourages the former from applying for credit in the first place (adverse selection). These informational transaction costs arise not just in explicit credit markets, but in any

3. In order to avoid ambiguity, when discussing generic transactions, I adopt the convention of referring to buyers, letter-of-credit applicants, and other debtors with male pronouns; sellers, letter-of-credit beneficiaries, and other creditors with female pronouns; and banks and other intermediaries with neuter pronouns.

contractual relationship that includes an implicit credit element — that is, in any contract where performance is not completely simultaneous.[4] Reducing such costs to manageable proportions, accordingly, will in many instances be crucial to the success of the overall contract.

The problems of adverse selection and moral hazard are likely to be especially significant when parties contract at a distance. The difficulty of verifying information about a far-off and unfamiliar location, organized according to local conventions and possibly in a different language; the problems of collecting at a distance and navigating a foreign legal system; and the relative infrequency of such transactions, making it difficult to cover the overhead costs of investigation and enforcement or to establish a credible business reputation, all combine to make reliance on ex post legal enforcement an especially cumbersome tool to ensure compliance with contractual obligations. Thus Mann's observation that long-distance sellers would have special concerns about the reliability and creditworthiness of their buyers, and would accordingly have special need for devices that address these concerns, is both intuitive and empirically plausible.

As both the practice of and the literature on commercial transactions attests, however, and as Mann himself has documented more fully in another context, a host of legal and commercial institutions are available to serve this accreditation function.[5] One such institution is secured credit, under which the debtor offers specific property as collateral for his loan, thus providing a source of funds out of which the creditor may satisfy her debt in the event of default, as well as, under most systems of secured credit, a relatively expedited process for collection.[6] Another such institution is the contractual guaranty, under which a third party undertakes a secondary obligation to pay the debt if the primary debtor does not.[7] A third device is the posting of a bond, to be forfeited to the creditor, to a third party, or even destroyed in the event of breach or other debtor misbehavior.[8] A fourth is the use of contractual intermediaries

4. *See generally* Y. Kotowitz, *Moral Hazard*, *in* 3 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 549 (J. Eatwell et al. eds., 1987); Charles Wilson, *Adverse Selection*, *in* 1 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 32 (J. Eatwell et al. eds., 1987).

5. *See generally* Mann, *Verification Institutions*, *supra* note 2.

6. *See, e.g.*, Ronald Mann, *The Role of Secured Credit in Small-Business Lending*, 86 GEO. L.J. 1 (1997); Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986); Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1 (1981); Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209 (1989); George G. Triantis, *Secured Debt Under Conditions of Imperfect Information*, 21 J. LEGAL STUD. 225 (1992).

7. *See generally* Avery Wiener Katz, *An Economic Analysis of the Guaranty Contract*, 66 U. CHI. L. REV. 47 (1999).

8. *See, e.g.*, Robert E. Scott, *Rethinking the Regulation of Coercive Creditor Remedies*, 89 COLUM. L. REV. 730 (1989) [hereinafter Scott, *Coercive Creditor Remedies*] (applying theory to context of debtor-creditor law in particular); Oliver E. Williamson, *Credible*

who have some link to the unknown debtor, whether through past transactional experience, common ethnic identity, or membership in a trade association, and who themselves are known or who have an established commercial reputation.[9] And a fifth alternative is the direct acquisition of knowledge, whether through personal investment, gossip, or a direct purchase from a specialist in the collection and processing of commercial information, such as Dun and Bradstreet or other credit reporting agencies.

Each of these alternatives alleviates the problems of moral hazard and adverse selection in various ways: by lowering the creditor's cost of collection (secured credit, third-party guaranties), raising the cost to the debtor of engaging in suboptimal behavior (bonds, collateral), or signaling private information of the debtor and third parties (all of the above, in that a party's willingness to assume special risk in the event of default credibly reveals his or its belief that such risk is low). They can be used separately or in concert, as when a applicant for an automobile loan is asked to provide credit references, to make a substantial down payment, to grant the lender a security interest in the car, to sign a promissory note, and in some cases to provide a co-signer. Most of them are sufficiently flexible, furthermore, so as to accommodate a variety of practical and legal forms. For instance, a bond can be posted in the form of out-of-pocket funds (as with a landlord's security deposit or a down payment), of a relationship-specific physical asset the value of which will be destroyed if the contract is discontinued or not renewed (as when a railroad builds a special spur to reach a particular mine or wellhead), of deferred compensation or future expected profits (as when an employer offers a pension for long-term service or a commercial buyer holds out the prospect of repeat business as a reward for high quality), or of reputation in the relevant commercial community (as when breach of contract can get one gossiped about or expelled from a trade association).

Given this rich variety of alternative verification and guaranty devices, therefore, a long-distance seller's need for information regarding her buyer does not explain, let alone predict, the use of the commercial letter of credit in particular. In order to provide such an

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Commitments: Using Hostages To Support Exchange, 73 AM. ECON. REV. 519 (1983) (developing general theory of bond posting).

9. *See generally* Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 138-143 (1992) (detailing the role of trade associations and commercial experience in private contractual enforcement); Janet T. Landa, *A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law*, 10 J. LEGAL STUD. 349 (1981) (detailing the informational role of ethnic middlemen); Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525 (1993) (detailing the same with historical discussion of reputation-supporting social networks in 11th-century Europe).

explanation, one would have to show that the letter of credit is cheaper than its alternatives, more reliable, or both. And in this regard, Mann's evidence is neither apposite nor helpful. Because his data look only at letters of credit, and are drawn from the files of the issuing banks rather than from the files of the buyer-applicants or seller-beneficiaries, they cannot tell us how or why these buyers and sellers choose to use letters of credit rather than (or, in conjunction with) these other devices.

More problematically, as Mann himself explains, the letter of credit is a relatively expensive verification device. Its price is typically set at a low but constant percentage of the amount at risk in the underlying sales transaction, which means that in large transactions the cost to the parties can reach thousands of dollars.[10] In contrast, documents of title cost in the neighborhood of one-tenth that amount; and their price does not increase with the size of the transaction.[11] A simple letter of reference printed on the bank's ordinary letterhead stationery would be even cheaper. Such alternate devices do not provide the seller with the same legal protections as does the letter of credit, to be sure, but under Mann's account it is bank reputation and not potential legal liability that does the informational work. There is no reason why credit references, title documents, or a host of other commercial documents regularly issued by banks could not carry (or could not be invested by the parties with) reputational weight in the same way that Mann suggests that letters of credit do and are.[12] Why then, don't the parties use such cheap and readily available devices to provide the necessary verification, instead of the relatively expensive letter of credit?

10. *See* Mann, *The Role of Letters of Credit*, *supra*, note 1, at 2499. Though the payment for a letter of credit is formally paid by the buyer-applicant, its cost is ultimately shared between the buyer and seller. As a general matter, the surplus from exchange tends to be divided among contracting parties in proportion to their relative eagerness to enter into the bargain (and in competitive markets, by their elasticities of supply and demand). Any transaction costs from exchange, or efficiency gains or losses resulting from a change in legal regime, accordingly, will be shared by all. *See generally* Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361 (1991).

11. *See* Mann, *The Role of Letters of Credit*, *supra* note 1, at 2508.

12. In a footnote to the latest version of his article, prepared after these comments were orally delivered, Mann acknowledges the theoretical force of this objection, but replies that the answer simply lies in the brute empirical fact that in the commercial world, letters of credit are understood to carry such weight and other documents are not. *See* Mann, *The Role of Letters of Credit*, *supra* note 1, at 2529 n.118. This response, however, obviously fails to explain why this conventional understanding exists, and why the understanding is not or could not be different, given the apparent availability of cheaper and equally effective methods for signaling the same information.

2. WHY USE A LETTER OF CREDIT AND THEN NOT MAKE IT LEGALLY BINDING?

Conversely, Mann's information-verification theory does not explain why the parties would go to the expense of obtaining a letter of credit, and then write it and use it in a way that deprives it of its main formal advantage — that is, legal enforceability against the issuing bank. It is no answer to say that the parties are primarily interested in signaling the buyer's creditworthiness, and that the bank's mere willingness to issue a letter of credit provides such a signal. For the issuance of a letter of credit, backed up by legal liability on the part of the bank, would provide an even stronger signal. After all, the greater the penalty paid to the bank in the event of the buyer's default, the more credible is its representation that the chance of default is low. A bank that stands immediately to lose out of pocket the face value of a letter of credit, and not just in the long-run reputational sense, will have sharper incentives to monitor the buyer and ensure his compliance with the underlying sales contract. It will also have sharper incentives to screen buyers before agreeing to issue the letter in the first place. A bank that assumes both legal and reputational liability will have sharper incentives yet.

If the response is that the seller does not need a perfect signal of the buyer's reliability, but only a sufficient one, the puzzle remains. For then the question becomes one of efficiency — how can the bank send a sufficiently reliable signal at lowest cost? And if we consider this question more closely, one finds again that a letter of credit backed up by reputational sanctions alone is a relatively expensive method of signaling. This is because the effectiveness of a reputational sanction requires that the party with the reputation (here, the bank) anticipate some supranormal profits (or more technically, economic rents) on its future operations. Otherwise, it has no incentive to spend resources or forego current profits to keep up its reputation. Indeed, the strength of a party's incentive to keep up its reputation, properly understood, is directly proportional to the expected future profits that serve as an effective bond for that reputation.

To illustrate with a numerical example: consider a bank that issues a $1 million letter of credit. In order for reputation alone to provide an incentive to honor this obligation, the issuing bank must have at stake an anticipated $1 million of profits on future letter-of-credit transactions, else in the event of a dispute it would prefer to forego these future transactions and to default on its current obligation. This $1 million, furthermore, must take the form of supranormal profits, measured as a premium over the ordinary market return to capital. Otherwise the bank could simply recoup its losses by engaging in alternate financial or commercial activities. In order for it to anticipate earning such profits in the future, the bank must plan to charge a price that exceeds its future expected costs of doing business, including normal returns to capital. Specifically, it must charge a markup that, when summed over all future transactions of the same type and discounted to present value, adds up to $1 million. The per-unit markup will of course depend on the number of similar transactions it engages in, together with its discount rate and the fraction of business that lies at stake in a potential default. For instance, if the bank engages in 1,000 transactions of the same type per year, faces a discount rate of 10%, and anticipates that a single default would result in the loss of all future business of this sort, the required markup would be $100 per transaction.[13] A larger issuer that engaged in 5,000 such transactions per year would only have to charge a markup of $20; while a smaller issuer spreading this cost over only 200 transactions per year would have to charge a higher markup of $500.

The assumption that a buyer's refusal to pay on a single letter of credit would cost the issuing bank its entire future letter-of-credit business, of course, is unrealistic. An alternative assumption of a 5% loss in future business (probably still too high, given the geographic separation of beneficiaries, the heterogeneity of buyers and sellers using the letter-of-credit device, the difficulty of determining the validity of the buyer's refusal in the absence of an authoritative public hearing, and the difficulty of allocating blame for the refusal between the buyer and the bank) would imply a markup of $2,000 for the medium-size issuer, 400 for the large issuer, and $10,000 for the small issuer. This is, recall, on a transaction that Mann tells us typically sells for around $2,500, so that if Mann's information is accurate, then a significant fraction of the cost of a letter of credit would have to consist of reputational rents. These calculations imply, somewhat implausibly, that the letter-of-credit divisions of commercial banks should earn profits well in excess of the normal economic return to capital.

Compare this figure with the likely expected costs of enforcing a letter of credit through the judicial system. Taking a lawsuit all the way to final judicial disposition is not cheap, but most letters of credit never lead to any dispute, because the formalistic rules of letter-of-credit law considerably streamline the resolution of any disputes that do arise, facilitating disposition or settlement at an early stage of the process.[14] Most significant in this regard is what specialists in the area

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13. The calculation is as follows: profits of $100 per transaction times 1,000 transactions per year equals $100,000 per year. The present value of $100,000 per year indefinitely, at an interest rate of 10%, is $100,000/.10 = $1 million.

14. Indeed, the formality of letter-of-credit law is regularly justified by experts in the field by the need to keep legal enforcement quick, cheap, and certain. *See, e.g.*, JOHN F. DOLAN, THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS (Warren et al. eds., 2d ed. 1991) at 2-55, 3-23, 3-24; U.C.C. § 5-103, cmt. 1 (1999).

refer to as the "independence principle": that is, liability under the letter of credit is both formally and substantively independent of the underlying contractual transaction it supports. Once the beneficiary demonstrates that she has presented conforming documents, accordingly, she is entitled to judgment. There is no need for her to demonstrate anything at all about the underlying contract; indeed, whether she is entitled to payment under the underlying contract is legally irrelevant.[15] Similarly, the issuer's available defenses to liability are quite limited. An issuer or applicant can avoid paying claims that are materially fraudulent or based on forged documents, but the standards of proof of fraud are high.[16] The current version of U.C.C. Article 5 formalizes the enforcement process even further, introducing several changes from prior law that are plainly intended to discourage interpretative disputes.[17] As an illustrative calculation, then, even if as many as one out of every fifty letters of credit led to litigation (certainly too high a figure) and the costs of litigation were as high as $50,000 (possibly too low, but not that low if the case is settled or resolved on the pleadings), this would still imply an expected enforcement cost of only $1,000 per transaction — half of what we estimated was necessary to support an equivalent reputational sanction.

Even if it turned out that reputational enforcement were generally cheaper than legal enforcement, furthermore, providing for both enforcement mechanisms would give the beneficiary an option to enforce with whatever sanction turned out ex post to be cheaper in the individual case. Like any other option, the availability of this option has positive value. Even if unused in the majority of cases, it would lower the beneficiary's expected costs of enforcing the bank's representations.

15. This central aspect of the letter of credit is part of its legal definition. U.C.C. § 5-102(a)(10) (1999), defining "letter of credit," and § 5-102(a)(6), defining "document," provide that letters of credit can condition payment only on the presentation of specified records. Similarly, the Comptroller of the Currency's Interpretive Ruling 7.7016, 12 C.F.R. § 7.7016 (1994), directs that "As a matter of sound banking practice, . . . the bank must not be called upon to determine questions of fact or law at issue between the account party and the beneficiary."

16. And these standards have been heightened by the 1995 revision to the statute. Compare revised § 5-109 (requiring "material fraud by the beneficiary on the issuer or applicant") with old § 5-114 (employing broader and vaguer standard of "fraud in the transaction").

17. *See, e.g.*, new § 5-102(a)(7) (defining good faith as mere "honesty in fact," in contrast to the more equitable standard of "reasonable commercial standards of fair dealing" found in Article 2 and the proposed revision to Article 1); new § 5-108(a) (substituting a strict compliance principle for the doctrines of waiver and estoppel that would otherwise apply under section 1-103); new § 5-108(e) (making the question of the issuer's compliance with the standard practice of financial institutions a question for the court and not the jury); new § 5-111(a) (eliminating consequential damages and, more strikingly, the duty to mitigate damages); and new § 5-111(e) (providing that courts must award attorneys' fees to the prevailing party in any dispute that arises over the issuer's duty to pay).

If legal enforceability would lower the cost to the parties of sending a credible signal of the buyer's creditworthiness, why don't the parties structure letters of credit so that as a regular matter they are formally as well as practically binding on the issuer? The costs of document preparation is no answer, since the parties could if they wished write the documentary conditions more liberally, so as to cover the incomplete documents that Mann shows that beneficiaries routinely submit and issuers and applicants routinely honor. Under U.C.C. Article 5, it is left entirely to the parties to determine which specific documents might serve as a condition for drawing on a letter of credit; it is even possible to condition the payment upon the mere presentation of a draft together with the beneficiary's conclusory statement that payment is due (the so-called "clean" letter of credit). Why, instead, do the parties write the conditions strictly instead of liberally?

That they do so deliberately seems inescapable. Mann's interview evidence backs up this conclusion, and for even more striking evidence, one need only look to the history of the recent revision of Article 5.[18] There, not only did the official drafting committee and representatives of the letter-of-credit industry quickly agree on the importance of adopting a legal standard of strict compliance with documentary conditions, but the industry successfully lobbied the drafters to maintain and even to strengthen legal rules that maintained their discretion to insist on strict compliance with documentary conditions as a condition of liability, but waive it broadly in practice.[19]

To summarize, the main theoretical puzzle raised by Mann's empirical findings remains. As he has shown, the parties to letters of credit go to substantial expense to cast their transactions in a legal form that, if designed appropriately and complied with by the seller, would provide a cheap and reliable method of enforcing the buyer's obligation to pay. But he also shows that in the majority of transactions the parties do not actually use this method to secure payment, instead preferring to rely on informal methods backed up by reputational sanctions. Mann's suggested explanation for his findings is that the parties are interested in verifying the buyer's reliability to the seller, not in legal liability per se. But his explanation turns out to be unconvincing once we recognize that a letter of credit backed up by reputational sanctions alone is likely to be a more expensive

18. *See* James J. White, *The Impact of Internationalization of Transnational Commercial Law: The Influence of International Practice on the Revision of Article 5 of the UCC*, 6 NW. J. INT'L L. & BUS. 189 (1995) (describing in particular the lobbying efforts of the U.S. Council on International Banking).

19. *See id.* at 205, 208. According to White, the bankers were particularly concerned about the U.C.C.'s duty of good faith, which they feared would bind them to exercise their discretion to waive strict compliance consistently across cases, or to pay when documents substantially (but not strictly) conformed.

verification device than is either a lesser document backed up by the same reputational sanctions, or the same letter of credit backed up by legal sanctions. Thus, assuming they are economically rational, buyers and sellers who go to the expense of purchasing letters of credit must be buying something more than verification of the buyer's reliability. What, then, are they buying?

3. THE PROBLEM OF BILATERAL INCENTIVES IN LONG-DISTANCE TRANSACTIONS

As I have already indicated, the answer likely lies in the bilateral nature of the incentive and informational problems facing long-distance buyers and sellers. Just as the seller is worried about the buyer's performance so is the buyer worried about the seller's. Just as the seller finds it difficult to acquire reliable credit information about an unknown customer in a distant location, and wishes to avoid the burdens of litigation in a foreign jurisdiction, so does the buyer. Thus, the buyer and the seller have similar need for verification of each other's contractual reliability.

If the parties arranged for prepayment by the buyer, or if they used a letter of credit with minimal documentary conditions, the seller would have little reason to worry about the buyer's performance, but the buyer would have significantly greater reason to worry about the seller's. Conversely, if the parties arranged for shipment on account, or relied entirely on the reputational interests of the buyer's bank to ensure buyer performance, the buyer would have greater protection, and the seller would have less. Using the letter of credit in the way that Mann describes, however, provides an intermediate solution that balances the verification and enforcement needs of buyer and seller. Furthermore, the very feature than Mann highlights — the fact that documentary conditions are set strictly as a matter of legal formality, but waived liberally in ordinary practice — may be the key that enables the device to motivate performance on both sides.

In order to see how this could be possible, consider the following alternate account of letters of credit, based on a set of admittedly stylized but empirically plausible assumptions. The first assumption is that in the period leading up to contractual performance, both the buyer and the seller receive some information that gives them some indication whether the other side is likely to perform. This information comes from a variety of communications and signals — exchange of preliminary documents such as specifications, conversations between agents, requests for modification, third-party market reports, and the like. The parties regard the information as reliable in that they have reason to think it accurate, but it is soft information, not of the sort that can be corroborated with reasonable cost or accuracy by a third-party enforcer such as a court or arbitrator.

In the terminology of the modern economic literature on incomplete contracting, then, the information is observable but not verifiable.[20] Because a court cannot verify the information, the parties cannot directly condition their legal obligations on it, whether in a letter of credit or otherwise. Because the parties can observe such information on their own, however, there is no reason they cannot condition their actual behavior on it. In particular, the seller's decision whether to submit documents that conform to the conditions of a letter of credit, and the buyer's decision whether to waive any nonconformities, can depend on such soft information.

Second, suppose that there is a variety of concrete actions that the parties can take that are correlated with, but not equivalent to, substantive contractual performance. This category would include the preparation of invoices and packing lists, procurement of inspection certificates and bills of lading, and so on. Because such actions are costly, both parties would prefer to avoid or minimize them if this can be done without putting at risk the underlying exchange. On the other hand, because of their relative concreteness and formality, such actions are both observable and verifiable by third-party enforcers at low cost. Thus, in contrast to the soft information described previously, they are contractible — that is, they can be used to condition legally enforceable obligations and can form the basis for the documentary terms of a letter of credit.

Under these assumptions, a seller who has sent signals of reliability to a buyer through informal channels does not need to concern herself as much with strict formal compliance with the documentary terms of a letter of credit. Because the buyer can tell that performance is likely to be forthcoming notwithstanding any documentary discrepancies, he is more likely to waive such discrepancies when they occur. The seller, anticipating such waiver, can thus save on the costs of formal documentation, complying substantially but not strictly.

Conversely, a seller whose underlying performance has been deficient will face greater difficulties obtaining payment, just because a buyer who has received signals of the deficiency through informal channels will be less likely to waive any documentary defects. A seller who anticipates such difficulties, of course, can protect herself by going to greater efforts to ensure that she has strictly complied with all the documentary conditions; for instance, the seller could engage a commercial specialist, such as a confirming bank, to check her documents to make sure they are free of error. Such protection, however, comes at a cost, for as Mann's informal survey indicates, banks charge for such a service.

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20. *See* Alan Schwartz, *Incomplete Contracts*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 277 (Peter Newman ed., 1998).

Given this framework, the costs of strict documentary compliance, combined with the threat that the buyer will refuse to waive formal defects and the seller will be forced to collect through an expensive legal proceeding, reinforce the seller's incentive to perform the underlying contract substantively. Substantive performance of the underlying contract, of course, is what the buyer is really interested in, not documentary compliance per se. But the potential enforcement of the documentary conditions, which are cheaply verifiable by a third party, operates as a substitute for enforcement of substantive performance, which is expensive for a third party to verify. The fact that enforcement of the documentary conditions is rare — in most instances they operate as an out-of-equilibrium threat — makes them even cheaper to enforce.

In order for this device to work, however, the seller must be assured that if she does perform substantively, the buyer will not seize on documentary noncompliance as an excuse not to pay. For if the seller lacks such assurance, she will need to undertake the expense of strict compliance to guard against such buyer opportunism, in which case the prospect of saving on document expenses can no longer operate as a reward for substantive performance. And this is where the issuing bank comes into the picture: as a monitor who supervises the buyer to ensure that he does not opportunistically enforce the documentary terms in situations where there has been no defect in the underlying substantive performance.

Note the distinction between the bank's role in this account of letters of credit, and the bank's role in Mann's account. Under my account, the bank's verification role is more limited than Mann indicates. The bank does not provide any general verification of the buyer's financial condition or commercial reliability. Rather, it provides the more specific verification that the buyer will honor the implicit bargain under which the documentary conditions are waived whenever there is no apparent substantive defect.

Second and similarly, the bank's incentives to perform this task are sharper than in Mann's account. Under his story, in contrast, the bank's incentive is purely reputational; if the buyer does not pay, future sellers will assume that the bank's client base is less financially reliable. Under my story, there is also a reputational incentive, but there is a legal incentive too, since the seller always retains the option of submitting complying documents. In most cases she will not wish to exercise this option, of course, since she can obtain payment without going to such expense. But if the buyer is operating in bad faith or is otherwise planning to breach the underlying contract, the seller will likely receive some advance signal of this fact and will make greater efforts to submit complying documents. The threat that the seller will actually comply with the letter of credit, thus placing the bank legally on the hook, gives the bank an incentive both to monitor the buyer for substantive compliance ex post, as well as to screen the buyer ex ante.

Moreover, the bank's reputational incentives are themselves more focused than Mann's account would suggest. According to his account, the market treats nonpayment of a letter of credit as a signal of general financial risk; because future sellers will regard the buyer (and the bank's client base more generally) as more likely to default on their contractual obligations, they will avoid dealing with this bank and buyer in the future or will insist on a larger risk premium in exchange for doing so. But as I have argued above, such a signal is weak. Lacking information about the specific transaction, the market will not be able easily to distinguish between cases in which there is actual breach and cases in which there is not, or between substantive risk and all the other reasons that might explain the rejection of a documentary presentation. Under my account, however, such distinctions need not be drawn, since the rejection of a substantially complying presentation is undesirable in itself. With each such rejection, the market will increasingly regard the bank as a stickler for details, and as having a client base made up of similar sticklers for detail. Future sellers will thus anticipate that if they take letters of credit from this buyer or bank, they will have to undertake additional costs of documentary compliance. This anticipated cost increase, then, will lead sellers to raise their price in a corresponding amount when dealing with the bank's future applicants on a letter-of-credit basis; and this will reduce the amount that applicants are willing to pay for a letter of credit in the first place.

The letter of credit thus operates as a bilateral formal enforcement device that in most cases does not need to be used. When the soft information coming through informal channels indicates that the parties will perform adequately, the seller can afford to cut corners on documentary compliance and the buyer can afford to waive the resultant defects. When the soft information indicates the possibility of breach, however, both parties will want to behave in a more legalistic fashion. But since the vast majority of contracts are performed rather than breached, the insistence on formalities is the relatively rare event.

This bilateral enforcement model offered above, if accurate, thus explains why the parties choose letters of credit, why the parties routinely choose formal conditions that are stricter than they plan to insist on in practice, why almost all letters of credit are paid notwithstanding their technical noncompliance with documentary terms, and why letters of credit are priced in proportion to their face value. The parties choose letters of credit because, unlike an ordinary credit reference, they motivate the seller's substantive performance as well as the buyer's. They choose formal conditions stricter than they plan to enforce in practice so that the costs of formal compliance, together with the buyer's discretion to refuse payment when the formal conditions are not met, reinforce the seller's incentives to perform substantively. Most letters of credit are paid in practice because most of the underlying substantive contracts are performed according to the buyer's expectation — that is, the device is effective. And letters of credit are priced according to their face value because, in most cases, the issuing bank is actually called upon to pay; thus, its expected costs of float and default risk are, in equilibrium, roughly proportional to the size of the credit.[21]

Note that my story fits reasonably well with the specific data Mann uncovers relating to the nature of discrepancy and waiver. There is no indication in his data that buyers are willing to waive documentary discrepancies in cases where there has been substantive contractual breach. Almost 60% of the defects he identifies involve technical defects that have little to do with the underlying bargain, and of the 28% that he classifies as substantive, over half consist of late or short shipment, which may not be a breach at all from either the legal or the practical viewpoint.[22]

Note further that this bilateral enforcement model comports with the traditional scholarly account of the letter of credit that Mann claims to rebut. According to Mann, the traditional explanation "hinges on the seller's having a reliable and assured right to payment" from the issuing bank; whereas in fact most sellers submit defective documents and hence have "no right to payment at all."[23] But here Mann is confusing the existence of a right with its exercise. Because the seller retains the option to present formally complying documents, she does ultimately have the legal right to compel payment. Because of the effectiveness of the informal channels of information and nonlegal enforcement, she usually chooses not to go to the trouble of establishing the preconditions of legal enforcement. But in this regard she is no different than many if not most contracting parties who choose to enter into legally binding arrangements.

The way in which waiver operates in the letter-of-credit setting, indeed, exemplifies its role in contractual relations and contract law

21. The administrative costs of processing payment admittedly do not vary with the size of the credit, but these processing costs may be small. In addition, reputational costs could either be fixed or variable, but, in equilibrium, reputational costs don't need to be paid.

22. Under both U.C.C. Article 2 and the U.N. Convention for the International Sale of Goods ("CISG"), quantity and delivery terms are supplemented by trade usage, course of dealing, course of performance, and any obligations arising out of the commercial principle of good faith. Under the CISG, parol evidence and other precontractual communications also enter into the bargain. Thus the seller's actual duty to ship under the contract may be quite different from that indicated in the letter of credit or other written documents. More importantly, even if the buyer has the technical legal right to reject the goods or claim damages for a nonconforming shipment, they may be perfectly adequate to his needs as a practical matter, especially after a price adjustment.

23. Mann, *The Role of Letters of Credit*, *supra* note 1, at 2496.

generally. Lisa Bernstein has argued, for instance, that contracting parties routinely place legal conditions in their agreements that they fully expect to waive.[24] This is not because they value compliance with such conditions in itself, but because the threat value of the conditions helps economize on the costs of contract enforcement. In Bernstein's view, the formal conditions are not intended to govern the parties' effective rights and duties in the context of a successful ongoing relationship. Rather, they are "endgame" norms to be invoked only in the event that the relationship breaks down.[25] Similarly, Robert Scott has argued that repossession, acceleration clauses, and other supposedly coercive provisions in debtor-creditor contracts are best understood as formal threats that serve to economize on monitoring and enforcement of the debtor's obligations, and that in most cases are not intended to be carried out.[26] Benjamin Klein and Richard Epstein have defended traditional at-will termination provisions in franchise and employment contracts on analogous grounds.[27]

It is an essential part of all these authors' accounts that such formal conditions be maintained as part of the parties' legally enforceable obligations, and not be watered down by doctrines such as waiver, good faith, or course of performance. Otherwise they will lose their threat value, and their resultant ability to support the parties' implicit relational expectations. Under the modern American law of contracts, however, the enforceability of such conditions has generally been eroding in just this fashion over the course of past decades.[28] Indeed, Bernstein has argued that the failure of courts to enforce strict compliance has been a major factor in the decision of private commercial actors to opt out of public enforcement and into private enforcement systems that do not recognize or substantially cut back on antiformalist doctrines such as waiver. As the earlier discussion has made clear, however, such incursions on strict compliance have for the most part been kept out of the law of letters of credit.

The more conventional wisdom of the scholarly literature on contracts, of course, is that the duty of good faith and similar restrictions on the untrammeled exercise of strict compliance are

24. *See* Lisa Bernstein, *Formalism in Commercial Law: The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. CHI. L. REV. 710 (1999) [hereinafter Bernstein, *Formalism in Commercial Law*].

25. *See id.* at 766.

26. *See* Scott, *Coercive Creditor Remedies*, *supra* note 8.

27. *See* Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 956-76 (1984); Benjamin Klein, *Transaction Cost Determinants of 'Unfair' Contractual Arrangements*, 70 AM. ECON. REV. PAPERS & PROCEEDINGS 356 (1980).

28. *See, e.g.*, Bernstein, *Formalism in Commercial Law*, *supra* note 24; Robert Scott, *The Uniformity Norm in Commercial Law: A Comparative Analysis of Common Law and Code Methodologies*, *in* JURISPRUDENTIAL FOUNDATIONS OF COMMERCIAL LAW (J. Kraus and S. Walt eds.) (forthcoming 2000).

necessary to prevent opportunism on the part of the party with the discretion and to encourage relational investment on the part of the party who is vulnerable. In the franchise context, for instance, Gillian Hadfield has argued that the doctrine of good faith is an essential limit on the franchisor's right to terminate the franchise contract at will; else franchisors will be able to expropriate franchisee investments and extort one-sided modifications to the franchise contract.[29] Stewart Schwab has similarly argued in the employment context that limits on at-will termination are necessary to protect employees' expectations and induce them to invest in human capital.[30]

If Mann's reputational story (as modified according to my proposed amendments) is correct, furthermore, then it also makes sense that the legal doctrine of strict compliance should be applied more formally in letter-of-credit law than in contract law generally. Such a distinction is sensible because in the letter-of-credit context, there is a credible reputational intermediary — the issuing bank — that has the ability and incentive to police the buyer-applicant so that he doesn't exercise his discretion opportunistically. In the ordinary two-party context, in contrast, such assurance is harder to find; it must come from the reputational interests of the party vested with discretion (as in Klein, Scott, and Epstein's account) or from the community of traders generally (as in Bernstein's).

4. LOOKING MORE CLOSELY AT THE DATA

In order for my revision of Mann's story to be more than a mere theoretical hypothesis, of course, it needs to be backed up by the data. In this regard, it is useful to identify the empirical predictions that my revision generates. If I am right, then we should expect to see letters of credit enforced strictly not just when the buyer's performance is uncertain, but also when seller performance is uncertain, when it is relatively costly to enforce the underlying substantive contractual arrangements, when other commitment devices are unavailable or uneconomical, and when the issuing bank's reputation is relatively weak. Similarly, we should expect to see high rates of noncompliance with formal conditions (and high rates of waiver) not just when buyer performance is relatively reliable, but also when seller performance is relatively reliable, when sellers have low-cost alternatives to contractual enforcement, and when the issuing bank's reputation is relatively strong.

29. *See* Gillian Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927 (1990)

30. *See* Stewart J. Schwab, *Life-Cycle Justice: Accommodating Just Cause and Employment at Will*, 92 MICH. L. REV. 8 (1993).

Mann's data, as reported, are not rich enough to test all of these hypotheses simultaneously, let alone determine their relative importance. Because he looks only at bank records and at letter-of-credit transactions in particular, his data cannot tell us what factors systematically influence buyers and sellers to use letters of credit as opposed to other contractual assurance devices. To answer that question, it would be necessary to collect similarly detailed information about buyers and sellers using other devices. Furthermore, because his information about individual buyers and sellers is limited to a few variables, and because his sample of banks is too small for him to consider bank characteristics as possible explanatory variables, it does not tell us much about the transactional factors that determine the risk of opportunism, and hence the rate of compliance and waiver. Some of the material that he recounts from his qualitative interviews, to be sure, is quite suggestive in this respect. For instance, the hypothesis that opportunism is more likely in contracts for the sale of commodities than in contracts for finished goods, because markets for the former are typically characterized by greater price fluctuations, is entirely plausible.[31] Similar hypotheses could be put forward regarding the specialized or nonspecialized nature of the goods, the thickness of the market to which they are being shipped, or their perishability. But, unfortunately, Mann's statistical analysis does not distinguish among transactions involving different types of goods, even though he states that he collected data on the type of good being traded.[32]

Mann does divide his sample into import and export transactions, and calculates the rate of discrepancy and waiver for each. But this single variable, however, is not sufficient to allow us to distinguish among the various possible explanations discussed above. Mann suggests, for instance, that the relatively high rate of discrepancies on letters of credit associated with shipments coming into the United States is due to the relative reliability of American compared with foreign buyers.[33] But the difference could also be attributable to the greater reliability of foreign sellers, the stronger commercial reputations of U.S. banks, or the greater sophistication of U.S. buyers or foreign sellers in collecting and assessing the soft information that allows the parties to save on the costs of strict formal compliance. The evidence is thus overdetermined; in order to identify the relative importance of these various hypotheses, we need more variables and a method of statistical analysis (such as multiple regression), that allows us to consider the separate effect of each variable on the data.

31. *See* Mann, *The Role of Letters of Credit*, *supra* note 1, at 2511.

32. *See id.* at 2497.

33. *See id.* at 2509.

One obvious possibility would be to distinguish not just between import and export transactions, but between transactions going into and coming out of different countries. Mann indicates that his data set includes the country of origin and shipment for each contract; it would be a reasonably straightforward matter to divide the sample into developed and less developed countries, capitalist and command economies, or countries with well-established legal systems and countries in transition. Such classifications would require some amount of subjective judgment, but the categories would not have to be perfect to be useful, and a variety of proxies such as OECD or WTO are available. Depending on how many countries were involved, the sample size of 500 might even be large enough to permit the use of individual country dummy variables without sacrificing overall statistical significance. But given the number of possible theoretical explanations, a more detailed statistical analysis is in order, appears possible on the existing data set, and would appear to promise substantial additional insight.

Going beyond Mann's current study, it would be desirable to collect similar information from a larger number of issuing banks, so that individual bank characteristics could be added into the statistical analysis. Mann's qualitative interviews did reveal some differences in bank policy; for example, his midwestern bank appeared to be more formalistic in reviewing letters of credit, and less interventionist in pressuring its applicants to waive defects, than were the other regional and national banks he surveyed. This difference, if accurate, could be attributable to the midwestern bank's customer base or to the type of transactions it tended to finance. For instance, perhaps its letter-of-credit business included a larger fraction of agricultural sales than other banks, and agricultural shipments are subject to a greater risk of opportunism than other sales contracts, perhaps due to the effects of weather and price fluctuations. On the other hand, it could also be the case that the bank, because of its relatively small size or more limited experience in financing letter-of-credit transactions, was less able to signal its reliability or evaluate soft information coming from abroad. With the current data set, one can do no better than Mann does in speculating based on individual anecdotes, but with a larger and more diverse sample, it would be possible to be more systematic.

5. CONCLUSION

Ronald Mann's information-verification theory of letters of credit is instructive, original, and important, but incomplete. It is incomplete in two respects. First, by focusing primarily on the seller's need to verify the buyer's reliability, he ignores the buyer's symmetric need to verify the seller's reliability. Second and more subtly, he presents the need for verification as an alternate and mutually exclusive explanation to the traditional account of letters of credit that emphasizes payment assurance, and thus he fails to recognize how verification and payment assurance operate in practice as complements rather than substitutes. More precisely, the fact that letters of credit are usually presented with documentary deficiencies that would preclude their legal enforcement does not mean that legal enforceability is not an important part of their commercial value. Rather, the threat of such enforceability is what provides the bank with the incentive to carry out its verification task credibly and cheaply, and conversely, the possibility of verification is what permits the parties to avoid in most instances the costs of actually carrying out that threat.

At least as important as Mann's theoretical contribution, however, is the empirical information he has unearthed. His study shows convincingly that the traditional payment-assurance account of letters of credit is inadequate; whatever one makes of his conclusions, the survey and transactional data he has collected substantially enrich our understanding of this commercial device and of the markets in which it is used. It is now up to commercial law scholars more generally to build on this groundwork, to develop more sophisticated accounts of letters of credit and similar contractual arrangements, and, following his example, to find ways to test those accounts against the data.