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THOUGHT-PROVOKING INSIGHTS
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This Week

Coming up next week: Emily Lau Ward (eBay, Inc.)

1. David G. Mallen: Advertising self-regulation is a voluntary process that advertisers want to succeed

PLI: With all the hubbub about indecency and the like on the airwaves, many are surprised to learn that the advertising industry has a well-established mechanism for self-regulation. Can you describe the system?

DAVID G. MALLEN: Self-regulation was born of a time when there were serious concerns about the truth and accuracy of advertising. And in some ways that environment parallels the environment today. Certainly that's the case with regard to children's advertising. So I would argue that our mission, which is to ensure that advertising is truthful and accurate, is more important than ever.

Self-regulation consists of several components: the National Advertising Review Council (NARC), which establishes the policies; NAD; the Children's Advertising Review Unit (CARU); the National Advertising Review Board (NARB), which is the appeal board that reviews NAD decisions. And, in terms of recent trends, the latest in self-regulation is the Electronic Retailing Self-Regulation Program, otherwise known as ERST, and that is an organization that looks at direct marketing. It includes infomercials and Internet advertising.

Again, the purpose of self-regulation is to ensure that advertising is truthful and accurate. And although self-regulation started as a way to fend off government regulation, over the years it has resulted in several other benefits, as well. Upholding the integrity and credibility of advertising means that advertising is more powerful—it means consumers can rely on it and trust it. Consumers can [trust] the purchase decisions that they make. Truthful advertising also encourages fair play among competitors. And the NAD, and self- regulation as a whole, has provided an efficient resolution forum for companies with disputes. So it's been a very successful program.

At NAD, 80% of the cases we look at are brought by competitors. The challengers pay a filing fee. It's a reduced fee if they're members of the BBB. But our mission is to investigate all kinds of advertising. We look at consumer complaints; we look at referrals from local BBBs. We also look at advertising from a variety of sources—it simply has to be national in scope, and that includes quite a bit these days: print, television, certainly the Internet, radio, you name it.

In the past year, we've looked at quite a range of products and services and product categories. We've looked at everything from baldness cures to the speed at which computers operate, and from how dishwashing detergent cleans dishes to the impact of calcium on your teeth and bones.

NAD uses a fairly straightforward and common sense approach. We'll look at advertising, and the first thing we'll ask is "What are the claims being made?" We'll start with the express claims, and then sometimes the more thorny issue is what implied claims that are being made. And then we look at the support for the claim. Advertising is sometimes very entertaining, but the support and substantiation can be very complicated. Some of the evidence that we've looked at recently in claims substantiation includes consumer surveys, product testing—whether it's testing that results from an industry protocol or companies that develop their own proprietary testing. Product demonstrations, sensory testing, pricing and sales data and accuracy of disclosure are all issues that we have looked at quite a bit in this past year.

The [process works as follows.] There are two rounds of evidentiary submissions, and the advertiser is asked to substantiate its claims. There is an opportunity to meet with NAD in a fairly informal, *ex parte* setting to discuss the concerns with your competitor's advertising or your own. One of the features of self-regulation, and a distinction between self-regulation and litigation, is that advertisers can submit proprietary evidence to NAD in confidence. And sometimes that's an important issue because there is a concern that what the challenger is doing is going on a fishing expedition. So we try and deal with that by letting the advertiser submit evidence in confidence. At the same time, we encourage the advertiser to share with us as much of the data as possible. We rely on both sides—we often have a battle of the experts in grappling with the data.

But there's no formal discovery at NAD, which is another distinction between NAD and litigation under the Lanham Act. And depending on the remedy and the situation that your clients are involved in, you may find NAD to be a very cost-effective alternative, or certainly something to consider in resolving advertising disputes.

The process takes about three-to-five months. That is certainly too long if the relief that you're looking for is having a commercial pulled from the air yesterday. But it is a very short amount of time compared to several years of fighting in court. NAD's decisions are made public, and they appear online and are published monthly in a document called NAD Case Reports. It provides the rationale for the decisions, the recommendations that we've made when we've asked companies to change their advertising. And in many cases, it provides a very detailed critique of the evidence. So, it may be something that is useful in formulating future advertising campaigns. And it is a resource of advertising law. There's also an appeal mechanism. Parties can appeal to the NARB, which is a panel of industry personnel from the advertising community. And they will hear the appeal and either uphold or reverse NAD's decision.

NAD's process is entirely voluntary. We don't have any power to compel. Yet, when companies appear before us, and we make a recommendation, we find that between 92 and 95 percent of the time, they will comply with the recommendation. And there are a few reasons for that. I think, by and large, the companies that come before us are companies that want effective self-regulation; their competitor may be pointing the finger at them today but, tomorrow, they'll want to challenge the competitor's advertising. And if a company does not comply with the NAD's decision, we do have the option of referring it to the government, in most cases that would be the Federal Trade Commission. So advertisers want the system to work.

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2. Joseph Siprut: A letter of credit may look like a contract, but it's not, so beware

PLI: Letters of credit can be tricky for the new practitioner. Are letters of credit generally subject to the same defenses (limitations) as contracts, such that any defenses that might be raised to the enforcement of a given contract can also be raised to the enforcement of a letter of credit procured in connection with the underlying contract?

JOSEPH SIPRUT: The short answer is no: letters of credit are not subject to the same defenses as the underlying contract.

Letters of credit are creatures of statute, not contract law (unlike their cousins, guaranty contracts and third-party beneficiary contracts). The general rule governing letters of credit (as set forth by the UCC, and adopted by the vast majority of states) is that the issuing bank's obligation to the beneficiary of the letter of credit is independent of the beneficiary's performance on the underlying contract. This rule is known as the "independence principle": the bank is not obligated—and indeed, is foreclosed—from going "out into the field" to determine whether the underlying contract has been performed.

Thus, events or circumstances outside the presented documents and the letter of credit itself do not determine whether the issuer has a duty to pay. This follows from the general notion that a beneficiary under a letter of credit has bargained for the right to be paid upon presentation of the documents—notwithstanding a default on the underlying contract—and the bank, for its part, has bargained to accept a fee in exchange for issuing a letter of credit and then seeking reimbursement from the bank customer for the funds paid out under the letter of credit. The bank has not bargained for the obligation to undertake an exhaustive analysis of the underlying agreement or the surrounding circumstances. Put simply, so long as the demand for payment under the letter of credit is proper—i.e., so long as the demand complies with the terms set forth by the letter of credit with respect to required documentation on presentment, etc.—the bank should pay the beneficiary.

The exception to the foregoing rule permits the issuing bank to refuse to pay the beneficiary of a letter of credit, notwithstanding the fulfillment of all presentation requirements thereunder, if a document presented to the bank is forged or fraudulent or if there is fraud in the underlying transaction.

Importantly, however, this has also been interpreted to mean that fraud in the underlying transaction can be deemed to be fraud in connection with the presentation of documents to the bank, such that the bank need not pay out on the letter of credit. For example, if a seller of goods ships 100 crates of widgets to the buyer, the buyer cannot prevent the bank from paying the seller on a letter of credit because the widgets were red instead of blue, or because some number of the widgets appear to be broken or are otherwise defective. But if the seller ships 100 empty crates, there is an argument that the transaction was outright fraudulent—and not a mere breach of contract.

In such cases, as well as in general cases where the beneficiary attempts to present forged or fraudulent documents to the bank for payment on a letter of credit, the bank customer has the right to file suit to enjoin the bank's payment to the beneficiary. The issue in any such suit would be strictly limited to whether the underlying transaction was fraudulent, and not whether the contract was breached. In the absence of outright fraud, the bank is obligated to pay out on the letter of credit, and the bank customer must, to pursue the matter further, sue the beneficiary separately under a breach of contract theory.

In sum, the defenses that may be raised to the enforcement of a letter of credit are limited to the following arguments: (1) the documents presented to the bank for payment do not comply with the terms provided for in the letter of credit itself—e.g., instead of presenting the bank with x, y and z, all of which are required for payment, the beneficiary has presented only x and y; (2) the beneficiary has indeed presented x, y and z, but one or more of the required documents has been forged or is otherwise fraudulent; and (3) there has been fraud in the underlying transaction—not just a breach of contract, but outright fraud—such that the bank can choose not to pay out on the letter of credit. If the bank does decide in good faith that it cannot determine fraud is at play, and that it therefore must pay out on the letter of credit, the bank customer may then file suit to enjoin the payment, but could succeed in the suit only upon a showing of fraud.