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## THE LAW APPLICABLE TO INTERNATIONAL LETTERS OF CREDIT

By ROGER J. GEWOLB†

A LETTER OF CREDIT (or "credit") is one of the most flexible payment devices known to the business world. Credits are frequently used to effect payment in international sales contracts and are often the means of financing production under such contracts.<sup>1</sup> Although credits are by no means new to bankers and businessmen, no statutory law and very little case law specifically dealt with the subject before the appearance of the Uniform Commercial Code.

Any sale in an international context necessarily raises problems of the choice of an applicable law. It can not be assumed that the Code will govern all rights and duties of the parties to a credit transaction where some of the parties conduct their businesses in a foreign country. Upon this premise, several exceptions to Code applicability in international letter of credit practice will be discussed.

The seventeen sections of article 5 of the Code are not a complete statement of letter of credit law. To ensure the continued flexibility of credits only the fundamental theories are embodied in the article.<sup>2</sup> Some of the provisions are new, but most merely verbalize the practices already existing in the trade. A number of excellent articles have been written dealing with the provisions of article 5.<sup>3</sup>

The Code's treatment of letters of credit has been generally well received. However, some of the problems generated by such a codifica-

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1. "[D]uring the last half-century the letter of credit has become the instrument for paying and financing in international commerce. . . ." 3 N.Y. LAW REVISION COMM., STUDY OF THE UNIFORM COMMERCIAL CODE 1575 (1955).

2. UNIFORM COMMERCIAL CODE § 5-102, comment 2.

3. Clarke, *Bank Deposits and Collections: Article IV; Letters of Credit: Article V*, 16 ARK. L. REV. 45 (1961-62); Funk, *Letters of Credit: U.C.C. Article 5 and the Uniform Customs and Practice*, 11 HOW. L.J. 88 (1965); Harfield, *Code Treatment of Letters of Credit*, 48 CORNELL L.Q. 92 (1962); Harfield, *Letters of Credit*, 76 BANKING L.J. 93 (1959); Horner and Leonard, *Article 5: Letters of Credit*, 15 OKLA. L. REV. 325 (1962); Mentschicoff, *How to Handle Letters of Credit*, 19 BUS. LAW. 107 (1963); Rowland, *Letters of Credit — Article 5 of the Uniform Commercial Code*, 30 MO. L. REV. 288 (1965).

As to letters of credit generally, see: GUTTERIDGE AND MEGRAH, *THE LAW OF BANKERS' COMMERCIAL CREDITS* (London, 1962); WARD AND HARFIELD, *BANK CREDITS AND ACCEPTANCES* (4th ed. 1958); KELSO, *INTERNATIONAL LAW OF COMMERCE* (2d ed. 1961).

Excellent comparative studies of credits are found in: STOUFFLET, *LE CRÉDIT DOCUMENTAIRE* (Thèse, Dijon, 1955); SCHNEIDER, *AKKREDITIVE IM GEBUNDENEM UND FREIEN ZAHLUNGSVERKEHR MIT DEM AUSLAND* (1955); WIELE, *DAS DOKUMENTEN-AKKREDITIVE UND DER ANGLO-AMERIKANISCHE LETTER OF CREDIT* (1955).

tion are only now becoming apparent. A brief description of the structure and operation of credits will serve as a basis for the examination of several of these problems in the light of the possible inapplicability of the Code in international commerce.

### I. HOW CREDITS OPERATE

The buyer who desires to pay for goods by means of a credit will ordinarily request his bank to extend its credit to him in the form of a letter sent to his seller. This letter informs the seller that the bank<sup>4</sup> undertakes to honor drafts<sup>5</sup> drawn by the seller upon the seller's compliance with the letter's terms.<sup>6</sup> The letter must be in writing and signed by the issuing bank.<sup>7</sup> No particular phrasing is required, but most bank credits employ approximately the same language.<sup>8</sup> The letter is addressed to the seller as the named beneficiary.

The issuing bank will usually send the letter to the seller-beneficiary by way of a correspondent bank in his city. Because the issuer undertakes to pay or accept drafts only if the conditions set out in the credit are met, the seller will not make use of the credit unless he assents to these conditions. It is the buyer alone who specifies these conditions. However, the seller may require the buyer to insert certain terms before it will assent to receive payment by way of the credit.

As in the case of a check or other short term instrument, payment by letter of credit is only conditional payment as between the buyer and seller. If the seller is furnished with a credit in his behalf, the buyer's obligation to pay directly is suspended, notwithstanding the payment terms of the underlying sales contract, until the seller gives seasonable notice that he will require the buyer to do so.<sup>9</sup>

One of the credit terms will identify the credit as either "clean" or documentary. A documentary credit conditions honor upon the presentation of documents with the draft. Clean credits, such as travelers' credits, are not so conditioned. Documentary credits are most often used in international commerce because they afford the buyer at

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4. The Code also provides that credits may be issued by persons other than banks. UNIFORM COMMERCIAL CODE §§ 5-102(1), 5-103(1)(a). The present discussion will not be concerned with such credits. The large international banks generally play the greatest part in credit practice.

5. The Code speaks of "drafts or other demands for payment." The necessity of a draft under a letter of credit is dealt with in: 3 N.Y. LAW REVISION COMM., *op. cit. supra* note 1, at 1635-38; 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, Sec. 5-103, Reason (A.L.I. 1956).

6. UNIFORM COMMERCIAL CODE § 5-103(1)(a).

7. UNIFORM COMMERCIAL CODE § 5-104(1).

8. "We hereby authorize you to draw at (sight, time) on the Bank of Podunk, up to an amount of  $x$  dollars for the account of Bernard Buyer."

9. UNIFORM COMMERCIAL CODE § 2-325(2).

least paper proof of the shipment of conforming goods. The documents ordinarily required are a bill of lading or air waybill, a commercial invoice, an insurance policy, an inspection certificate and, often, a certificate of origin.<sup>10</sup>

If the buyer's bank finds that these documents comply on their face with the credit terms, and if the other terms have been met, it will honor the seller's draft. The bank then surrenders these documents to the buyer to allow his receipt of the goods and charges his account. If the draft presented is a time draft, the bank will charge the buyer's account at maturity. If the issuer discounts the draft for the seller, it will charge immediately.

In this respect, the credit agreement may be compared to an escrow in which the issuing bank acts as escrowee.<sup>11</sup> Unless otherwise agreed, the issuer assumes no responsibility for the performance of the underlying obligation of the buyer and seller.<sup>12</sup> It is unlikely that a bank would agree to assume this responsibility for policing the agreement of the parties.<sup>13</sup>

A letter of credit also resembles a third-party beneficiary agreement. The buyer engages the bank's promise to pay the seller and, in return, the buyer promises to reimburse the bank. The effect is that the seller has the promise of a party of virtually unquestioned responsibility added to that of the buyer.

The term "contract" has been intentionally avoided in the present discussion. Because consideration is not necessary to establish a credit under the Code,<sup>14</sup> and because article 5 avoids the use of the word in this context altogether, it is at best questionable whether a credit agreement may be referred to as a contract. Section 5-105 eliminates the necessity of the beneficiary to establish the passage of consideration from the buyer to his bank. Without this provision, if he were unable to prove such consideration he would be a mere donee beneficiary and could not sue the bank for wrongful dishonor of his draft.<sup>15</sup>

In addition to specifying the tenor of drafts under the credit and the requisite documents accompanying them the credit will stipulate several other terms. One such term is that it may be revocable or

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10. Certificates of origin are consular-issued documents attesting that the goods, or materials used in their production, were not obtained in a country of adverse political or economic interest to the importing country.

11. Funk, *supra* note 3, at 101.

12. UNIFORM COMMERCIAL CODE §§ 5-109(1)(a), 5-114(1).

13. The argument is made that the very low cost of issuing credits would be made impossible by such a requirement. In some cases, the expense of the issuer's inspection of the goods, for example, would render the cost of credits prohibitive. Mentschicoff, *supra* note 3, at 114.

14. UNIFORM COMMERCIAL CODE § 5-105.

15. UNIFORM COMMERCIAL CODE § 5-105 and comment; Mentschicoff, *supra* note 3, at 109.

irrevocable.<sup>16</sup> If the credit does not stipulate as to this matter, the Code makes no decision as to how the credit will be treated.<sup>17</sup> If the credit does make this provision, the rules are clear.

A revocable credit, unless otherwise agreed, may be modified or revoked by the issuer without prior notice to the buyer or seller.<sup>18</sup> The buyer may also revoke or modify without notice to the seller. An irrevocable credit, once established as regards the buyer,<sup>19</sup> may be revoked or modified only with his consent.<sup>20</sup> Once established with regard to the seller,<sup>21</sup> the credit may only be modified or revoked with his consent.<sup>22</sup>

A credit may also be revolving or non-revolving. Instead of providing a final expiration date after which no drafts may be drawn, a revolving credit provides for a certain sum to be drawn in drafts each period. Thus, each month the seller may be able to draw up to \$100,000. In this connection, credits may also be cumulative or non-cumulative. If the beneficiary in the above example draws only \$80,000 in July, he will have \$120,000 in available funds in August under a cumulative revolving credit.

It may further be provided that a credit is to be a "notation" credit. Any person purchasing or paying drafts under such a credit must note the amount of the draft in the space provided on the back of the credit.<sup>23</sup> If not so noted, the issuing bank may delay honor of the draft for as long as thirty days.<sup>24</sup> If the credit is not a notation type, the danger of fraudulent overdrafts by the beneficiary arises. If such overdrafts are made, good faith holders of the overdrawn drafts will have priority in the order in which the drafts were purchased, rather than the order in which they were honored.<sup>25</sup>

Transferability is a further term to be provided. The right to draw under the credit may be transferred or assigned only when

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16. UNIFORM COMMERCIAL CODE § 5-103(1)(a).

17. UNIFORM COMMERCIAL CODE § 5-103, comment 1. However, evidence of ordinary course of dealing or usage of trade (§ 1-205) may determine whether the credit will be treated as revocable or irrevocable. If credits in a certain locale do not usually specify that they are revocable, but are treated as revocable by local bankers, the proponent of revocability may advance this argument in support of his case.

18. UNIFORM COMMERCIAL CODE § 5-106(3).

19. At the time the credit is sent to him or the credit or a written advice thereof is sent to the beneficiary, UNIFORM COMMERCIAL CODE § 5-106(1)(a).

20. UNIFORM COMMERCIAL CODE § 5-106(2).

21. At the time he received the credit or a written advice of its issuance. UNIFORM COMMERCIAL CODE § 5-106(1)(b).

22. UNIFORM COMMERCIAL CODE § 5-106(2).

23. UNIFORM COMMERCIAL CODE § 5-108(2).

24. UNIFORM COMMERCIAL CODE § 5-108(2)(b).

25. UNIFORM COMMERCIAL CODE § 5-108(3)(b).

expressly stated in the credit.<sup>26</sup> However, the beneficiary of a non-transferable, non-assignable credit may assign his right to the proceeds before his performance.<sup>27</sup>

A very important characteristic of a credit is whether it is confirmed or unconfirmed ("advised"). As stated previously, the issuing bank will generally forward the credit to the seller-beneficiary by way of a bank in his own city, usually a correspondent of the issuer. Under an unconfirmed credit this second bank simply transmits the credit to the beneficiary "advising" him of the availability of funds at the issuing bank. The advising bank may also indicate its willingness to forward his draft and documents to the issuer for honor. An advising bank assumes no obligation to honor drafts.<sup>28</sup>

On the other hand, the correspondent may confirm a credit instead of merely advising it. Unlike an advising bank, a confirming bank directly obligates itself on the credit, as though it were the original issuer, and acquires the rights of an issuer.<sup>29</sup> Confirmed credits are particularly desirable where an issuing bank is in a politically or financially unstable country. If, for example, the issuer fails or is expropriated, the seller has a bank in his own country to look to for payment.

A confirming bank may fulfill its obligation in one of two ways. (1) It may itself honor the draft by payment or acceptance. (2) It may "negotiate" the draft. In the first situation, the draft will be drawn on the confirming bank, not the issuer.<sup>30</sup> If the confirming bank discounts an accepted draft for the seller, it may hold the draft until maturity, whereupon it will be sent to the issuer for payment. If the confirming bank rediscounts the acceptance, its purchaser will make presentment at maturity. In either case, the documents originally attached to the draft will be sent to the issuer immediately for delivery to the buyer.

As with any time draft, the letter of credit time draft is a credit-extension device. Whether credit is extended to the buyer by the seller who holds the acceptance until maturity or by a purchaser from him by discount before maturity, the buyer receives his goods some time before payment is due.

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26. UNIFORM COMMERCIAL CODE § 5-116(1).

27. UNIFORM COMMERCIAL CODE § 5-116(2).

28. UNIFORM COMMERCIAL CODE § 5-107(1). The advice usually states: "This letter is issued solely as an advice of credit . . . and conveys no engagement by us. . . ." It is this language that identifies an unconfirmed credit, for, very often, credits do not expressly state whether they are confirmed or unconfirmed.

29. UNIFORM COMMERCIAL CODE § 5-107(2).

30. It is drawn on the confirming bank because only a drawee may pay or accept a draft. In this case the confirming bank's name will be added to that of the issuer:

To: Banque Fichue, Paris.

Drawn Under LC #1234, Podunk Bank.

In the second instance, the confirming bank may "negotiate" the draft. This means that the bank purchases the draft and attached documents as a regular indorsee or payee. It then sends the draft and documents to the issuer for payment or acceptance. The issuer will be the drawee in this situation and the confirming bank becomes a holder of the paper.

It is important to note that the negotiation of drafts is not limited to confirming banks. A mere advising bank may also negotiate under a "negotiation credit." This credit differs from an ordinary ("straight") credit in that the issuing bank promises the indorsees and bona fide holders of drafts drawn under and in compliance with it that the issuer will honor such drafts. This promise is the key to a negotiation credit. In its absence, the credit will almost surely be treated as "straight." Under the straight credit, only the issuer or a confirming bank in the first instance above may pay or accept the draft.

The difference between a confirming bank which negotiates and a negotiating bank is that the latter becomes an ordinary holder of the paper. The negotiating bank thus has the contingent liability of the seller-beneficiary who drew the draft to look to in case of dishonor. By contrast, a confirming bank which negotiates may sometimes be required to take the paper without recourse to the drawer.<sup>31</sup> The confirming bank thus has no rights against the seller on the draft. The distinction is a reasonable one. The negotiating bank is not a party to the credit nor held to its terms.<sup>32</sup> However, the confirming bank has obligated itself on the credit, and it should not have an independent right against the seller on the draft which does not subject the bank to the credit terms.

As a financing tool, the negotiation credit is preferable to the straight variety. Under a negotiation credit, the seller may draw his draft and immediately receive funds from a bank in his own country.

One alternative solution for the seller who wishes to finance production is the "back-to-back" arrangement. In simplest form, the beneficiary under the original credit requests his bank to open a credit in favor of his supplier. The beneficiary then assigns the original credit to his bank. If the original credit is transferable, the issuer of the second credit reimburses itself whenever it pays the supplier's drafts by drawing under the original credit and presenting the draft and

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31. UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS, Art. 3 (ICC Brochure No. 222, 1962) [hereinafter cited as ICC UNIFORM CUSTOMS]. In this situation the seller will draw the draft to its own order and indorse it "without recourse" to the confirming bank.

32. Harfield, *Letters of Credit*, 76 BANKING L.J. 93 (1959).

documents to the original issuer.<sup>33</sup> It is seen that, although the seller is not put in possession of funds, the financing effect of the back-to-back credit is the same as that under a negotiation credit.

The buyer also has an additional method by which to extend its period of credit. Where, for example, the buyer must pay against sixty day time drafts and cannot meet a maturity date, he may "re-finance" the draft accepted in favor of the seller. In other words, upon the maturity of the seller's draft, the buyer draws his own draft on himself for, at most, 180 days. Instead of reimbursing the issuer for the amount of the seller's draft, the buyer assumes a new obligation independent of the credit by drawing the draft to the order of the issuer.

## II. EXCEPTIONS TO ARTICLE 5 APPLICABILITY

There are three main exceptions to applicability of article 5. These exceptions are usages of trade, choice of law and conflict of laws rules. In the following discussion, the parties are assumed to be an American buyer, a French seller who ships from his country, an American issuing bank and the French seller's bank. It is further assumed that suit is brought in an American court in a state which has adopted the Code. No problems exist as to jurisdiction of the French parties.

Before the lawyer sets out to find an applicable law, he must determine that the credit terms have been complied with. If these terms have not been met by the seller, an issuing or confirming bank may not honor the seller's draft. Even where the applicable law is established, the credit terms are the primary law of the parties. If, for example, the Code is the applicable law, the seasoned practitioner knows that the credit terms will prevail over certain provisions of article 5.<sup>34</sup> Where the seller's clear compliance with one of these Code provisions implies the failure to comply with a credit term expressly stipulating to the contrary, the issuer would be buying a lawsuit by honoring the seller's draft. Conversely, though the credit is complied with, if a term conflicts with a rule of law not allowing agreement to the contrary, the bank also should not honor it.

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33. See *Decker Steel Co. v. The Exchange Nat'l Bank of Chicago*, 330 F.2d 82 (7th Cir. 1964), wherein it was held that the opening of an irrevocable credit by the assignee bank in favor of the seller of the assignor-beneficiary of the first credit constituted value and entitled the assignee bank to protection on the draft from the buyer's defense of non-conforming goods.

34. UNIFORM COMMERCIAL CODE §§ 1-102(3); 5-106(1), (2), (3); 5-107(1), (4); 5-109(1), (2); 5-110; 5-111; 5-112(1); 5-113; 5-114(2), (3) expressly allow agreement contrary to their provisions. However, agreement to the contrary is not limited to these sections, because the presence of express authorization to agree otherwise in some sections does not imply that other sections' effects may not also be varied by agreement. UNIFORM COMMERCIAL CODE § 1-102(4) and comment 3.



### A. *Usages of Trade and Uniform Customs*

The express terms of the credit will also prevail over usages of trade and courses of dealing.<sup>35</sup> Such usages constitute the first exception to the applicability of the Code. Section 1-205(3) provides that a course of dealing or usage of trade, if proved, may supplement or qualify the parties' agreement. Thus, provisions of article 5 may be ineffective where a contrary usage of trade is shown to exist. For example, section 5-112(1)(a), which gives the issuer three banking days to honor without the consent of the beneficiary, may give way to a usage of trade of allowing four days for honor. Further, if the credit states that the bank may have five days, the credit provision will govern. The credit term prevails in this case because the express provision of the parties takes precedence over any usages of trade.<sup>36</sup>

The most important usages of the letter of credit trade are found in the Uniform Customs and Practice for Documentary Credits.<sup>37</sup> This written compilation is the expressed understanding of international credit bankers in the United States and abroad as to practices prevailing in their trade. It was formulated by the International Chamber of Commerce at Amsterdam, in original version, in 1929. Though not law in any of the United States,<sup>38</sup> Uniform Customs is adhered to by innumerable bankers on both sides of the ocean. Because adherence is on a purely voluntary basis, it will govern the credit agreement when made a part of that agreement.<sup>39</sup> It may become a part of the credit by virtue of section 1-205 as well as by the express agreement of the parties. Since section 1-205 has been discussed, express agreement as to Uniform Customs will now be considered.

A distinction must necessarily be drawn between an express agreement of the parties and a wholesale incorporation by reference. Where the parties insert one or more provisions of the Uniform Customs in the letter of credit, their agreement is of the same effect as if

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35. UNIFORM COMMERCIAL CODE § 1-205(4).

36. *Ibid.*

37. ICC UNIFORM CUSTOMS (rev. 1962).

38. Nevertheless, New York has effectively substituted Uniform Customs for article 5 of the Code. NEW YORK UNIFORM COMMERCIAL CODE § 5-102(4) provides that article 5 is inapplicable if by a credit's terms, by agreement, by course of dealing, or by usage of trade the credit is subject in whole or in part to Uniform Customs. Thus, article 5 will apply only where the parties expressly stipulate to that effect. It is unlikely that a New York bank would stipulate that the Code should apply. Funk, *supra* note 3, at 117. But query whether reference to a minor provision of Uniform Customs, not even covered by the provisions of article 5, renders all seventeen provisions inapplicable. Harfield, *Code Treatment of Letters of Credit*, 48 CORNELL L.Q. 92, 96 n.5 (1962).

39. One writer has stated that article 5 of the Code is but a codification of the Uniform Customs. Rowland, *supra* note 3, at 288 n.2. A comparison of the provisions of article 5 of the UNIFORM COMMERCIAL CODE and the UNIFORM CUSTOMS discloses the improbability of such a relation.

they had agreed to the matter in their own words. However, where Uniform Customs is incorporated by a standard clause in the bank's regular letter of credit form, it is arguable that either the buyer or the seller is the unwilling subject of an "adhesion" contract.<sup>40</sup>

Incorporation of Uniform Customs by reference presents another troublesome possibility. Although most issuers incorporate Uniform Customs into both the actual letter of credit and the application for credit initially prepared by the buyer, a number of banks employ different incorporation clauses in the two cases. The application for the credit might state that "unless otherwise expressly agreed, Uniform Customs and Practice shall apply," while the actual credit states only that it is "subject to Uniform Customs and Practice." The buyer who reads the first type of clause might conceivably persuade his bank to omit part or all of the Uniform Customs from the application agreement. This omission would constitute an agreement otherwise, under the application's terms. The seller in this situation would not have notice of his right to dissuade the issuer from Uniform Customs because the actual credit appears to be subject to Uniform Customs with no possibility of agreement otherwise. The impractical effect of such a situation would find the seller bound by Uniform Customs in its agreement with the issuer, while the buyer is not so bound. Such a result is a clear invitation to litigation.

When Uniform Customs is incorporated into the issuer's credit, the confirming bank is under an obligation to include the incorporation in its confirmation.<sup>41</sup> If an advising bank fails to transmit the incorporation, Uniform Customs is nevertheless in effect as between the issuer and the beneficiary, even though the latter has no notice of it.<sup>42</sup>

The pre-eminence of the credit terms over certain Code provisions has already been mentioned. The credit terms will also displace the provisions of Uniform Customs.<sup>43</sup> Where both the Code and Uniform Customs apply, the chances of a conflict of their respective provisions are slight; there is but little overlap between the two. If, however, such a conflict is found, Uniform Customs will prevail, at least where the credit specifically incorporates it.<sup>44</sup>

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40. Funk, *supra* note 3, at 89-90.

41. GUTTERIDGE AND MEGRAH, *op. cit. supra* note 3, at 175.

42. UNIFORM COMMERCIAL CODE § 5-107(3).

43. UNIFORM COMMERCIAL CODE § 1-205(4); ICC UNIFORM CUSTOMS (rev. 1962), General Provisions and Definitions, § a. These two provisions state that express contrary agreement will prevail over a usage of trade and the UNIFORM CUSTOMS provisions, respectively. However, they do not specify where this agreement is to be found. It is clear that a contrary agreement in the body of the credit pre-empts the field, but may not agreement elsewhere, such as in the sales contract, preclude application of trade usages and UNIFORM CUSTOMS?

44. Funk, *supra* note 3, at 95.

### B. *Choice of an Applicable Law*

The applicability of Code article 5 is further precluded by the parties' choice of an applicable law. The present version of section 1-105(1)<sup>45</sup> allows the parties to make this stipulation. The section does not require the choice to be an express one. Rather, it is the *agreement* as to an applicable law that is given effect. Section 1-201(3) makes it clear that the choice may be implied from the circumstances surrounding the credit agreement.

The application for issuance of the credit usually expressly states that the law of the state of the issuer and Uniform Customs are the applicable law. Because the application is an agreement solely between the buyer and his bank, the seller is not bound by their choice of law.<sup>46</sup> The seller's assent is made only to the actual credit.

The Code states that if the law chosen bears a "reasonable relation" to the credit transaction, it will be the applicable law.<sup>47</sup> This is a clear recognition of party autonomy.<sup>48</sup> Freedom to contractually designate an applicable law has long been recognized in most countries.<sup>49</sup> However, this freedom is not plenary. Several limitations on the right to choose an applicable law are equally recognized.

The "reasonable relation" test of the Code requires that the law chosen be that of a jurisdiction in which a sufficiently significant portion of the making or performance of the contract occurs.<sup>50</sup> The law must not be selected to purposefully avoid a proscriptive or mandatory law of the forum.<sup>51</sup> Nor must the choice be made in bad faith, such as a choice made in an offer by an excessively dominant party which has the effect of an adhesion contract. Contracts of adhesion have always been an exception to the doctrine of party autonomy. The policy seeks to protect a party of inferior bargaining power against the offer of an unfair contract on a take-it-or-leave-it basis.<sup>52</sup>

Section 1-105(2) limits the right it confers. When the five Code sections specified therein designate an applicable law, the parties may

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45. Originally, § 1-105 contained a rather detailed and unworkable set of choice of law rules. See the 1952 Official Draft. These provisions were deleted in 1956 because they failed to meet with general acceptance. 1956 RECOMMENDATIONS, *supra* note 5, at 3-7; Rheinstein, *Conflict of Laws in the Uniform Commercial Code*, 16 LAW & CONTEMP. PROB. 114 (1951).

46. Nordstrom, *Choice of Law and the Uniform Commercial Code*, 24 OHIO ST. L.J. 364, 370-71 (1963).

47. UNIFORM COMMERCIAL CODE § 1-105(1) and comment 1.

48. Nordstrom, *supra* note 46, at 364.

49. Siegelman v. Cunard White Star, Inc., 221 F.2d 189 (2d Cir. 1955); Rheinstein, *supra* note 45, at 133; RESTATEMENT (SECOND), CONFLICT OF LAWS §§ 332(2), 332a and comment c (Tent. Draft No. 6, 1960).

50. UNIFORM COMMERCIAL CODE § 1-105, comment 1.

51. GOODRICH, CONFLICT OF LAWS 203 (4th ed. 1964).

52. *Ibid.*

choose a different law only to the extent permitted by the designated law, including its conflict of law rules. Of these sections, section 4-102 is of special concern to a discussion of credits.

Where the issuing and intermediary banks are situated in different jurisdictions, the documentary draft will pass through the issuer's state's collection facilities. Article 4 will then be applicable as well as article 5.<sup>53</sup>

Section 4-102(2) states that the liability of a bank for action or non-action with respect to any item handled by it for presentment, payment or collection is governed by the law of the place where the bank is located. The same provision governs the law applicable to a branch's liability. It should be noted that when the law of the situs of the bank or its branch is the Code, section 4-102, comment 2(d) allows the situs rule of section 4-102(2) to be contracted away. Section 4-102(2), as well as the four others, clearly emphasizes the importance of the law of the situs. The requirement of also considering the conflict of laws rules of the situs<sup>54</sup> ensures that the forum will decide whether an expressed choice of a law, other than that of the situs, is effective according to how a court in the situs would have decided this question.<sup>55</sup>

Thus, even though the credit agreement states that it is to be governed by French law, liability for loss of a draft by an English bank, not a party to the credit, to which the draft was negotiated by a French bank, is governed by the English law under section 4-102. If the English conflict of laws rule designated the law of the place of negotiation as determinative of liability, the law of France would apply.

Where the effectiveness of a special indorsement to make a French negotiating bank a mere agent for collection is in question, the applicable law will be that of France. However, if a French court would decide that the applicable law is that of the place of payment, the law of the issuing bank, the Code, would govern. Thus, the possibility of a *renvoi* to the Code is recognized by section 1-105(2).<sup>56</sup>

From a practical view, it is doubtful that an American issuing bank would agree with either its customer or the French beneficiary that any law other than the Code and Uniform Customs should govern. Thus, expressed choice of law is, at best, an improbable means of avoiding the applicability of article 5.<sup>57</sup>

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53. Mentschicoff, *supra* note 3, at 110.

54. UNIFORM COMMERCIAL CODE § 1-105(2).

55. Nordstrom, *supra* note 46, at 375.

56. GOODRICH, *op. cit. supra* note 51, at 13.

57. It is more likely in any given case that the court will imply the choice from the attendant circumstances. UNIFORM COMMERCIAL CODE §§ 1-201(3), 1-105(1).

### C. *Conflict of Laws Rules*

In the absence of an express or implied choice of law, or if such choice is held ineffective, the forum's conflict of laws rules will determine the applicable law. While the Code does not purport to govern the credit in all situations, it does purport to apply, in the absence of a choice of law, to transactions bearing an "appropriate relation" to the Code.<sup>58</sup> "Appropriate relation" is not defined, nor is it distinguished from, the "reasonable relation" necessary to choose an applicable law. In order to tie together any loose ends, the Code leaves the question of appropriate relation to the courts when significant contacts are found with both a Code state and another jurisdiction.<sup>59</sup> In view of the likelihood of this situation arising in every conflicts case, the Code does not appear to be of much help.

The traditional conflict of laws rules are also of little assistance. Probably due to the dearth of statutory and case law dealing with credits before the appearance of article 5, no American conflict of laws rules exist which specifically govern the letter of credit.<sup>60</sup> American writers have treated the subject only indirectly in considering drafts and sales contracts in international commerce. Only the English text writers, Gutteridge and Megrah, have considered the matter of conflicts on letters of credit.

In an American court, the applicable law will be that of the jurisdiction having the "most significant relation" or "contacts" with the transaction.<sup>61</sup> The forum attempts to apply the law of the jurisdiction having the greatest interest in the transaction. Thus, it will carefully avoid the former automatic references to "place of making" and "place of performance" which were often based on mere fortuitous circumstances.

Conflicts rules governing the credit agreement will be discussed first. As between the American buyer and his issuing bank, the Code

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58. UNIFORM COMMERCIAL CODE § 1-105(1).

59. UNIFORM COMMERCIAL CODE § 1-105, comment 3.

60. Successive drafts of § 1-105 prior to 1956 specifically provided that both the credit agreement and the draft would be governed by the Code if the drafts were to be presented in the Code state. UNIFORM COMMERCIAL CODE § 1-105(2)(e) (Official Draft, 1952). The reports of the New York Law Revision Commission do not disclose whether this provision was deleted, because it was believed that the true conflicts rule was otherwise, or because of the general disapproval of detailed conflicts provisions in the Code. This same problem exists with respect to the 1956 RECOMMENDATIONS, *supra* note 5.

In its present version, article 5 appears to ignore the fact that drafts drawn under the credit are drawn outside Code territory. It further ignores the possibility that a French confirming bank will not be governed by the rules stated in UNIFORM COMMERCIAL CODE §§ 5-106; 5-107; 5-111; 5-112; 5-114; 5-115; 5-117.

61. GOODRICH, *op. cit. supra* note 51, at 202-04 and n.35; RESTATEMENT (SECOND), CONFLICT OF LAWS § 332(1) (Tent. Draft No. 6, 1960).

will be the applicable law if these parties are situated in a Code state. Their agreement will have no significant contact with France because the seller is not a party to the agreement. Moreover, the sales contract of the buyer and the seller underlying the credit has no relation to the credit agreement.

As between the French beneficiary and the American issuing bank, the applicable law will be the Code. The state of issuance of the credit is the place to which the seller must look for payment or acceptance of his draft. He is held to have contemplated payment or acceptance in this place when he assented to payment by the letter of credit.<sup>62</sup>

Where only the validity of the credit agreement is in issue and no question of a banker's liability for manner of performance is involved, the applicable law is again that of the state of the issuer.<sup>63</sup> It is only the issued credit that is in question. Thus, the contacts, if any, with the beneficiary's country are negligible. An English or Indian law requiring proof of consideration for a letter of credit issued to a beneficiary in that country by a foreign issuer would therefore be of no effect where the issuer was located in an American Code state.<sup>64</sup>

The above rule of the situs of the issuing bank also applies as between a French confirming bank and the French seller. Because a confirming bank directly obligates itself on the credit as though it were the issuer,<sup>65</sup> the law of the situs of the confirming bank (French law) will govern the validity of and obligation under the confirmed credit between these parties. Even though the original credit was issued by an American bank, the Code itself shows that the American issuer's state's relation to the confirmed credit would not be an appropriate one.<sup>66</sup>

Thus, the Code will govern liability under the credit agreement, in the absence of a choice of law, except where the rights of a French confirming bank are involved. In this last situation, French law will govern the French bank's obligation to the seller-beneficiary.

By contrast, the draft will generally not be governed by the Code. The draft must, first of all, conform to the terms of the credit. If it

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62. GUTTERIDGE AND MEGRAH, *op. cit. supra* note 3, at 169-71. Also see text accompanying notes 65, 66 *infra*.

63. *Id.* at 170.

64. UNIFORM COMMERCIAL CODE § 5-105.

65. UNIFORM COMMERCIAL CODE § 5-107(2); ICC UNIFORM CUSTOMS, art. 3 (rev. 1962).

66. UNIFORM COMMERCIAL CODE § 1-105, comment 2, states: "Cases where a relation to the enacting state is not 'appropriate' include, for example, those where the parties have clearly contracted on the basis of some other law, as where the law of the place of contracting and the law of the place of contemplated performance are the same and are contrary to the law under the Code." In the situation of a confirming bank, the place of its contracting and the place of contemplated performance are at its office. French law will thus apply as between the confirming bank and the seller.

does not so conform, no rule of law can make it enforceable between the parties to the credit. An issuer who honors the draft will have breached his duty under the credit agreement.

As previously stated, American writers on conflict of laws have not specifically dealt with credits. In particular, the fundamental relation of the draft to the credit is left unclear by them. Should the draft and credit be regarded as parts of the same transaction, governed by the same law? It is more reasonable to view the draft and credit as separate instruments for conflict of laws purposes because they perform essentially different functions. Professors Gutteridge and Megrah have expressed this view, at least with regard to time drafts.<sup>67</sup>

In England, sight drafts are not regarded as a necessary part of the credit transaction.<sup>68</sup> The sight draft is merely "ancillary" to its operation.<sup>69</sup> Professor Gutteridge states that payment under a credit would be made, if proper documents were presented, even though the sight draft were irregular.<sup>70</sup> However, he does not state that payment would be made if no draft were presented at all. The ancillary status of the sight draft is, therefore, at least questionable.

Professor Gutteridge also does not state that an irregular time draft would be accepted in the above situation. He admits that the time draft is not ancillary. Because it is essentially a credit-extension device, actual payment being made some time after the goods are received, the time draft has an independent existence and function.<sup>71</sup> It is a separate entity in the commercial paper market and is thus governed by the law that would apply if there were no letter of credit involved. Recourse on the time draft must therefore be considered separately from the obligations under the credit.

Professor Gutteridge's argument warrants criticism only because it does not go far enough. He believes that it is practical to consider recourse on the draft in isolation from the credit only when the draft is in the hands of a holder not bound by the credit terms. If the holder is obligated under the credit itself, the draft is unnecessary to vindication of his rights or liabilities.<sup>72</sup> Professor Gutteridge defines two situations in which a holder may be a holder not bound by the credit terms.

(1) Where the draft is a time draft which, after acceptance, is negotiated to a purchaser, such purchaser is not bound by the credit terms.<sup>73</sup> The documents have been separated from the draft before

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67. GUTTERIDGE AND MEGRAH, *op. cit. supra* note 3, at 52-62.

68. *Id.* at 52-54.

69. *Ibid.*

70. *Id.* at 52.

71. *Id.* at 52, 53.

72. See text accompanying note 32 *supra*.

73. GUTTERIDGE AND MEGRAH, *op. cit. supra* note 3, at 53-54.

negotiation to him and he is not subject to the credit terms.<sup>74</sup> Thus, the purchaser's recourse, as well as other parties' recourse to him, exists only on the draft.

(2) Where a negotiating bank purchases the draft before it is separated from the documents by acceptance or payment by the issuer, the negotiating banker will also be a holder not bound by the credit. He is also not held to warrant the validity of the documents.<sup>75</sup> His status as a holder unbound by the credit terms exists as to negotiation of both time and sight drafts. Thus, a sight draft is not ancillary to the credit where it passes through a negotiating bank on its way to the issuer or confirming bank. A time draft will also have an independent function in this situation, even though it has not yet been separated from the documents. The function these drafts perform is to provide the sole evidence of purchase of the draft by the negotiating bank or the discounter after acceptance in (1) above. Although a notation credit would evidence the negotiating bank's purchase in some cases, such credit would not disclose the purchase of the draft by a purchaser after acceptance because the draft has already been noted as sold to his transferor and because the credit no longer must be presented to transfer the draft. Nor would a notation credit accord either party the standing of a holder. The draft is necessary to be a holder.

It is therefore practical to consider recourse on the draft in isolation from the credit not only in the case of discounted acceptances, but also in the common situation of time and sight drafts which pass through a negotiating bank. Professor Gutteridge presents these situations as exceptions to the general proposition of the ancillary nature of the credit draft. However, these situations arise frequently in credit practice, and the ancillary function of the draft is seen only when a draft under a straight credit is sent directly to the issuer or is honored by a confirming bank in the seller's country. As to situations other than these, the draft has an independent function and existence and, as a result, its validity and transfer will be governed by the law that would govern a simple draft drawn on the buyer.

Cases dealing with conflict of laws on negotiable instruments appear to favor protection of the negotiable character of the paper,<sup>76</sup> sometimes at the resultant expense of the transferor. Consequently, in cases where indorsements made in foreign nations have been held to be governed by the law of the place of indorsement, the result was

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74. *Ibid.*

75. *Id.* at 59-62.

76. Stumberg, *Commercial Paper and the Conflict of Laws*, 6 VAND. L. REV. 489, 496 (1953).



often reached in order to protect a holder. The validity of paper negotiable on its face and relied upon as such was thereby upheld.<sup>77</sup>

This reasoning underlies the general rule that the validity of the transfer of a draft is governed by the law of the place of transfer.<sup>78</sup> If the transfer is by indorsement, the effective validity of the indorsement is consequently governed by the place of indorsement.<sup>79</sup> This same law determines the indorsee's rights as against both the drawer and acceptor.<sup>80</sup>

Commercial paper is not usually treated as an intangible because it passes by negotiation and actual delivery. Its transfer is thus governed by the law applying to movables, that of the situs at the time of transfer. However, even if the transfer is regarded as the mere assignment of a chose in action, the same law will apply because there must be a delivery to effect such an assignment, as there must be a delivery to transfer by negotiation.<sup>81</sup>

It may be argued that, inasmuch as a negotiation is a transfer of the right to enforce the performance of the drawee's obligation, the applicable law should be that of the place of the issuing bank. The first difficulty with this view is that the issuer is not always the drawee, as was noted in the situation of a confirming bank which honors the draft outright. Secondly, a negotiation usually creates new obligations as well. Except where an indorsement is made "without recourse," the indorser adds his promise to pay if the primary obligor does not.<sup>82</sup>

In our example credit, the draft is drawn in France by the beneficiary. The draft is drawn on the issuer or on the seller's bank if it confirmed. The draft may sometimes even be drawn on a mere advising bank. This latter bank, though appearing as the drawee, is under no obligation to the beneficiary unless it negotiates.<sup>83</sup> If it fails to pay or accept the seller's draft, the seller's only recourse is to the issuer.<sup>84</sup>

The seller draws the draft to the order of either the issuing bank, the intermediary bank or to his own order. When drawn to the order of either bank, the draft is indorsed by it to the seller. When drawn to the seller's own order, it is indorsed by him to the bank at which he draws. In either instance, the bank may ordinarily become a holder of

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77. *Id.* at 497.

78. Morris, *Some Conflict of Laws Problems Relating to Negotiable Instruments*, 66 W. VA. L. REV. 91, 96-99 (1964).

79. Stumberg, *supra* note 76, at 493; Morris, *supra* note 78, at 92.

80. Morris, *supra* note 78, at 96, 98.

81. GOODRICH, *op. cit. supra* note 51, at 320-21.

82. Stumberg, *supra* note 76, at 495.

83. Harfield, *Letters of Credit*, 76 BANKING L.J. 98 (1959).

84. *Ibid.*

the draft.<sup>85</sup> Thus, the law of France, the place of indorsement, may be held applicable in order to protect a negotiating bank or confirming bank which negotiates as well as holders of an accepted draft separated from the documents. In addition to the policy of protecting holders, there are also significant contacts with France. Besides the drawing, the goods represented by the draft are often produced in the seller's country. It is most likely the seller's domicile and is also the "place of making" of the seller's contracts with all subsequent transferees.

Formal validity of a draft is governed by the law of the place of drawing.<sup>86</sup> Questions such as the conditionality of the promise to pay or provisions for payment of collection fees, both formally determinative of negotiability, are thus decided under French law.<sup>87</sup>

Thus, formal validity and negotiability will be determined according to the French law. The effectiveness of an indorsement to pass title to the paper and the consequent ability of the purchaser to be a holder in due course will also be governed by French law.

In a choice of law by the court, as well as in a choice by the parties, it is unclear whether the law chosen to govern the credit or draft is the "whole" law of that jurisdiction or only its internal law. If the whole law of France is intended, French conflicts rules are applicable and the possibility of a *renvoi* to the Code arises.

In party choice of law situations it is arguable that the parties intended only the internal law to apply, not having contemplated applicability of the conflicts rule. The *Restatement* takes this view.<sup>88</sup> On the other hand, it would have been very simple to insert the word "internal" in the expressed choice of law. If the parties' choice is implied by the court, however, this argument will be immaterial. Gen-

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85. Where the seller draws to his own order and indorses to the bank, the bank may become a holder by reason of its position as an indorsee. Where drawn to the order of the bank and indorsed to the seller, the bank may also be a holder under UNIFORM COMMERCIAL CODE § 3-302(2), which permits a payee to be a holder in due course. If the bank is also the drawee, it can not, of course, be a holder of its own obligation.

86. *Swift & Co. v. Bankers Trust Co.*, 230 N.Y. 135, 19 N.E.2d 992 (1939); *Morris*, *supra* note 78, at 103-05. Banks impliedly concede this point. The export-import financing guides of one West coast bank and one Eastern bank provide examples of drafts drawn in conformity with the local law of some 100 countries.

87. Professor Cheshire states that, rather than the place of drawing, it is the "place of issue" that determines formal validity. Because delivery as well as drawing is necessary to the issuance of a draft, it is the law of the place of first delivery to a holder that should govern. CHESHIRE, *PRIVATE INTERNATIONAL LAW* 234 (7th ed. 1965). However, in ordinary credit practice, both drawing and first delivery to a holder occur at the same place. Thus, the place of drawing of the draft is a workable rule.

One possible exception is where the seller's bank is a mere advising bank which does not negotiate. If it merely forwards the draft to the issuer for collection, the "place of issue" is at the issuing bank and formal validity of the draft is governed by the Code.

88. *RESTATEMENT (SECOND), CONFLICT OF LAWS* § 332, comment *e* (Tent. Draft No. 6, 1960). *But see* GOODRICH, *op. cit. supra* note 51, at 206.

erally, in party choice cases, local law alone will apply. When the forum chooses the applicable law on the conflicts basis of most significant relation, it will look to another law if a court in the jurisdiction chosen would do so.<sup>89</sup>

A second question in a choice by either the court or the parties is whether all issues are governed by the law chosen. The parties may, of course, specifically provide for different laws to govern different issues.<sup>90</sup> Nevertheless, when their choice of law is implied by the court, or where the court chooses a law on a conflicts rule basis, the law chosen is said to govern all issues. Unlike the conflicts approach in torts, the issues in a contract case are supposedly treated as a whole under the applicable law chosen. In practice, this is simply not true. Though the majority of contacts with the credit are found to be at the situs of the issuer, the forum will not automatically decide the rights of an indorsee of the draft in France under the Code. Though not often apparent on a cursory reading of the decisions, the particular issue before the court will be determinative of a foreign law's "contacts" with the whole transaction.<sup>91</sup> Thus, although the majority of the contacts with the *credit* are in the issuer's state, a court may find that the most "significant" contacts with the *transaction* as a whole are in France, if the suit involves the effectiveness of the transfer of a draft in France.

### III. THE APPLICABLE LAW

The following subjects are, for the most part, left unanswered or unclear by article 5 of the Code. The problems involved are further complicated by the possible applicability of Uniform Customs or French law, or both. For these problems, the Code purports to state an applicable rule of law, but it does not fully cover the field. Moreover, the Code may not even govern the problem it confusingly purports to.

#### A. *Revocability of Credits*

Section 5-103(1)(a) ingenuously states that a credit may be either revocable or irrevocable. If the credit does not expressly state that it is to be treated as one or the other, the section is of little use. It leaves the task of discovering a usage of trade in favor of an interpretation of revocability or irrevocability to the courts.<sup>92</sup>

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89. GOODRICH, *op. cit. supra* note 51, at 206.

90. *Id.* at 206, n.45.

91. *Id.* at 206.

92. UNIFORM COMMERCIAL CODE § 5-103, comment 1.

Section 2-325(3) takes a more definite position. This section provides that, unless otherwise agreed, the term "letter of credit" in a contract for sale means an irrevocable credit. However, this section concerns the underlying sales contract between the buyer and seller, not the credit issued by the bank. The section declares only that the buyer, by revoking a credit silent as to revocability, breaches his obligation to pay under the sales contract. The section does not cover the question of whether he also breaches the credit agreement. The question of the issuer's power to revoke a credit that is silent as to revocability is also not covered. Because the credit agreement is in question, the issuer's and buyer's power to revoke, as regards each other and the seller, will be determined by the law of the issuer's state.<sup>93</sup> This law is the Code, which does not solve the problem.

Uniform Customs, however, easily resolves the problem by providing that a credit is deemed revocable in the absence of stipulation otherwise.<sup>94</sup> If this provision is read together with section 2-325(3) of the Code, the buyer's revocation of the silent credit is seen to breach the sales contract, but not the credit called for as the means of payment thereunder. This result is justifiable. After revoking, the buyer is no longer liable to anyone on the credit. He is liable to the seller for breach of their contract, which section 2-325(3) says intended an irrevocable credit as payment. The issuing bank is also relieved of responsibility on the credit. It is simply removed from the picture altogether. The issuer was never more than the medium of payment. Payment having failed, it should have no further rights or duties. It is thus seen that applicability of Uniform Customs with the Code provides a reasonable solution to a problem insoluble under the Code alone. In fact, the presumption of an irrevocable credit in section 2-325(3) is not even necessary. If the buyer does not pay reasonably soon after his revocation of the credit, he will be in breach anyway. Under Uniform Customs, the issuer may also revoke a credit which does not stipulate as to revocability.<sup>95</sup>

Because a confirming bank directly obligates itself on the credit,<sup>96</sup> the question of revocability of a confirmed credit is governed by the law of the situs of the confirming bank — French law.<sup>97</sup> As in most civil law systems, French law treats its subjects in broad terms. Letters of credit as such are not dealt with by the French Codes as a separate

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93. See text following note 66 *supra*.

94. ICC UNIFORM CUSTOMS art. 1 (rev. 1962).

95. Cf. Harfield, *Code Treatment of Letters of Credit*, 48 CORNELL L.Q. 92, 98 n.6 (1962).

96. UNIFORM COMMERCIAL CODE § 5-107(2); ICC UNIFORM CUSTOMS art. 3 (rev. 1962).

97. See text accompanying notes 65, 66 *supra*.

type of contract. They are governed by general contract principles.<sup>98</sup> To the extent that the *Code de commerce* fails to cover a commercial question, the applicable provisions of the *Code Civil* control. Therefore, although the credit is a commercial contract (involving a bank), it is covered by the *Code Civil* and not the *Code de commerce*.

In French law, as in American law, a contract is invalid in the absence of the consent of a party to be bound thereby.<sup>99</sup> Thus, the beneficiary of a credit may no more compel an issuer who did not intend to make a binding promise to pay or accept<sup>100</sup> than under American law. However, if the confirmed credit is silent as to revocability, the question of how it is to be treated is here presented with regard to the confirming bank's obligation to the seller. Article 1159 of *Code Civil* provides that interpretation of an ambiguous contract shall be supplemented by the customs of the place of making. If the failure to stipulate as to revocability may be considered an ambiguity, customs of French credit practice will be applicable because France is the place of making the confirmed credit contract. One such custom is Uniform Customs. It has been seen that Uniform Customs treats the credit as revocable in the absence of stipulation otherwise.

If a total failure to stipulate does not qualify as an ambiguity under French law, Uniform Customs may nevertheless apply if it has been made an express term of the French bank's confirmation. On the other hand, article 1162 of *Code Civil* may make the credit irrevocable. This article provides that a contract is to be interpreted against the party "who made the stipulation." In every contract, questions of interpretation are to be resolved against the party who drew up the terms.<sup>101</sup> This party had the opportunity to more clearly state its terms.<sup>102</sup> Thus, the buyer who opened the credit and the confirming bank which adopted its terms by confirming may find that a credit which does not provide for revocability is irrevocable as against the seller who had no part in drawing up the credit terms.

#### B. *Documentary Compliance with the Credit*

The issue of documentary compliance may arise in any of three situations: (1) where the seller sues the issuer for wrongful dishonor of his draft, (2) where the buyer sues the issuer for a wrongful honor of the seller's draft, and (3) where the issuer sues the buyer for reimbursement after paying the draft.

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98. SCHLESINGER, IN 1 HEARINGS ON THE UNIFORM COMMERCIAL CODE, NEW YORK LAW REVISION COMMISSION 627 (1954).

99. CODE CIVIL art. 1108.

100. FLATTET, LES CONTRATS POUR LE COMPTE D'AUTRUI 148-49 (Paris, 1950).

101. CARBONNIER, THÉORIE DES OBLIGATIONS 252 (Paris, 1963).

102. *Ibid.*

The Code does not provide standards of documentary compliance. It only requires the issuing bank to examine the documents with care and to ascertain that "on their face they appear to comply with the terms of the credit."<sup>103</sup> The issuer, in presenting the documents to the buyer, does not warrant their genuineness or effectiveness.<sup>104</sup> An intermediary bank which transfers the documents also does not warrant their genuineness or effectiveness.<sup>105</sup> In fact, such bank warrants only its good faith and authority.<sup>106</sup> Except for these rules treating documents in an extremely broad manner, the Code makes no provision as to when documents under a credit comply. One writer thinks this a salutary judgment.<sup>107</sup> Uniform Customs, on the other hand, contains rather detailed provisions for compliance.<sup>108</sup> As previously stated,<sup>109</sup> these provisions are applicable only in the absence of express agreement to the contrary. For example, if the credit states that bills of lading need only show that the goods have been received for shipment by the carrier, article 18 of Uniform Customs, requiring all bills of lading to be "on board" bills, is ineffective.

The usage of trade provision of section 1-205 may also set the standard for at least the buyer and issuer. If Uniform Customs is not applicable and the credit is silent as to the type of bill required, a usage of trade, such as that of the Franco-American *ouillejette* industry,<sup>110</sup> to pay only against "on board" bills will be binding on the parties. The issuer would breach his duty to the buyer if he honored against presentment of a "Received for Shipment" bill.<sup>111</sup> It may be urged that the issuer cannot be held to such specialized knowledge of the trade. This argument provides the basis for the next problem.

### C. *Negligence of the Issuer or Intermediary Banks*

In addition to the general obligation of good faith,<sup>112</sup> an American issuing bank must observe "general banking usage," but unless otherwise agreed, does not assume responsibility for the act or omission of

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103. UNIFORM COMMERCIAL CODE § 5-109(2).

104. *Ibid.*

105. UNIFORM COMMERCIAL CODE § 7-508, comment 2.

106. UNIFORM COMMERCIAL CODE §§ 5-111(2); 7-508.

107. Mentschicoff, *How to Handle Letters of Credit*, 19 BUS. LAW. 107 (1963).

108. ICC UNIFORM CUSTOMS §§ C, D (rev. 1962).

109. See note 43 *supra*.

110. An industry plagued by the dilemmatic propensity of its product to perish rapidly and, in so doing, produce two healthy new *ouillejettes* for each perished one. The situation is unfortunate for the seller who, through delay by the carrier, will receive at best only one-half the value of the merchandise actually delivered. The necessity of paying only if certain the goods are on board ship is evident.

111. A bill which merely shows that the goods have been delivered to the carrier for shipment. The bill does not state that the goods have been loaded for shipment.

112. UNIFORM COMMERCIAL CODE §§ 1-203; 5-109(1).

any person other than itself or its branch.<sup>113</sup> Nor is the issuer responsible for loss or destruction of a draft or document in transit or in possession of others.<sup>114</sup> Lastly, the section relieves the issuer of responsibility for error based on knowledge or lack of knowledge of any usage of any particular trade.<sup>115</sup> This last provision is a clear exception to section 1-205(3) which gives effect to usages of trade of which the parties "are or should be aware." The exception is justified by the draftsmen on the basis that an issuer performs "a banking and not a trade function."<sup>116</sup>

The necessity of such an exception is questionable in view of present-day customer service facilities of large commercial banks which issue credits. In their advertising, these banks do not merely affirm their banking acumen. They also assert their special knowledge of particular industries as an inducement to obtaining business of firms in these industries. It is not at all difficult to find advertisements such as "we know your business, speak its language," or "stop up at our Plastics Division," among the prolific advertising of today's large banks.

Because sections 5-109 and 5-107, which limit the bank's responsibility in this area, are "unless otherwise agreed" provisions, at least one writer<sup>117</sup> believes that such advertising might constitute an agreement under the Code's broad definition of that term,<sup>118</sup> if followed by the customer's business in reliance on the advertising. It is not that the bank does not actually possess the specialized knowledge; it almost always does. However, it should be held in accordance with this knowledge.

In the *ouillejette* example above, a banker in the issuer's Perishable Goods Division would probably know of the industry's practice of paying only against "On Board" bills of lading. Nevertheless, under section 5-109(1)(c) the bank would escape liability if it, in good faith, honored another type of bill where the credit was silent. Professor Mentschicoff's view would regard the honor as wrongful. Her view is justified, in part, by the questionable nature of the bank's "good faith" in this situation. However, the idea of an "agreement" is sustainable only where it can be shown exactly what elements of the issuer's special knowledge were relied upon. That the general assertion of knowledge of an industry cannot be made a term of an agreement is obvious.

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113. UNIFORM COMMERCIAL CODE § 5-109(1)(b).

114. *Ibid.*

115. UNIFORM COMMERCIAL CODE § 5-109(1)(c).

116. UNIFORM COMMERCIAL CODE § 5-109, comment 1.

117. Mentschicoff, *supra* note 107, at 115.

118. UNIFORM COMMERCIAL CODE § 1-201(3).

The issuer's correspondent may be negligent in the transfer of a credit by code or cable or in transmitting the issuer's instructions. Errors in transmission and translation are the buyer's loss.<sup>119</sup> Moreover, erroneous notification by the correspondent to the beneficiary is of no effect. The beneficiary is bound by the terms of the credit as originally issued.<sup>120</sup>

These rules apply to questions of the issuer's liability on the credit agreement. However, loss or destruction of a draft in transit is not so clearly outside the issuer's scope of liability as section 5-109 appears to make it. The loss will be governed by the law of the situs of the draft at the time of the loss. As between the issuer and an intermediary bank, the applicable law is that of the jurisdiction of the bank in relation of principal to the other.<sup>121</sup> The French confirming bank's liability for error based on special knowledge or lack thereof will be governed completely by the French law.

#### D. *Issuer's Duty and Privilege to Honor*

The Code takes a commercially justifiable position as to the obligation of the issuer to honor a documentary draft.<sup>122</sup> The issuer is never obligated to dishonor. It has the privilege of dishonoring in one important instance, to be dealt with shortly.

Section 5-114(2) is a complex provision. It provides that:

Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) . . . or is forged or fraudulent or there is fraud in the transaction

- (a) the issuer must honor . . . [if] demanded by a negotiating bank or other holder . . . which has taken the draft . . . under the credit and *under circumstances which would make it a holder in due course* (Section 3-302) *and in an appropriate case* would make it a person to whom a document of title has been duly negotiated (Section 7-502) . . .
- (b) *in all other cases* as against its customer, an issuer acting in good faith may honor the draft . . . despite notification from the [buyer] of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor. [Emphasis added.]

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119. UNIFORM COMMERCIAL CODE § 5-107(4).

120. UNIFORM COMMERCIAL CODE § 5-107(3).

121. GUTTERIDGE AND MEGRAH, *THE LAW OF BANKERS' COMMERCIAL CREDITS* 169 (London, 1962).

122. UNIFORM COMMERCIAL CODE § 5-114, comment 2; Mentschicoff, *supra* note 107, at 110-11.



Even though the issuing bank has notice of fraud or forgery in the documents or fraud in the transaction, it *may* honor a draft presented by any person who also presents documents complying with the credit on their face and regular on their face. By so honoring, the issuer entitles itself to reimbursement from the beneficiary. Thus, the question of the issuer's duty and privilege of honor arises only where the issuer dishonors. May it then assert its customer's defenses in a suit by the beneficiary for wrongful dishonor?

Subsection (a) clearly embodies a policy of protecting innocent third parties who have given value for the draft. Such person must meet the requirements of a holder in due course (section 3-302) on the draft,<sup>123</sup> but the subsection does not state that he must, in fact, be a holder in due course. Rather, it requires him to have taken under the credit and "under circumstances which would make it a holder in due course (section 3-302)." This language does not reveal whether the holder must be an actual holder in due course or merely meet the requirements of section 3-302. The official comments to section 5-114 are of no help.

A negotiating bank or other holder who purchases the draft in good faith without notice that it is overdue, dishonored or subject to any defense or claim fulfills the requisites of section 3-302. Such person may not be a holder in due course, however, if the draft is not negotiable.<sup>124</sup> The question thus arises whether section 5-114(2)(a) protects holders who fail to be holders in due course because of a formal defect in the instrument precluding negotiability.

Drafts of section 5-114(2) prior to 1956 clearly required the negotiating bank or other holder to be a holder in due course.<sup>125</sup> In the deliberations and reports of the New York Law Revision Commission from 1954 to 1955, the protected party is clearly referred to as a holder in due course, despite occasional reference to a "bona fide purchaser."

In 1956, the report of the Commission referred to the protected party solely as an "innocent purchaser who paid value" and a "purchaser of the draft and documents for value without notice of a fraud or forgery."<sup>126</sup> No mention was made of the necessity for the draft to be negotiable.

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123. Query whether only § 3-302 applies to negotiating banks or whether the particular holder in due course provisions of § 4-209 must also be considered.

124. UNIFORM COMMERCIAL CODE § 3-302 applies only to negotiable instruments. UNIFORM COMMERCIAL CODE § 3-102(1)(e).

125. UNIFORM COMMERCIAL CODE § 5-111(1), (2) (Official Draft, 1952).

126. NEW YORK LAW REVISION COMMISSION, REPORT AND APPENDICES RELATING TO THE COMMERCIAL CODE 46, 435 (1956).

The subsequent American Law Institute draft of the Code carried, for the first time, the language of the present subsection (a). No attempt was made to explain the reason for its inclusion. Writers on this later draft of the section have failed to consider the present necessity of the protected party to be the holder of negotiable paper. These writers have assumed that subsection (a) applies, as did its predecessor, to holders in due course only.<sup>127</sup>

If, as the testimony warrants, subsection (a) protects only holders in due course, a negotiating bank or other holder must be the holder of negotiable paper as well as satisfy the requirements of section 3-302. Because formal negotiability of the draft is determined by the law of the place of drawing,<sup>128</sup> a negotiating bank or other holder's right to the protection of subsection (a) will thus depend on the law of France.

Also, on a choice of law basis or a usage of trade basis, negotiability may be determined by a law other than the Code. If the parties specify an applicable law, it will govern the draft's negotiability, at least where the draft is drawn in the country whose law was chosen. A usage of trade, in this country or France, to treat as negotiable paper that which would be non-negotiable under section 3-104, may also bring a holder or negotiating bank within subsection (a). Section 3-104 determines negotiability only for purposes of article 3 of the Code. Thus, despite the apparent conditionality of a documentary draft drawn under a credit,<sup>129</sup> such a draft may be either negotiable or non-negotiable.<sup>130</sup> If a draft is non-negotiable under the provisions of the Code, a usage of trade treating similar drafts as negotiable will prevail over the requirements of section 3-104.<sup>131</sup>

On the other hand, it is arguable that subsection (a) requires only satisfaction of the conditions of section 3-302. If the paper is not negotiable, the holder's right to honor will not be denied if the documents comply on their face. The general rule is that an indorsee of non-negotiable paper is at best the assignee of the indorser and thus subject to all defenses to which the indorser is subject. Thus, the negotiating bank or other holder which takes from the beneficiary has

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127. NEW JERSEY UNIFORM COMMERCIAL CODE STUDY COMMISSION, NEW JERSEY STUDY COMMENT 3 TO SECTION 5-114; SECOND REPORT TO THE GOVERNOR (1960); Bombaugh, *The Illinois Uniform Commercial Code: Article 5 — Letters of Credit*, 50 ILL. B.J. 600, 604 (1962); 1956 RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE § 5-114, Reason (A.L.I. 1956).

128. See text accompanying notes 86, 87 *supra*.

129. UNIFORM COMMERCIAL CODE § 5-103(1)(b).

130. UNIFORM COMMERCIAL CODE §§ 4-104(1)(f); 3-105(1)(d).

131. For example, banks often treat as negotiable time drafts payable "sixty days after date of bill of lading." Such paper is non-negotiable under § 3-109. However, it is possible for the holder of such paper to be a holder in due course.

no better claim than the beneficiary. However, it should be remembered that article 5 provides its own conditions of negotiation, presentment and payment of documentary drafts to which its provisions apply.<sup>132</sup> In fact, although contrary to the traditional limitation of the assignee's rights stated above, section 5-114(2)(b) itself allows the issuer to honor the assignee's draft despite notification of fraud or forgery. Therefore, the distinction between two classes of persons made in subsections (a) and (b) can not be based on the negotiability or non-negotiability of the draft.

Furthermore, under section 3-302, a holder in due course must not have notice of any defense against the draft on the part of any person. It is thus debatable whether a bank which negotiates a draft accompanied by non-complying documents can be a holder in due course.<sup>133</sup> Yet, such a bank may come within the protection of subsection (a).

Lastly, the holder surely may not be a holder in due course against the buyer, for the buyer is not a party to the instrument<sup>134</sup> since his name does not appear on the draft. For the same reason, the holder also may not be a holder in due course as to the issuer where the draft is drawn on a bank other than the issuer.<sup>135</sup> Nevertheless, the issuer must honor the draft under subsection (a). These illustrations reveal that if the draft is formally non-negotiable, but the holder meets the requirements of section 3-302, he is entitled to the protection of subsection (a).

French law will determine whether these requirements have been met. Questions as to whether value has been given and whether there has been notice of a defense are governed by French law, because the validity of the indorsee's claim and his immunity to defenses (treated separately under the civil law) are determined by the law of the place of indorsement.<sup>136</sup>

With regard to the documents, subsection (a) requires that the holder must be one to whom documents of title have been duly negotiated under section 7-502. However, the phrase requiring due negotiation is qualified by language similar to that qualifying the status of the holder of the draft — "in an appropriate case." Only a

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132. CLARKE, BAILEY & YOUNG, *BANK DEPOSITS AND COLLECTIONS (UNDER THE UNIFORM COMMERCIAL CODE)* 108 (A.L.I. — A.B.A. 1959).

133. 1 *NEW YORK LAW REVISION COMMISSION, HEARINGS ON THE UNIFORM COMMERCIAL CODE* 601 (1954).

134. *UNIFORM COMMERCIAL CODE* § 3-305(2). *But see* the broad definition of "party" at § 1-201(29).

135. See text accompanying notes 83, 84 *supra*.

136. See text accompanying notes 79, 80 *supra*.

negotiable document of title may be duly negotiated.<sup>137</sup> Thus, if the "appropriate case" reference does not permit a negative inference — that, where not appropriate, he need not be a due negotiatee — a most curious result would follow. The presenting holder would be required to have negotiable documents of title, but not a negotiable draft, to be treated as what some writers assert to be a holder in due course of the draft. The "appropriate case" and "under circumstances" references must therefore be taken to be parallel qualifications. They qualify their respective clauses of subsection (a) by permitting both the draft and documents to be negotiable or non-negotiable.

The issuer may assert its customer's defenses of fraud or forgery against a person who falls within the provision of subsection (b). It may refuse to honor without consequent liability. However, it may also honor the draft if it chooses to do so in good faith. The buyer's only remedy is to obtain an injunction against such honor. The policy behind subsection (b) is obviously not one of protecting innocent holders who give value, as in subsection (a). The beneficiary or his agent may not be innocent, having, in fact, perpetrated the fraud. Nor will such persons be holders, because the draft has never been negotiated to them.

Subsection (b) is based on economic considerations. If the issuer were required to determine whether or not the documents are forged or whether there is fraud in the transaction, it could not engage in letter of credit practice for the small commission it charges. This subsection's effect may give a lawyer reason to pause, however deep his appreciation of the low cost of commercial banking services. Under subsection (b) it is conceivable that a banker could ignore his customer's notice that a bill of lading is forged, even if notice were given as the seller knocked at the banker's door to make presentment. Despite the basic requirement of the banker's good faith, he could probably honor and enforce reimbursement from the buyer, if he states that he was simply unable to decide if the bill was forged and unwilling to hazard a guess.<sup>138</sup>

This example is somewhat unrealistic. Several factors will generally mitigate the effect of subsection (b). The issuer will ordinarily inform its customer of his right to obtain an injunction and will often take the full three days for honor to allow him the exercise of that

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137. UNIFORM COMMERCIAL CODE § 7-501(4).

138. One writer even states that the issuer may honor under subsection (b) "even where [the defect is] apparent on the face of the documents" if he does so in good faith. Rowland, *Letters of Credit — Article 5 of the Uniform Commercial Code*, 30 Mo. L. Rev. 288, 291 (1965). This is obviously a difficult assertion to sustain unless "apparent" refers to everyone but the issuer.

right. The issuer may also be somewhat picayunish as to documentary compliance. It can refuse honor for most any technical discrepancy in the documents, within the bounds of good faith. Notwithstanding these dilatory tactics, the issuer will virtually always honor when the draft is presented by a person within subsection (a). It will very often honor in subsection (b) cases, no matter how valued the customer.

The provisions of Uniform Customs do not greatly differ from those of the Code in respect of the issuer's obligation.<sup>139</sup> Uniform Customs provides that the issuer has a reasonable time in which to honor.<sup>140</sup> Because section 5-112(1) of the Code does not expressly allow for agreement otherwise, the Code limitation of three banking days, without the seller's consent, may prevail even where Uniform Customs is applicable.<sup>141</sup> Applicability of the French law, by choice of law or conflicts rule, has already been considered.

#### E. *Use of Credit in Portions*

If the credit does not specify otherwise, it may be used in portions "in the discretion of the beneficiary."<sup>142</sup> Where a seller requires funds to finance production of each of several shipments to the buyer, section 5-110(1) permits him to ship, draw a draft and apply the funds received in payment or discount thereof to production of future shipments.

Neither the Code nor Uniform Customs discloses whether partial use of the credit must be proportional to the amount of goods shipped, as evidenced by the documents presented. If the goods are of a unit price, drawing must be proportional.<sup>143</sup> However, it is unclear whether such unit prices must be stated in the credit or documents presented so as to give the issuer notice of the price. Although the problem concerns the drawing of drafts, the basic question is the right to draw under the credit agreement. Therefore, the Code will govern this question of proportionality of drafts.<sup>144</sup> If a confirming bank is involved, its obligation to pay proportionally will be governed by the French law.<sup>145</sup>

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139. ICC UNIFORM CUSTOMS § B (rev. 1962).

140. ICC UNIFORM CUSTOMS art. 8 (rev. 1962).

141. *But see* note 34 *supra*.

142. UNIFORM COMMERCIAL CODE § 5-110(1); ICC UNIFORM CUSTOMS art. 33 (rev. 1962), provides that, unless otherwise agreed, partial shipments are allowed.

143. Harfield, *Code Treatment*, *supra* note 95, at 101-02.

144. See text accompanying note 62 *supra*.

145. See text accompanying notes 65, 66 *supra*.

#### IV. CONCLUSION

This paper has attempted to point out several exceptions to article 5 applicability. The international practitioner should safeguard his client's interests in these areas by becoming familiar with the Uniform Customs, by choosing a favorable applicable law when feasible, and by carefully drafting the credit terms. All his efforts should be directed toward avoiding litigation. It is, after all, the absence of litigation in the letter of credit field that has permitted the incredible flexibility and popularity of credits.