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# Article 5 of the Uniform Commercial Code

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# ARTICLE 5 OF THE UNIFORM COMMERCIAL CODE

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Article 8 provides a modernized and improved statute regulating the transfer of investment securities. Building upon the Uniform Stock Transfer Act and the Uniform Act for the Simplification of Fiduciary Security Transfers, the Code draftsmen have provided an integrated statute to regulate all securities meeting the broad functional definition of "investment securities."

Today's lecture will deal with Article 5 of the Uniform Commercial Code. Article 5, concerning letters of credit, provides a new statutory framework upon which this important financing device can be based. It is used primarily in financing international sales transactions for which elaborate rules and practice have been developed by the bankers engaged in this field, but it may also be used in domestic transactions.

I plan to make a few general remarks about article 5 and then devote the balance of the time allotted to a discussion of particular problems under the article.

## LETTERS OF CREDIT — CODIFICATION OF THE SZTEJN RULE

The Code defines a letter of credit as an "engagement by a bank or other person made at the request of a customer . . . that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the credit."[1] The conditions may relate merely to the proper identification of the person drawing the drafts, as in the case of "clean" or travelers' letters of credit, or, in the case of the more important and more common commercial documentary credits, may require that the draft be accompanied by certain prescribed documents such as bills of lading or warehouse receipts.[2]

1. UNIFORM COMMERCIAL CODE § 5-103(1)(a).
2. The Code applies to both documentary and clean credits. See *id.* § 5-102(1).

The documentary letter of credit is of enormous economic importance and performs a major role in many international sales transactions. I am advised that this instrument is widely used in New Orleans in the importing and exporting of such commodities as coffee, sugar, and cotton. As a matter of fact, Louisiana is one of the few states, other than New York, that has any decisional and statutory law on the subject of letters of credit. There appear to be five cases,[3] three of them decided in federal courts, and four statutory provisions.[4] Two of the cases grew out of the failure of the Interstate Trust and Banking Company, which was in the business of issuing credits in support of coffee importing transactions in the early '30's.[5] Article 5 of the Uniform Commercial Code is not at variance with the few rules set forth in these cases and statutes other than in one minor matter relating to form. The Code's simple requirements as to form[6] do not specify the necessity for two signatures on bank credits as do the Louisiana Revised Statutes.[7]

Let me use a somewhat simplified version of the Interstate Trust and Banking Company case fact pattern as an illustration of how a letter of credit transaction works. A Brazilian coffee seller makes a contract for the sale of coffee to a New Orleans importer and specifies a letter of credit as the means of payment. At least two inferences can be drawn from the fact that the parties provided for a letter of credit. First of all, it is likely, as in all documentary transactions, that the seller is not willing to do business relying on the open credit of the New Orleans importer whose credit rating and reliability may be unknown or insufficient to the Brazilian. He wants the firm obligation of a well-known bank before he releases control of the goods. It is also possible that the Brazilian seller is a middle man who wants to use the bank credit issued to cover this con-

3. Ornstein v. Hickerson, 40 F. Supp. 305 (E.D. La. 1941); Vivacqua Irmaos, S.A. v. Hickerson, 193 La. 495, 190 So. 657 (1939); Bank of America v. Whitney-Central Nat'l Bank, 291 Fed. 929 (5th Cir. 1923), *cert. denied*, 264 U.S. 598 (1924); In re Interstate Trust & Banking Co., 188 La. 211, 176 So. 1 (1937). See also Pan-American Bank & Trust Co. v. Nat'l City Bank of New York, 6 F.2d 762 (2d Cir. 1925), *cert. denied*, 269 U.S. 554 (1925), relating to the ultra vires question.

4. LA. R.S. 6:237 (powers of banking associations); 6:39 (signatures to letters of credit); 6:40 (recordation of drafts accepted or letters of credit issued); 6:41 (penalty for violation of 6:38-40 (1950).

5. Ornstein v. Hickerson, 40 F. Supp. 305 (E.D. La. 1941); Vivacqua Irmaos, S.A. v. Hickerson, 193 La. 495, 190 So. 659 (1939).

6. UNIFORM COMMERCIAL CODE § 5-104.

7. LA. R.S. 6:39 (1950).

tract as security to borrow money from a Brazilian bank to buy the coffee.[8]

Let us focus for a moment on the mechanics of having a letter of credit issued by the New Orleans bank. The coffee importer first enters an agreement with his bank by which the bank engages to issue a credit to the Brazilian seller and for which the bank receives a commission from the customer. The bank secures itself by having the documents controlling the purchased coffee run in favor of the bank. The agreement between the buying customer and bank will typically exculpate the bank from most conceivable responsibilities other than the duty of exercising ordinary care in seeing to it that the documents specified in the letter of credit are tendered by the presenter of the draft and that they are regular on their face.[9] In the kind of transaction which we are using as an illustration the bank will then send the seller a letter of credit instrument irrevocably undertaking to honor drafts drawn on it, which total the purchase price, when such drafts are accompanied by documents evidencing delivery of the coffee to a ship sailing from Brazil and bound for New Orleans. The credit will require that the ocean bill of lading, controlling the goods, run in favor of the financing New Orleans bank. It will itemize exactly what documents are to accompany any draft drawn under the credit and might include, in addition to the on board bill of lading, a consular invoice, a commercial invoice, and an insurance policy or certificate covering the usual risks.

The letter of credit will also undoubtedly include a provision that "unless otherwise expressly stated, [the] credit is subject to the Uniform Customs and Practice for Commercial Documentary Credits fixed by the Thirteenth Congress of the International Chamber of Commerce." These recently revised Customs and Practice adhered to by most of the major banks of the world[10] include further elaborate exculpatory provisions, and

8. The Brazilian seller may have a letter of credit issued by a Brazilian bank to pay his seller. This so-called "back to back" credit will usually call for exactly the same documents to enable the Brazilian seller to meet the conditions of the primary credit.

9. Examples of agreement forms may be found in WARD & HARFIELD, BANK CREDITS AND ACCEPTANCES 202-08 (4th ed. 1958).

10. Reprints of *Uniform Customs and Practice for Documentary Credits* (1962), are contained in INTERNATIONAL CHAMBER OF COMMERCE BROCHURE No. 222 (1962), distributed by the Banker's Association for Foreign Trade (U.S.A.) and the Committee on International Banking (U.S.A.). They are also reprinted in HOGAN & PENNEY, NEW YORK STATE SUPPLEMENT TO BANKS AND THE UNIFORM COMMERCIAL CODE (1964) published by the New York State Bank-

go to great lengths to specify the details of documentary compliance. Separate provisions deal with the customs of the trade with respect to shipping terms, provisions on documents, bills of lading, railway bills of lading, insurance, invoices, and the interpretation of terms.

In the illustration we have used, the Brazilian exporter may well receive the letter of credit instrument directly from the New Orleans issuer. Another common means of notifying the seller of the issuance of the credit is to use a Brazilian bank as the agent of the New Orleans bank to "advise" the credit. The request to open the credit as between the two banks would in all likelihood be accomplished by the use of a cablegram. The Brazilian bank will deliver an instrument to the seller formally advising that the New Orleans bank has issued the credit and spell out the conditions for documentary compliance. The advising bank may also offer to undertake the collection of the draft for the account of the seller and to advance money in anticipation of collection. In some cases the advising bank may bind itself to honor drafts when accompanied by the appropriate documents, in which case it is in the same legal position with regard to the seller beneficiary as the New Orleans issuer itself and is spoken of as a "confirming bank."

When the seller receives the letter of credit, he has a binding bank commitment that assures him of payment when the conditions of the letter are met. When he puts the coffee on board the ship in Rio and secures the documents called for, he merely has to attach them to a draft for the price and he can count on the draft being paid.

The provisions of Article 5 of the Uniform Commercial Code would ordinarily affect such a letter of credit transaction in only a few minor respects. There should be no concern on the part of Louisiana practitioners and bankers about having to learn new law or change their practices. The proposed statute is limited to a few skeletal rules and key definitions which are designed to afford an intelligble framework upon which letter of credit business can be done. An early section on "scope" specifies the kind of engagements which are embraced within the article and those which are excluded.[11] The definitions in section 5-103

ers Association. They are commented upon and described in Shattuck & Guernsey, *Letters of Credit — a Comparison of Article 5 of the Uniform Commercial Code and the Washington Practice*, 37 WASH. L. REV. 325-66, 500-56 (1962).

11. UNIFORM COMMERCIAL CODE § 5-102.

are in full accord with commercial understanding. The few formal requirements of section 5-104 present the one possible variation with Louisiana law in the failure to require two signatures as earlier mentioned.[12]

While letter of credit experts have long recognized the absence of the need for consideration to establish or modify a credit, section 5-105 alleviates any doubts on this score. It is sometimes important to know at what point in time the issuing bank is bound to the seller-beneficiary, in our example, the Brazilian exporter. Clear rules with respect to the "establishment" of an irrevocable credit as to the customer and beneficiary are set forth in section 5-106. Section 5-107 spells out the role and responsibilities of the advising bank. In our example, such an advising bank would undoubtedly be located in Brazil, the home territory of the seller. The Code makes advising banks responsible for their own errors in transmitting the notice of any credit, but where such error is made the issuer is bound only by the credit's original terms. If the local bank "confirms" as well as "advises," it becomes directly obligated on the credit to the extent of its confirmation as though it were an issuer.[13] Other provisions deal with "notation credits,"[14] the availability of the credit in portions,[15] warranties on transfer and presentment,[16] time allowed for honor or rejection,[17] indemnities,[18] remedy for improper dishonor or anticipatory repudiation,[19] transfer and assignment,[20] and insolvency of banks holding funds for documentary credits.[21] Although some of the rules provided are new to letter of credit law and new to Louisiana, no major difficulty or objection should be anticipated.

There are two provisions which deserve more than mere inclusion in a summary listing. They are section 5-109 concerning the issuer's obligation to its customer, and section 5-114 respecting the issuer's duty and privilege to honor and right to reimbursement. These provisions are basic to the letter of credit

12. See text at note 6 *supra*.
13. UNIFORM COMMERCIAL CODE § 5-107(2).
14. *Id.* § 5-108.
15. *Id.* § 5-110.
16. *Id.* § 5-111.
17. *Id.* § 5-112.
18. *Id.* § 5-113.
19. *Id.* § 5-115.
20. *Id.* § 5-116.
21. *Id.* § 5-117.

transaction and are the most important found in the letter of credit article.

The obligations of an issuer to its customer are spelled out in section 5-109. The issuer owes its customer a duty of good faith and the observance of any general banking usage, but it assumes no responsibilities for the performance of the underlying contract. The bank is to be concerned only with documents. Furthermore, the issuer is not liable for any acts or omissions of any person other than itself or its branches. Issuers are not held responsible for knowledge or lack of knowledge of the usages of any particular trade.[22] The issuer is required to examine the documents with care to ascertain that they comply on their face with the terms of the credit, but no liability is imposed for the genuineness, falsity, or effect of any such documents. Section 5-114, dealing with the issuer's duty and privilege to honor and right to reimbursement, emphasizes again that it is a deal in documents and not in goods. The issuer is required to honor a draft complying with the terms of the credit regardless of whether the goods or documents conform to the underlying contract of sale. Even when forged documents are presented, the issuer is bound to honor the draft where the presenter is a negotiating bank or other intermediary party in the position of a holder in due course. If, for example, our Brazilian coffee exporter had discounted the draft with a Brazilian bank which qualified as a holder in due course, it would be incumbent upon the issuing bank to honor the draft when presented on behalf of the Brazilian bank even though it becomes apparent that the exporter had shipped sawdust rather than coffee or had obtained forged documents of title, assuming, of course, that the documents appeared "on their face to comply with the terms of the credit."[23] The underlying circumstances and even the fact of forgery of a document are immaterial in this deal in "superficially regular" documents. The Code permits the innocent Brazilian bank to recover against the issuer but then allows the issuer to obtain reimbursement from its customer who initially chose to rely upon the seller.[24] One might

22. Professor Soia Mentschikoff has speculated as to the effect of advertisements published by large banks, such as Chase Manhattan, proclaiming that they have people in departments who are experts in all the intricacies of the various trades. Mentschikoff, *Article 5 — Letters of Credit*, UNIFORM COMMERCIAL CODE HANDBOOK (ABA Section of Corporation Banking and Business Law) 163-64 (1964).

23. UNIFORM COMMERCIAL CODE § 5-114(2)(a).

24. *Id.* § 5-114(3).

argue at this point that, in fact, the customer-buyer had made clear his lack of reliance by insisting upon a letter of credit. The simple answer to this argument is that the buyer could have required additional documents and certificates which would have substantially reduced the risk of forgery, such as an inspection certificate, consular invoice, or the like. Even though the documents are forged, if the bank exercises reasonable care in examining them, the Code places the risk upon the customer-buyer rather than the issuing bank upon the theory that the bank is in no better position to detect forgeries than the customer. Banks also argue vigorously that making them insurers of genuineness would unduly add to the cost of issuing credits and lead to higher bank charges.

A different problem is encountered when the presentation is made on behalf of the beneficiary himself, or a person not in the position of a holder in due course. If, in fact, the documents are fraudulent or forged, the issuer is given the option to refuse honor of the draft.[25] As against its customer, however, the issuing bank, acting in good faith, may honor a draft drawn against the credit notwithstanding a receipt of notice from the customer of fraud, forgery, or other defect not apparent on the face of the document. In that situation the Code provides that the customer may apply to a court of appropriate jurisdiction to enjoin the bank from honoring the draft.[26] The New Orleans coffee importer might say to his New Orleans bank, "I have been advised that the bill of lading representing the coffee is forged," or "that the so-called coffee is in fact sawdust." The issuing bank is faced with a difficult decision. If it chooses to believe its customer and dishonor the draft, it risks the impairment of the currency of its letters of credit in Brazilian trade circles, if it later turns out that the documents were not in fact forged or the shipment was in fact coffee. On the other hand, if the bank chooses to honor the draft and the coffee turns out to be sawdust, the bank will suffer a loss of reputation and good will with its New Orleans customer and his friends. The Code does not solve this problem but gives the bank some protection if it makes a good faith decision. If the bank chooses to honor the draft the customer is left to his recourse against the seller for breach of warranty and of course this presents the customer

25. *Id.* § 5-114(2)(b).

26. *Ibid.* See also Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 31 N.Y.2d 631 (Sup. Ct. 1941); Balbo Oil Corp. v. G. D. Zigourakis, 40 Misc. 2d 710, 243 N.Y.S.2d 806 (Sup. Ct. 1963).

with the possibility of having to bring suit in Brazil. Since no such injunction cases have been reported in Louisiana, the Code's provision for this remedy would seem to fill a definite need in a jurisdiction with such a relatively large volume of letter of credit business.

There may be some pressures to leave out article 5 in any proposed enactment legislation; however, I believe that this would be a great mistake.[27] While New York has pretty well emasculated the article,[28] there appears to be little prospect of problems generated by credits on which both Louisiana and New York bankers appear. My impression is that the Louisiana banks are firmly enough established in this area so as not to require New York banks to issue, confirm, or advise. In the rare case where there is such a potential dual arrangement, difficulties can be avoided by careful draftsmanship.

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27. See comment in support of the rejection of the New York variation of § 5-102 in REPORTS OF THE PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, nos. 1 and 2 (1962).

28. UNIFORM COMMERCIAL CODE § 5-102(4) (N.Y.), discussed in Harfield, *Code Treatment of Letters of Credit*, 48 CORN. L.Q. 92, 95-98 (1926) (commenting on an earlier amendment to § 5-102(1)), reads:

"(4) Unless otherwise agreed, this Article 5 does not apply to a letter of credit or a credit if by its terms or by agreement, course of dealings or usage of trade such letter of credit or credit is subject in whole or in part to the Uniform Customs and Practice for Commercial Documentary Credits fixed by the Thirteenth or by any subsequent Congress of the International Chamber of Commerce."