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The Uniform Commercial Code in Minnesota: Article 5—Letters of Credit

This article is fourth in a series being published to acquaint Minnesota practitioners with the newly enacted Uniform Commercial Code. Mr. Halls examines the Letters of Credit article of the UCC.

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INTRODUCTION

The larger banks in Minnesota have issued letters of credit since World War II. Although widely used in Minnesota, they have not been the subject of legislation prior to the adoption of article 5 of the Uniform Commercial Code. This article explains the nature of a letter of credit, how it works, its advantages as a credit tool, and the rights and duties of the parties to a letter of credit transaction. Some of the more significant sections of article 5 are also examined.

The letter of credit may be defined as an engagement by the issuer of the letter of credit, made at the request of the issuer's

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1. ALI & NATIONAL CONFERENCE ON UNIFORM LAWS, UNIFORM COMMERCIAL CODE, 1962 OFFICIAL TEXT WITH COMMENTS (1963) [hereinafter cited as Code; the official comments will be cited CODE § ___, comment]. The Code has been enacted in Minnesota and appears in MINN. STAT. ANN. §§ 396.1-101 through 396.10-105 (Temp. pamph. 1965). Most references in the text will be to the statutory Uniform Commercial Code which will be referred to as Code in the text, but footnote references will be to the 1962 official text.

In 1938 the International Chamber of Commerce adopted the "Uniform Customs and Practice for Documentary Credits," which was last amended in 1962. See INTERNATIONAL CHAMBER OF COMMERCE, UNIFORM CUSTOMS AND PRACTICE FOR COMMERCIAL DOCUMENTARY CREDITS (Brochure No. 222, 1962 revision); [hereinafter cited UNIFORM CUSTOMS]. A STUDY OF THE EFFECT OF THE UNIFORM COMMERCIAL CODE ON MINNESOTA LAW 551–52 (1964) [hereinafter cited MINN. STUDY]. Minnesota banks have generally followed the UNIFORM CUSTOMS.

2. This article is intended to function as a primer on letters of credit for Minnesota lawyers with clients who may find the letter of credit useful in financing purchases or sales of goods in domestic or international trade. For more scholarly treatment of the subject matter, see the books and articles listed in the bibliography at the end of this article.
customer, that the issuer will honor drafts drawn by the beneficiary of the credit upon the beneficiary’s compliance with the conditions specified in the letter of credit. Letters of credit are usually used to finance the purchase of goods. Four parties are generally involved:

1. The “issuer”—the bank or other person who issues the letter of credit;
2. The “beneficiary”—the person entitled to draw or demand payment under the credit, and usually the seller of the goods;
3. The “customer”—the financial customer of the issuer, and usually the buyer of the goods;
4. The “advising bank” or the “confirming bank”—usually the beneficiary’s bank and often a correspondent of the issuing bank. An “advising bank” merely notifies the beneficiary of the issuance of the letter of credit. Its only duty is to accurately communicate the terms of credit. A “confirming bank” becomes directly obligated on the credit to the extent of its confirmation as though it were the issuer and acquires the rights of an issuer.

For purposes of illustration, assume that a Minnesota manufacturer wishes to buy parts from a California company. Neither company has had prior experience with the other. The buyer wants to buy the parts on open account and pay for them after delivery. The seller wants cash in advance of delivery. The issuance of a letter of credit is a solution to this payment problem. The parties agree that the buyer will furnish a letter of credit issued by a responsible financial institution. The Minnesota manufacturer, the customer, takes the sales contract to its bank and applies for a letter of credit. The application contains an agreement that the customer will reimburse the issuer for money paid out pursuant to the letter of credit and the conditions upon which the credit is being issued. These are conditions precedent to the issuer paying the beneficiary. Typically, the beneficiary must present, within a certain number of days from the issuance of the credit, a sight draft, an invoice covering the order, a bill of lading indicating shipment, and a certificate of insurance covering loss

3. See Code § 5–103(1)(a). It may seem that a letter of credit is in the nature of a guaranty. In fact, there is a vast difference between a guaranty and a letter of credit. The issuer of a letter of credit assumes a primary obligation to the beneficiary as opposed to a secondary liability under a guaranty.
of the goods in transit. Depending on the financial responsibility of the customer, the bank will either issue the letter of credit on the customer's promise to reimburse or require collateral. The issuer then forwards the letter of credit to the beneficiary who examines it to determine its acceptability and conformance with the understanding reached with the buyer. The seller then prepares and ships the parts and presents the required documents to the issuer before the specified expiration date. After receiving the sight draft and the accompanying documents, the issuer has three days to examine the documents. If the documents are in order, the issuer must pay. After payment, the issuer is entitled to immediate reimbursement from the customer.

If the parts are defective, or the documents forged or fraudulent, the customer must still reimburse the issuer, because the liability of the issuer is independent of the underlying contract between buyer and seller. The customer has the burden of seeking out honest, able suppliers. However, the customer is not entirely at the mercy of the seller. During negotiations with the seller the customer can arrange for partial payment upon presentation of the various documents with the balance or "holdback" payable after receipt and acceptance of the merchandise. The customer can also require presentation of a certificate of inspection from an independent engineer or inspector with the other documents. A number of firms specialize in such inspections.

Time letters of credit can also be negotiated. The funds are then paid out by the issuer against a time draft instead of a sight draft. The time credit allows the customer to reimburse the issuer from the sale of the merchandise. Instead of paying the time draft upon presentation, the issuer indicates acceptance on the face of the instrument. If the seller desires, he can discount this acceptance with another bank.

This hypothetical involves one of the simplest letter of credit transactions. For instance, a fourth party — the advising bank or

8. See Code § 5-112(1). The three day rule appears to be an extension of time insofar as prior practice is concerned. Uniform Customs art. 10, gave the issuer a reasonable time. Some courts have followed the twenty-four hour rule of negotiable instruments law.
10. See Code § 5-114(3).
13. In the case of a sight draft, a bank customarily pays it and then seeks immediate reimbursement from the customer. In the case of a time acceptance, the customer makes the funds available to the bank the day before the maturity of the acceptance. See Code § 5-114(3).
confirming bank — often becomes involved. Since the beneficiary does not know the issuer, he may prefer to rely on his own bank to confirm the issuance of the credit.

SCOPE OF ARTICLE 5

Article 5 covers both "documentary" and "clean" credits. Documentary credits require the presentation of drafts or documentary demands for payment. Clean credits do not require the presentation of documents and have no named beneficiary. To come within article 5, a clean credit must conspicuously state that it is a letter of credit. Documentary credits issued by parties other than a bank come within article 5 if they require that the draft or demand for payment be accompanied by a document of title. Thus, under a "floor planning arrangement" a finance company might agree to pay drafts drawn by an automobile manufacturer when accompanied by documents of title. Clean credits issued by nonbankers also come within article 5.

THE IRREVOCABILITY OF A LETTER OF CREDIT

This article discusses only irrevocable letters of credit since the use of revocable credits is rare. Although section 5-103(1)(a) states that a credit may be revocable or irrevocable, it neither gives guidelines for making the determination nor creates a presumption. Therefore, the beneficiary should make certain the letter of credit is clearly irrevocable to obviate the possibility of cancellation after issuance.

TIME OF ESTABLISHMENT AND MODIFICATION OF THE CREDIT

The letter of credit is established as to the customer as soon as
as it is sent to him, or when the letter of credit or an authorized written advice of its issuance is sent to the beneficiary. Once the credit has been established, it can be modified only with the customer's consent. The letter of credit is established for the beneficiary when he receives it or an authorized written advice of its issuance. Since it is possible for the credit to be established as to the customer prior to being established as to the beneficiary, the issuer and customer can agree to modify it without the beneficiary's consent. But once the credit is established as to the beneficiary, it can be modified only with the consent of the beneficiary, the issuer, and the customer.  

**AVAILABILITY OF CREDIT IN PORTIONS AND THE NOTATION CREDIT**

Underlying sales contracts may provide for separate shipments of goods at varying intervals of time. The beneficiary might then utilize the letter of credit in portions by drawing multiple drafts for the price of each separate shipment to be accompanied by documents evidencing the shipment. Section 5–110(1) provides: “unless otherwise specified a credit may be used in portions in the discretion of the beneficiary.”

If a beneficiary fraudulently negotiates drafts, exceeding the face amount of the credit, an obvious problem arises. This problem is handled by section 5–108. The solution depends on whether the credit is or is not a “notation credit.” A notation credit is one which specifies that any person purchasing or paying drafts drawn under the credit must note the amount of the draft on the letter of credit or the advice of credit. It is useful if the beneficiary wants to use the credit in portions, because the beneficiary's bank is more likely to discount drafts drawn under a notation credit. To have a discounted draft honored, the discounting bank must make an appropriate notation on the credit. Therefore, by merely looking for previous notations on the credit, it can be determined with reasonable certainty if the beneficiary has sold drafts elsewhere. When the discounting bank forwards the documents required by the credit, it warrants to the issuer that this notation has been made. Unless the notation credit or a signed statement guaranteeing notation accompanies the draft, the issuer may delay honor until evidence of notation is furnished. The obligations of the issuer and the customer continue only “a reasonable

time not exceeding thirty days."²³ If the credit is not a notation credit and the beneficiary has drawn and discounted drafts exceeding the face amount of the credit, the issuer may honor the drafts "in the order in which they are presented and is discharged pro tanto by honor of any such draft or demand."²⁴ Between good faith purchasers, the first purchaser has priority and is entitled to recover any payment received by the second purchaser from the issuer.²⁵

INDEMNITIES

A bank seeking to obtain payment, acceptance, negotiation, or reimbursement under a credit may give an indemnity agreement to induce action by the issuer.²⁶ For example, if the presenting bank knew a required document had already been forwarded, it might offer to indemnify the issuer against loss resulting from the absence of the document in question. The Code makes it clear that state banks have authority to furnish such indemnities.²⁷

ISSUER'S DUTY AND PRIVILEGE TO HONOR

The hypothetical demonstrated that the issuer must honor drafts whatever the quality of the goods. If the beneficiary forges a required document, the issuer must honor the draft if the presenter is an innocent third party.²⁸ If a defrauding or forging beneficiary deals with the issuer directly, there is no obligation to honor the draft. However, the issuer has the privilege of honoring it, even if the customer gives notification of the alleged forgery. If the issuer chooses to exercise its privilege of honoring, the customer's remedy is to seek an injunction preventing payment.²⁹

²⁷. See Code § 5–113, comment 1. While it has been customary for banks to furnish an indemnity agreement in order to induce honor, negotiation, or reimbursement under a letter of credit, the authority to do so was not express before the Code. Many bank lawyers felt a bank did not have the implied power to furnish such an indemnity. Section 5–113 clears up the question. As far as national banks are concerned, Regulation M of the Board of Governors of the Federal Reserve System authorizes foreign branches of national banks to issue such indemnities. 12 C.F.R. § 213.4(a) (1968). However, it is not clear whether a national bank has such power in a domestic transaction.
Minnesota has adopted two optional subsections provided by the draftsmen of the Code to cover situations where payment must be made by the issuer before it has an opportunity to examine required documents in the possession of one of its agents. Any such payment is conditional. The issuer may reject, within three banking days, such later received documents which fail to conform with the credit. Failure to reject documents within three days functions as acceptance, making payment final. Rejection entitles the issuer to recover from the beneficiary any payment made under the credit.

REMEDIES FOR IMPROPER DISHONOR OR ANTICIPATORY REPUDIATION

If the issuer wrongfully dishonors a draft or demand, the party entitled to payment or acceptance may recover "the face amount of the draft . . . incidental damages . . . and interest but less any amount realized by . . . disposition of the subject matter of the transaction." If the documents or goods have not been sold, they must be turned over to the issuer on payment of the judgment. Any anticipatory repudiation of the credit by the issuer prior to presentment gives the beneficiary "the rights of a seller after anticipatory repudiation by the buyer under Section 2-610 . . . ."

TRANSFER AND ASSIGNMENT OF LETTERS OF CREDIT

The power to assign the right to draw drafts under a credit must be expressly created. However, before performing the conditions of the credit, the beneficiary may always assign his right to the proceeds. Such a transfer is classified as an assignment of a contract right under article 9 of the Code. This allows the beneficiary to induce its bank to open a letter of credit in favor of the beneficiary's supplier. This is known as a "back to back" credit. The assignment of proceeds is effective only when credit or advice of credit is received by the assignee. Such delivery to

32. Code § 5-115(1).
33. Code § 5-115(2).
34. See Code § 5-116(1).
35. See Code § 5-116(2).
the assignee creates a perfected security interest under article 9 and no financing statement is required. The issuer is allowed to accept any drafts drawn under a credit prior to proper notification of the assignment.

CONCLUSION

To meaningfully advise a client, the practitioner must go beyond the text of article 5. Although the Code covers the basic principles applicable to letters of credit, some areas are not included. Furthermore, other statutory and nonstatutory rules affect letters of credit. Many bank letter of credit forms incorporate by reference, Uniform Customs and Practices for Commercial Documentary Credits by the International Chamber of Commerce. The effect of such an incorporation is not certain. Many writers on the subject feel there are no substantial conflicts between the Code and the Uniform Customs. However, it seems advisable to have a working knowledge of both, as well as a familiarity with doctrines of incorporation by reference in commercial contracts.

Article 5 should also be considered in conjunction with article 9. For instance, issuing banks in Minnesota sometimes take a trust receipt or factor's lien on the merchandise being financed. Article 9 will streamline this secured financing and give the issuer some new advantages. Section 9-107(b) gives such an issuer a "purchase money security interest" in the documents, goods, and the proceeds from the sale of the goods. The indemnity agreement signed by the customer constitutes the security agreement.

Sometimes specialized economic advice is also advisable. For example, in international sales transactions consideration should be given to the problem of "currency risk." Currency risk involves the possibilities of currency inconvertibility and fluctuations in exchange rates. Minimization of this problem can be achieved by consulting a bank with expertise in international trade matters.

38. See Code § 9-305.
41. See note 1 supra.
43. See Wiley, supra note 42, at 498.
Because of its flexibility, the letter of credit is an excellent mechanism for financing the purchase and sale of goods. Inclusion of article 5 in the Code should encourage the use of letters of credit in international and domestic trade. Mastery of the intricacies of this form of credit financing should be of value to Minnesota practitioners and their clients.

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COMMENTS