

N J L R C

New Jersey Law Revision Commission

FINAL REPORT

UNIFORM COMMERCIAL CODE

REVISED ARTICLE 5. - LETTERS OF CREDIT

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Introduction

The New Jersey Law Revision Commission (Commission) reviewed Revised Article 5. Letters of Credit pursuant to its statutory mandate to consider recommendations of the National Conference of Commissioners on Uniform State Laws (NCCUSL). The Commission studied the revision, held public hearings and received written submissions from experts in the field. As a result of its study, the Commission recommends that the Legislature enact Revised Article 5. Letters of Credit (with conforming and miscellaneous amendments to Articles 1, 2 and 9) with non-uniform amendments to Sections 5-108(e) and 5-111(e). The Commission also recommends that the Legislature enact conforming amendments to state banking law.

Letters of Credit

The documentary credit, or letter of credit, is a payment device used by distant buyers and sellers of goods in an international trade transaction. The documentary credit solves several considerations surrounding the payment process. On the one hand, the seller may refuse to extend credit to a buyer whose credit standing it does not know. On the other hand, the buyer may want to avoid payment of the goods prior to shipment. The documentary credit solves these payment considerations by interposing a bank that acts as a neutral paymaster between the parties.

In a typical transaction, a bank undertakes to pay the seller the value of the credit provided the seller complies with the documentary conditions specified in the credit. The applicant (buyer), the bank and beneficiary (seller) set the documentary conditions, usually documents evidencing shipment, place of origin, insurance and the like. Normally, after shipment of goods, the seller presents the letter of credit and the required documents to the bank. The bank examines the letter's terms and the documents. If the documents comply with credit's terms, the bank pays the seller the value of the credit. In most cases, the transaction is completed and the expectations of the parties are satisfied.

Letters of credit known as standbys serve a second purpose. Standby letters of credit function as a guarantee of payment in the event of a specified default. These credits often are used in domestic transactions to support an underlying obligation such as the obligation to complete a construction contract. Payment is due when the party entitled to enforce the letter of credit presents the letter and certification of default to the bank. Standby letters of credit are used by public and private entities.

The Revision Process

In August 1995, NCCUSL and the American Law Institute approved Uniform Commercial Code Revised Article 5 -- Letters of Credit (with Conforming and Miscellaneous Amendments to Articles 1, 2 and 9) and forwarded the revised article for enactment by state legislatures. Revised Article 5 replaces the original article drafted 40 years ago, and adopted by the New Jersey legislature in 1961.

The revision is the product of a lengthy process of study and debate. The Chair of the Uniform Commercial Code Committee's Letter of Credit Subcommittee appointed an American Bar Association task force on the study of UCC Article 5 on April 12, 1986.

Four years later, the Task Force published its report entitled An examination of U.C.C. Article 5 reprinted in 45 Bus. Law 1521 (1990). The report analyzed and made recommendations for each section of the original statute. In response, a drafting committee and reporter were appointed to draft a revised Article 5.

The revision was prompted by changes in commercial practice and problems in existing law. Professor James E. Byrne, Chair of the Task Force on the Study of UCC Article 5, explained that “forty years of hard use have revealed weaknesses, gaps, and errors in the original statute which compromise its relevance.”¹ Additionally, case law developed along discordant lines in reaction to developments in letter of credit practices.² Moreover, it was generally agreed that the UCC should conform to the Uniform Customs and Practices for Documentary Credits (UCP). The UCP, which contains internationally recognized standards for letters of credit, governs virtually all commercial letters of credit.

Select List of Benefits of Revised Article 5

Revised Article 5 embodies the freedom of contract principle by allowing the parties to vary most provisions by agreement. The virtue of this approach is its flexibility. As letter of credit practices evolve parties may adjust their agreements to reflect varying allocations of rights and liabilities. There are only eight mandatory provisions. These provisions control basic issues such as scope, good faith and the independence principle.

Revised Article 5 also adopts the “strict compliance” standard for bank examination of documents. This standard clarifies the bank’s duty, since, under existing law, the “substantial compliance” standard was applied by some jurisdictions. Adopting the stricter standard ensures that banks pay only upon a tender of the required documents, thus enforcing the applicant’s conditions of payment. Beneficiaries cannot expect payment by a tender of imperfect documents.

Additionally, the revision tracks UCP international standards. It does so by allowing parties to agree to be governed by the UCP rather than the Article 5 rules. This approach, which conforms domestic to international law, is totally appropriate in the letter of credit context, since commercial letters of credit are almost always international transactions. The UCP, which is published by the International Chamber of Commerce (ICC) in Paris, France, promotes international trade and business. The ICC periodically revises the UCP to reflect current letter of credit trade practices. Permitting parties to incorporate the UCP by agreement appropriately recognizes the importance of international rules in this area.

Moreover, Revised Article 5 restates the “independence principle.” This principle recognizes the independence of the letter of credit from the contract between the applicant and beneficiary, and other contracts surrounding the sale. It thereby protects the letter of

¹ The Task Force on the Study of U.C.C. Article 5, An examination of U.C.C. Article 5 (Letters of Credit) 45 Bus. Law 1521, 1532 (1990).

² The Prefatory Note to the revision states “Measured in terms of these areas which are vital to any system of commercial law, the current combination of statute and case law is found wanting in major respects both as to predictability and certainty.” U.C.C. Revised Article 5. Letters of Credit, Prefatory Note at 1 (1995).

credit from disputes arising between the applicant and beneficiary. Because of the “independence principle,” the bank ignores non-documentary conditions when making its decision to honor the credit.

The Commission’s Study

The Commission’s review extended over several months and drew the attention of letter of credit experts, the Executive Director of NCCUSL and the Chair of the Drafting Committee of Revised Article 5. The review process produced a vigorous and public debate among interested parties concerning several provisions of the revised article.³

While the Commission supported the provisions of Revised Article 5, it developed serious reservations about recommending the enactment of Official Text Sections 5-108(e) and 5-111(e). After considering the arguments and written submissions of experts, the Commission, by letter dated April 2, 1996, informed NCCUSL and the American Law Institute that it would not refer the Official Text statute to the Legislature for enactment because of concerns with Sections 5-108(e) and 5-111(e). The Commission requested NCCUSL to reconsider these provisions, since it was still early in the enactment process.

In response, on April 25, 1996, Frederick Miller, Executive Director of NCCUSL, and Carlyle C. Ring, Jr., Chair of the Revised Article 5 Drafting Committee, appeared before the Commission. Margaret L. Moses, Esq., a letter of credit expert, and representatives from the letter of credit user community also appeared before the Commission. The policy, economic and legal issues related to Sections 5-108(e) and 5-111(e) were extensively debated and explored by the Commission. Subsequently, on May 25, 1996, the Commission voted to recommend that the Legislature adopt Revised Article 5 with non-uniform amendments to Sections 5-108(e) and 5-111(e).

Discussion

Section 5-108(e). Right of Jury Trial

Official Text Section 5-108(e) provides:

An issuer shall observe standard practice of financial institutions that regularly issue letters of credit. Determination of the issuer’s observance of the standard practice is a matter of interpretation for the court.(underline added). The court shall offer the parties a reasonable opportunity to present evidence of the standard practice.

The Commission’s inquiry centered on the meaning of the underlined sentence and particularly on the meaning of the term “issuer’s observance.” Ms. Moses maintained that Section 5-108(e) violated the right of jury trial guaranteed by the Seventh Amendment of

³ Margaret L. Moses, Look Before Leaping to Adopt Revised Article 5, 143 N.J.L.J. 35 (1996) at 11; Sandra Schnitzer Stern, Revised Article 5 Brings Uniformity, Predictability to Letters of Credit 143 N.J.L.J. 779 (1996) at 11; Robert Rosenblith, Esq., NatWest Bank, untitled memorandum (on file with the Commission); and letter dated February 20, 1996 from Carlyle C. Ring Jr., vice-president and General Counsel of Atlantic Research Corporation and Chair of Revised Article 5 Drafting Committee to John J. A. Burke, Associate Counsel, New Jersey Law Revision (on file with the Commission).

the United States Constitution and New Jersey Constitution, art. 1 par. 9. She asserted that the question of whether the issuer observed standard practice was an ordinary fact question for the jury. This question required the jury to evaluate the conduct of the issuer in the letter of credit transaction and to determine whether that conduct met the obligations of standard practice. By assigning this fact question to the court, she argued, Section 5-108(e) was unconstitutional.

N.J. Const. (1947) art. 1, par. 9 provides a right of jury trial in cases where that right existed at common law at the time the state constitution was adopted. State v. Anderson, 127 N.J. 191, 207 (1992). For this analysis, our courts generally refer to the 1947 constitution. The pre-1947 judicial system provided jury trials for cases where a legal remedy was sought. Since a suit to require payment of a letter of credit is legal in nature, a jury trial right has always applied to letter of credit cases. In jury trial cases, matters of law are decided by the court and matters of fact are left to the jury. Consequently, unless the parties waive the jury trial right, the New Jersey Constitution requires that, in letter of credit cases, the jury resolves disputes about ordinary facts.

Having found that juries decide facts, the Commission next considered the question to what degree Section 5-108(e) requires the court to determine them. The language of the section states that the court determines the “issuer’s observance of the standard practice.” Evaluating whether a bank meets a standard practice is clearly a fact question. Hence, the Commission found that whether the issuer complied with standard practices was a fact dispute that required jury determination. Since Section 5-108(e) assigns an ordinary fact question to the court, it abridges the constitutional right of jury trial. N.J. Const. (1947) art. 1, par. 9.

However, Frederick Miller, Executive Director of NCCUSL, informed the Commission that they were misreading Section 5-108(e). According to Mr. Miller, Section 5-108(e) does not assign an ordinary fact dispute concerning the issuer’s conduct to the court. Rather, it assigns to the court only the question of what constitutes a standard practice. If there is a fact dispute of whether the issuer actually complied with standard practices, this fact dispute goes to the jury. Mr. Miller maintained that Section 5-108(e) does not usurp the jury function with respect to ordinary fact questions concerning the issuer’s conduct in a letter of credit transaction. On the basis of Mr. Miller’s presentation, the Commission concluded that it had no substantive disagreement with the intent of the Official Text. Its concern was how to manifest that finding.

Mr. Miller proposed that the ambiguity of Section 5-108(e) could be corrected by an Official Comment. He offered to work with the Commission to prepare appropriate commentary to amend the existing Official Comment to Section 5-108. The proposed amendment then would be presented to the Conference for approval at its 1996 Annual Meeting. Mr. Miller encouraged the Commission not to recommend a non-uniform amendment because he considered this section a central provision of the revision.

The Commission considered two alternatives to resolve this problem of interpretation: (1) clarification by comment or (2) making a non-uniform amendment to the Official Text. The Commission chose to amend the Official Text rather than cure the ambiguity by comment. This decision follows from the Commission view that the Official

Text language can support several reasonable interpretations. The Commission decided that the text of the statute should be clear; that it was preferable not to rely on an explanatory comment since comments are not legislation. The Commission determined that the best way to state the drafter's purpose and minimize confusion about the meaning of Section 5-108(e) was to remove the term "issuer's observance of." This amendment clarifies that the court determines standard practices, and that ordinary facts in dispute are resolved by juries if the case is tried to one.

The Commission rejected the position that the New Jersey Constitution required a jury to resolve disputed fact questions concerning the interpretation of written and non-written standard practices. The Commission found that the Legislature has the authority to require the court to determine standard practices as a matter of law without contravening the jury trial right on ordinary fact questions.

Section 5-111(e). Mandatory Attorney's Fees

Section 5-111(e) provides:

Reasonable attorney's fees and other expenses of litigation must be awarded to the prevailing party in an action in which a remedy is sought under this article.

This section adopts the English rule whereby the losing party pays the costs of litigation of the prevailing party. The Commission was informed that the drafting committee fully debated this issue and adopted the rule in lieu of imposing consequential damages on banks and of broadening the good faith standard. The Official Comment indicates that the rule's purpose is to protect the applicant from undeserved loses under the reimbursement agreement which usually shifts the issuer's litigation costs to the applicant.

In general, New Jersey follows the American rule that each party bears its cost of litigation. While New Jersey has enacted fee shifting statutes, these statutes generally protect parties without substantial economic or political power, or implement broad public policy.⁴ The award of mandatory attorney's fees to the prevailing party in Article 5 litigation does not fall within New Jersey exceptions to the American rule. Since the New Jersey Supreme Court exclusively controls the practice of law, and since the Court permits deviations from the American rule only to achieve public policy objectives, it is likely that the court would disfavor Section 5-111(e).

The rule also may have a chilling effect on the beneficiary's exercise of its right to sue on a letter of credit. A beneficiary obtains a letter of credit for the purpose of having a bank assume the payment obligation and risk of insolvency of the applicant. While the credit is not a guarantee of payment, the beneficiary knows that, if the required documents are tendered, the bank is obligated to honor the letter of credit regardless of any disputes

⁴ E.g., Consumer Fraud Act, N.J.S. 56:8-19 (requiring court to award to prevailing consumer reasonable attorney's fees, costs of suits and filing costs); Law Against Discrimination, N.J.S. 10:5-27.1 (giving court discretion to award to prevailing party reasonable attorney's fees); Residential Tenant's Security Deposit Return, N.J.S. 46:8-21.1 (giving court discretion to award to prevailing tenant reasonable attorney's fees).

arising from the underlying transaction. Section 5-111(e) may penalize a beneficiary in some wrongful dishonor cases.

Under Revised Article 5, the documents must “strictly comply” with the credit’s terms. The “strict compliance” standard requires an almost mirror image of the documents specified in the letter of credit. The strict “compliance standard” reduces the uncertainty of whether a bank should honor the beneficiary’s presentation. But whether the documents “strictly comply” with the documentary conditions in the credit is not a matter of scientific certainty. Cases where reasonable minds can differ are bound to exist.

A beneficiary is likely to sue the issuer when the applicant is insolvent and the issuer is the sole recourse for payment. In order to refuse payment of the credit, a bank may rely on a minor discrepancy that, were the applicant solvent, it would waive to accommodate the applicant. Since a bank may err in examining documents, and since the strict compliance standard is a matter of interpretation, penalizing a beneficiary which brings a good faith wrongful dishonor suit by requiring the beneficiary to pay the bank’s attorney’s fees if the bank prevails is unwarranted. The rule shields banks from liability on the letter of credit. In the case of the insolvent applicant, the application of the rule does not achieve its stated purpose of protecting the applicant. It thwarts the beneficiary’s expectation of payment.

Section 5-111(e) has the salutary goal of discouraging frivolous litigation. However, New Jersey has already enacted a frivolous claims statute to deal with this issue. A beneficiary that uses the legal system improperly to recover payment on a letter of credit is subject to payment of the bank’s attorney’s fees under this frivolous claims statute.⁵ Although the Commission does not oppose a revised section discouraging frivolous claims, such a provision duplicates existing state law.

Proposed Non-Uniform Amendments and Comments

Right of Jury Trial

Section 5-108(e) is recommended in the following form:

An issuer shall observe standard practice of financial institutions that regularly issue letters of credit. Determination [of the issuer’s observance] of the standard practice is a matter of interpretation for the court. The court shall offer the parties a reasonable opportunity to present evidence of the standard practice.

Comment

The second sentence of Section 5-108(e) is a non-uniform amendment of the Official Text recommended by the New Jersey Law Revision Commission (hereafter the Commission). The Official Text states “Determination of the issuer’s observance of the standard practice is a matter of interpretation for the court.” The New Jersey amendment

⁵ N.J.S. 2A:15-59.1.

strikes the phrase “the issuer’s observance of” from the Official Text, leaving the sentence to say “Determination of the standard practice is a matter of interpretation for the court.”

The Commission’s amendment addresses the ambiguity surrounding the meaning of the second sentence of this subsection. The Commission found that the term “issuer’s observance of” supported more than one reasonable interpretation of the court’s duty with regard to the issuer’s conduct. One interpretation was that the second sentence required the court to determine the ordinary fact question of whether the issuer complied with standard practices related to letters of credit. This interpretation is based on reading the term “issuer’s observance of” to mean “issuer’s compliance with” standard practice, a reasonable understanding of the term “observance.”

However, if read this way, Section 5-108(e) might abridge the constitutional right of jury trial. N.J. Const. (1947) art. 1, par. 9 provides a right of jury trial in cases where that right existed at common law at the time the state constitution was adopted. State v. Anderson, 127 N.J. 191, 207 (1992). For this analysis, our courts generally refer to the 1947 constitution. The pre-1947 judicial system provided jury trials for cases where a legal remedy was sought. Since a suit to require payment of a letter of credit is legal in nature, a jury trial right has always applied to letter of credit cases. In jury trial cases, matters of law are decided by the court and matters of fact are left to the jury. Evaluating whether a bank complied with standard practice is clearly an ordinary fact question. Since Section 5-108(e) may be read to take this question from the jury, it is susceptible of being interpreted so as to violate the right of jury trial.

Although the language of the second sentence supports this result, it does not reflect the intended meaning of this subsection. According to the drafters of Revised Article 5, the second sentence of this section is intended only to make certain that the court determines standard practice of financial institutions that regularly issue letters of credit. The second sentence does not mean that the court resolves factual disputes surrounding the conduct of the issuer. The drafter’s maintain that ordinary fact questions related to the issuer’s conduct in a particular transaction is a question for the trier of fact, which, if the case is tried to a jury, is a jury question.

The Commission considered clarifying this subsection by comment, but determined that this method of correction was inappropriate because the statute remains the legitimate statement of the law. The Commission decided that the best way to solve the problem of interpretation was to amend the statute by removing the ambiguous term “issuer’s observance of,” while indicating in comment that no change from the approved reading of the subsection is intended by the amendment. Consequently, as amended, the second sentence states the drafter’s intention in a clear and definite manner. The question of what constitutes standard practice is a question of law for the court. The question of whether the issuer complied with that standard, if in dispute, is a question for ~~the~~ trier of fact.

Attorney’s Fees

Section 5-111(e) is recommended in the following form:

Reasonable attorney's fees and other expenses of litigation [must] may be awarded to the prevailing party in an action in which a remedy is sought under this article.

Comment

This section is a non-uniform amendment to the Official Text recommended by the New Jersey Law Revision Commission. The Official Text uses the word "must" instead of "may" in this section. The New Jersey amendment makes the award of attorney's fees and expenses of litigation discretionary, rather than mandatory, with the court. This amendment is consistent with New Jersey practice disfavoring mandatory transfer of the cost of attorney's fees.

The amendment was motivated by its potential adverse effect on beneficiaries in wrongful dishonor litigation. These cases often involve difficult questions of whether the beneficiary tendered complying documents to the bank when making its presentation for payment. The "strict compliance" standard, while reducing the degree of uncertainty about whether a bank should honor the letter of credit, is not a matter of scientific certainty. Reasonable minds can differ on whether documents "strictly comply" with the letter of credit. No policy reason justifies punishing a beneficiary that loses a wrongful dishonor suit by making that beneficiary pay the bank's attorney's fees.

In general, a plaintiff that brings a reasonable, though ultimately unsuccessful suit, should not be required to pay the attorney's fees of the prevailing party. The transfer of the cost of attorney's fees and litigation is appropriate where, for example, a party brings a suit in bad faith or raises frivolous claims. In multiple issue cases, the court has the discretion to determine the prevailing party.

Recommended Amendments to Local Law

The Commission recommends conforming amendments to two New Jersey banking statutes related to letters of credit. N.J.S. 17:9A-25(3) states that a bank is authorized "To issue letters of credit authorizing holders thereof to draw drafts upon it or upon its correspondents at sight or on time; to guarantee the payment by its customers of amounts due or to become due upon the purchase by such customers of real or personal property." 17:9A-62 places limitations on a bank's liability, the general rule being that "Except as provided in this article, the total liabilities of any person shall not exceed 10% of the capital funds of the bank." This limitation on liability applies to standby letters of credit pursuant to N.J.A.C. 3:11-9.2.

N.J.S. 17:9A-213.1 contains a prohibition against a bank guaranteeing obligations of other persons. It states, "Except as in this act or otherwise by law provided, no bank or savings bank shall have power to guarantee the obligations of others; or to insure or indemnify against the acts, omissions, undertakings, liabilities or losses of others."

Conforming Amendments

17:9A-25 is amended as follows:

(3) To issue letters of credit ~~authorizing holders thereof to draw drafts upon it or upon its correspondents at sight or on time~~; to guarantee the payment by its customers of amounts due or to become due upon the purchase by such customers of real or personal property;

Comment

This amendment conforms this section with U.C.C. Revised Article 5. Letters of Credit (1995) which explicitly recognizes deferred credits. 17:9A-25(3) limits letters of credit to those payable by draft at sight or on time. However, the deferred payment credit does not use a draft and calls for payment on a date that is a fixed period of time after a specified date. “The deferred payment credit differs from the acceptance credit in that it generates no draft and no acceptance.”⁶ Rather, “the issuer signals its obligation by letter, by advice, or by some other nonnegotiable undertaking.”⁷

17:9A-213.1 is amended as follows:

Except as in this act or otherwise by law provided, and except for letters of credit issued pursuant to 12A:5-101 to 12A: 5-116, no bank or savings bank shall have power to guarantee the obligations of others; or to insure or indemnify against the acts, omissions, undertakings, liabilities or losses of others.

Comment

The amendment clarifies that 17:9A-213.1 does not apply to letters of credit. While courts have recognized an exception for letters of credit, it is preferable that the statute make an explicit reference to U.C.C. Revised Article 5. Letters of Credit (1995).

⁶ John Dolan, The Law of Letters of Credit at 1-11 (1991).

⁷ Id.