

July 1959

## Article 5: Letters of Credit

David R. Mason

*Professor of Law, Montana State University School of Law*

Follow this and additional works at: <https://scholarworks.umt.edu/mlr>



Part of the [Law Commons](#)

Let us know how access to this document benefits you.

---

### Recommended Citation

David R. Mason, *Article 5: Letters of Credit*, 21 Mont. L. Rev. 47 (1959).

Available at: <https://scholarworks.umt.edu/mlr/vol21/iss1/5>

This Article is brought to you for free and open access by ScholarWorks at University of Montana. It has been accepted for inclusion in Montana Law Review by an authorized editor of ScholarWorks at University of Montana. For more information, please contact [scholarworks@mso.umt.edu](mailto:scholarworks@mso.umt.edu).

## Article 5: Letters of Credit

By DAVID R. MASON\*

Article 5 of the Uniform Commercial Code is the first attempt at comprehensive codification of an area of the law which has developed for the most part in the last fifty years. Letters of credit originated as a method of financing foreign trade and have been playing a larger role in domestic trade, particularly in the automobile field, since World War II.<sup>1</sup>

In Montana there appears to be no case law on letters of credit, although there is some statutory law. A few provisions have remained in the statutes since their original enactment in 1895.<sup>2</sup> These provisions are drawn on the theory that the promise of the writer of a letter of credit is that he will guarantee the repayment of the money to the person advancing credit;<sup>3</sup> but the issuer of a modern letter of credit is neither a guarantor nor a surety.<sup>4</sup> In addition the Uniform Negotiable Instruments Law, enacted in Montana in 1903, contains provisions for "virtual acceptances." It provides that an unconditional promise in writing to accept a bill of exchange before it is drawn is deemed an actual acceptance in favor of every person who, upon the faith thereof, receives the bill for value.<sup>5</sup> While this gives statutory sanction to a procedure very similar to that involved in letters of credit, yet it would not cover a promise containing conditional stipulations relating to accompanying documents which are found in letters of credit. The only other statutory provision found in Montana is that which authorizes banks organized and existing under the laws of this state to issue letters of credit authorizing drafts at sight or on time not exceeding one year, provided letters of credit issued at any one time to any one person shall not exceed 20 per cent of the capital and surplus of the bank.<sup>6</sup>

The Code recognizes that the law of letters of credit is still developing, and it does not attempt to codify all of the law. Comment 2 to section 5-102 states:

Subsection (3) recognizes that in the present state of the law and variety of practices as to letters of credit, no statute can effectively or wisely codify all the possible law of letters of credit without stultifying further development of this useful financing

\*Professor of Law, Montana State University. Member of the Montana Bar. LL.B. 1924, B.A. 1926, University of South Dakota; S.J.D. 1927, Harvard University.

<sup>1</sup>See FINKELSTEIN, *LEGAL ASPECTS OF COMMERCIAL LETTERS OF CREDIT* (1930); *Recent Extensions in the Use of Commercial Letters of Credit*, 66 *YALE L.J.* 902 (1957).

<sup>2</sup>REVISED CODES OF MONTANA 1947, §§ 30-601 to -609. (Hereinafter REVISED CODES OF MONTANA are cited R.C.M.)

<sup>3</sup>R.C.M. 1947, § 30-601, defines a letter of credit as "a written instrument, addressed by one person to another, requesting the latter to give credit to the person in whose favor it is drawn." These provisions seem to have been taken from California, where it was reasoned as early as 1885 that a letter of credit was a contract of guaranty. *Lafargue v. Harrison*, 70 *Cal.* 380, 59 *Am. Rep.* 416, 9 *Pac.* 259 (1885).

<sup>4</sup>FINKELSTEIN, *supra* note 1, at 32-39; Epps and Chappell, *Assimilation of the Letter of Credit by the Common Law*, 38 *VA. L. REV.* 531 (1952).

<sup>5</sup>R.C.M. 1947, § 55-1104. The adoption of article 3 of the Code would abolish "virtual acceptances." UNIFORM COMMERCIAL CODE § 3-410(1). (Hereinafter UNIFORM COMMERCIAL CODE is cited UCC.)

<sup>6</sup>R.C.M. 1947, § 5-1001.

device. The more important areas not covered by this Article revolve around the question of when documents in fact and in law do or do not comply with the terms of the credit. In addition such minor matters as the absence of expiration dates and the effect of extending shipment but not expiration dates are also left untouched for future adjudication. The rules embodied in the Article can be viewed as those expressing the fundamental theories underlying letters of credit. For this reason the second sentence of subsection (3) makes explicit the court's power to apply a particular rule by analogy to cases not within its terms, or to refrain from doing so. . . .

In defining a letter of credit the Code sets forth the requirement that there be an engagement by a bank or other person made at the request of a customer that the issuer will honor drafts or other demands upon compliance with the conditions specified in the credit. The "engagement" may be by way of a promise to honor or by way of authority to honor, thus including in the definition papers called "authorities to purchase or pay."

A letter of credit may be revocable or irrevocable. If irrevocable it can be modified or revoked only with the consent of the parties. If revocable it may be modified or revoked without notice to or consent of the parties, but the issuer is liable to innocent third parties who have negotiated or honored drafts drawn under the credit before receiving notice of cancellation.<sup>8</sup>

There are two forms covered by the Code, namely, the "documentary" letter of credit and the "clean" letter of credit. The "documentary" letter of credit is very likely to arise out of negotiations for a contract for the sale of goods. A typical case is where a seller is not wholly satisfied with the buyer's credit and is unwilling to ship without assurance of payment, whereas the buyer is unwilling to pay before receiving the goods or is unable to pay without funds derived from their disposition. In such a situation, the buyer asks his bank or other financier to issue a letter of credit. The "issuer" (financier) at the request of the "customer" (buyer) issues a letter of credit engaging to honor drafts or demands of payment of the "beneficiary" (seller), provided they are accompanied by other documents, such as bills of lading, invoices, insurance policies and the like.<sup>9</sup> The Code also contemplates that an "advising bank" may give notification of the issuance of a letter of credit by another bank.<sup>10</sup> A "confirming bank" is a bank which engages that it will honor a credit or that such credit will be honored by the issuer or a third bank.<sup>11</sup> This may arise when the seller is not familiar with the issuing bank and prefers the obligation of a bank of his own choosing.

The obligation of the issuer of a letter of credit is a direct and primary obligation to the seller. The issuer is not concerned with the underlying sales contract. Further, the issuer cannot excuse itself from honoring the draft by the insertion of an additional general term that all documents must be satisfactory to it, although it may require that specified docu-

<sup>7</sup>UCC § 5-103 (1) (a).

<sup>8</sup>UCC § 5-106.

<sup>9</sup>UCC § 5-103 (1) (b).

<sup>10</sup>UCC § 5-103 (1) (e).

<sup>11</sup>UCC § 5-103 (1) (f).

ments be satisfactory to it.<sup>12</sup> It has an obligation to examine documents with good faith and care, but it is not otherwise responsible for the genuineness of the documents.<sup>13</sup>

The advising bank assumes no obligation to honor drafts or demands for payment under the credit. Such a bank is liable if it incorrectly states the terms of the instrument. However, the customer bears as against the issuer all risks of transmission and reasonable translation or interpretation of any message relating to a credit.<sup>14</sup>

A "clean" letter of credit is covered by the 1957 official text of the Code as a result of criticism of the 1952 draft from which it was omitted. Such a letter of credit is one which does not require documents to be presented as one of the conditions of honor. A so-called "traveler's" letter of credit is a "clean" letter of credit. It names the customer as beneficiary and may be obtained to enable the customer or his agent to make purchases in the open market. In order that article 5 apply to such a credit, it is necessary that the paper contain a conspicuous notation that it is a letter of credit.<sup>15</sup>

Unless otherwise specified a credit may be used in portions at the discretion of the beneficiary.<sup>16</sup> Also, a letter of credit may be transferred or assigned if it is expressly designated as transferable or assignable, and the beneficiary may assign his rights to the proceeds even though the credit specifically states that it is nontransferable or nonassignable.<sup>17</sup>

In case the issuer improperly dishonors a draft, the person entitled to honor has against the issuer with respect to any document the rights of a person in the position of a seller. This is also the rule applicable to the rights of a beneficiary where the issuer repudiates the credit before presentation of the draft.<sup>18</sup>

The Code gives priority to the owner or beneficiary of the letter of credit against the assets of the issuer who becomes insolvent before the transaction is completed.<sup>19</sup> A comment explains that this does no wrong to the bank's depositors and other general creditors:

The typical letter of credit transaction facilitates the movement of goods. . . . [The issuer] expects to be put in funds by its customer before it makes disbursements, or to be reimbursed immediately afterwards. And everybody understands that the documents received upon honor of complying drafts are to be turned over to the customer at once when he makes reimbursement or signs trust receipts. Only the bank's commission, if the transaction is completed, will enter the bank's general assets and join the other backing of its deposit liabilities.<sup>20</sup>

The above indicates the principal features of article 5 of the Code. This article is largely a codification of existing case law and practices,

<sup>12</sup>UCC § 5-114(1).

<sup>13</sup>UCC § 5-109.

<sup>14</sup>UCC § 5-107.

<sup>15</sup>UCC § 5-102(1)(c).

<sup>16</sup>UCC § 5-110(1).

<sup>17</sup>UCC § 5-116.

<sup>18</sup>UCC § 5-115.

<sup>19</sup>UCC § 5-117.

<sup>20</sup>UCC § 5-117, comment.

and sets an independent theoretical frame for the further development of letters of credit.<sup>21</sup> If adopted in Montana it would replace the existing inadequate statutory provisions framed on an erroneous theory that a letter of credit is a mere guarantee of money to one advancing credit,<sup>22</sup> and would afford a sound legal basis for the use of this growing financing device.

<sup>21</sup>UCC § 5-101, comment.

<sup>22</sup>It would appear that the adoption of article 5 would not repeal by implication the present prohibitions upon Montana banks authorizing drafts on time exceeding one year, and issuing letters of credit at any one time to any one person for more than 20% of capital and surplus. See note 6 *supra*.