

## **Contracting out of the United Nations Convention on Independent Guarantees and Standby Letters of Credit**

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### **Introduction**

The purpose of this note is to answer two questions under the United Nations Convention on Independent Guarantees and Standby Letters of Credit (the Convention)<sup>1</sup>: Can parties choose an alternate legal regime? And, which articles, if any, can parties vary? The answers to these questions revolve around two central goals. The first relates to the principle of freedom of contract that underlies letter of credit jurisprudence. Letter of credit law is often justified on the grounds that parties are afforded the freedom to agree on the principles that govern a transaction.<sup>2</sup> Both the applicant and beneficiary agree to shift risk in case of a dispute. The intended shift takes advantage of and assures the independence of letters of credit.<sup>3</sup> Based on this principle, it is not surprising to expect contracting parties to be able to opt out of or modify the rules that apply to their agreement.

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<sup>1</sup> United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, U.N. Doc. A/RES/50/48 (Dec. 11, 1995) [hereinafter *The Convention*].

<sup>2</sup> Revised U.C.C. § 1-302 cmt. 1 (1995) (“freedom of contract is a principle of the Uniform Commercial Code”).

<sup>3</sup> See *Amwest Sur. Ins. Co. v. Concord Bank*, 248 F. Supp. 2d 867, 875 (E.D. Mo. 2003) (“The most fundamental principle of modern letter of credit law is that the three contractual relationships giving rise to the letter of credit are completely independent of each other, and the rights and obligations of the parties to one are not affected by the breach or nonperformance of any of the others.”); *Banco Nacional de Mexico, S.A. v. Societe Generale*, 34 A.D.3d 124, 128 (N.Y. App. Div. 2006) (New York Rev. U.C.C. Article 5) (“[t]he ‘letter of credit’ prong of any commercial transaction concerns the documents themselves and is not dependent on the resolution of disputes or questions of fact concerning the underlying transaction.”); *Grunwald v. Wells Fargo Bank, N.A.*, 725 N.W.2d 324, 328 (Iowa Ct. App. 2005) (“Central to the unique purpose of letters of credit is the ‘independence principle,’ which requires the issuer to pay a beneficiary on proper demand regardless of a breach or default on the underlying contract.”); *New Orleans Brass, L.L.C. v. Whitney Nat’l Bank*, 818 So. 2d 1057, 1060 (La. Ct. App. 2002) (“The independence principle states that the underlying contract . . . between the applicant and the beneficiary, will be viewed as distinct from an overarching contract, i.e. the letter of credit, which is between the applicant's bank and the beneficiary.”).

However, the Convention also sets out to achieve a competing goal. The Convention creates a uniform international standard that “bridges” the disparities between different jurisdictions in their treatment of independent guarantees and letters of credit.<sup>4</sup> Jurisdictions have, otherwise, relied on rules of practice or their own domestic law or applied another jurisdiction’s law. Uniformity is at least a primary goal of the Convention.<sup>5</sup> Allowing parties to contract out of specific articles would certainly weaken uniformity.

The working group addressed these two interests and attempted to create a uniform law that struck a balance between them.<sup>6</sup> Although not expressly stated, the Convention has generally succeeded in this regard. The Convention sufficiently permits parties to contract freely, while preserving its uniform nature through non-variable articles. The American Bar Association (ABA) has provided a list of non-variable Convention articles. The list, however, misses a few mandatory Articles of the Convention.<sup>7</sup>

Part I of this note provides a general framework and context for opting out of the Convention and varying its Articles. Two main sources will be used; the first is the Working Group’s notes and the second is the Uniform Commercial Code (hereinafter “U.C.C.”) Revised Article 5 along with other supplemental materials. Part II of this note discusses how parties may opt out of the Convention. Finally, Part III addresses the variability of Articles in the Convention.

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<sup>4</sup> United Nations Commission on International Trade Law [UNCITRAL], *Report of the Working Group on International Contract Practices on the Work of its Twentieth Session*, ¶ 92, U.N. Doc. A/CN.9/388 (Dec. 23, 1993).

<sup>5</sup> *Id.* ¶¶ 91-92 (showing that the Working Group decided that the Convention should be a Convention in order to preserve uniformity).

<sup>6</sup> *Id.* at ¶¶ 91-2 (the drafting committee discussed the importance of creating a uniform that also retains the fundamental nature of Letters of Credit, party autonomy).

<sup>7</sup> A.B.A., *Report to the House of Delegates on the Adoption of the UN Convention in 1998* ANNUAL SURVEY OF LETTER OF CREDIT LAW AND PRACTICE 278 (James E. Byrne, ed., 1998) (hereinafter A.B.A.).

## I. Framework and Context

### A. Framework

The text of the Convention is silent regarding the variability of its articles; therefore a framework for analyzing variability must be outlined. Two main sources, along with traditional Letter of Credit authority, will be used. The first source will be the working group's notes, letters, and discussions (Notes). The Notes offer insight into the delegates' intent, and reasoning. Examining the Notes will be essential to determine the choice of law mechanism in the Convention and which if any of its articles can be varied.

The second source is Uniform Commercial Code Revised Article 5 (Article 5). The United States is the only nation with a systematic legal regime, adopted by its states, that governs letters of credit.<sup>8</sup> Some nations have a regulatory scheme for dealing with letters of credit, but are not as comprehensive as Article 5.<sup>9</sup> Both the Convention and Article 5 were drafted within a short timeframe of one another. Article 5 is cited in the Notes as an authority on numerous issues pertaining to the drafting of the Convention.<sup>10</sup> Furthermore, the ABA has cited the similarity between the two as a reason for why the United States should adopt the Convention.<sup>11</sup> Article 5 also serves as a framework for the ABA's analysis.<sup>12</sup> In line with the ABA's approach this article will use the Notes to understand the intent

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<sup>8</sup> James E. Byrne, *Contracting Out of Revised UCC Article 5 (Letters of Credit)*, 40 LOY. LA. L. REV. 315 (2006).

<sup>9</sup> UNCITRAL, *Stand-By letters of Credit and Guarantees: Report of the Secretary General*, ¶ 46 U.N. Doc. A/CN.9/301 (Mar. 21, 1988).

<sup>10</sup> See, e.g., YEARBOOK OF THE U.N. COMM. ON INT'L. TRADE LAW, 1990, VOL. XXI, 248; UNCITRAL, *supra* note 9, ¶¶ 47-48 (discussing the importance of U.C.C. prior Article 5 as well).

<sup>11</sup> A.B.A., *supra* note 7, at 286 ("Taken as a whole, the UN Convention is not in conflict with [U.S.] domestic law").

<sup>12</sup> *Id.* at 277 ("U.S. domestic law is based upon Article 5 of the Uniform Commercial Code which has been enacted with some variation in all fifty states. This model statute was revised in 1995 and is in the process of adoption with 16 jurisdictions having adopted it as of February 1, 1997. Because of the speed with which the revision is being adopted and the wide-spread support it has justifiably attracted, this report considers the Convention in light of Revised UCC Article 5 which is likely to be in effect by the time that the UN Convention comes into effect.").

and reasoning of the Working Group, along with the juxtaposition of Article 5.

Finally, variability must be defined. Contracting parties can vary an article of the Convention in two ways; an article can be excluded or altered. An article that is substantially altered is considered excluded.<sup>13</sup>

### B. Context

Throughout the Notes, the delegates debated whether the Convention should be drafted as a convention or a model law.<sup>14</sup> The implications of choosing either one are far reaching. A model law, similar to Article 5, can be adopted piece meal. For example, different states have chosen to adopt Article 5 at different times. Furthermore, some states have adopted non-conforming amendments to the official version of Article 5 or omitted complete subsections. The effect of creating a model law is to provide potential adopters maximum flexibility in what exactly they are adopting.

A Convention is quite the opposite; notwithstanding any reservations, it must be adopted as a whole. Although there was disagreement throughout the Notes, the delegates ultimately chose to draft a Convention. The working group reasoned that a model law would weaken uniformity, which is a fundamental goal of this systematic legal regime. The working group further reasoned that parties could exclude themselves from the Convention entirely or vary some of its articles. The aforementioned balancing interests were therefore achieved.<sup>15</sup> It is important to note the unique questions this choice places before individual states within the United States. This result is unique to the United States because of

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<sup>13</sup> See UNCITRAL, Explanatory note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, cmt. 11, U.N. Doc. A/CN.9/431 (July 4, 1996), available at <http://daccess-ods.un.org/TMP/9645256.html> [hereinafter Explanatory Note].

<sup>14</sup> UNCITRAL, *supra* note 4, ¶¶ 91-92.

<sup>15</sup> *Id.* ¶¶ 91-93 (“although less flexible in nature than a model law...a convention regulating international guarantee letters might be incorporated in national legislation through a simplified legislative process”).

federalism, the way commercial law is adopted within the United States and the rights afforded to each individual state.<sup>16</sup>

Finally, different courts may rule differently on the variability of articles of the Convention. A court in one jurisdiction may give effect to altering Article 7(2) of the Convention while another may not. This note attempts to address the practical consequences that parties may face, if they choose to vary a given article of the Convention.

## II. Choice of Law

### A. Choice of Law under Revised U.C.C. Article 5

Article 5 explicitly contains its own choice of law rules.<sup>17</sup> This, at the time, was a relatively novel idea. Prior U.C.C. Article 5 was silent on choice of law and, instead, relied on prior U.C.C. Article 1-105(1). Before widespread adoption of the 1995 revision of Article 5 parties could only choose law that had a reasonable relation to the transaction.<sup>18</sup>

Article 5-116 provides parties complete freedom in choosing any legal regime to apply to their transaction.<sup>19</sup> The requirement that the legal regime have a “reasonable relation” to the transaction has been dropped.<sup>20</sup>

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<sup>16</sup> See generally James White, *Implementing the Standby Letter of Credit Convention with the Law of Wyoming*, 1 Geo. Mason J. Int'l Comm. L. 1 (2010) (discussing potential path to adoption of the Convention for the United States).

<sup>17</sup> U.C.C. § 5-116 (1995) (Choice of Law and Forum).

<sup>18</sup> See prior U.C.C. §1-105(1) (“Except as provided hereafter in this section, when a transaction bears a *reasonable relation* to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties. Failing such an agreement this Act applies to transactions bearing an appropriate relation to this state”) (emphasis added); See e.g., *MSF Holding Ltd. v. Fiduciary Trust Co. Int'l*, 435 F. Supp. 2d 285, 295 (S.D.N.Y. 2006) (choosing New York law as the governing law, which had a reasonable relation to the transaction since the Letter of Credit was issued in New York and the Defendant was physically located in New York); *Trust One Mortgage Corp. v. Invest Am. Mortgage Corp.*, 134 Cal. App.4th 1302, 1308-09 (Cal. Ct. App. 2005) (ruling under California law a choice of law provision is given effect only if the jurisdiction bears a reasonable relationship to the transaction; one of the parties living in the jurisdiction is enough to establish a reasonable relationship).

<sup>19</sup> *Banco Nacional de Mexico, S.A. (BANAMEX) v. Societe Generale*, 34 A.D.3d 124, 130 (N.Y. App. Div. 2006) (New York Rev. Article 5) (stating U.C.C. Revised Article 5-116 no longer requires that the jurisdiction have a reasonable relationship to the transaction. Parties have the freedom to apply any law to their transaction).

Therefore, two contracting parties located in Texas can have the substantive law of North Carolina apply to its transaction.

## **B. Choice of Law under the Convention**

The Convention offers contracting parties similar latitude in choosing a legal regime to apply to their transaction. Articles 1, 21 and 22 of the Convention act as its choice of law mechanism.

### **1. Article 1 (Scope of Application) of the Convention**

Article 1 of the Convention applies to international undertakings “unless the undertaking excludes the application of the Convention.”<sup>21</sup> Therefore, like Article 5-116, contracting parties may choose to have their transaction governed by different law. The instrument or undertaking must explicitly exclude the Convention, and may name a different legal regime. Similar to Article 5-116, Article 1 of the Convention does not require that the governing law have a reasonable relationship to the transaction.<sup>22</sup>

Article 1(3) explicitly removes Articles 21 (Choice of applicable law) and 22 (Determination of applicable law) from its scope. Therefore even if parties choose to apply a legal regime other than the Convention, a court will still use Articles 21 and 22 as the governing choice of law mechanism.<sup>23</sup> The purpose of making Article 1 independent of Articles 21 and 22 is to avoid problems that may arise from *renvoi*. *Renvoi* is a subsection of conflict of law rules that is applied when a forum must apply the law of another jurisdiction.<sup>24</sup> The forum must then decide whether to apply the other jurisdiction’s law as a whole or only the relevant substantive

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<sup>20</sup> *Id.* (“this provision requires applications of . . . substantive letter of credit law when the parties choose it, regardless of any relationship or lack thereof”).

<sup>21</sup> The Convention, *supra* note 1, art. 1(1) (Scope of application).

<sup>22</sup> Explanatory Note, *supra* note 13, cmts. 11, 52-53 (noting the manner in which the Convention might be excluded and other law applied).

<sup>23</sup> *Id.* cmt. 52 (“the Convention contains . . . conflict of law rules to be applied by the courts of Contracting States in order to identify the law applicable to international undertakings as defined in article 2, regardless of whether in any given case the Convention itself would prove to be the applicable law”).

<sup>24</sup> ROBERT A. LEGLAR, AMERICAN CONFLICTS LAW 11-3 (Revised 1968).

portions.<sup>25</sup> Problems arise when a forum looks to another jurisdiction's choice of law rules, which direct the forum to look at its own rules. This back-and-forth reference has been avoided by the Convention by making Articles 21 and 22 applicable to the forum, even if the contracting parties choose to apply a different legal regime under Article 1(1).<sup>26</sup>

There was discussion on the limited practical effects of choosing another legal regime, and therefore the purpose of allowing parties to choose a different legal regime.<sup>27</sup> Some delegates noted how few countries have specific laws on guaranty letters.<sup>28</sup> Therefore, opting out of the Convention, and not choosing another system of law would result in a forum applying either general contract law or may simply apply the Conventions since it would be the only national law.<sup>29</sup> This reasoning, however, is misguided. Most letters of credit are issued by U.S. banks. The U.S. has a systematic legal regime to deal with letters of credit, and each state has adopted Article 5 individually. Arguably, the U.S. alone has fifty different legal regimes (each state is a legal regime). Offering the flexibility to opt out and have the instrument governed by a given state's law may be desirable to the parties.

## 2. Article 21 (Choice of applicable law) of the Convention

Article 21 is straightforward. This article guides the forum as to which law to apply to the transaction. Article 21 makes clear that the forum must apply the law that is specified in the undertaking, or agreed upon elsewhere by the issuer and beneficiary.<sup>30</sup> As previously noted, parties cannot contract out of Articles 21 and 22.

During the drafting process, the working group did not immediately agree on a choice of law provision. There was extensive debate as to the

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<sup>25</sup> *Id.*

<sup>26</sup> *See*, UNCITRAL, *supra* note 4, ¶ 85 (“Inclusion of such rules in the draft Convention would strengthen the reliability and commercial utility of the instruments being covered by recognizing party autonomy in the choice of law and reducing the extent to which disputes would arise as to determination of the applicable law.”).

<sup>27</sup> *Id.* ¶ 105.

<sup>28</sup> *Id.* ¶ 101.

<sup>29</sup> *Id.*

<sup>30</sup> The Convention, *supra* note 1 art. 21 (Choice of applicable law).

practicality of including such a provision. The argument in opposition to including a choice of law provision is twofold. Firstly, if the Convention were drafted as a prototypical convention it would establish a requirement for its own adoption. Secondly, some delegates to the working group argued that a choice of law provision would be useless since conflict of laws questions rarely pose a problem in practice. The working group did eventually agree that a choice of law provision was necessary,<sup>31</sup> and for good reason.<sup>32</sup>

One issue that Article 21 does not address is the degree of formality required by parties to choose another legal regime. The Article's silence on this matter can imply that the Convention seeks to liberally interpret choice of law provisions specified in the undertaking. Therefore, a clause stating that "Chinese national law will apply" may be sufficient as opposed to one stating "This agreement is not subject to the law of [the] Convention, but instead shall be subject to Chinese national law."

More ambiguity exists as to the placement of a valid choice of law clause within an instrument. In other words, where is it acceptable for the issuer and beneficiary to agree on a choice of law, the instrument itself, or some other separate instrument? Article 21(a) gives effect to choice of law provisions "[s]tipulated in the undertaking or demonstrated by the terms and conditions of the undertaking."<sup>33</sup> However, Article 21(b) goes on to give effect to choice of law "[a]greed elsewhere."<sup>34</sup> Therefore, it may be possible that the beneficiary and issuer form a choice of law agreement, outside of the undertaking (which does not mention the choice of law provision). Such a practice could cause confusion in a commercial setting, as it would be unclear from the face of the undertaking that a choice of law agreement exists.

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<sup>31</sup> UNCITRAL, *Report of the Working Group on International Contract Practices on the Work of its Seventeenth Session*, ¶ 139, U.N. Doc. A/CN.9/361 (April 27, 1992).

<sup>32</sup> UNCITRAL, *Report of the Working Group on International Contract Practices on the Work of its Twenty-Second Session*, ¶ 49, U.N. Doc. A/CN.9/405 (November 16, 1994) ("inclusion of such rules in the draft Convention would strengthen reliability and utility of the instrument covered by recognizing party autonomy in the choice of law and by reducing the extent to which disputes would arise in relation to determination of the issue of applicable law. After deliberation, the prevailing view was that the draft Convention should contain provisions on applicable law").

<sup>33</sup> The Convention, *supra* note 1, art. 21(a).

<sup>34</sup> *Id.* art. 21(b).



### III. Varying Articles

The Convention is silent on the issue of variability of its articles. Although silent, the Notes offer insight as to which articles are mandatory and which can be altered or excluded. Article 5 expressly stipulates which of its sections can be varied and can therefore offer insight into the variability of the Convention's articles. The ABA has compiled a list of Convention articles that are mandatory.<sup>35</sup> This list is incomplete and must be supplemented in order to be aligned with international practices regarding independent guarantees and standby letters of credit.

#### A. Variability under Revised Article 5 Section 5-103(c)

Article 5 § 5-103(c) expressly provides which of its provisions are mandatory and deems the rest to be variable. A total of nine provisions of Article 5 are mandatory, Sections: 5-103(a), (c), and (d) (Scope); 5-102(a)(9) and (a)(10) (Definitions); 5-106(d) (Issuance, Amendment, Cancellation, and Duration); 5-114(d) (Assignment of Proceeds); 5-117(d) (Subrogation of Issuer, Applicant, and Nominated Person); and "except to the extent prohibited" in Revised U.C.C. § 1-302.<sup>36</sup>

The main reason for deeming a provision mandatory must be that the provision is essential to the set of rules or body of law. An essential provision, if varied, would alter the fundamental nature of the undertaking. All of the aforementioned non-variable provisions are essential to Revised Article 5.<sup>37</sup> It is important to note that listing Revised Article 5 Section 5-114(d) (Assignment of Proceeds) in Article 5-103(c) does not signify a blanket sanction on its variability.<sup>38</sup> Article 5-114(d) (Assignment of

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<sup>35</sup> A.B.A., *supra* note 7, at 278.

<sup>36</sup> U.C.C. § 5-103(c) (1995) ("With the exception of this subsection, subsections (a) and (d), Sections 5-102(a)(9) and (10), 5-106(d), and 5-114(d), and except to the extent prohibited in Sections 1-102(3) and 5-117(d), the effect of this article may be varied by agreement or by a provision stated or incorporated by reference in an undertaking. A term in an agreement or undertaking generally excusing liability or generally limiting remedies for failure to perform obligations is not sufficient to vary obligations prescribed by this article").

<sup>37</sup> A detailed study of U.C.C. § 5-103(c) is beyond the scope of this note. For a comprehensive study on U.S. Revised U.C.C. Article 5 § 5-103(c), *see generally* James E. Byrne, *supra* note 8, at 316.

<sup>38</sup> *See* James E. Byrne, *supra* note 8, at 340-41

Proceeds) can be varied as long as it does not permit an issuer to unreasonably forbid an assignment of proceeds.<sup>39</sup>

## **B. Which Articles of the Convention can be Varied?**

The text of the Convention provides very little guidance, if any, on the subject of the variability of its Articles. The UNCITRAL commentary states clearly that articles can be varied, and that there is significant flexibility allowing such variability.<sup>40</sup> What remains unclear is which articles are mandatory, which ones can be excluded, and which can be altered.

### **1. An Introduction to Convention Variation**

The working group intended that only non-essential articles be variable.<sup>41</sup> One delegate suggested requiring an express statement of party autonomy, such a statement would allow contracting parties to vary any non-mandatory article.<sup>42</sup> Ultimately, the working group did not include an express statement regarding this issue. The Explanatory Note of the Secretariat provides:

Full freedom is given to the parties to exclude completely the coverage of the Convention (article 1), with the result that another law becomes applicable. Since the Convention, if it is applicable, is to a large extent suppletive rather than mandatory, wide breadth is given to exclude or alter the rules of the Convention in any given case.<sup>43</sup>

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<sup>39</sup> *Id.* at 341 (“The statement in Revised U.C.C. section 5-103 that this provision cannot be varied without any qualification, however, is somewhat of an overstatement . . . In effect, this limitation on variance is only a limitation on its exclusion and unreasonable refusal . . .”).

<sup>40</sup> *See* Explanatory Note, *supra* note 12, cmt. 11 (“Since the Convention, if it is applicable, is to a large extent suppletive rather than mandatory, wide breadth is given to exclude or alter the rules of the Convention in any given case”).

<sup>41</sup> UNCITRAL, Secretariat, *Independent Guarantees and Standby Letters of Credit, Discussion of Some Issues of a Uniform Law*, ¶ 74, U.N. Doc. A/CN.9/WG.II/WP.65 (November 13, 1989) (showing that a delegate suggested disallowing variations that would undermine the essential nature of the Convention).

<sup>42</sup> *Id.* ¶ 73.

It is unclear which articles are considered “mandatory” or essential. An article is “mandatory” if excluding or substantially altering it would undermine the fundamental nature of the undertakings governed by the Convention. To maintain uniformity, states adopting the Convention should adhere to this definition of “mandatory.” A state that adopts the Convention and narrows the definition of “mandatory” would give parties too much autonomy to vary articles, thus potentially altering the fundamental nature of the undertaking. In other words, the Convention would then govern undertakings not independent in nature.

## 2. Variation According to the ABA

The subsequent chart lists the articles deemed as non-variable and “mandatory” by the ABA. Each article will be examined to explain its “mandatory” or non-variable status.

<b>Non-Variable Articles of the Convention</b> <sup>44</sup>
Article 2 (Scope of application)
Article 7(2) (Formality Requirement)
Article 11(2) (Retention of operative instrument)
Article 14 (Standard of conduct and liability of guarantor/issuer)
Article 19 (Exception to payment obligation)
Article 20 (Provisional Court Measures)

### i. **Articles 1 (Scope of application), 21 (Choice of applicable law), and 22 (Determination of applicable law)**

It is unlikely that Convention Article 1 (Scope of application) can be varied. Undertakings governed by the Convention can be excluded, but undertakings not covered cannot be included. The scope of application of the Convention is a legislative statement of scope, and cannot be contracted without legislative action. Any attempt to do so might give rise to a contractual obligation, which cannot be inferred under the Convention. The only way that Article 1 can be varied is by applying another legal regime. Furthermore, Convention Article 1(3) stipulates that Articles 21 (Choice of applicable law) and 22 (Determination of applicable law) apply to an

<sup>43</sup> Explanatory Note, *supra* note 12, cmt. 11.

<sup>44</sup> A.B.A., *supra* note 7, at 278 (listing the non-variable or “mandatory” articles of the Convention).

undertaking governed by the Convention regardless of whether the contracting parties have opted out of the Convention. Therefore, Articles 21 (Choice of applicable law) and 22 (Determination of applicable law) are also essential to the Convention and cannot be excluded.<sup>45</sup>

## ii. Article 7(2) (Issuance, form and irrevocability of undertaking)

Convention Article 7(2) (Issuance, form and irrevocability of undertaking) provides that an undertaking may be issued in any form “which preserves a complete record of the text of the undertaking and provides authentication of its source by generally accepted means or by a procedure agreed upon by the guarantor/issuer and the beneficiary.”<sup>46</sup> This article is straightforward. An undertaking can be issued in any form, including a non-paper-based-medium, as long as the medium keeps a complete record of the undertaking and is properly authenticated.<sup>47</sup>

Article 7(2) takes a liberal approach to formal requirements. The only requirement is that a complete record of the text be preserved. The Convention is forward-thinking in this regard. Although undertakings and presented documents are usually expected to be in paper form, a shift toward electronic issuance and presentation is underway.<sup>48</sup>

Section 5-104 of Article 5 provides the same function as does Article 7(2), but is not listed in the non-variable provision outlined in Article 5 section 5-103.<sup>49</sup> At first blush classifying Article 7(2) and Article 5 section 5-103 as non-variable is essential. Allowing undertakings that do not preserve a complete record and are not properly authenticated would cause problems for the contracting parties. However, it is important to keep in mind that the fundamental purpose of letters of credit is to shift risk between contracting parties through agreement.<sup>50</sup>

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<sup>45</sup> See *supra* Part II.B.1.

<sup>46</sup> The Convention, *supra* note 1, art. 7

<sup>47</sup> See Explanatory Note, *supra* note 12, cmt. 26.

<sup>48</sup> See e.g., *eUCP Supplement to UCP500 for Electronic Presentation*, International Chamber of Commerce [ICC] Publ'n No. 500/3 (2002).

<sup>49</sup> See U.C.C. § 5-103(c) (1995).

<sup>50</sup> See *supra* note 3.

Convention Article 7(2) prohibits the issuance of oral undertakings. Practically, it would be unthinkable for a guarantor/issuer to orally issue an undertaking because the risks associated with such a practice would be astronomical. This practice would benefit neither of the parties to the undertaking. Therefore, practically speaking, it is of little consequence whether parties are permitted to vary this article and allow oral issuance.

### iii. Article 11(2) (Retention of operative instrument)

Convention Article 11(2) (Cessation of right to demand payment) provides that the beneficiary and issuer may agree that the document embodying the undertaking must be returned to the issuer in order to terminate the beneficiary's right to demand payment prior to expiry or another form of termination.<sup>51</sup> However, Article 11(2) confers no rights onto a beneficiary that retains physical possession of the undertaking after the beneficiary's right to demand payment ceases because the undertaking has expired or the amount of the undertaking has already been paid.<sup>52</sup>

In some jurisdictions, physical retention of the undertaking by the beneficiary prolongs the beneficiary's rights to demand payment.<sup>53</sup> In some cases, regardless of whether the undertaking has expired, the beneficiary can still demand payment as long as he retains physical control. The Convention has rendered this practice ineffective by including Article 11(2) and aligning itself with international standard practice. In this light, the ABA correctly labeled Convention Article 11(2) (Cessation of right to demand payment) as mandatory.

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<sup>51</sup> See The Convention, *supra* note 1, art. 11(2).

<sup>52</sup> *Id.*

<sup>53</sup> See generally Explanatory Note, *supra* note 12, cmt. 34 (“A degree of uncertainty still surrounds, in some jurisdictions, the question of the effect of retention of the instrument embodying the undertaking as regards definitive cessation of the right to demand payment. The Convention, in line with what is regarded widely as the best practice, provides that in no case does retention of the instrument prolong the right to demand payment if the amount available has already been paid or if the undertaking has expired (article 11(2)). Apart from those two contexts, the parties remain free to stipulate a requirement of return of the undertaking in order to terminate the right to demand payment.”).

**iv. Article 14(a) (Standard of conduct and liability of guarantor/issuer)**

Convention Article 14 (Standard of conduct and liability of guarantor/issuer) provides that a guarantor/issuer must carry out its obligations with good faith and exercise reasonable care.<sup>54</sup> These standards are to be interpreted with regard to internationally accepted practices.<sup>55</sup> Parties can contract for a lower standard,<sup>56</sup> but the issuer can never be exculpated from liability for failing to act in good faith or exercising reasonable care.<sup>57</sup>

Good faith is not explicitly defined in the Convention or in international practice. However, Article 5 section 5-102(a)(7) defines good faith as “honesty in fact and in the conduct or transaction concerned.”<sup>58</sup> An “honesty in fact” definition of good faith suits the purposes of independent guarantees and standby letters of credit. “Honesty in fact” requires the guarantor/issuer to take facts at face value without further investigation.

A broad definition of good faith is undesirable because the definition should be limited within the context of independent guarantees and standby letters of credit.<sup>59</sup> Such a limitation is warranted in order to preserve the independence principle. For example, in a case where there are allegations of fraud, the guarantor/issuer is not required to investigate the underlying transaction.

Convention Article 14(1) permits contracting parties to define the standard of good faith in accordance with internationally set practice. However, Article 14(2) forbids contracting parties from exculpating the guarantor/issuer from liability for failing to act in good faith and acting with

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<sup>54</sup> See The Convention, *supra* note 1, art. 14(1).

<sup>55</sup> See Explanatory Note, *supra* note 12, cmt. 38.

<sup>56</sup> *Id.*

<sup>57</sup> See Explanatory Note, *supra* note 1, art. 14(2).

<sup>58</sup> U.C.C. § 5-102(a)(7) (1995).

<sup>59</sup> James G. Barnes, *Defining Good Faith Letter of Credit Practices*, 28 LOY. L.A. L. REV. 101, 109 (1994) (arguing that an expansion of the definition of good faith beyond the “honesty in fact” standard would contradict the substantive decision that compliance should be strict instead of reasonable).

gross negligence.<sup>60</sup> In other words, Article 14 sets a minimum standard of conduct rather than *the* standard of conduct. From a public policy standpoint, excluding Article 14(2) would be considered unconscionable. Very few courts would allow contracting parties to release the guarantor/issuer from liability for acting with gross negligence.

The ABA, therefore, was correct in determining that Convention Article 14 cannot be excluded. However, even though Article 14 cannot be excluded, parties can still agree to set the level of standard of conduct. Courts would allow contracting parties to alter the standard of conduct outlined in Article 14.

Reasonable care does not have much bearing on undertakings. It is usually cited out of habit and has no true definition or function. There is no real definition of reasonable care in international practice or in Article 5. For example, the preclusion rule is practiced on the international level, but is at times considered unreasonable.

**v. Article 19 (Exception to payment obligation) and Article 20  
(Provisional court measures)**

The Convention was drafted to “bridge” the differences between different jurisdictions. A “bridge” was most needed in the area referred to by common law countries as the fraud exception to the independence principle. The treatment of fraud is unique in this regard because of the disparity in its treatment between jurisdictions.<sup>61</sup> Convention Article 19 (Exception to payment obligation) was drafted to deal with the issues arising out of this disparity by offering a uniform treatment of fraud.

Article 19 provides the issuer with an exception to its obligation to honor a beneficiary’s presentation.<sup>62</sup> Although the words “fraud” and “abuse” are not used, there is a clear standard regarding the exception to

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<sup>60</sup> The Convention, *supra* note 1, art. 14.

<sup>61</sup> See JAMES E. BYRNE, HAWKLAND UNIFORM COMMERCIAL CODE SERIES, VOLUME 6B, [REV.] ARTICLE 5 LETTERS OF CREDIT, 5-109:7 (West Group Pub. 2008) (Discussing that what common law countries call “fraud” is referred to as an “abusive drawing” in civil code countries. Abusive drawings are very closely dependent on notions of good faith.). An example of an abusive drawing would be where a beneficiary coerces the applicant into default and then draws on the letter of credit.

<sup>62</sup> See The Convention, *supra* note 1, art. 19.

payment obligation. The standard is compatible with Article 5 section 5-109 and would perpetuate the high standard of showing<sup>63</sup> required to prove letter of credit fraud set by cases such as *Sztejn v. J. Henry Schroder Banking Corporation*.<sup>64</sup>

The ABA deemed Articles 19 (Exception to payment obligation) and 20 (Provisional court measure) to be non-variable, even though Article 5 section 5-109 is variable.<sup>65</sup> Varying Convention Articles 19 and 20 has the potential of expanding or narrowing the exception to the independence principle. Awarding injunctive relief too liberally would undermine the independence principle. It would disturb the aforementioned agreement to shift the risk between the applicant and the beneficiary, thereby undermining letter of credit practice as a whole. The beneficiary would feel less and less secure with using letters of credit if injunctions could be easily obtained. On the other hand, if it is too difficult for an applicant to receive injunctive relief based on a claim of fraud or forgery, concerns regarding equity would arise. This would again undermine letter of credit practice.

Since such a delicate balance is required, the ABA is correct in deeming Articles 19 (Exception to payment obligation) and 20 (Provisional court measure) as mandatory. These two Articles should not be permitted to be excluded or substantially altered.

A court has three options if the contracting parties decided to vary the Convention Articles 19 (Exception to payment obligation) and 20 (Provisional court measure). The first would be to simply refuse to enforce it as contrary to public policy and letter of credit law.<sup>66</sup> The second would be to revert to reasoning outlined in *Sztejn*.<sup>67</sup> Therefore, as a practical matter varying Articles 19 (Exception to payment obligation) and 20 (Provisional court measure) would have little to no affect on letter of credit standard

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<sup>63</sup> UNCITRAL, Report of the Working Group on International Contract Practices on the Work of its Twenty-Third Session, ¶ 120, UN Doc. A/CN.9/408 (Feb. 15 1995).

<sup>64</sup> 31 N.Y.S.2d 631 (N.Y. Sup. Ct. 1941).

<sup>65</sup> See U.C.C. § 5-103(c) (1995) (U.C.C. § 5-109 is not included in the list of non-variable sections in §5-103(c). Therefore, the drafters of U.C.C. Revised Article 5 intended that § 5-109 be variable).

<sup>66</sup> James E. Byrne, *supra* note 8, at 360.

<sup>67</sup> *Id.* (citing *Sztejn v. J. Henry Schroder Banking Corp.*, 31 N.Y.S.2d 631 (Sup. Ct. 1941)).



practice. Finally, a court may simply treat the undertaking as a traditional contract instead of an independent undertaking.<sup>68</sup>

Although Articles 19 (Exception to payment obligation) and 20 (Provisional court measure) are mandatory and cannot be substantially altered, courts should and will likely permit some alteration. For example, Convention Article 19 (Exception to payment obligation) does not provide a list of protected parties. Contracting parties may wish to align themselves with Article 5 section 5-109, which does have a list of protected parties, and protects a confirmer who has honored in good faith. Furthermore, contracting parties may alter Article 19 (Exception to payment obligation) and agree on a different form of relief, such as arbitration, where there is letter of credit fraud. Finally, contracting parties should be allowed to agree that minute lies are permissible and do not constitute letter of credit fraud. Therefore, while Articles 19 (Exception to payment obligation) and 20 (Provisional court measure) may not be excluded, they can be altered.

### 3. What is missing?

The ABA's understanding of the variability of articles in the Convention is incomplete. If their list of non-variable articles is endorsed, parties will be permitted to vary articles that are essential to the Convention.

<b>Essential Articles Not Included in ABA's List of Non-Variable Articles</b>
Article 1 (Scope)
Article 3 (Independence of undertaking)
Article 6(b) (Definitions)
Article 2 (Undertaking)
Article 12(c) (Expiry)
Article 14(a) (Good faith and Reasonableness)

#### i. Article 3 (Independence of undertaking)

Convention Article 3 (Independence of undertaking) outlines the independence principle as it applies to independent guarantees and standby letters of credit. Convention Article 3 is mandatory and cannot be excluded or altered. The independence principle is the fundamental characteristic of

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<sup>68</sup> *Id.* at 360-61.

guarantees and standby letters of credit altering it would render the undertaking a contract.

### **ii. Article 12(c) (Expiry)**

Convention Article 12(c) (Expiry) provides that if an undertaking does not stipulate an expiration date and holds itself to be perpetual, the undertaking will expire six years after it is issued.

Contracting parties would have to exclude Convention Article 12(c) (Expiry) in order to agree that their undertaking is perpetual. Different courts may rule differently on this matter. However, courts should maintain a commercially sound rule and not give effect to such a variation. Independent undertakings are inherently finite and courts should align themselves with this notion.<sup>69</sup>

### **iii. Worthy of Note: Article 10 (Assignment of Proceeds), Definitions, and obligations.**

Although it's parallel provision in Article 5 is designated as non-variable in Article 5 section 5-103(c),<sup>70</sup> Convention Article 10 (Assignment of Proceeds) needs to be variable.<sup>71</sup> Despite its designation as non-variable, assignment of proceeds can actually be altered under Article 5<sup>72</sup> and should be permitted in the Convention.

The definition of an undertaking in Convention Article 2 (Undertaking) and the definitions in Article 6 (Definitions) do not have to be mandatory. Contracting parties can alter these definitions and still have their undertaking appropriately governed by the Convention. Finally, the obligations of the guarantor/issuer can also be altered by agreement. These practices are in accordance with internationally accepted rules and laws.

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<sup>69</sup> Explanatory Note, *supra* note 12, cmt. 35.

<sup>70</sup> U.C.C. § 5-103(c) (1995) (stating that §5-114(d) concerning assignment of proceeds cannot be varied).

<sup>71</sup> *See supra* Part III.A.

<sup>72</sup> James E. Byrne, *supra* note 8, at 340-41 (“[I]n effect, this limitation on variance is only a limitation on its exclusion and unreasonable refusal ...”).

### **Conclusion**

The Convention provides a clear mechanism for contracting parties to opt out of the Convention and choose some other legal regime to govern their agreement. Convention Articles 1 (Scope of application), 21 (Choice of applicable law), and 22 (Determination of applicable law) give contracting parties a great deal of latitude in choosing opting out of the Convention. However, if any litigation does occur Article 1(3) applies, even if another legal regime governs the undertaking.

The variability of Articles under the Convention is slightly more complex. The text and Notes are generally silent on which Articles are mandatory and essential to the Convention. The ABA has provided a list of Convention Articles that it deems to be non-variable. This list is incomplete. A more functional approach to the variability of articles would be to mimic Article 4 section 5-103(c) where appropriate. Such an approach entails making Convention Article 3 (Independence of undertaking) and Article 12(c) (Expiry) mandatory, without the possibility of alteration. Assignment of proceeds, and the definitions need not be mandatory under the Convention and can be altered or excluded.