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Article 5 - Recent Developments

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Article 5- Recent Developments

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ARTICLE 5 - RECENT DEVELOPMENTS

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I. Mitigation in Letter of Credit Transactions

Assume a Buyer has procured a letter of credit to pay for contracted goods but no longer wants the goods. The Buyer and the Issuer would like to force the Beneficiary to mitigate. Assume that both the Issuer and Applicant repudiate their obligation or that the Applicant has failed and the Issuer repudiates its obligation to pay under the letter of credit. At the moment of repudiation the price for a gallon of the underlying oil that is the subject of the letter of credit is \$.75 and that the letter of credit provides for payment at \$1.00 per gallon. Seller off loads the oil, presents the proper documents and the documents are dishonored when the oil is worth \$.75. The oil continues to decline in value to \$.40 and the Beneficiary sues the Issuer and asks for the full amount of its draw. (Assume that to be \$1 per gallon times 1 million gallons or a \$1 million claim.) Can the Issuer reduce the Beneficiary's claim by the amount that could have been saved by the Beneficiary's mitigation--namely the difference between \$.75 per gallon (the value of the oil at the time of repudiation) and \$.40 per gallon (the value of the oil at the time of buyer's later disposition)?

The answer is no. One sentence in Section 5-111(a) reads as follows: "The claimant is not obligated to take action to avoid damages that might be due from the issuer under this section." That sentence is further elaborated by the following language from Comment 1 to 5-111.

"The right to specific performance is new. The express limitation on the duty of the beneficiary to mitigate damages adopts the position of certain courts and commentators. Because the letter of credit depends upon speed and certainty of payment, it is important that the issuer not be given an incentive to dishonor. The issuer might have an incentive to dishonor if it could rely on the burden of mitigation falling on the beneficiary (to sell goods and sue only for the difference between the price of the goods sold and the amount due under the letter of credit). Under the scheme contemplated by Section 5-111(a), the beneficiary would present the documents to the issuer. If the issuer wrongfully dishonored, the beneficiary would have no further duty to the issuer with respect to the goods covered by documents that the issuer dishonored and returned. The issuer thus takes the risk that the beneficiary will let the goods rot or be destroyed. Of course the beneficiary may have a duty of mitigation to the

applicant arising from the underlying agreement, but the issuer would not have the right to assert that duty by way of defense or setoff. See Section 5-117(d). If the beneficiary sells the goods covered by dishonored documents or if the beneficiary sells a draft after acceptance but before dishonor by the issuer, the net amount so gained should be subtracted from the amount of the beneficiary's damages--at least where the damage claim against the issuer equals or exceeds the damage suffered by the beneficiary. If, on the other hand, the beneficiary suffers damages in an underlying transaction in an amount that exceeds the amount of the wrongfully dishonored demand (e.g., where the letter of credit does not cover 100 percent of the underlying obligation), the damages avoided should not necessarily be deducted from the beneficiary's claim against the issuer. In such a case, the damages would be the lesser of (i) the amount recoverable in the absence of mitigation (that is, the amount that is subject to the dishonor or repudiation plus any incidental damages) and (ii) the damages remaining after deduction for the amount of damages actually avoided."

The burden of mitigation is on the Applicant or if the Applicant has failed, on the Issuer. By procuring a letter of credit the Seller has purchased the right not to mitigate, at least vis a vis the Issuer.

For a different, but similar case, consider *Clark Oil Trading Co. v. J. Aron & Co.*, 32 UCC2d 699 (N.Y.Ct. 1997). There was a letter of credit for slightly more than \$8 million. The contract price was .9770 per gallon of heating oil that Aron was obliged to deliver to Clark. As often happens, there were some difficulties with delivery which were seized upon by Clark to avoid a bad bargain. Shortly before the time of delivery Clark repudiated the contract. It justified its repudiation on the ground that the Seller-Beneficiary had itself broken the contract. The Seller proceeded with performance, delivering the oil to an oil storage facility in Bayonne, N.J., presented documents and collected more than \$8 million from Bank Paribas, the Issuer. Clark then sued Aron and claimed that Aron had had a duty to mitigate on Clark's repudiation. The court agrees with that proposition, but concludes that Aron's failure to mitigate was an insubstantial breach following the substantial breach of Clark and leaves Clark with essentially the entire loss. In the interim, Clark had resold the oil for a little under \$5 million.

Because Bank Paribas honored the letter of credit, this case does not deal with 5-111. However, it presents an interesting question whether the policy of 5-111 (against requiring the beneficiary to mitigate) should be extended to the beneficiary's underlying obligation under Article 2 of the UCC. Put another way, by bargaining for a letter of credit had the parties implicitly agreed that the seller was free to continue

performance even after repudiation by the buyer at least if that performance was necessary to procure payment? That is not a crazy conclusion, but it is not required by 5-111. Although that is the practical outcome of the Clark case, it is in conflict with the language and legal analysis of that case. What do you think?

II. Fraud and Injunction Under Revised 5-109

Assume that a letter of credit requires a certification by an official of the government of Bangladesh that the goods originated in Bangladesh. Assume further that the beneficiary's advising bank presents documents, one of which is later conceded to be a counterfeit certification for goods that were made in Pakistan.

Under old Article 5 and under Revised 5-109, the beneficiary's act would constitute material fraud and render the documents either "forged" or "materially fraudulent". If the other conditions under 5-109 are met, honor should be enjoined and, if the issuer chose to do so, it would have a right to decline to honor.

What if the advising bank claims to be a holder in due course? The persons entitled to demand payment under 5-109 are quite narrowly specified in 5-109(a)(1) as follows:

(a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:

(1) the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person[.]

In this case the person demanding payment may have been a "nominated person," but if it was merely a holder in due course

of the drafts and not a nominated person, that would be insufficient to entitle it to payment. Under Revised 5-102, a nominated person is "a person whom the issuer (i) designates or authorizes to pay, accept, negotiate, or otherwise give value under a letter of credit and (ii) undertakes by agreement or custom and practice to reimburse." Thus, if this were a "freely negotiable" letter, so that every bank in the world was a potential "nominated person", the bank would qualify as a nominated person who had given value in good faith. Being merely a holder in due course would not be enough.

Apply these rules to a recent New York case, *Regent Corp. U.S.A. v. Azmat Bangladesh Ltd.*, 32 UCC2d 900 (N.Y. Cty. 1997). Azmat presented a fraudulent document that purported to be the certification of an official government representative of Bangladesh, but was a forgery. Apparently the goods had come from Pakistan, not from Bangladesh. The fraud was discovered in the middle of a series of transactions where some letters had been honored by Citibank's and Bank of New York's acceptance and others had not been honored. Honor was enjoined. The court found that the advising bank, IFIC, was not a holder in due course because the documents were not payable at a time certain. The time payable was tied to the date on the bill of lading. The court did allow IFIC to state a separate cause of action against the banks for a claim on the drafts that had been accepted.

Note how the new Code would deal with this case. First IFIC would have to qualify as a nominated person who has given value in good faith and without notice of forgery or material fraud. If it was not a nominated person, or if it knew of the forged document, it could not qualify. The new Code does not recognize holders in due course as special persons unless they have taken drafts "after acceptance by the issuer or nominated person." IFIC might be able to recover on the accepted drafts. Of course, on those too, there would be a question of its knowledge of and connivance with the beneficiary. (The claim was made that the fraud was done at the insistence or at least with the cooperation of IFIC to the end that the beneficiary's indebtedness to IFIC could be paid off.)

III. Bank's Duty to Give Notice Upon Dishonor

Assume that beneficiary presents documents that have two minor defects. The defects are that the bill of lading identifies New York instead of New Jersey as the shipment's origination, and omits the contact person's FAX number. The bank, regarding these as "minor" errors, asked for and got a waiver from its applicant. Notwithstanding the waiver, the bank refused to pay. However, the bank failed to notify the beneficiary within seven days of presentment that it was

dishonoring. The issuer had been discussing the deviations with the applicant, and in the communications with the beneficiary during the seven-day period, the issuer gave indications that it would ultimately pay.

Upon issuer's dishonor, what liability under Revised 5-108? The bank argued that there was no proximate cause between its refusal to pay or to give notice and the loss because the discrepancies could not have been cured by the beneficiary. Furthermore, it argued that the beneficiary knew of the discrepancies and that that knowledge barred its recovery.

Under the terms of Revised 5-108 and of UCP 500, the issuer has a reasonable time, but not beyond seven days (seven business days under the UCC and seven banking days under the UCP) to give notice of discrepancy. Under Revised 5-108(c) the bank is foreclosed from defending its dishonor by showing discrepancies if it fails to give that notice:

(c) Except as otherwise provided in subsection (d), an issuer is precluded from asserting as a basis for dishonor any discrepancy if timely notice is not given, or any discrepancy not stated in the notice if timely notice is given.

In the case posed, Revised 5-108 would foreclose the bank from proving discrepancies upon its failure to honor. It would lose a suit for wrongful dishonor; it would be no defense that the beneficiary knew or suspected there were discrepancies. Nor would it be any defense that any discrepancies could not be cured.

This outcome under 5-108 is consistent with the most recent conclusion in a long-running case entitled: *Bombay Indus. Inc. v. Bank of New York*, 32 UCC2d 1155 (N.Y. Cty. 1997). In the earlier version of that case the lower court held that once the issuer had sought and received a waiver, it would have to follow that waiver. That decision was reversed on appeal, but the bank still loses because the court now finds that the bank did not give notice within the seven-day period under the UCP. It further finds that knowledge on the part of the beneficiary of the discrepancies or the inability of the beneficiary to cure is not relevant.

Where a letter of credit requires presentation "no later than 15 days after shipment, but within validity of the credit" and where a presentation is made on the 14th day, at least one court holds that the rules in the UCP do not enlarge the time (beyond the 15 days) for a cure. See *Banco General Ruinahui, S.A. v. Citibank International*, 30 UCC2d 1163 (1996). (I would not be embarrassed to argue for a contrary interpretation of the UCP and section 5-108 of the UCC.)

IV. Fraud and the Bank's Duty to Its Customer on Clean Letters of Credit.

Bank issues a "clean" letter of credit at the request of its Applicant. (A clean letter of credit requires the presentation of only a draft and no other document; for obvious reasons, it is sometimes called a "suicide" letter of credit.) The beneficiary presents a draft and the applicant seeks an injunction because he claims that there is fraud and that the presentation under 5-109 "would facilitate a material fraud by the beneficiary on the issuer" (i.e., that the beneficiary knows that he has not earned the right under the underlying contract and is intentionally presenting the draft as an attempt to defraud the applicant).

One response to the argument is that no draft could ever be materially fraudulent or facilitate a material fraud because, by hypothesis, the applicant has agreed to commit suicide, i.e., he has by his very act given authority to someone to draw on his bank account without any representation at all. The Comments to Revised 5-109 take the position that the beneficiary can commit fraud in presenting a draft under a clean letter, but that the court should be "skeptical" of such claims:

Whether a beneficiary can commit fraud by presenting a draft under a clean letter of credit (one calling only for a draft and no other documents) has been much debated. Under the current formulation it would be possible but difficult for there to be fraud in such a presentation. If the applicant were able to show that the beneficiary were committing material fraud on the applicant in the underlying transaction, then payment would facilitate a material fraud by the beneficiary on the applicant and honor could be enjoined. The courts should be skeptical of claims of fraud by one who has signed a "suicide" or clean credit and thus granted a beneficiary the right to draw by mere presentation of a draft.

For a case in which the bank paid on a clean letter of credit and was then sued by its applicant for its failure to educate its applicant about the risks of clean letters, see *McCormack v. Citibank*, 30 UCC2d 1175 (8th Cir. 1996). The court rules as a matter of law that the issuer did not owe a fiduciary duty to its customer to spell out the ramifications of a clean letter. The customer needs to keep its own eyes open.

V. Multiple Transactions and Waivers.

Assume that beneficiary and account party have multiple transactions and on a number of occasions beneficiary presents

similar documents and the bank always honors. Unbeknownst to the beneficiary, honor occurs not because its presentation strictly complies, but because the applicant waives. On the final transaction, the applicant refuses to waive, or the issuer fails to ask for a waiver. Is there a duty to pay? The answer is no. The comments to Revised 5-108 indorse the position in the leading case from the Fourth Circuit, Courtaulds:

The issuer's obligation to dishonor when there is no apparent compliance with the letter of credit runs only to the applicant. No other party to the transaction can complain if the applicant waives compliance with terms or conditions of the letter of credit or agrees to a less stringent standard for compliance than that supplied by this article. Except as otherwise agreed with the applicant, an issuer may dishonor a noncomplying presentation despite an applicant's waiver.

Waiver of discrepancies by an issuer or an applicant in one or more presentations does not waive similar discrepancies in a future presentation. Neither the issuer nor the beneficiary can reasonably rely upon honor over past waivers as a basis for concluding that a future defective presentation will justify honor. The reasoning of Courtaulds of North America Inc. v. North Carolina National Bank, 528 F.2d 802 (4th Cir. 1975) is accepted and that expressed in Schweibish v. Pontchartrain State Bank, 389 So.2d 731 (La.App. 1980) and Titanium Metals Corp. v. Space Metals, Inc., 529 P.2d 431 (Utah 1974) is rejected.

Accord, Bangkok Vest Manufacturing Co. Ltd. v. Park Avenue Bank, N.A. Inc., 31 UCC2d 1098 (N.Y. Cty. 1997).