Buffalo Law Review

Volume 15 | Number 3 Article 13

4-1-1966

Commercial Law—Uniform Commercial Code—Bank May Cancel Letter of Credit Without Verifying Accuracy of Customer's Affidavit

Charles E. Milch

RECENT CASES

COMMERCIAL LAW—UNIFORM COMMERCIAL CODE—BANK MAY CANCEL LETTER OF CREDIT WITHOUT VERIFYING ACCURACY OF CUSTOMER'S AFFIDAVIT

At the request of a corporation, defendant bank issued an irrevocable letter of credit in favor of plaintiff contractor making scheduled sums of money available over an eleven month period subject to certain terms and conditions. The letter of credit provided that the bank could cancel any drawing scheduled to be available thereunder if more than ten days before the availability date it received from an officer of the corporation "an affidavit to the effect that one or more of the events described in" a stated clause of plaintiff's construction contract "has occurred." Although, undisputedly, none of the described events had in fact occurred and plaintiff was in no way in default on the construction contract, the corporation sent to defendant bank an affidavit stating that "one or more of the events described . . . have occurred," and defendant bank notified plaintiff contractor that the drawing of the final payment under the letter of credit, otherwise available, was cancelled. The condition expressed in the letter of credit, unlike the construction contract, was not the *occurrence* of any of the described events, but the mere receipt of an *affidavit* that such events had occurred. Plaintiff brought an action arising from defendant's failure to make the final payment under the letter of credit. Defendant appealed from an order of the Supreme Court at Special Term denying its cross motion for summary judgment. *Held,* defendant's cross motion for summary judgment granted; the bank had no legal duty to verify the accuracy of the customer's affidavit. *Fair Pavilions, Inc. v. First Nat'l City Bank,* 24 A.D.2d 109, 264 N.Y.S.2d 255 (1st Dep't 1965).

Under the Uniform Commercial Code, a letter of credit is an engagement by a bank or other person made at the request of a customer (the buyer) that the issuer (the bank) will honor drafts or other demands for payment made by a specified beneficiary (the seller) upon compliance with the conditions specified in the letter of credit itself.[1] Letters of credit have developed principally as aids to commerce by providing a practical method of financing in the common situation where a buyer in one locality desires to purchase goods from a seller in another, and each party desires to protect himself as fully as possible.[2] In the typical transaction, a bank that issues a letter of credit undertakes that it will pay any draft drawn and negotiated pursuant to its terms. Thus, the bank merely sells its credit.[3] In this respect, it somewhat resembles a contract of

1. N.Y. U.C.C. § 5-103(1)(a) (definition of letter of credit).
2. See Shirai v. Blum, 239 N.Y. 172, 146 N.E. 194, 38 A.L.R. 603 (1924); Kingdom of Sweden v. New York Trust Co., 197 Misc. 431, 96 N.Y.S.2d 779 (Sup. Ct. 1949).
3. Courteen Seed Co. v. Hong Kong & Shanghai Banking Corp., 245 N.Y. 377, 157 N.E. 272, 56 A.L.R. 1186 (1927).

guaranty.[4] While the letter itself does not possess the necessary attributes of a negotiable instrument,[5] it is similar to a negotiable instrument,[6] because bona fide purchasers of such drafts will not be subject to equities and defenses that may be available in an action on the contract out of which the letter of credit arose.[7] By cancelling a letter of credit before the date of expiration, the issuing bank commits an anticipatory breach of contract, and becomes liable for damages caused the beneficiary by reason of the breach.[8] The beneficiary has an immediate right of action for wrongful dishonor.[9] The damages recoverable by the beneficiary are primarily the face amount of the draft, together with incidental damages and interest.[10]

There are three separate and distinct contracts involved in a letter of credit transaction—the contract of the bank with its customer whereby it agrees to issue the letter of credit, the letter of credit itself, and the contract of sale between the customer of the bank (the buyer) and the beneficiary (the seller). Except insofar as its terms and conditions are expressly incorporated therein, and then only to the extent of receipt of documents required by the terms of the letter itself, the letter of credit is separate and distinct from the contract of sale between the buyer and seller.[11] The letter of credit constitutes the sole contract of the issuing bank with the beneficiary.[12] But the bank has an obligation to examine those documents specified in the letter of credit[13] to

4. See Evansville Nat'l Bank v. Kaufmann, 93 N.Y. 273, 45 Am. Rep. 204 (1883) (a letter to a named addressee engaging that any drafts drawn upon a third person were guaranteed to be paid at maturity by the writer was described as a letter of credit, although the case was decided under principles relating solely to contracts of guaranty).

5. Birckhead v. Brown, 5 Hill (N.Y.) 634 (Sup. Ct. 1843).

6. Second Nat'l Bank v. M. Samuel & Sons, Inc., 12 F.2d 963 (2d Cir.), *cert. denied*, 273 U.S. 720 (1926).

7. Merchants' Bank v. Griswold, 72 N.Y. 472, 28 Am. Rep. 159 (1878); Courteen Seed Co. v. Hong Kong & Shanghai Banking Corp., 245 N.Y. 377, 157 N.E. 272, 56 A.L.R. 1186 (1927).

8. Ernesto Foglino & Co. v. Webster, 217 App. Div. 282, 216 N.Y. Supp. 225 (1st Dep't), *modified on other grounds*, 244 N.Y. 516, 155 N.E. 878 (1926).

9. N.Y. U.C.C. § 5-115(2) provides that "when an issuer wrongfully cancels or otherwise repudiates a credit before presentment of a draft or demand for payment drawn under it the beneficiary has the rights of a seller after anticipatory repudiation by the buyer under § 2-610 if he learns of the repudiation in time reasonably to avoid procurement of the required documents. Otherwise the beneficiary has an immediate right of action for wrongful dishonor."

10. N.Y. U.C.C. § 5-115(1) provides that "when an issuer wrongfully dishonors a draft or demand for payment presented under a credit the person entitled to honor has with respect to any documents the rights of a person in the position of a seller . . . and may recover from the issuer the face amount of the draft or demand together with incidental damages under Section 2-710 on seller's incidental damages and interest but less any amount realized by resale or other use or disposition of the subject matter of the transaction. . . ."

11. Maurice O'Meara Co. v. National Park Bank, 239 N.Y. 386, 146 N.E. 636 (1925); Ernesto Foglino & Co. v. Webster, 217 App. Div. 282, 216 N.Y. Supp. 225 (1st Dep't), *modified on other grounds*, 244 N.Y. 516, 155 N.E. 878 (1926); Frey & Son, Inc. v. Sherburne Co., 193 App. Div. 849, 184 N.Y. Supp. 661 (1st Dep't 1920); Kingdom of Sweden v. New York Trust Co., 197 Misc. 431, 96 N.Y.S.2d 779 (Sup. Ct. 1949); Brown v. C. Rosenstein Co., 120 Misc. 787, 200 N.Y. Supp. 491 (Sup. Ct. 1923).

12. Lamborn v. Lake Shore Banking & Trust Co., 196 App. Div. 504, 188 N.Y. Supp. 162 (1st Dep't), *aff'd*, 231 N.Y. 616, 132 N.E. 911 (1921).

13. Camp v. Corn Exch. Nat'l Bank, 285 Pa. 337, 132 Atl. 189 (1926).

determine if they conform to the specifications set forth in the letter of credit.[14] The performance of the sales contract between the buyer and seller is not a condition precedent to performance under the letter of credit or to the buyer's agreement to reimburse the issuing bank.[15] The issuing bank has no concern with any question which may arise between the buyer and the seller of the merchandise for whose purchase price the letter of credit was issued.[16] It is a basic principle that courts cannot impose upon the parties to a letter of credit any condition not contained in the letter.[17] But courts should avoid a construction of a letter of credit contract which would place a serious restriction upon ordinary business methods.[18] The fact that a customer who has procured a letter of credit to facilitate the purchase of goods notifies the issuer that the goods do not conform to the sales contract requirements and requests the issuer not to pay a draft drawn thereunder does not change the relationship of the parties, and the issuer has an obligation to pay the draft if the documents presented with it fulfill the specific requirements of the letter of credit, leaving the buyer to his right to bring an appropriate action against the seller.[19] The Uniform Commercial Code recognizes this independent nature of the letter of credit engagement.[20] Thus, the sole measure of the bank's obligation is to be found in the terms of the letter of credit.[21]

In the instant case, the sole issue before the court was whether mere receipt of the affidavit effectually empowered the bank to cancel the credit without resulting liability or whether defendant bank owed plaintiff contractor a duty to investigate the correctness of the asserted violation.[22] The court believed that the answer to this question depended upon the independence of

14. Laudisi v. American Exch. Nat'l Bank, 239 N.Y. 234, 146 N.E. 347 (1924); Bank of New York & Trust Co. v. Atterbury Bros., 226 App. Div. 117, 234 N.Y. Supp. 442 (1st Dep't 1929).

15. Kingdom of Sweden v. New York Trust Co., 197 Misc. 431, 96 N.Y.S.2d 779 (Sup. Ct. 1949).

16. Williams Ice Cream Co. v. Chase Nat'l Bank, 210 App. Div. 179, 205 N.Y. Supp. 446 (1st Dep't 1924); Lamborn v. Lake Shore Banking & Trust Co., 196 App. Div. 504, 188 N.Y. Supp. 162 (1st Dep't), *aff'd*, 231 N.Y. 616, 132 N.E. 911 (1921).

17. Bank of America v. Whitney-Central Nat'l Bank, 291 Fed. 929 (5th Cir. 1923); Maurice O'Meara Co. v. National Park Bank, 239 N.Y. 386, 146 N.E. 636 (1925); Laudisi v. American Exch. Nat'l Bank, 239 N.Y. 234, 146 N.E. 347 (1924); Asbury Park & Ocean Grove Bank v. National City Bank, 35 N.Y.S.2d 985 (Sup. Ct. 1942), *aff'd*, 268 App. Div. 984, 52 N.Y.S.2d 583 (1st Dep't 1944).

18. Bank of Italy v. Merchants' Nat'l Bank, 197 App. Div. 150, 188 N.Y. Supp. 183 (4th Dep't 1921).

19. Laudisi v. American Exch. Nat'l Bank, 239 N.Y. 234, 146 N.E. 347 (1924).

20. See N.Y. U.C.C. § 5-114(1) which provides in part that "an issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary." Official comment 1 to § 5-114 says that "the letter of credit . . . is recognized by this Article as independent of the underlying contract between the customer and the beneficiary."

21. North Woods Paper Mills v. National City Bank, 121 N.Y.S.2d 543 (Sup. Ct. 1953), *aff'd*, 283 App. Div. 731, 127 N.Y.S.2d 663 (2d Dep't 1954).

22. The question of irrevocability was not at issue in the instant case. Irrevocable was held to mean not revocable so long as the conditions specified in the letter of credit were met.

the letter of credit contract from the contract of sale between buyer and seller. Under the contract of sale, the buyer could terminate the credit "on the occurrence of any of the events" described in the contract of sale. But the condition expressed in the letter of credit was the mere receipt of an affidavit containing an assertion that the event had occurred. The court reasoned that it should avoid a construction which would place a serious restriction upon ordinary business methods. A letter of credit is governed by the same general principles of law as are all other contracts in writing.[23] Thus, letters of credit must receive a reasonable construction having regard to the intent of the parties and the circumstances,[24] and the intention of the parties is to be ascertained by a consideration of the terms of the letter as construed in the light of its purpose and the circumstances attending its execution.[25] As between the issuer and the beneficiary of a letter of credit, it has been held that since the letter was prepared by the issuer, it is necessary to take the words in the letter as strongly against the issuer as a reasonable reading would justify.[26] But the bank should not have to assume the burden of determining the accuracy of the representation for this would cause an undue hardship on the bank. On this ground, the Appellate Division held that the letter of credit was, on its face, a complete statement of the obligations owed by the bank to the beneficiary. Therefore, said the court, since the letter of credit was independent of the sales contract between buyer and seller, the mere presentation of an affidavit by the customer was sufficient justification for the bank to refuse payment to the beneficiary.

There is surprisingly little decisional law in the field of letters of credit, especially in view of the vast amount of money and the vast number of transactions which take place in this field.[27] In almost no state outside of New York is there a comprehensive and cohesive body of common law dealing with letters of credit. Prior to the enactment of the Uniform Commercial Code, letters of credit transactions were handled by only a handful of American banks,[28] despite their usefulness in many different commercial situations where the parties did business in different localities. By codifying the law on this subject, the Uniform Commercial Code has done much to make this useful tool more readily available to a wider segment of the business community. The instant case illustrates a typical letter of credit problem. In coming to a just solution of a situation not explicitly dealt with by the statute, the court must consider public policy. It could be argued that since plaintiff contractor did not breach the sales contract, it should be entitled to receive the final payment from the bank under the letter

23. See Bank of United States v. Seltzer, 233 App. Div. 225, 251 N.Y. Supp. 637 (1st Dep't 1931).

24. Lamborn v. National Park Bank, 212 App. Div. 25, 208 N.Y. Supp. 428 (1st Dep't), *aff'd*, 240 N.Y. 520, 148 N.E. 664 (1925).

25. Maurice O'Meara Co. v. National Park Bank, 239 N.Y. 386, 146 N.E. 636 (1925).

26. Lamborn v. National Park Bank, 212 App. Div. 25, 208 N.Y. Supp. 428 (1st Dep't), *aff'd*, 240 N.Y. 520, 148 N.E. 664 (1925); Bank of Italy v. Merchants' Nat'l Bank, 197 App. Div. 150, 188 N.Y. Supp. 183 (4th Dep't 1921).

27. See Harfield, *Code Treatment of Letters of Credit*, 48 Cornell L.Q. 92 (1962).

28. See 1 Bogert, Britton, & Hawkland, *Sales and Securities* 340 (4th ed. 1962).

of credit. But using a better approach, the court has reached a result in line with commercial practice. Often the bank and the beneficiary are geographically distant. The bank, draftsman of its own obligation, undertook to make payment upon demand unless it received *notice* to the contrary from its customer that the beneficiary had not fulfilled its underlying obligation. It would be too much to ask that the bank investigate to determine if the beneficiary had, in fact, failed to perform each condition of its obligation. Distance and expense would make such a requirement prohibitive. Furthermore, the problem in this case might, in all likelihood, have been caused by carelessness on the part of plaintiff or its lawyer in failing to note the difference between the condition as expressed in the sales contract and in the letter of credit. If plaintiff had been aware of the existence of the discrepancy, it ought to have insisted that it be rectified. Since the bank performed exactly what it had promised to do, it would appear that the court was correct in holding for the bank in this situation.

CHARLES E. MILCH

CONFLICT OF LAWS—NEW YORK LAW APPLIED TO BANK ACCOUNT OF MARRIED FOREIGN DOMICILIARIES

The Duke and Duchess of Arion, nationals and domiciliaries of Spain, sent cash and securities to New York for safekeeping and investment during the years of Spanish political uncertainty from 1919 to the end of the Civil War. In establishing joint custodial accounts with several New York banks, the husband and wife signed standard bank survivorship agreement forms valid under New York law,[1] but void under the community property law of Spain.[2] In one account, the agreement expressly provided that the rights of all parties would be governed by New York law. The husband died in 1957, the wife in 1959. Neither had ever been in New York. After the husband's death, the wife assumed control of the property (nearly 2 million dollars) in New York and undertook to dispose of it by a will executed according to New York law.[3] Plaintiff, as the husband's ancillary administrator in New York, sued defendant, individually and as executor of the wife's will, to establish title to one-half the property in New York, which, plaintiff claimed, became part of the husband's estate under the community property law of Spain.[4] After trial, the complaint was dismissed on the merits.[5] The Appellate Division unanimously affirmed without opinion.[6] The Court of Appeals affirmed 4 to 3. *Held*, that when married foreigners place property in New York for safekeeping and

1. N.Y. Banking Law § 134(3).
2. See Spanish Civil Code arts. 1334, 1394.
3. N.Y. Deced. Est. Law § 47.
4. See Spanish Civil Code arts. 1424, 1426.
5. Wyatt v. Fulrath, 38 Misc. 2d 1012, 239 N.Y.S.2d 486 (Sup. Ct. 1963).
6. Wyatt v. Fulrath, 22 A.D.2d 853, 254 N.Y.S.2d 216 (1st Dep't 1964).