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COMMERCIAL CODE UPDATE FOR LETTERS OF CREDIT

House Bill 5327 as enrolled
Public Act 488 of 1998
Second Analysis (12-21-98)

Sponsor: Rep. Andrew Richner
House Committee: Commerce
Senate Committee: Economic Development,
International Trade and Regulatory
Affairs

THE APPARENT PROBLEM:

Article 5 of the Uniform Commercial Code governs letters of credit issued by banks. The primary purpose of a letter of credit is to assure a seller of prompt and reliable payment. The Michigan Law Revision Commission recommends the repeal of the original version of Article 5 of the code, and the adoption of a revised version.

According to the Michigan Law Revision Commission, concerns about letters of credit have arisen because the use of letters of credit has become so prevalent since this article first was enacted by the Michigan legislature in 1964. For example, in 1990, \$200 billion in credits were outstanding in the United States, while an estimated half billion dollars in credit was outstanding in 1950.

One reason for the marked increase in letters of credit is that since 1964, two major uses for the letter of credit have come to exist: the traditional (and increasingly popular) 'commercial letter of credit', and the newer 'standby letter of credit'. A commercial letter of credit is used to effect sales in domestic and international transactions. The purpose of the letter of credit is to assure the seller (the beneficiary of the letter of credit) of prompt and dependable payment. A standby letter of credit is a means of securing performance of obligations, and is used in transactions such as those involving a promissory note, an installment purchase obligation, a construction contract, or a personal or real property lease.

A commercial letter of credit operates to effect payment for sales in domestic as well as international transactions. When a buyer contracts with a seller to make a purchase, and either of the parties is not willing to enter into an open account sale, a

commercial letter of credit will ordinarily be used. There are generally three parties to each commercial letter of credit transaction: the applicant (buyer), the issuer (bank), and the beneficiary (seller). In the simplest commercial letter of credit, the buyer will ask a bank to issue a letter of credit in favor of the seller. The terms of the underlying contract between the buyer and seller dictate the terms of the credit. The letter of credit assures the seller, the beneficiary of the letter of credit, prompt and dependable payment.

The standby letter or credit evolved after the original Article 5 was adopted in 1964. In contrast to the commercial letter of credit, the standby letter of credit is a means of securing performance of obligations, as it is often used in circumstances that involve an unexecuted promise such as a promissory note, an installment purchase obligation, a construction contract, or a personal or real property lease. According to the Michigan Law Review Commission, other examples of uses for the standby letter of credit include bail bonds, municipal obligations, child custody arrangements, local improvements, federal food stamp distribution, supply contracts, tax shelter investments, and sometimes the international sale of goods.

Some argue that the practice of issuing letters of credit has grown so much that the original Article 5 of the Uniform Commercial Code is inadequate in certain areas. As of July 1997, sixteen states had adopted a revised version of Article 5 of the Uniform Commercial Code.

THE CONTENT OF THE BILL:

House Bill 5327 would rewrite Article 5 of the Uniform Commercial Code (MCL 440.5101 through

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440.5117), as recommended by the American Law Institute and the National Conference of Commissioners on Uniform State Laws. The Uniform Commercial Code establishes business practice standards in an effort to ensure speed and predictability during transactions conducted by businesses located in different states. The bill would generally revise provisions dealing with letters of credit, and add provisions to include transactions undertaken electronically using computer technology.

Specifically, House Bill 5327 would amend Article 5, letters of credit, to do the following:

- Provide that a letter of credit could be issued in any form that was a record.
- Define "record" without reference to a written document (i.e., "information that is inscribed on a tangible medium, or that is stored in an electronic or other medium and is retrievable in perceivable form").
- Specify that the issuer of a letter of credit (e.g., a bank) would have to honor a presentation that, as determined by the standard practice, appeared to comply strictly with the terms and conditions of the letter of credit. ("Presentation" would refer to delivery of a document to an issuer for honor or giving of value under a letter of credit.)
- Provide that an issuer would have a reasonable time, but not more than seven business days after receiving documents, to 1) honor (pay or deliver an item of value); 2) accept a draft or incur a deferred obligation, if the letter of credit provided for honor to be completed more than seven business days after presentation; or 3) give notice to the presenter of discrepancies in the presentation.
- Require an issuer to notify a beneficiary of discrepancies.
- Require an issuer to observe standard practice of financial institutions that regularly issue letters of credit.
- Provide that a prevailing party would be entitled to recover attorney's fees and other expenses of litigation.

"Letter of credit" would mean "a definite undertaking . . . by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution, to itself or for its own account, to

honor a documentary presentation by payment or delivery of an item of value".

MCL 440.1105 et al.

BACKGROUND INFORMATION:

This bill is one of several recommended to the Michigan legislature by the Michigan Law Revision Commission, in order to update and to recodify codes of law, including for example, the Uniform Commercial Code.

The National Conference of Commissioners on Uniform State Laws was created in 1892. The conference identifies outmoded statutes, substantiates its recommendations to eliminate those statutes with scholarly research, and then drafts uniform up-dated statutes. The updated "tentative" statutes are drafted over several years, allowing for ample review, argument, and revision. Revisions of the drafts are facilitated through a network of linkages constituted by scholars and practitioners who serve as members of the law sections of the federal and local bar associations, as well as those who serve as volunteer commissioners in state-level review commissions. These contexts provide an opportunity for stakeholders to study unacceptable statutes in light of emerging legal doctrines. The conference proposes the new statutes, first to the law sections, and then to the entirety of the American Bar Association for review by scholars, teachers of law, and legal practitioners. Once endorsed by the American Bar Association, the uniform statutes are disseminated to a network of state-level Uniform Law Commissions (for example the Michigan Law Revision Commission), whose members review the proposals once again, and then in some instances recommend their introduction as bills in the state legislatures.

According to the conference, since its organization, the conference has drafted more than 200 uniform laws on many subjects and in various fields of law, setting patterns for uniformity across the nation. Uniform acts include the Uniform Probate Code, the Uniform Child Custody Jurisdiction Act, the Uniform Partnership Act, the Uniform Anatomical Gift Act and the Uniform Limited Partnership Act. Beginning in 1940, the conference made a significant decision to attack major commercial problems with comprehensive legal solutions--a decision that set in motion the project to produce the Uniform Commercial Code. The code took ten years to complete and another 14 years before it was enacted

across the country. It remains the signature product of the conference. Today the conference is recognized primarily for its work in commercial law, family law, probate and estates, law of business organizations, health law, and conflicts in law. It rarely drafts law that is regulatory in character.

In Michigan, the Law Revision Commission has issued more than 30 annual reports, although the commission was created by statute in 1986 (MCL 4.1401). Each year the commission issues a report to describe the topics of its study reports, and to recommend statutes. Some statutes are enacted into law. Under its enabling statute, section 401 of Public Act 268 of 1986, the commission's membership is: four legislators to be bicameral and bipartisan, the director of the Legislative Service Bureau (or designee), and four members appointed by the Legislative Council. The Legislative Council designates the chair. The commission's reports are available at its Web Site, <http://www.dcl.edu>.

FISCAL IMPLICATIONS:

According to the Senate Fiscal Agency, the bill would have no fiscal impact on state or local government. (11-19-98)

ARGUMENTS:

For:

This proposed version of the Article 5 of the Uniform Commercial Code, the article governing letters of credit, is necessary in order to update the code. This portion of the code has essentially been left unchanged for 34 years, since its enactment in 1964. There are several important ways the current code is unclear. For example, this proposed version of the article envisions full use of the Internet and the electronic transfer of letters of credit. It clarifies the duties of issuers, and it allows any prevailing party to collect reasonable attorney's fees and other expenses of litigation, a provision added to address the complaints of beneficiaries (sellers) against issuers (banks). The Michigan legislature should adopt the expanded and improved revised Article 5 in order to facilitate practical transactions and make way for unforeseen developments that are certain to come.

Against:

According to the Michigan Law Review Commission, in spite of the positive implications of revised Article 5, commentators have raised objections to the revised article. Chief among those objections are two: (1) that the definition of "good faith" should include not only "honesty in fact," but also "the observance of reasonable commercial standards of fair dealing in the letter of credit transaction" and (2) that the provision for mandatory attorneys fees is improper.

Analyst: J. Hunault

■ This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.