

MEMORANDUM

TO: ULC International Legal Developments Committee

FROM: Edwin E. Smith, Chair, the Committee to Implement the UN Convention on Independent Guarantees and Stand-by Letters of Credit

CC: Professor Marilyn E. Phelan, Division Chair
Professor James J. White, Reporter

DATE: November 9, 2009

SUBJECT: Report from the Committee to Implement the United Nations Convention on Independent Guaranties and Stand-by Letters of Credit

The Committee (the “Committee”) to Implement the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (the “Convention”) has considered the request made at the ULC 2009 annual meeting that it reconsider its draft of the text of the federal legislation that it had recommended to implement the Convention. In response to the request, the Committee met by telephone and has refined its draft. A copy of the revised draft recommended by the Committee is attached as Exhibit A, together with a copy of the draft marked to show revisions from the annual meeting draft as Exhibit B.

This report summarizes the background for the request, the Committee’s recommendation for a revised version of the federal implementing legislation, and the reasons for the Committee’s recommendation.

Background

As may be recalled, at the annual meeting the Committee recommended that the Convention be implemented by federal legislation that incorporated the Official Text of Article 5 of the Uniform Commercial Code. This implementation approach is possible because the provisions of the Official Text of Article 5, with two small exceptions noted below, produce outcomes substantially identical to those produced under the Convention.

The proposed legislation contained in the annual meeting draft incorporated the Official Text of Article 5 through the following choice of law rules.

- If a letter of credit stated that it was governed by the Convention, then the law of the Convention would apply.
- If a letter of credit stated that it was governed by the law of a chosen state of the United

States, then the law of that state, in particular Article 5 of that state, would apply without giving effect to the Convention.

- If the letter of credit did not state a governing law, then the Official Text of Article 5 would apply as federal law. However, in the two instances in which the Convention varied from Article 5, dealing with so-called “perpetual” letters of credit and the issuer’s rights of setoff, the Convention would govern and not Article 5 or other state law.

The reasons for the Committee’s recommendation contained in the annual meeting draft were set forth in the Committee’s June 1, 2009, memorandum to the ULC Executive Committee, a copy of which is attached to this report as Exhibit C.

At the annual meeting, there was a good deal of discussion as to the section of the proposed legislation that provided the choice of law rule if the letter of credit does not state a governing law. A number of Commissioners felt strongly that, if a letter of credit issued from a particular state in the United States did not state a governing law, the law of that state should govern the letter of credit, in particular the Article 5 as enacted in that state, rather than, as federal law, the Official Text of Article 5. Under this approach, the Official Text of Article 5 would apply as federal law only if and to the extent that the law of the Article 5 as enacted by that state varied from the uniform version of Article 5 for a letter of credit within the scope of the Convention and produced a different outcome than under the Convention.

After considerable debate at the annual meeting, the following motion was approved by the Conference at the annual meeting:

1. The Committee should consider whether Section 5(b) of the proposed federal legislation [addressing the choice of law rule when the letter of credit does not state a governing law] should be amended so that the law that implements the Convention is the applicable state's version of Article 5 rather than federal law consisting of the Official Text of Article 5. The Committee should report to the Executive Committee the Committee's recommendation whether to retain the current Section 5(b) or to propose the state law implementation alternative in a form approved by the Committee.
2. The Executive Committee will have the discretion whether to approve the Committee's recommendation. If the Executive Committee approves the Committee's recommendation, no further action will be required for the Committee's report to be accepted by the Conference. If the Executive Committee does not approve the Committee's recommendation, the Executive Committee shall determine what further action is required for the report to be accepted by the Conference.

Following the annual meeting, the Committee held two telephone conferences in which this issue was extensively discussed and the revised draft of the federal implementing legislation was produced.

The Committee's Recommendation

The Committee continues to recommend that, when a letter of credit within the scope of the Convention does not state a governing law, the law that governs the letter of credit should be the Official Text of Article 5 as federal law. This will be the Committee's recommendation to the Executive Committee as embodied in the revised draft of the federal legislation.

However, in the revised draft, and in response to comments made from the floor at the annual meeting, the Committee did make two important refinements to the annual meeting draft. Both of these refinements were designed to address letters of credit that implicate the law of a foreign country.

First, under the revised draft, if a letter of credit states that it governed by the law of a foreign country, the law of the foreign country governs the letter of credit, including the Convention as implemented in the foreign country.

Second, under the revised draft, when a letter of credit does not state its governing law, it is first necessary to apply the choice of law rules of the Official Text of Article 5 as federal law to determine which jurisdiction's substantive law governs the letter of credit. If the law so determined is the law of a foreign country, then the substantive law of the foreign country governs. If the law so determined is the law of a state of the United States, then the Official Text of Article 5 governs as substantive law. For example, if the letter of credit does not state a governing law and is issued from Japan, Japanese substantive law would govern the letter of credit. If the letter of credit does not state a governing law and is issued from New York, then the Official Text of Article 5 governs as federal law.

And in the revised draft, for a letter of credit that does not state its governing law, the Convention, and not Article 5 or other state law, continues to govern in the two instances noted, dealing with so-called "perpetual" letters of credit and the issuer's rights of setoff.

Reasons for the Committee's Recommendation

When a letter of credit within the scope of the Convention does not state a governing law, the Committee prefers to implement the Convention through the Official Text of Article 5 as federal law for several reasons.

Practitioners. Many on the Committee were concerned that the use of a local Article 5 as enacted in a particular state would require lawyers to make the difficult determination whether a state had deviated far enough from the Official Text in its enactment so that the state's version of some part of Article 5 could not be regarded as a proper implementation of the Convention. In that case one would have to look to the Official Text of Article 5 as the backup implementation. To nominate some agency to make that determination was thought to be too cumbersome, but leaving the lawyer to make that determination on his own was thought to be problematic. Particular concern were raised for opinion practice and the risk of larger

transaction costs.

Industry representatives. The Committee was also informed that industry representatives would oppose the approach of looking to Article 5 as enacted by a particular state. The Committee advisors and observers who deal regularly with banks and others who use international standby credits reported that use of the “as enacted” model would make their constituents uneasy and might delay the project by a year or more while someone was trying to placate that constituency.

State Department. Mr. Burman, the State Department representative, was of the opinion that the various federal agencies that are comfortable with the use of “state law” in the form of the Official Text of Article 5 would be resistant to the explicit use of Article 5 as enacted in a particular state. The adoption of the “as enacted” model would, at minimum, require renegotiation with the Justice and Commerce Departments and might cause them to withdraw their support entirely. In contrast, Mr. Burman stated in our conference calls that neither the Congress nor the federal agencies will regard the Official Text of Article 5 as “real” federal law. According to him there is little chance that the use the Official Text of Article 5 as a federal law will invite the Congress to intrude further into state commercial law.

U.S. territories and possessions. Although Article 5 has been enacted in every state of the United States and the District of Columbia, Article 5 has not been adopted in all U.S. territories and possessions. For example, Puerto Rico has not adopted Article 5. If a U.S. territory or possession has not enacted Article 5, it would likely be necessary, even under the “as enacted” model, for the Official Text of Article 5 to apply in that territory or possession in any event for letters of credit within the scope of the Convention.

Drafting. The best efforts of the reporter and of the Committee members to draft the “as enacted” language proved unequal to the task. The best we could do was to present a complicated and quite awkward provision. We feared that those complications would cause lack of clarity and might invite misinterpretation.