

## MEMORANDUM

TO: Uniform Law Commissioners

FROM: Edwin E. Smith, Chair, and Professor James J. White, Reporter, the Committee to Implement the United Nations Convention on Independent Guarantees and Standby Letters of Credit

CC: Robert A. Stein, President  
John A. Sebert, Executive Director

DATE: June 4, 2010

SUBJECT: Report on the Implementation of the United Nations Convention on Independent Guaranties and Standby Letters of Credit

The Committee (the “Committee”) of the Uniform Law Commission (the “ULC”) to Implement the United Nations Convention on Independent Guaranties and Standby Letters of Credit (the “Convention”) presents this report to the Uniform Law Commissioners as an update to the work of the Committee since the 2009 ULC annual meeting in Santa Fe. The work has culminated in the refinement of a draft of federal legislation, approved by the ULC Executive Committee, by which the Convention may be implemented in the United States.

The report consists of four parts. Part I is a brief description of the background of the Committee and the project. Part II is a summary of the events that took place at the 2009 ULC annual meeting. Part III is a summary of the events that took place following the 2009 ULC annual meeting. Part IV contains the text of the draft federal legislation.

### **I. Background**

The Committee was formed with representatives from the American Law Institute and the ULC, together with members of the Canadian Uniform Law Conference and the Mexican Uniform Law Center, to examine the Convention and how it may be implemented in the United States, Canada and Mexico. In looking at implementation in the United States, the Committee found that, with two minor exceptions, the Convention produces the same outcomes for letter of credit transactions within the scope of the Convention as under Article 5 of the Uniform Commercial Code (“Article 5”). The Committee considered various alternative methods of implementation of the Convention in the United States before making a recommendation as to the method of implementation.

### **II. Events at the 2009 ULC Annual meeting**

A. Recommendation at the 2009 Annual Meeting

At the 2009 ULC annual meeting, the Committee recommended that the Convention be implemented in the United States by federal legislation that addresses choice of law. The legislation would be enacted by Congress in connection with the Senate's advice and consent for the ratification of the Convention.

The federal implementing legislation would coordinate the provisions of the Convention with state law, especially Article 5, in a way that would be transparent for users of letters of credit. The proposed legislation would accomplish this objective in two ways. First, the proposed legislation would clarify choice of law issues for letters of credit that state that they are governed by either the Convention or by the law of a particular state. If a letter of credit states that it is governed by the Convention, then the law of the Convention would apply. If a letter of credit states that it is governed by the law of a chosen state, then the law of that state, in particular Article 5, would apply and not the Convention. Second, the proposed legislation would implement the Convention by validating the right of parties to choose the law of the Convention to govern their letter of credit or, if the letter of credit does not state a governing law, by implementing the Convention through the Official Text of Article 5. However, in two instances in which the Convention varies 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.

B. Reasons for the 2009 Recommendation

The approach for implementing the Convention recommended by the Committee was viewed by the Committee as taking a middle ground between two other contrasting approaches: self-execution and pre-implementation. Under the self-execution approach, the Convention would replace Article 5 for letters of credit within the scope of the Convention, creating a body of federal law that would parallel the provisions of Article 5. Under the pre-implementation approach the Convention would be implemented through state law, particularly Article 5 as already in effect in all states and the District of Columbia.

Each of the self-execution and pre-implementation approaches has advantages and disadvantages. The self-execution approach would not require federal or state implementing legislation. However, there is a disadvantage to implementation of the Convention as a self-executing treaty: the possible uncertainty that could arise as practitioners and courts interpret the new language of the Convention in contrast to the language of Article 5. Article 5 is a well-established and well-respected source of letter of credit law, and one with which U.S. courts and U.S. practitioners are familiar. If the Convention were to be implemented as a self-executing treaty, it would preempt Article 5 with regard to the subject matter that it covers and with respect to the transactions and undertakings that are within the scope of the Convention. Because the Convention's text (as opposed to its substance) does vary from the text of Article 5, though, adoption of the text of the Convention as controlling law may arguably under some circumstances lead to uncertainty as practitioners and courts interpret the new language of the

Convention. This could result in interpretations of the Convention text that vary from the substance of Article 5. This disadvantage could be compounded to the extent that practitioners and judges used to referring to Article 5 may perhaps be less likely to be aware of the Convention.

The pre-implementation approach would respect state law, in particular Article 5, but would run the risk that a foreign party to a letter of credit that wished for the letter of credit to be governed by the text of the Convention would not be confident that Article 5 would produce the same outcome as under the text of the Convention. Moreover, under the pre-implementation approach, the provisions of the Convention would need to be self-executing in some respects even if the rest of the Convention was not. For example, the provisions of the Convention dealing with perpetual letters of credit and the issuer's rights of setoff would need to be self-executing. The Convention would also need to be self-executing to the extent that the terms of a particular state's Article 5 departed from the Official Text of Article 5 in a manner that produced a different outcome than under the Convention. The combination of self-execution in part and pre-implementation in part would be a technique never used before by the United States in implementing a commercial treaty.

The approach recommended by the Committee for the proposed federal legislation preserves the advantages of the self-execution and pre-implementation approaches while avoiding their disadvantages. Under the proposed federal legislation, parties that wish for a letter of credit to be governed by the text of the Convention may obtain that result, and parties that wish for their letters of credit to be governed by the Article 5 of a particular state may do likewise. These provisions validate the freedom of parties to a letter of credit to choose that the letter of credit be governed by the text of the Convention or to "opt out" of the Convention, as permitted by the Convention, by choosing the Article 5 of a particular state to govern the letter of credit.

However, when a letter of credit is silent as to its governing law, the provisions of the Official Text of Article 5, including its choice of law rules, would apply, as modified by the provisions of the Convention dealing with perpetual letters of credit and the issuer's setoff rights. Under the choice of law rules of the Official Text of Article 5, a letter of credit issued from the United States will be governed by the substantive provisions of the Official Text of Article 5. And, if the letter of credit states that it is subject to one of the codes of conduct of banks that regularly issue letters of credit, the Uniform Customs and Practice for Documentary Letters of Credit (the "UCP") or the International Standby Practices (the "ISP"), as many letters of credit are, the UCP or the ISP would modify substantive provisions of the Official Text of Article 5, consistent with both Article 5 and the Convention.

This approach has the advantage of preserving familiar state law as the means of implementing the Convention when the parties do not select a governing law for a letter of credit issued from the United States. It does so through federal legislation that adopts the Official Text of Article 5 as federal law but modifies Article 5 slightly as a matter of federal law to take into account the perpetual letter of credit and issuer setoff provisions of the Convention. In addition,

this approach respects the ability of the parties further to modify the terms of a letter of credit by incorporating the terms of the UCP or the ISP even if a governing law is not stated in the letter of credit. This approach was favored by the letter of credit industry advisors to the Committee, who felt that the approach would alleviate concerns from the industry that self-execution of the Convention could lead to uncertainty as practitioners and courts interpret the new language of the Convention in contrast to the Official Text of Article 5.

### C. Actions at the 2009 Annual Meeting

At the 2009 ULC 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 Article 5 as enacted by that state varied from the Official Text 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 2009 annual meeting, the following motion was approved by the ULC:

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.

## **III. Events Following the 2009 Annual Meeting**

### A. The Committee's Recommendation to the ULC Executive Committee

Following the 2009 annual meeting, the Committee held two telephone conferences in which the choice of law issue that was the subject of the motion was extensively discussed and from which a revised draft of the federal implementing legislation was produced. As a result of

the Committee's deliberations, the Committee continued to recommend, and so recommended to ULC the Executive Committee, 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 adopted as federal law through the proposed federal legislation.

However, in the revised draft, and in response to comments made from the floor at the 2009 annual meeting, the Committee did make two important refinements to the 2009 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 is 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, and not the Article 5 as adopted by that state, governs as substantive law. For example, if the letter of credit does not state a governing law and is issued from Japan, the choice of law rules of the Official Text of Article 5 would provide that 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 would govern as federal law.

And in the revised draft, as in the 2009 annual meeting 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.

#### B. Reasons for the Committee's Recommendation to the Executive Committee

When a letter of credit within the scope of the Convention does not state a governing law, the Committee preferred 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 lawyers to make that determination on their own was thought to be problematic. Particular concerns 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. Harold Burman, the State Department observer to the Committee, 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 of 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 that 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.

### C. Subsequent Events

Subsequent to the Committee’s recommendation to the ULC Executive Committee, and the refinement of the draft of the federal implementing legislation, the following events have occurred:

- The ULC Uniform Commercial Code Committee approved the revised draft of the federal implementing legislation on October 23, 2009.
- The draft was approved by the Permanent Editorial Board for the Uniform Commercial Code on October 24, 2009.
- The draft was presented to the American Law Institute Council for informational

purposes on December 4, 2009.

- The draft was approved unanimously by the International Legal Developments Committee of the ULC on December 5, 2009.
- The draft was approved unanimously by the ULC Executive Committee on January 10, 2010.

The draft is currently being circulated for comment to various federal agencies with a view to the legislation being enacted by Congress in connection with adoption of the Convention by the United States.

#### **IV. The Draft Legislation**

Below is the current draft of the federal implementing legislation. Attached hereto is a copy of the draft marked from the version presented at the 2009 annual meeting.

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#### ***An Act***

To implement the United Nations Convention on Independent Guarantees and Standby Letters of Credit.

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

#### **Section 1. Short Title.**

This Act may be cited as “Independent Guarantees and Standby Letters of Credit Convention Implementation Act of 20\_\_.”

#### **Section 2. Findings and Purpose.**

##### **(a) Findings**

(1) Commercial financial assurances, such as commercial letters of credit, standby letters of credit and independent guarantees, are integral to commerce and trade;

(2) Laws that promote predictable payment increase the value of such assurances, support responsible domestic and international commercial practice and reduce systemic risk and enhance safety and soundness of bank and other financial institution practices;

- (3) The United Nations Convention on Independent Guarantees and Standby Letters of Credit (the “Convention”) achieves these objectives;
- (4) Because the independence principle and other principles embodied in the Convention are already embodied in the Official Text of the Uniform Commercial Code, implementation of the Convention introduces only minor changes to uniform state law in the United States. Article 5 of the Uniform Commercial Code, entitled “Letters of Credit,” codifies the law of commercial and standby letters of credit, including undertakings commonly referred to as independent guarantees;
- (5) Federal and State law bodies in the United States as well as banking and import-export interests were leaders in the development of the Convention;
- (6) Implementation of the Convention by the United States would further the uniformity and harmonization of international commercial and financial law.

**(b) Purpose.**

The purpose of this Act is to implement the Convention in the United States. This Act does that by giving effect to the choice of law provisions of the Convention and of Article 5 of the UCC.

**Section 3. Definitions.** In this Act,

- (a) “Convention” means the United Nations Convention on Independent Guarantees and Standby Letters of Credit.
- (b) “Foreign Jurisdiction” means a jurisdiction other than the United States or a State.
- (c) “State” means a state of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States.
- (d) “UCC” or “Uniform Commercial Code,” means the 2009 Official Text of the Uniform Commercial Code promulgated by American Law Institute and the Uniform Law Commission.

**Section 4. Scope.** This Act applies only to an international independent undertaking that is within the scope of the Convention and to which the Convention applies (“undertaking”).

**Section 5. Implementation of the Convention in the United States.**

- (a) **Undertakings that Choose the Convention as Applicable Law.** An undertaking that expressly states that it is governed by the Convention shall be governed by the text of

the Convention as the applicable law.

**(b) Undertakings that Choose the Law of a Foreign Jurisdiction as Applicable Law.**

An undertaking that expressly states that it is governed by the law of a Foreign Jurisdiction shall be governed by the law of that Foreign Jurisdiction, including the Convention if and as implemented in that Foreign Jurisdiction.

**(c) Undertakings that Choose State Law as Applicable Law.** An undertaking that expressly states that it is governed by the law of a State shall be governed by the law of that State and not by the Convention.

**(d) Undertakings that do not Choose Applicable Law.**

(i) An undertaking that does not choose applicable law is governed by the law of the obligor's location as determined by Section 5-116(b) of the UCC.

(ii) Where that location is a Foreign Jurisdiction, the law of that Foreign Jurisdiction governs, including the Convention if and as implemented in that Foreign Jurisdiction.

(iii) Where that location is a State, Article 5 of the UCC governs as the law that implements the Convention in the United States, except that:

(A) Article 12(c) of the Convention, and not Section 5-106(c) or (d) of the UCC, shall govern the duration of the undertaking and

(B) Article 18 of the Convention shall govern the issuer's right of setoff.

**Section 6. Effective Date and Preservation of Prior Rights.** This Act shall take effect on the date on which the Convention enters into force with respect to the United States. This Act applies to undertakings issued on and after the effective date of this Act. This Act does not apply to a transaction, event, obligation or duty arising out of or associated with an undertaking that was issued before the effective date of this Act.

Version Marked from the 2009 Annual Meeting Draft

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**Section 1. Short Title.**

This Act may be cited as “Independent Guarantees and Standby Letters of Credit Convention Implementation Act of ~~2009~~.<20  .>”

**Section 2. Findings and Purpose.**

**(a) Findings**

- (1) Commercial ~~finance~~<financial> assurances<,> such as <commercial >letters of credit, standby letters of credit, and ~~bank and financial institution~~<independent> guarantees<,> are integral to commerce and trade;
- (2) Laws that promote predictable payment increase the value of such assurances, support responsible domestic and international commercial practice, and reduce systemic risk and enhance safety and soundness of bank and other financial institution practices;
- (3) The United Nations Convention on Independent Guarantees and Standby Letters of Credit (<the>“Convention”) achieves these objectives;
- (4) Because the independence <principle and other>principles embodied in the Convention are already embodied in the ~~text of~~ Official ~~Version~~<Text> of <the>Uniform Commercial Code<,> implementation of the Convention introduces only minor changes to uniform state law in the United States. Article 5 of the ~~ucc~~<Uniform Commercial Code>, entitled “Letters of

Credit,” codifies the law of commercial and standby letters of credit, including undertakings ~~known outside the United States~~ <commonly referred to> as independent guarantees. <:i>

(5) Federal and State law bodies in the United States as well as banking and import-export interests were leaders in the development of the Convention. <:i>

<(6) Implementation of the Convention by the United States would further the uniformity and harmonization of international commercial and financial law.>

**(b) Purpose.**

The purpose of this Act is to implement the Convention in the United States. This Act does that by giving ~~full~~ effect to the choice of law provisions of the Convention and of Article 5 of the UCC.

**Section 3. Definitions.** In this Act,

(a) “Convention” means the United Nations Convention on Independent Guarantees and Standby Letters of Credit.

(b) “~~State~~ <Foreign Jurisdiction>” means a ~~State~~ <jurisdiction other than the United States or a State.>

<(c) “State” means a state> of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States.

(~~e~~ <d>) “UCC” or “Uniform Commercial Code,” means the <2009> Official Text of the Uniform Commercial Code, ~~prepared and published~~ <promulgated> by American Law Institute and the Uniform Law Commission.

**Section 4. Scope.** This Act applies only to an international independent undertaking that is within the scope of the Convention and to which the Convention applies ("undertaking").

## Section 5. Implementation of the Convention in the United States<u>

(a) **Undertakings that Choose the Convention as Applicable Law.** An undertaking that expressly states that it is governed by the Convention shall be governed by the text of the Convention as the applicable law.

(b) **Undertakings that ~~do not~~ Choose the Law of a Foreign Jurisdiction as Applicable Law.** An undertaking that ~~does not~~ expressly ~~state its governing law~~ states that it is governed by the law of a Foreign Jurisdiction shall be governed by the law of that Foreign Jurisdiction, including the ~~conflict of laws rules, as stated in Article 5 of the UCC, except that (i) Article 12(c) of the Convention, and not Section 5-106(c) or (d) of the UCC, shall govern the duration of the undertaking and (ii) Article 18 of the Convention shall govern the issuer's right of setoff. Except as otherwise stated in this Section 5, Article 5 of the UCC is the law that implements the Convention in the United States~~ Convention if and as implemented in that Foreign Jurisdiction.

~~Section 6.~~ (c) **Undertakings that Choose State Law as ~~the~~ Applicable Law.** An undertaking that expressly states that it is governed by the law of a State shall be governed by the law of that State and not by the Convention.

### (d) Undertakings that do not Choose Applicable Law.

(i) An undertaking that does not choose applicable law is governed by the law of the obligor's location as determined by Section 5-116(b) of the UCC.

(ii) Where that location is a Foreign Jurisdiction, the law of that Foreign Jurisdiction governs, including the Convention if and as implemented in that Foreign Jurisdiction.

(iii) Where that location is a State, Article 5 of the UCC governs as the law that implements the Convention in the United States, except that:

(A) Article 12(c) of the Convention, and not Section 5-106(c) or (d) of the UCC, shall govern the duration of the undertaking and

<(B) Article 18 of the Convention shall govern the issuer's right of setoff.>

**Section 7.<6.> Effective Date and Preservation of Prior Rights.** This Act shall take effect on the date on which the Convention enters into force with respect to the United States. This Act applies to undertakings issued <on and >after the effective date of this Act. This Act does not apply to a transaction, event, obligation or duty arising out of or associated with an undertaking that was issued before the effective date of this Act.