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Symposium Commentary

Donald J. Rapson

COMMENTARY

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I would like to address briefly some pragmatic and philosophical concerns that have been raised with respect to some of the matters discussed at this symposium.

I. Letters of Credit

First, concerning letter of credit law, I would like to draw attention to some important provisions in revised article 5. In particular, I would like to address a fundamental point in revised Uniform Commercial Code section 5-116. UCC section 5-116(c) provides that:

> Except as otherwise provided in this subsection, the liability of an issuer, nominated person, or adviser is governed by any rules of custom or practice, such as the Uniform Customs and Practice for Documentary Credits, to which the letter of credit, confirmation, or other undertaking is expressly made subject. *If (i) this Article would govern the liability of an issuer*, nominated person, or adviser under subsection (a) or (b), (ii) *the relevant undertaking incorporates rules of custom or practice*, and (iii) there is conflict between this article and those rules applied to that undertaking, *those rules govern* except to the extent of any conflict with the nonvariable provisions specified in Section 5-103(c)(emphasis added).

The Uniform Customs and Practice for Documentary Credits (UCP) is a publication of the International Chamber of Commerce, which is a private organization. Thus, if revised article 5 is adopted by the states, a state statute will incorporate rules made by a private international body *as to matters of liability*, so that the rules of that private body will preempt many of the rules in the state statute. Moreover, the incorporation is so open-ended that it incorporates not only the UCP as presently written but also the UCP as it may be amended or revised in the future.

This scenario raises an important issue concerning the proper delegation of legislative authority. A proponent of section 5-116 may respond, perhaps, that the section does not involve the delegation of legislative authority at all, but merely authorizes parties to agree on alternate rules. In this sense, the contention is that section 5-116 is merely a more particularized version of UCC section 1-102(3), which allows parties to vary most UCC rules by agreement.

My pragmatic sensitivities, however, tell me that this position is wrong. How, after all, does a beneficiary of a letter of credit enter into such an "agreement" with the issuer and when does that agreement occur? My experience has been that the beneficiary gets the letter of credit at or shortly before the closing or the funding of the transaction. Often, there is really no opportunity to negotiate the terms of the letter of credit. Accordingly, in terms of traditional contract law, I wonder how one can say when and how an agreement has been made to vary the rules provided for in the UCC. Under that reasoning, the contract, such as it is, is formed simply when the beneficiary "accepts" a letter of credit issued by an issuer with which it has no direct contact, by not objecting to the term incorporating the UCP. That is, silence results in a purported agreement that the liability rules of the UCP preempt those of Article 5.

I have great difficulty in believing that this is an appropriate interpretation and application of section 1-102(3), notwithstanding a few recent decisions to that effect. I also find it curious that the proponents of this attenuated use of contract law are the same people who criticize others like myself for applying contract principles to letters of credit. Moreover, it is particularly troubling that the use of the magic words "subject to the UCP" in the boilerplate of the letter of credit can preempt the UCC on important matters. For example, what would happen if, at some future time, the UCP were amended to provide for compulsory arbitration of all disputed issues? Would the simple, boilerplate incantation of the phrase "subject to the UCP" then deprive a beneficiary of the ability to seek judicial enforcement of the letter of credit? The drafters have told me that the answer to this question is "yes." Similarly, what would happen if the UCP required mitigation of damages before a beneficiary could draw on a letter of credit? Would a beneficiary then be prevented from drawing on a letter of credit that incorporated the UCP without demonstrating mitigation? I would hope not, but as revised article 5 is written, I believe, unfortunately, that this would be the result, so total is the delegation to the UCP.

II. SURETYSHIP AND GUARANTY LAW

Second, I would like to address some important issues in suretyship and guaranty law. Professor Cohen spoke about this subject extensively, but declined to tell you that the new Restatement of Suretyship and Guaranty (for which he served as Reporter) is a really wonderful document. Yet, wonderful as that document is, one must wonder what its effect will be. In describing an issue of suretyship and guaranty law, Professor Cohen stated, perhaps inadvertently, that the Restatement would govern the issue. I wish that were the case, but it is not so simple. Restatements do not themselves govern anything. They are merely the product of an esteemed, but private, organization—the American Law Institute. Restatements "govern" only if the rules in them are adopted by courts.

I hope that the Restatement of Suretyship and Guaranty will be widely accepted and applied by the courts, avoiding the fate of its predecessor, the 1941 Restatement of Security (drafted by my mentor, Professor John Hanna). But acceptance will not happen automatically. Rather, for the new Restatement to be properly appreciated, a number of things will have to happen. First of all, American law schools will have to restructure the way that they teach commercial law. In this country, there are four decades of lawyers and judges who are unfamiliar with suretyship and guaranty law because it has not been taught in American law schools since the 1950s. When the Uniform Commercial Code came upon us, law schools restructured their commercial law curricula to track the Code, which deals in only a very sketchy fashion with the subject of suretyship and guaranty.

Equally important in determining whether the new Restatement will be widely accepted by the courts is the question whether judges and lawyers will be willing to abandon hoary precedents unthinkingly applied to case after case in favor of the modern approach that the Restatement adopts. In this regard, let us consider the relatively simple topic of extensions. What happens if an obligee grants the principal obligor an extension of the due date for fulfilling the underlying obligation? The traditional common law rule, still dominant in most jurisdictions, is that the mere granting of the extension automatically discharges the secondary obligor as a matter of *strictissimi juris* without the necessity of the secondary obligor demonstrating any harm or prejudice that would result from the extension. The Restatement, following the trail blazed by revised article 3 of the Uniform Commercial Code, adopts a very different rule. Under the Restatement rule, the secondary obligor is discharged by an extension only to the extent that the secondary obligor is harmed by it. While this is, I believe, the better rule, it is not the traditional rule in most jurisdictions. What will motivate the courts to change the accepted law in those jurisdictions?

The third thing that must happen for the new Restatement to achieve the influence it deserves is that lawyers who structure and document commercial transactions must learn to recognize suretyship and guaranty issues in the first place. At present, that level of recognition, regrettably, does not exist. I recently chaired a program at which we discussed a very simple hypothetical: A, the owner of a business has granted Bank a security interest in all of A's assets; A then sells the assets to B, who either assumes A's obligations to the Bank or takes the assets subject to the Bank's security interest. Few people in the audience knew that, as a matter of well-accepted law, B becomes the principal obligor while A now assumes the role of secondary obligor and, accordingly, gets the benefit of suretyship defenses. Indeed, in the course of my observations of both lawyers who serve as in-house counsel to lenders and other commercial lawyers, I have concluded that few are cognizant of this basic rule of suretyship and guaranty law. It is to be hoped that the Restatement will have an educative effect here, but this remains to be seen.

The new Restatement recognizes a number of other changes from traditional suretyship rules. One change is the elimination of the ancient "reservation of rights" doctrine, which is replaced with a new and more conceptually appropriate doctrine known as "preservation of recourse." This change is important in the area of workouts. Under the old reservation of rights doctrine, an obligee who grants an extension to a principal obligor can avoid the automatic discharge of the secondary obligor by saying to the principal obligor, "but I reserve my rights against the secondary obligor." By so reserving rights against the secondary obligor, the obligee has brought about two important legal results. First, the secondary obligor is not discharged even if the reservation of rights has not been communicated to it. Second, the rights of the secondary obligor (who then performs the obligation) as against the principal obligor continue as though the extension had not been granted. Thus, the obligee can enforce performance by the secondary obligor and the secondary obligor may then seek performance from the principal obligor without regard to the extension. How many principal obligors realize that an extension granted to them accompanied by the incantation of reservation of rights language means that they may still be liable before the extended due date? Under the new doctrine, there must be express language in the workout documents indicating that not only is the obligee reserving its right to proceed against the secondary obligor, but also that the principal obligor will remain liable to the secondary obligor. Will lawyers take cognizance of the Restatement and start to draft their documents in accordance with the Restatement rules? Only time will tell.

The Restatement also clarifies the law governing waiver of suretyship defenses. Most lawyers know that an obligee can avoid suretyship defenses of secondary obligors by the simple expedient of getting meaningful waivers of those defenses in the documents establishing the secondary obligation. Indeed, lawyers who are sensitive to suretyship issues are well versed in drafting long, cumbersome documents with pages and pages of waivers. Modern word processing enables ever-lengthier documents with ever-lengthier waivers to be produced with little additional effort. Are such lengthy waivers necessary? Revised article 3 and, more importantly, the new Restatement provide that a simple statement to the effect that "the secondary obligor waives all suretyship defenses" will suffice. Will lawyers abandon their yards-long waivers for such a simple sentence? I hope so, but what will motivate them to do so? Can a Restatement which, of course, is not law until adopted by courts, bring this about? Probably not.

This observation has led some to suggest that it would be a good idea to codify the Restatement as a new article of the Uniform Commercial Code and, in fact, many are suggesting that such codification proceed immediately. While eventual codification might well be appropriate, the problem is that the Restatement is still new and many of its forward-looking provisions do not yet represent a consensus. There is a risk that the beneficial effects of bringing these provisions into the Restatement, thus spurring the courts to adopt them, might be undone if codification is undertaken too soon. The Restatement drafting process is, not surprisingly, significantly different from the legislative drafting process. Most particularly, special interest groups play a larger role in legislative drafting. Thus, Restatement rules that are less generous to those interest groups than the older doctrines are likely to be at risk if the Restatement rules are challenged before they have achieved a greater patina through adoption by the courts. While, of course, special interests were present in the process of drafting the Restatement, there was a greater willingness to defer to the "better" rule, as recommended and elucidated by the Reporter, because the Restatement is not itself law. Such deference is unlikely to be present in a legislative drafting effort.

While I once advocated that there be a UCC article devoted to suretyship, I now suggest greater caution. Let's wait five or even ten years and see what happens to the rules set out in the Restatement of Suretyship and Guaranty. If it has the impact we all hope for, then we can proceed to codification. By exercising this caution, we are likely to enact better rules.

There are numerous additional developments of significance in the new Restatement but, in the interest of brevity, I will mention only one more. When those of us in the lending business buy a portfolio of loans, we are quite concerned with obtaining rights not only against the principal obligor on those loans but also against any secondary obligors for them. Yet, relatively few people know that in several jurisdictions a guaranty is not assignable as part of an assignment of the underlying loan if the guaranty, as it usually does in "plain vanilla" guaranty forms, specifies only the name of the original creditor as the beneficiary of the guaranty without expressly permitting its assignment. This creates a serious problem in practice. Those who are unaware of this doctrine can be the victims of very unpleasant surprises, while those who are aware of the doctrine have an important task to perform in advising their clients as to the potential limits of the rights acquired. One of the great benefits of the new Restatement is that it adopts the better view that secondary obligations are generally assignable and, indeed, are automatically assigned in conjunction with assignment of the underlying obligation.

III. Conclusion

This year has seen two major developments in the American law of credit enhancement—the promulgation of revised article 5 of the Uniform Commercial Code, and the approval of the Restatement of Suretyship and Guaranty. Both of these developments deserve careful study now and close attention over the years.