Letters of Credit: Dishonor When a Required Document Fails to Conform to the Section 7-507(b) Warranty

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LETTERS OF CREDIT: DISHONOR WHEN A REQUIRED DOCUMENT FAILS TO CONFORM TO THE SECTION 7-507(b) WARRANTY

Kerry L. Macintosh*

INTRODUCTION

Interest in letters of credit has intensified in recent years. The unfortunate impact of the recent Iranian Revolution on international business transactions, together with lesser commercial fiascoes, have produced a spate of cases1 which, in turn, have spawned a spate of law review articles discussing the proper definition and application of grounds for dishonoring a demand for payment under the letter of credit.2

One such ground for dishonor, however, remains virtually unnoticed. Under section 5-114 of the Uniform Commercial Code (U.C.C.),3 the failure of a required document4 to conform to any one

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4. The term “document” is used in two different senses in the U.C.C. “Document,” as it is used in Article Five of the U.C.C., is defined as “any paper including document of title, security, invoice, certificate, notice of default and the like.” Id. § 5-103(1)(b). Within Article Seven, “document” has the narrower meaning of “document of title.” Id. § 7-102(1)(e). The term “document of title” includes:
of the three transfer warranties of section 7-507 justifies dishonor. This article will focus on the second of these three warranties, section 7-507(b):

Where a person negotiates or transfers a document of title for value otherwise than as a mere intermediary under the next following section, then unless otherwise agreed he warrants to his immediate purchaser only in addition to any warranty made in selling the goods . . . .

(b) that he has no knowledge of any fact which would impair its validity or worth.  

What is the content of the section 7-507(b) warranty? Under the language of section 5-114, when does the section 7-507(b) warranty operate as a ground for dishonor? Finally, what are the practical and conceptual consequences of the section 7-507(b) ground for dishonor? Before addressing these questions, this article will supply necessary background by discussing the independence of the issuer’s obligation under the letter of credit, and fraud as the most widely analyzed and employed ground for dishonor under section 5-114.

In aid of this discussion, the following introduction to the basic letter of credit transaction is provided. Suppose a seller and buyer enter into a contract for the sale of goods. If they are dealing at a distance, the seller may be uneasy about shipping his goods into the

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bill of lading, dock warrant, dock receipt, warehouse receipt or order for the delivery of goods, and also any other document which in the regular course of business or financing is treated as adequately evidencing that the person in possession of it is entitled to receive, hold and dispose of the document and the goods it covers.

_id._ § 1-201(15).

To avoid confusion, this article will utilize the term “document” to refer to a document within the meaning of Article Five, and “document of title” to refer to a document within the meaning of Article Seven.

5. _Id._ § 7-507.

6. Section 7-507(a) contains a warranty that the document of title which has been negotiated or transferred is “genuine,” that is, free of forgery or counterfeiting. _Id._ § 1-201(18). Since § 5-114(2) expressly allows dishonor where a required document is forged, the inclusion of failure to conform to the § 7-507(a) warranty as a further ground for dishonor seemingly adds little to the content of § 5-114.

Section 7-507(c) contains a warranty that negotiation or transfer of the document of title is rightful and fully effective with respect to the title to the document and the goods it represents. Unlike § 7-507(a), this warranty may provide the basis for an additional ground for dishonor which is distinct from the other grounds stated in § 5-114(2). Investigation of this possibility is beyond the scope of this article. However, to the extent the § 7-507(c) warranty overlaps with the § 7-507(b) warranty, it will be briefly discussed in this article. _See infra_ note 40.

7. The letter of credit transaction outlined here involves a sale of goods. A letter of credit which finances a sale of goods has been termed a “traditional” letter of credit. _Comment, supra_ note 2, at 219. The letter of credit has many other uses. _See generally_ J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 18-1, at 708-09 (2d ed. 1980).
buyer’s jurisdiction without any guaranty of payment. Accordingly, he instructs the buyer to obtain a letter of credit from an “issuer”: a bank or other person who issues letters of credit. The seller will be a “beneficiary” of the credit: that is, a person who is entitled under its terms to draw or demand payment. The buyer will be a “customer”: that is, a person who causes an issuer to issue a credit. By issuing the letter of credit, the issuer engages to honor drafts or other demands for payment made by the beneficiary, upon compliance with the conditions specified in the credit. In a sale of goods transaction, the conditions typically will include presentation of a document of title, an invoice, and a certificate of insurance covering the goods to be sold. Upon presentation of complying documents, the issuer will honor the seller’s demand for payment of the purchase price. The buyer, in turn, will then reimburse the issuer.

I. THE INDEPENDENCE PRINCIPLE

Under section 5-114(1), the issuer “must honor a draft or de-

For example, the so-called “standby” letter of credit may be issued to secure a performance obligation under a contract. Default in performance triggers the issuer’s obligation to pay. Id. at 709.

Only “traditional” letters of credit will be discussed in this article. Section 7-507 warranties relate to documents of title; documents of title evidence entitlement to goods. Thus, there can be no § 7-507(b) ground for dishonor in a letter of credit transaction unless goods are involved.

A simple documentary sale would be sufficient to protect the seller from the possibility that the buyer will obtain possession of the goods without having paid for them. J. WHITE & R. SUMMERS, supra note 7, § 18-1, at 705. In such a sale, the seller ships the goods to the buyer, perhaps forwarding a negotiable document of title covering the goods, together with a sight draft drawn on the buyer in the amount of the purchase price, through banking channels. Upon payment of the sight draft, the buyer is entitled to receive the document of title, which then may be exchanged for the goods.

The documentary sale does not solve other concerns which may plague the seller in a long-distance transaction, however. If the buyer simply refuses to honor the sight draft after the goods arrive at their destination, he will not obtain possession of the goods, but the seller will be confronted with the potentially difficult task of reselling, storing, or reshipping the goods at a distance, and in a location which may be unfamiliar or even foreign. Moreover, if the buyer’s refusal to pay constitutes a breach of contract, the seller will be put in a position where he may have to go to the expense and trouble of suing the buyer in a faraway or foreign jurisdiction. Id. at 706. The letter of credit device softens these concerns by introducing the promise of a bank or other solvent third party that the seller will be paid so long as the conditions specified in the credit are met.

10. Id. § 5-103(1)(d).
11. Id. § 5-103(12)(g).
12. Id. § 5-103(1)(a).
13. The customer’s duty to reimburse the issuer is governed by § 5-114(3), which provides: “Unless otherwise agreed an issuer which has duly honored a draft or demand for payment is entitled to immediate reimbursement of any payment made under the credit and to be put in effectively available funds not later than the day before maturity of any acceptance made under the credit.”
mand 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.” Section 5-114(1) reflects a basic principle of letter of credit law: the obligation of the issuer to pay is independent of the underlying transaction between the customer and the beneficiary.\textsuperscript{14} The importance of this independence principle is readily explained. The primary purpose of the letter of credit is to assure the beneficiary of prompt payment.\textsuperscript{15} If payment were dependent upon the vicissitudes of the underlying transaction, the beneficiary would have little incentive to utilize the letter of credit device.

A. Fraud as an Exception to the Independence Principle

Despite the importance of the independence principle, it is not an absolute. Before the U.C.C. was enacted, the courts had demonstrated a willingness to soften the principle in extreme cases. \textit{Sztejn v. J. Henry Schroder Banking Corp.}\textsuperscript{16} is the seminal case. There, a buyer who had caused a letter of credit to be issued in favor of the seller sought to restrain the issuer from making payment, alleging that the seller had intentionally shipped fifty crates of rubbish in place of the fifty crates of bristles called for in the underlying contract. The documents presented to the issuer stated that bristles had been shipped, thereby complying on their face with the letter of credit’s terms. Nevertheless, the \textit{Sztejn} court denied a motion to dismiss the buyer’s complaint. It reasoned as follows:

No hardship will be caused by permitting the bank to refuse payment where fraud is claimed, where the merchandise is not merely inferior in quality but consists of worthless rubbish, where the draft and the accompanying documents are in the hands of one who stands in the same position as the fraudulent seller, where the bank has been given notice of the fraud before being presented with the drafts and documents for payment, and where the bank itself does not wish to pay pending an adjudication of the rights and obligations of the other parties. While the primary factor in the issuance of the letter of credit is the credit standing of the buyer, the security afforded by the merchandise is also taken into account . . . . Although the bank is not interested in the exact detailed performance of the sales contract, it is vitally interested in assuring itself

\begin{itemize}
\item[14.] J. \textsc{White} & R. \textsc{Summers}, \textit{supra} note 7, § 18-2, at 711-12.
\item[15.] Maurice O’Meara \textsc{Co. v. National Park Bank}, 239 N.Y. 386, 397, 146 N.E. 636, 639 (1925).
\item[16.] 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. 1941).
\end{itemize}
that there are some goods represented by the documents.17

The fraud exception to the independence principle which was announced in Sztejn was later codified18 in section 5-114:

(2) Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a certificated security (Section 8-306) or is forged or fraudulent or there is fraud in the transaction:

(b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor.19

Under the language of section 5-114(2)(b), the presence of fraud gives the issuer the option to honor or dishonor the demand for payment, so long as it acts in good faith. Moreover, the customer may also effect dishonor by bringing an action seeking an injunction against payment.

The drafters of section 5-114 left the critical terms "fraudulent" and "fraud in the transaction" undefined. Much scholarly attention has been focused on this interpretive problem. Recently, Symons has

17. Id. at 723, 31 N.Y.S.2d at 635.
18. J. WHITE & R. SUMMERS, supra note 7, § 18-6, at 736; Symons, supra note 2, at 354; Comment, supra note 2, at 227. Other writers have suggested that § 5-114(2) extends rather than codifies Sztejn. Characterizing Sztejn as a case involving forged or fraudulent documents, these writers argue that § 5-114(2) added a new ground for dishonor by including the language "fraud in the transaction." See 2 R. ALDERMAN, A TRANSACTIONAL GUIDE TO THE UNIFORM COMMERCIAL CODE 762 (2d ed. 1983); Harfield, supra note 2, at 605. This argument is not entirely persuasive. To the extent the documents presented in Sztejn deliberately misrepresented the nature of the goods shipped, they may be characterized as fraudulent. However, the Sztejn court also used language which indicates that it viewed the problem before it as one of "fraud in the transaction": "[The party demanding payment] should not be heard to complain because [the issuer] is not forced to pay the draft accompanied by documents covering a transaction which it has reason to believe is fraudulent." Sztejn, 177 Misc. at 722, 31 N.Y.S.2d at 634 (emphasis added).
19. U.C.C. § 5-114(2)(b) (emphasis added). Subpart (a) of § 5-114(2), omitted above, requires the issuer to honor a demand for payment, regardless of fraud, if:

honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiated (Section 7-502) or a bona fide purchaser of a certificated security (Section 8-302).

For purposes of this article, it will henceforth be assumed that the special circumstances enumerated in § 5-114(2)(a) do not apply.
suggested that dishonor should be permitted whenever an intentional fraud has been perpetrated. In other words, fraud is to be interpreted as meaning common law fraud, which Symons defines as a false representation knowingly or recklessly made with the intention of inducing another to rely thereon. For example, dishonor would be permitted if the beneficiary of a letter of credit, knowing that only forty-nine crates of bristles had been shipped, presented a bill of lading which stated that fifty crates of bristles had been shipped. Other writers have found this interpretation of fraud to be persuasive.

On the other hand, Harfield has argued in favor of an "egregious fraud" standard for allowing dishonor. Harfield accepts Sztejn as a case in which dishonor was justified. Referring back to the facts of Sztejn, dishonor presumably would be allowed under the egregious fraud standard if the beneficiary, knowing that fifty crates of rubbish had been shipped, presented a bill of lading which stated that fifty crates of bristles had been shipped. In other words, simple intent to deceive is not sufficient; it is the extreme or outrageous nature of the fraud that is determinative.

Whatever the outcome of the scholarly debate between proponents of the intentional fraud and egregious fraud standards, it is evident that many courts recite the latter. Their phraseology is varied, 

20. Symons, supra note 2, at 339.
21. Id. at 345.
22. A bill of lading is a document of title. U.C.C. § 1-201(15) (1978). It is defined as "a document evidencing the receipt of goods for shipment issued by a person engaged in the business of transporting or forwarding goods." Id. § 1-201(6).
25. Harfield, supra note 2, at 602.
26. Consider the illustration provided by one proponent of the egregious fraud standard:

For example, a claim that paper does not, in fact, have the tensile strength, or that grapes or sugar are not, in fact, of the quality specified in an invoice does not furnish a valid basis for enjoining the payment of a draft presented with the invoice. On the other hand, if a discrepancy with respect to quality is so great that the goods delivered are not, in fact, the kind of goods described in the documents, the discrepancy may constitute fraud. For example, a bank may be enjoined from paying a draft if the accompanying documents purport to cover manila hemp but actually cover rags.

but the substance is always the same: "An injunction against honor should be limited to situations where the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served";28 "[the fraud] must be of such an egregious nature as to vitiate the entire underlying transaction";29 "A court of equity has the limited duty of 'guaranteeing that [the beneficiary] not be allowed to take unconscientious advantage of the situation and run off with plaintiff's money on a pro forma declaration which has absolutely no basis in fact.'"30

Therefore, in many jurisdictions, the fraud exception to the independence principle remains narrow. A model transaction will illustrate. Suppose a seller and buyer enter into a contract for the sale of 100 bushels of Washington apples, and the buyer causes its bank to issue a letter of credit in the seller's favor. Further, suppose the seller presents to the issuer conforming documents representing that 100 bushels of Washington apples have been shipped, together with a demand for payment, in full knowledge that a small but not insignificant percentage of the apples are wormy, and will certainly be unacceptable to the buyer. This behavior does not amount to conduct so extreme as to vitiate the entire underlying transaction; accordingly, in jurisdictions adopting the egregious fraud standard, even if the issuer and buyer are aware of the defect, honor will not be excused and cannot be enjoined. In such jurisdictions, the independence principle slumbers unsuspectingly on, virtually untouched by section 5-114(2)—at least, for the moment.

II. FAILURE TO CONFORM TO THE SECTION 7-507(b) WARRANTY AS A GROUND FOR DISHONOR

So much scholarly and judicial attention has been lavished on fraud as a ground for dishonor, that the uninitiated might believe it


was the only such ground specified in section 5-114(2). Such is not the case. Under section 5-114(2), the failure of a required document to conform to the three section 7-507 warranties also justifies dishonor. The task of this article is to analyze the section 7-507(b) ground for dishonor. As a first step, the content of the section 7-507(b) warranty must be defined.

A. Defining the Content of the Section 7-507(b) Warranty

What does a person promise when he warrants under section 7-507(b) "that he has no knowledge of any fact which would impair [the document of title's] validity or worth"? Unfortunately, extensive research produced no cases interpreting section 7-507(b).

Section 7-507 itself was modeled after similar provisions in three prior uniform acts: 31 section 36 of the Uniform Sales Act (U.S.A.); 32 section 44 of the Uniform Warehouse Receipts Act (U.W.R.A.); 33 and section 35 of the Uniform Bills of Lading Act (U.B.L.A.). 34 Sec-

32. U.S.A. § 36 (act withdrawn 1951). This section provided:
   A person who for value negotiates or transfers a document of title by indorsement or delivery, including one who assigns for value a claim secured by a document of title unless a contrary intention appears, warrants:
   (a) That the document is genuine;
   (b) That he has a legal right to negotiate or transfer it;
   (c) That he has knowledge of no fact which would impair the validity or worth of the document, and
   (d) That he has a right to transfer the title to the goods and that the goods are merchantable or fit for a particular purpose, whenever such warranties would have been implied if the contract of the parties had been to transfer without a document of title the goods represented thereby.
33. U.W.R.A. § 44 (act withdrawn 1951). This section provided:
   A person who for value negotiates or transfers a receipt by indorsement or delivery, including one who assigns for value a claim secured by a receipt, unless a contrary intention appears, warrants
   (a) That the receipt is genuine,
   (b) That he has a legal right to negotiate or transfer it,
   (c) That he has knowledge of no fact which would impair the validity or worth of the receipt, and
   (d) That he has a right to transfer the title to the goods and that the goods are merchantable or fit for a particular purpose whenever such warranties would have been implied, if the contract of the parties had been to transfer without a receipt the goods represented thereby.
34. U.B.L.A. § 35 (act withdrawn 1951). This section provided:
tion 114 of the Federal Bills of Lading Act also is similar. Each of these provisions contains a warranty analogous to the section 7-507(b) warranty. But case authority interpreting these analogous warranties is virtually non-existent. Only one such case was found: Stanford Seed Co. v. Balfour, Guthrie & Co. At issue in Stanford Seed was a negotiable warehouse receipt covering 60,000 pounds of perennial rye grass seed. The receipt represented on its face that it had been issued in return for seed delivered to the warehouseman by Balfour, Guthrie & Co., Ltd. When the warehouseman filed a bankruptcy petition, the

A person who negotiates or transfers for value a bill by indorsement or delivery, including one who assigns for value a claim secured by a bill, unless a contrary intention appears, warrants

(a) That the bill is genuine,
(b) That he has a legal right to transfer it,
(c) That he has knowledge of no fact which would impair the validity or worth of the bill, and
(d) That he has a right to transfer the title to the goods, and that the goods are merchantable or fit for a particular purpose whenever such warranties would have been implied, if the contract of the parties had been to transfer without a bill the goods represented thereby.

In the case of an assignment of a claim secured by a bill, the liability of the assignor shall not exceed the amount of the claim.

35. 49 U.S.C. app. § 114 (1982). This section provides:

A person who negotiates or transfers for value a bill by indorsement or delivery, unless a contrary intention appears, warrants

(a) That the bill be genuine,
(b) That he has a legal right to transfer it;
(c) That he has knowledge of no fact which would impair the validity or worth of the bill;
(d) That he has a right to transfer the title to the goods, and that the goods are merchantable or fit for a particular purpose whenever such warranties would have been implied if the contract of the parties had been to transfer without a bill the goods represented thereby.


Williston does mention that § 36 of the U.S.A. follows § 115 of the Uniform Negotiable Instruments Law. Id. at § 431 n.43. Section 115(4) creates a warranty of "no knowledge of any fact which would impair the validity of the instrument or render it valueless." J. CRAWFORD, THE NEGOTIABLE INSTRUMENTS LAW § 115(4) (2d ed. 1902). By contrast, § 36(c) of the U.S.A., and § 7-507(b) of the U.C.C., contain warranties against knowledge which would "impair the . . . worth of the document." The difference in degree between utter valuelessness and mere impairment of worth makes § 115(4) a poor interpretive aid for either § 36(c) of the U.S.A. or § 7-507(b) of the U.C.C. Also, since § 115(4) applies to negotiable instruments, rather than documents of title, cases interpreting § 115(4) are not helpful in determining which facts concerning the underlying goods would impair the validity or worth of a document of title.

37. 27 Misc. 2d 147, 208 N.Y.S.2d 996 (Sup. Ct. 1960).
then holder of the receipt sued Balfour, alleging that Balfour never delivered any seed to the warehouseman, and that there never was any seed in the warehouse to cover the receipt. On these allegations, the Stanford Seed court denied Balfour's motion to dismiss for failure to state a cause of action, stating:

If it is true, as we must assume it is on this motion that Balfour did not deliver any seed to the warehouseman where, on the face of the warehouse receipt [the warehouseman] states that it did . . . it follows . . . that Balfour had knowledge of a fact which would impair the validity or worth of the receipt. This would constitute a violation of section 44 of the Uniform Warehouse Receipt Act . . . .

Assuming that the analogous section 7-507(b) warranty may be similarly interpreted, Stanford Seed suggests that the section 7-507(b) ground for dishonor may function, at a minimum, to allow dishonor where there is knowledge that no goods stand behind a document of title, contrary to representations on the face of the document of title. To this extent, the section 7-507(b) ground for dishonor is reminiscent of the egregious fraud ground for dishonor.

However, there is nothing in Stanford Seed, nor in the language of section 7-507(b), to suggest that knowledge of a fact impairing the validity or worth of the document of title is limited to knowledge that there are no goods whatsoever. A document of title simply represents rights in goods. Logically, any fact which affects the worth of the goods covered by the document of title should affect the worth of the document of title itself. Thus, a person who transfers a document of title knowing the goods it represents are defective has knowledge of a fact which might impair the worth of the document of title. Further, a misrepresentation of the actual nature or number of the goods covered by the document of title might affect the worth of the document of title. Thus, a person who transfers a document of title knowing the goods it represents are fewer in number or of a different kind than stated in the document of title may have knowledge of a fact which impairs the worth of the document of title. Finally, it appears that the language of section 7-507(b) places no limitation on the degree to which the worth of the document of title must be impaired. Thus, a

38. Id. at 150-51, 208 N.Y.S.2d at 1000.
40. Under § 7-507(c), a person who negotiates or transfers a document of title warrants "that his negotiation or transfer is rightful and fully effective with respect to the title to the document and the goods it represents." Id. § 7-507(c). If the goods are different in nature or fewer in number than is represented on the face of the document of title, arguably a transfer of the document of title is not

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relatively minor defect or misrepresentation may be sufficient to impair the worth of a document of title.\textsuperscript{41}

\textbf{B. Interpreting Section 5-114(2)}

The next step is to analyze the language of section 5-114(2), which creates the section 7-507(b) ground for dishonor. Section 5-114(2) allows dishonor when "a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507)." Several interpretations of this ambiguous language are possible.

As a starting point, one could assume that the language "warranties \textit{made} on negotiation or transfer" limits dishonor to situations in which a section 7-507 warranty is actually made, and then breached. If such is the case, a question immediately suggests itself: warranties \textit{made to whom}?

Since the decision to honor or dishonor rests directly with the issuer, and indirectly with the customer (through the device of an injunction), it seems reasonable to conclude that the breach of a section 7-507 warranty must directly concern one of these two parties in order to constitute an effective ground for dishonor. Thus, one possibility is that the drafters of section 5-114 intended to allow dishonor fully effective with respect to title to the goods it represents. To this extent, there is a potential for overlap between the § 7-507(b) and § 7-507(c) warranties.

Simon v. Estate of Allen, 497 S.W.2d 800 (Tex. Civ. App. 1973), \textit{cert. denied}, 419 U.S. 843 (1974), lends support to this hypothesis. There, the transferee of warehouse receipts covering bales of cotton discovered that 7,459 bales represented by the receipts were missing from the warehouse at the time the receipts were transferred to him. It was held that the transferor of the receipts had breached the § 7-507(c) warranty under these circumstances. \textit{Id.} at 804.

The § 7-507(c) warranty remains a narrower ground for dishonor than the § 7-507(b) warranty, since it does not apply where there are defects in the goods represented by the document of title. It is broader since it does not require the person negotiating or transferring the document of title to have knowledge of the discrepancy between the goods and the document of title in order for a breach to occur. Of course, under either the § 7-507(b) or the § 7-507(c) ground for dishonor, the same difficulties in construing the ambiguous language of § 5-114(2) apply. \textit{See infra} text accompanying notes 42-55.

\textsuperscript{41} There are breaches of the underlying contract for sale between the buyer and seller which, even if known, will not impair the validity or worth of the document of title within the meaning of § 7-507(b). Suppose the seller ships non-defective goods, which conform to the description of their nature and quantity provided on the face of the document of title. In such a case, there is no disparity between the worth of the document of title, and the worth of the underlying goods, for the goods are not defective, and they are what they are represented to be. Nevertheless, the seller may have breached a warranty. For example, the goods may not be fit for the buyer's particular purpose, in violation of a § 2-315 warranty. \textit{See generally} U.C.C. § 2-315 (1978). Or, the goods may not have certain characteristics or performance capabilities attributed to them by the seller (but not reflected in the document of title description), in violation of a § 2-313 warranty. \textit{See generally id.} § 2-313.
where a section 7-507 warranty is made to the issuer, or to the customer, and breached.

There are two difficulties with this interpretation. First, a person who negotiates or transfers a document of title makes the section 7-507 warranties to his immediate purchaser only.\(^4\) Suppose the beneficiary first makes a demand for payment on a confirming bank,\(^4\) negotiating the document of title required under the letter of credit. Since "purchase" is defined to include taking by negotiation,\(^4\) the confirming bank may be the "immediate purchaser" of the document of title within the meaning of section 7-507.\(^4\) Moreover, the confirming bank itself, upon transfer or negotiation of the document of title to the issuer, makes only an intermediary's warranty\(^4\) of good faith and authority.\(^4\) Since no section 7-507 warranties were made to the issuer or customer, the beneficiary has insulated itself from the section 7-507 ground for dishonor by the simple device of transferring the document of title through banking channels.\(^4\)

Second, section 7-507 stipulates that its warranties are made when the document of title is negotiated or transferred for value.\(^4\) At the time when the issuer is deciding whether to honor the demand for payment under the letter of credit, or the customer is seeking an injunction against honor, the beneficiary (or other claimant) presumably has not yet negotiated or transferred the document of title to the

\(^{42}\) Id. \$ 7-507.

\(^{43}\) "Confirming bank" is defined as a bank which engages either that it will itself honor a credit already issued by another bank or that such a credit will be honored by the issuer or a third bank. Id. \$ 5-103(1)(f).

\(^{44}\) Id. \$ 1-201(32).

\(^{45}\) "Purchaser" is defined as a person who takes by purchase. Id. \$ 1-201(33).

\(^{46}\) Id. \$ 5-111(2).

\(^{47}\) Id. \$ 7-508.

\(^{48}\) This result might be disputed by some scholars. Squillante and Fonseca argue that where an intermediary is involved, the transferee of the document of title purchases it from the one who entrusted it, and not from the intermediary, so that the warranty of \$ 7-507 is not impaired. The only support offered for this conclusion, however, is that the authors "cannot believe that one can escape warranties by using an intermediary." 2 A. SQUILLANTE & J. FONSECA, THE LAW OF MODERN COMMERCIAL PRACTICES \$ 9:59, at 476 n.88 (rev. ed. 1981).

\(^{49}\) "Value" is defined in U.C.C. \$ 1-201(44) (1978):

Except as otherwise provided with respect to negotiable instruments and bank collections (Sections 3-303, 4-208 and 4-209) a person gives "value" for rights if he acquires them

(a) in return for a binding commitment to extend credit or for the extension of immediately available credit whether or not drawn upon and whether or not a chargeback is provided for in the event of difficulties in collection; or

(b) as security for or in total or partial satisfaction of a pre-existing claim; or

(c) by accepting delivery pursuant to a pre-existing contract for purchase; or

(d) generally, in return for any consideration sufficient to support a simple contract.
issuer, nor has value, in the form of payment under the letter of credit, yet flowed to the beneficiary. Therefore, the very section 7-507 warranties which the issuer or customer may wish to assert as grounds for dishonor will not yet have come into existence, and dishonor for breach of those warranties will be impossible.

It appears that interpreting section 5-114(2) to allow dishonor only where a section 7-507 warranty is actually made to an issuer or customer, and then breached, creates a ground for dishonor which is not only inconsistent in its application, but also completely non-functional. A second possible interpretation is that section 5-114(2) allows dishonor only where a section 7-507 warranty is actually made to some random individual or entity during the process of transferring the document of title, and breached. Although this second interpretation eliminates the problems discussed above, it engenders new ones.

As was the case with the first interpretation, the second interpretation inserts an element of arbitrariness into the section 7-507 ground for dishonor. It has been noted that the document of title cannot have been negotiated or transferred for value to the issuer or the customer at the critical moment when the demand for payment under the letter of credit is made. But, whether the document of title has been negotiated or transferred for value to any other person, thereby creating the section 7-507 warranties, depends on whether any other person has been included in the chain of transfer from the beneficiary to the issuer and customer. In other words, whereas presentation of the document of title indirectly through banking channels is sufficient to

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50. Actually, none of the definitions of "value" contained in § 1-201(44) fit neatly in the context of the letter of credit transaction. The letter of credit contract between the issuer and the customer obligates the issuer to honor the beneficiary's demand for payment, upon satisfaction of certain conditions. Thus, the issuer "acquires" the document of title when it performs under the letter of credit contract by giving the beneficiary money.

Given this background, it does not seem accurate to say that the issuer "acquires" the document of title in return for a binding commitment to extend credit, or an extension of credit. Id. § 1-201(44)(a). It is the beneficiary's act of drawing upon credit already extended him under the letter of credit contract which triggers acquisition of the document of title. Nor does the issuer "acquire" the document of title as security for or in satisfaction of some pre-existing claim against the beneficiary, id. § 1-201(44)(b), or by accepting delivery pursuant to a pre-existing contract for purchase. Id. § 1-201(44)(c).

It is perhaps most accurate to say that the issuer "acquires" the document of title in return for any consideration sufficient to support a simple contract, since money surely qualifies as such consideration. Id. § 1-201(44)(d). However, to the extent § 1-201(44)(d) suggests that the value be given as consideration for a contract, its application also seems inappropriate, since the issuer is not "acquiring" the document of title pursuant to some simple contract of sale between it and the beneficiary.
insulate the beneficiary from the section 7-507 ground for dishonor under the first interpretation of section 5-114, presentation of the document of title *directly* to the issuer should be sufficient to insulate the beneficiary from the section 7-507 ground for dishonor under the second interpretation of section 5-114.

There is a still more serious objection to the second interpretation, which may be raised against the first interpretation as well. Section 5-114(2) makes specific reference to *section 7-507* warranties. However, the Federal Bills of Lading Act (F.B.L.A.)\textsuperscript{51} preempts Article Seven whenever it applies.\textsuperscript{52} The F.B.L.A. applies to:

> Bills of lading issued by any common carrier for the transportation of goods in any Territory of the United States, or the District of Columbia, or from a place in a State to a place in a foreign country, or from a place in one State to a place in another State, or from a place in one State to a place in the same State through another State or foreign country, shall be governed by this chapter.\textsuperscript{53}

In other words, if section 5-114(2) requires section 7-507 warranties actually to be made, there will be no section 7-507 warranties, and no section 7-507 ground for dishonor, whenever the letter of credit transaction involves a bill of lading used in interstate commerce, or in an international export transaction. Since the letter of credit device is most useful when the parties are dealing at a distance,\textsuperscript{54} the result of such an interpretation is to eliminate the section 7-507 ground for dishonor altogether in many letter of credit transactions. Moreover, because the F.B.L.A. includes a provision whereby a person who negotiates or transfers a bill of lading makes essentially the same warranties as those contained in section 7-507,\textsuperscript{55} the distinction drawn between letter of credit transactions which involve bills of lading subject to the F.B.L.A., and those which do not, is irrational.

If one discards the staring assumption that section 5-114(2) limits dishonor to cases where a section 7-507 warranty is actually made, and breached, a third interpretation is possible. Section 5-114(2) speaks of "*the* warranties made on negotiation or transfer of a document of title (Section 7-507)." Perhaps this language may be interpreted as a shorthand reference to the section 7-507 warranties, rather

\begin{flushleft}
\textsuperscript{52} U.C.C. § 7-103 (1978).
\textsuperscript{54} See supra note 8.
\textsuperscript{55} 49 U.S.C. app. § 114 (1982), supra note 35.
\end{flushleft}
than as a requirement that section 7-507 warranties actually be made. Thus, the issuer would be entitled to dishonor, or the customer to seek an injunction, whenever a document is presented which fails to conform to the content of a section 7-507 warranty, regardless of whether any section 7-507 warranty is actually made, or to whom it is made. On balance, this third interpretation seems most attractive. It eliminates the paradox which results if dishonor is allowed for breach of a warranty that, by definition, cannot yet have been made. It also avoids arbitrary application of the section 7-507 ground for dishonor depending on whether the document of title is presented through banking channels. Finally, it does not draw illogical distinctions between letter of credit transactions which involve bills of lading subject to the F.B.L.A., and those which involve bills of lading subject to Article Seven.

C. Applying the Section 7-507(b) Ground for Dishonor

To discover the proper application of the section 7-507(b) ground for dishonor, it remains only to combine the results of the above analyses of sections 7-507(b) and 5-114(2). The same model transaction discussed previously in this article will be used to illustrate. Again, assume the seller knows that a small but not insignificant number of the apples to be sold are wormy. In section 7-507(b) jargon, this gives him knowledge of a fact which impairs the worth of any document of title he obtains in exchange for the apples. Therefore, although the document of title complies on its face with the letter of credit's terms, it does not conform to one of the "warranties made on negotiation or transfer of a document of title."56 Under section 5-114(2), then, the issuer may dishonor, and the buyer seek an injunction, regardless of whether the section 7-507(b) warranty is actually made, or to whom it is made.

III. Consequences of the Section 7-507(b) Ground for Dishonor

As demonstrated by the foregoing analysis, the practical consequence of the section 7-507(b) ground for dishonor is that an issuer or

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56. This model transaction happens to involve goods which are defective, but the nature and quantity of which are accurately represented in the document of title. The § 7-507(b) ground for dishonor could also apply where the nature or quantity of the goods is misrepresented in such a way as to suggest the document of title covers more valuable goods than is in fact the case. Any degree of misrepresentation suffices so long as the worth of the document of title is impaired.
its customer may achieve dishonor even in cases where a defect in the goods, or a misdescription in the document of title, is relatively minor, so long as the defect or misdescription is sufficient to impair the worth of the document of title. The conceptual consequences of the section 7-507(b) ground for dishonor are less clear.

In those jurisdictions where fraud must be egregious to constitute a ground for dishonor, only a severe defect in the goods, or a gross misrepresentation in the document of title covering the goods, justifies relief. By choosing to limit dishonor to instances of egregious fraud, these jurisdictions manifested their belief in the importance of the independence principle, and their determination that the principle should be preserved in as pure a form as possible. However, these same jurisdictions must allow dishonor in the case of a lesser defect or misrepresentation, so long as the issuer or customer is clever enough to assert section 7-507(b), rather than fraud, as a ground for dishonor. Thus, in such jurisdictions, the section 7-507(b) ground for dishonor introduces a conceptual inconsistency into section 5-114(2), and cuts a gaping hole in the independence principle, as it is currently understood.

On the other hand, some scholars argue that common law fraud, rather than egregious fraud, is the standard for dishonor adopted by section 5-114(2). In other words, any knowing material misrepresentation, made with the intention of inducing reliance, constitutes a ground for dishonor. This interpretation of the fraud ground for dishonor is reminiscent of the section 7-507(b) ground for dishonor, which applies where the person negotiating or transferring the document of title has knowledge of a fact impairing its validity or worth. Why did the drafters of section 5-114(2) include the section 7-507(b) ground for dishonor? Did they fail to realize that the fraud and section 7-507(b) grounds for dishonor were conceptually inconsistent, or did they have some reason for believing the two grounds to be

57. See Symons, supra note 2, at 367-68.
58. "Scienter" has been defined as knowledge or belief that a representation is false, or that there is insufficient information to support the representation. W. Prosser & W. Keeton, The Law of Torts § 105, at 728 (5th ed. 1984).
59. In 1940, the National Conference of Commissioners on Uniform State Laws, which had previously drafted such uniform commercial acts as the U.S.A., U.B.L.A., and U.W.R.A., adopted a proposal to draft a comprehensive commercial code. In 1944, the American Law Institute agreed to co-sponsor the project. J. White & R. Summers, supra note 7, at 2-3.
conceptually compatible? Unfortunately, research into the drafting history of section 5-114(2) produces no clear answers to these questions.

In 1941, the National Conference of Commissioners on Uniform State Laws (N.C.C.U.S.L.) was engaged in the task of revising the Uniform Sales Act. Section 36 of the U.S.A., one of the precursors of section 7-507 of the U.C.C., was amended by the addition of the following subsection:

(2) A seller who negotiates or transfers a document of title to a banker, or causes it to be so negotiated, and thereby induces the banker to make payment of or advances on the price, thereby makes to the banker the warranties described in subsection 1(a), (b), (c) and (d), and also warrants the genuineness of all documents presented which are required to accompany the document of title, and the truth of all statements about the goods contained in any invoice so required.

But neither the warranty in subsection 1(c) nor the warranty of truth of statements in the invoice may be used by the banker as a defense against an obligation incurred by him to the seller to make tentative payment against documents, unless the character of the breach of warranty be so gross as to make out deliberate fraud . . . .

The comment appended to this draft provision explained that subsection (2):

state[d] the case-law, so far as concerns the barring of discrepancy of quality and minor defect in the goods from being a defense under a banker's credit when the documents conform . . . . The fact is, that only extraordinary circumstances have any business to excuse payment when the documents do conform. The fact is, also, that bare-faced fraud should be enough so to excuse.

The express limitation of dishonor to instances of gross breach of the warranty of truth of statements in the invoice, or the subsection 1(c) warranty, was believed necessary to eliminate the possibility of dishonor for minor defects in the goods. The warranty contained in subsection 1(c) of section 36 is a predecessor of the section 7-507(b) warranty; it provided “that he [the person negotiating or transferring the document of title] has knowledge of no fact which would impair the validity or worth of the document.” Thus, there is evidence that

61. Id. Comment on § 36, reprinted in 1 U.C.C. DRAFTS at 454.
62. Id. § 36(1)(c), reprinted in 1 U.C.C. DRAFTS at 453.
the revisors of section 36 were aware that permitting dishonor where there was knowledge of a fact impairing the validity or worth of the document of title would result in permitting dishonor for defects in the goods which were not egregious.

As the process of drafting the U.C.C. got underway with the help of the American Law Institute (A.L.I.), later provisions retained and broadened this limitation upon the ability to dishonor:

An issuer is not excused from honor by the fact that the goods or documents do not conform to the underlying contract for sale or to the warranties described in Section 67(1) of the Uniform Revised Sales Act; but as against any person it is excused by falsity of or failure of title to any document required as a condition and is also excused against a seller or consignor by such a non-conformity as amounts to a failure of consideration.63

The corresponding draft of section 67(1) of the Uniform Revised Sales Act (U.R.S.A) incorporated the warranties of section 66,64 a predecessor of section 7-507:

Where a person negotiates or transfers a document of title for value otherwise than as a mere intermediary under Section 68, then unless otherwise agreed he warrants to his purchaser in addition to any warranty made in selling the goods
(a) that the document is genuine; and
(b) that he has no knowledge of any fact which would impair its validity or worth; and
(c) that his negotiation or transfer is rightful and fully effective with respect to the title to the document and the goods it represents.65

Still later drafts provided that any failure of the documents to

64. Section 67(1) provided:
Any person who procures issuance of a document of title or other third party document and so deals with it that payment or advances are at any time made against it or against a draft or claim which it secures warrants to each person who makes such payment or advances but only to the extent thereof
(a) all the facts warranted under Section 66; and
(b) the genuineness of any document which he causes to accompany the document of title; and
(c) the truth of all representations made in the document of title, including any description therein purporting to be the description of the goods, or made by him in his invoice or any other accompanying documents.
Id. U.R.S.A. § 67(1), reprinted in 5 U.C.C. DRAFTS at 265.
65. Id. U.R.S.A. § 66, reprinted in 5 U.C.C. DRAFTS at 265.
conform to “the warranties implied from dealing with documents of title” did not constitute grounds for dishonor. Although the “warranties implied from dealing with documents of title” were not identified with greater specificity, in light of the previous drafting history, it seems a fair inference that the phrase included the three warranties which were eventually contained in section 7-507 of the UCC.

The 1957 Official Text of the UCC marked a sudden reversal of this consistent drafting policy. For the first time, failure of a required document to conform to the section 7-507 warranties became a ground for dishonor. One searches in vain for any explanation of this critical change. It is possible that the drafters were responding to a criticism made in a study of the letter of credit provisions of the U.C.C. commissioned by the New York Law Revision Commission.

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69. The first official text of the U.C.C. appeared in 1952. In 1953, the governor of New York assigned to the New York Law Revision Commission the task of preparing a study of the U.C.C. I N.Y. Law Revision Comm'n, Report of the Law Revision Commission for 1954 and Record of Hearings on the Uniform Commercial Code 7 (1954). In the course of this study, the Commission conducted public hearings, received memoranda and correspondence from prominent scholars, lawyers,
The study complained that section 5-111(1) of the 1952 Official Text of the U.C.C. was "hopelessly ambiguous" with regard to the issuer's ability to dishonor without liability to the beneficiary, where there was forgery or fraud in a required document.\textsuperscript{70} The confusion, the study argued, stemmed from the language prohibiting dishonor where a document failed to conform to the "warranties implied from dealing with documents":

It would have been easy to say that an issuer is not excused from honor by the fact that there is a forgery or fraud or alleged forgery or fraud in a document apparently regular on its face. But the Code does not use such simple language. It says that the issuer is not excused from honor by the fact that the documents "do not conform . . . to the warranties implied from dealing with documents." The reference is perhaps to the warranties stated in Section 5-110(1), and with respect to documents of title in Sections 7-507 and 7-508. Without going into a detailed analysis of these sections, one gathers from merely reading them that a beneficiary who personally has manufactured a forged or fraudulent document would be held liable for breach of a warranty; and it is arguable, though not certain, that such warranty would be regarded as one "implied for dealing with documents."\textsuperscript{71}

This commentary implied an identity between documents which failed to conform to the "warranties implied from dealing with documents" and forged or fraudulent documents. Perhaps this implication persuaded the drafters of the U.C.C. that they could safely secure the issuer's option to dishonor when forged or fraudulent documents were presented by eliminating the criticized language and adding section 7-507 as a new basis for dishonor. But, did the drafters realize that, although there was some overlap between documents which failed to conform to the section 7-507 warranties and forged or fraudulent documents, the two were not necessarily identical? Did they realize that, by adding the section 7-507(b) ground for dishonor, they were setting up a standard for dishonor which was inconsistent with an egregious fraud standard?

\textsuperscript{71} Id.
Symons suggests that, by adding the section 7-507(b) ground for dishonor, the drafters indicated their intent to allow dishonor in cases of knowing misconduct falling short of egregious fraud. This interpretation of the drafters' intent receives some weak support from the fact that, at least in 1941, there was a realization on the part of the N.C.C.U.S.L. that allowing dishonor for breach of the section 36(1)(c) warranty of the U.S.A. (the model for the section 7-507(b) warranty) would open the door to dishonor based on defects in the goods which were not egregious. However, it is also possible that the drafters simply failed to realize, sixteen years later, that by incorporating section 7-507(b) into section 5-114(2), they were creating a ground for dishonor which was conceptually inconsistent with an intended egregious fraud standard for dishonor. In the absence of hard evidence, any attempt to divine the drafters' intent in adding the section 7-507(b) ground for dishonor, and thereby determine whether section 5-114(2) is internally consistent, remains sheer speculation.

CONCLUSION

The section 7-507(b) ground for dishonor has received little scholarly or judicial attention. This seems strange in view of its wide-ranging ramifications. As a practical matter, it makes dishonor possible where a seller knows that the goods he shipped are defective, or that the document of title covering the goods contains a misrepresentation, where the defect or misrepresentation impairs the document of title's worth. As a conceptual matter, it conflicts with the fraud ground for dishonor also included within section 5-114(2), at least in the many jurisdictions adopting the egregious fraud standard.

This writer has some misgivings regarding the advisability of the section 7-507(b) ground for dishonor. The role of the letter of credit device as a means of guaranteeing payment to an anxious beneficiary must be kept firmly in mind. Traditionally, the independence principle has served to safeguard this role. Yet, the section 7-507(b) ground for dishonor seriously weakens the independence principle by allowing dishonor for defects or misrepresentations which are not egregious. Some might claim that the difficulty of proving knowledge of the defect or misrepresentation prevents wholesale destruction of the principle. However, where the defect or misrepresentation is patent, such knowledge may be readily inferred. Furthermore, this damage

72. Symons, supra note 2, at 368.
73. See id. at 381.
to the independence principle is not offset by any pressing need to protect the issuer or customer from the heinous acts of the beneficiary by allowing dishonor. Where a defect or misrepresentation is not egregious, the issuer's security interest in the goods and document of title is not seriously impaired, nor will the customer sustain any heavy financial loss.

Those twin guardians of the U.C.C., the A.L.I. and the N.C.C.U.S.L., would be well advised to consider whether the section 7-507(b) ground for dishonor should be eliminated from section 5-114(2). Even if the section 7-507(b) ground for dishonor is retained, clarification of the present ambiguous language of section 5-114(2), which causes needless confusion as to the ground's proper application, would be helpful.