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U.C.C. § 5-114: Party Claiming Holder in Due Course Status in a Letter of Credit Transaction Has the Burden of Proving Such Status

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UNIFORM COMMERCIAL CODE

U.C.C. § 5-114: Party claiming holder in due course status in a letter of credit transaction has the burden of proving such status.

Designed to facilitate the flow of international commerce by providing shippers with positive assurances of payment for goods shipped, Uniform Commercial Code section 5-114(1)[207] provides that an issuer of a letter of credit must honor a draft drawn, or demand made, upon the credit regardless of whether the goods conform to the underlying contract.[208] The Code recognizes, however, that there may be instances in which the customer or issuer needs protection from the wrongful acts of either the beneficiary or holders of drafts drawn on a credit. Accordingly, section 5-114 permits a court to enjoin the honor of a draft or demand when there is "fraud in the transaction,"[209] except as against a holder in due course.[210] Section

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[207] N.Y.U.C.C. § 5-114(1) (McKinney 1964), provides in pertinent part:

> An issuer must honor a draft or demand 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.

[208] The letter of credit substantially reduces the seller's risks in commercial transactions since the documentary transaction generally is completed and the irrevocable credit established at a bank before the seller begins performance of the contract. The customer pays the issuer to issue a letter of credit, which is drawn so as to permit the beneficiary-seller to draw drafts on it. Upon issuance of the letter of credit, the beneficiary may receive notification from an advising bank. Once the advising bank has notified the beneficiary that the irrevocable credit has been issued, payment to the seller may not be defeated if the seller performs the contract in good faith and presents the requisite documentation to the issuer. Further, because a holder in due course takes a letter of credit free from all contractual claims, the letter is highly marketable. This allows a beneficiary to sell the credit prior to execution of the contract and obtain funds with which to perform the contract. For definitions of terms relevant to letters of credit, see N.Y.U.C.C. § 5-103 (McKinney 1964). *See generally* J. WHITE & R. SUMMERS, THE LAW UNDER THE UNIFORM COMMERCIAL CODE, 601-06 (1972) [hereinafter cited as WHITE & SUMMERS]. *See also* N.Y.U.C.C. § 5-103, official comments, at 653-54 (McKinney 1964).

[209] N.Y.U.C.C. § 5-114(2)(b) (McKinney 1964). The Code is silent as to the definition of fraud in the transaction. Professors White and Summers state that the term implies egregious fraud, and not merely fraud in the inducement. WHITE & SUMMERS, *supra* note 208, at 625. Section 5-114, which provides protection against fraud in the transaction, incorporates much of the common law as enunciated in Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. N.Y. County 1941). In the *Sztejn* case, the seller shipped "cowhair, other worthless material and rubbish" instead of the bristles called for in the contract. After shipping the "merchandise," the seller obtained the proper documents and submitted them to a bank, which presented the papers to the issuer for payment. The buyer then sought injunctive relief to prevent the issuer from paying the draft. Finding that the presenting bank was merely an agent for the seller rather than a holder in due course, the court held that the bank was not entitled to payment under the draft. *Id.* at 723, 31 N.Y.S.2d at 635. *See* B. KOZOLCHYK, COMMERCIAL LETTERS OF CREDIT IN THE AMERICAS 285-88 (1966), *reprinted in* R. SPIEDEL, R. SUMMERS & J. WHITE, TEACHING MATERIALS ON COMMERCIAL AND CONSUMER LAW 1252-54 (2d ed. 1974).

5-114(2)(a) specifically references article 3 of the Code in discussing holder in due course[211] but does not indicate which party has the burden of proving such status. In *United Bank Ltd. v. Cambridge Sporting Goods Corp.*,[212] the Court of Appeals unanimously held that once fraud in the transaction is established, the burden of proving holder in due course status is upon the person seeking to obtain payment of a draft by invoking that status.[213]

Defendant Cambridge, the purchaser-customer, ordered twenty-eight thousand pairs of boxing gloves from Duke Sports, a Pakistani company. At the request of plaintiffs, two Pakistani banks who financed the sale, an irrevocable letter of credit naming Duke as beneficiary was issued by Manufacturers Hanover Trust Company of New York. Subsequently, Duke advised that it was unable to meet the delivery date specified in the contract. Cambridge immediately terminated the contract and notified one of the Pakistani banks of the cancellation. Despite the cancellation, Duke obtained documents evidencing shipments of boxing gloves and drew drafts on the credit payable to plaintiff banks.[214] When it subsequently was discovered that Duke had shipped "old, unpadded, ripped, and mildewed gloves"[215] instead of the new boxing gloves ordered, Cambridge obtained a preliminary injunction to prevent Manufacturers Hanover from honoring the drafts. Cambridge further proceeded to levy on the funds subject to the letter of credit and was awarded a default judgment against Duke.[216] Claiming to be holders in due course, the Pakistani banks instituted the present action against Cambridge, seeking release of the levy and payment of the drafts.[217] The trial court refused to entertain defendant's

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[210] N.Y.U.C.C. § 5-114(2)(a) (McKinney 1964) provides that despite a claim of fraud in the transaction

> [t]he issuer must honor the draft or demand for payment if honor is demanded by a . . . 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
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> . . . .

[211] N.Y.U.C.C. § 3-302(1) (McKinney 1964), defines a holder in due course as a "holder who takes the instrument (a) for value; and (b) in good faith; and (c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person."

[212] 41 N.Y.2d 254, 360 N.E.2d 943, 392 N.Y.S.2d 265 (1976), *rev'g* 49 App. Div. 2d 868, 374 N.Y.S.2d 639 (1st Dep't 1975) (mem.).

[213] 41 N.Y.2d at 257-58, 360 N.E.2d at 947, 392 N.Y.S.2d at 269.

[214] *Id.* at 256, 360 N.E.2d at 946, 392 N.Y.S.2d at 268.

[215] *Id.*

[216] *Id.* at 257, 360 N.E.2d at 947, 392 N.Y.S.2d at 268.

[217] *Id.*

claim of fraud in the transaction, finding that Cambridge first had to demonstrate that plaintiffs were not holders in due course. Consequently, the lower court ordered that payment of the drafts be made.[218] This decision subsequently was upheld by the Appellate Division, First Department.[219]

The Court of Appeals reversed, holding that once fraud in the transaction is established, a person claiming to be a holder in due course in a letter of credit situation has the burden of proving such status.[220] Observing that section 5-114(2)(a) makes reference to, and draws upon, article 3 of the Code for other purposes, Judge Gabrielli reasoned that it is logical to employ the article 3 burden of proof rules as well.[221] Therefore, the court concluded, once the defense of fraud in the transaction is shown, the burden of proving holder in due course status is on the party demanding payment by virtue of such status.[222]

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[218] 49 App. Div. 2d at 868, 374 N.Y.S.2d at 639. Cambridge had never denied the signatures on the drafts, and they therefore were deemed admitted. *Id.* at 868, 374 N.Y.S.2d at 639-40. The N.Y.U.C.C. § 3-307(1) (McKinney 1964), provides that "[u]nless specifically denied in the pleadings each signature on an instrument is admitted." Thus, once the signatures were admitted, absent additional evidence, the plaintiffs were entitled to payment. 49 App. Div. 2d at 868, 374 N.Y.S.2d at 640. *See* N.Y.U.C.C. § 3-307(2) (McKinney 1964) which states: "When signatures are admitted or established, production of the instrument entitles a holder to recover on it unless the defendant establishes a defense."

[219] 49 App. Div. 2d at 868, 374 N.Y.S.2d at 639.

[220] 41 N.Y.2d at 265, 360 N.E.2d at 952, 392 N.Y.S.2d at 274.

[221] *Id.* at 262, 360 N.E.2d at 950, 392 N.Y.S.2d at 272. Under the article 3 burden of proof rules, "[a]fter it is shown that a defense exists a person claiming the rights of a holder in due course has the burden of establishing that he or some person under whom he claims is in all respects a holder in due course." N.Y.U.C.C. § 3-307(3) (McKinney 1964). Thus, to prevail on the claim of holder in due course status, the banks must show they had no notice of the fraud prior to accepting the drafts. *See id.* § 3-302(1)(c).

[222] 41 N.Y.2d at 262, 360 N.E.2d at 950, 392 N.Y.S.2d at 272-73. *See* N.Y.U.C.C. § 3-307, official comment 3 (McKinney 1964). The Court of Appeals found no evidence in the record that plaintiffs were holders in due course, so it dismissed their petition. 41 N.Y.2d at 265, 360 N.E.2d at 952, 392 N.Y.S.2d at 274.

A related issue before the Court concerned the admissibility of certain evidence bearing on plaintiffs' alleged holder in due course status. Before trial, Cambridge had sought to depose the Pakistani banks. Since this request was denied, Cambridge used written interrogatories as a substitute. At trial, the banks introduced only the answers to the interrogatories into evidence. This evidence was objected to by Cambridge as conclusory and self-serving. The banks claimed that the answers were admissible pursuant to an exception to CPLR 3117(a)(2). CPLR 3117(a)(2) provides that an *adverse party* may introduce answers to interrogatories for any purpose, to the extent they otherwise are admissible by the rules of evidence. The exception to CPLR 3117 invoked by the banks allows either party to use interrogatory answers against a party who was present or represented at the time they were taken if the witness is more than 100 miles from the situs of the trial or is beyond the jurisdiction of the court. CPLR 3117(a)(3)(ii). The trial court reasoned that since defendant Cambridge had caused the interrogatories to be used, it was in no position to argue that it lacked an opportu-

The decision in *United Bank* is in consonance with the plain language of the Code and in accord with prior case law.[223] It is submitted that in factual settings involving the fraudulent shipment of totally worthless merchandise, such as *United Bank*, the defrauded buyer should be afforded the protection of section 5-114 by having the onus of proving holder in due course status placed upon the party seeking payment. If this burden is not met, the party victimized by fraud in the transaction will be protected. On the other hand, should the holder carry the burden, his claim will be sustained in the face of an accusation of fraud. This is in keeping with the Code's underlying philosophy that as between two innocent parties, the one farthest from the fraud should be protected.[224] As a result of the *United Bank* decision, a practitioner pursuing an action in which he is seeking to claim holder in due course status in connection with article 5 of the Code must be prepared to carry the burden of proving such status.

DEVELOPMENTS IN NEW YORK PRACTICE

Evidence of habitual carelessness held admissible to establish plaintiff's negligence in products liability action.

New York courts uniformly have excluded evidence of habitual carelessness in negligence actions, deeming proof of such behavior

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nity to cross-examine. 41 N.Y.2d at 264, 360 N.E.2d at 951, 392 N.Y.S.2d at 273. The Court of Appeals reversed, holding that where the party serving the interrogatories does not have the opportunity to cross-examine or impeach the party offering the answers, the exception contained in CPLR 3117(a)(3)(ii) is not satisfied and the answers are inadmissible. Noting that the exception to CPLR 3117 requires that "the absence of a witness must not have been procured by the party seeking to offer a deposition or responses to interrogatories," the Court also found the answers inadmissible because the plaintiff banks had refused to produce a prospective witness and objected to a deposition. 41 N.Y.2d at 265, 360 N.E.2d at 952, 392 N.Y.S.2d at 274 (citing CPLR § 3117(a)(3)(ii)). In the Court's opinion, this was tantamount to procuring the absence of a witness from the jurisdiction. 41 N.Y.2d at 265, 360 N.E.2d at 952, 392 N.Y.S.2d at 274.

[223] *See* Banco Espanol de Credito v. State Street Bank & Trust Co., 409 F.2d 711 (1st Cir. 1969); Sztejn v. J. Henry Schroder Banking Corp., 177 Misc. 719, 31 N.Y.S.2d 631 (Sup. Ct. N.Y. County 1941). In *Banco Espanol* the buyer and seller failed to agree upon the precise shipping documents required to collect on the letter of credit. Judge Coffin, in applying the Massachusetts Code, had no doubt that once a defense of improper documentation was established, § 5-114(2) and article 3 placed the burden of proof upon the party seeking to claim holder in due course protection.

[224] The *United Bank* Court noted that while contrary authority exists, the better view is that as between two innocent parties, the party who chooses to deal with fraudfeasors should bear the ultimate loss. Thus, fraud on the part of the seller may not be used by a buyer to defeat the rights of a holder in due course. 41 N.Y.2d at 261 n.6, 360 N.E.2d at 949 n.6, 392 N.Y.S.2d at 271 n.6. *See generally* N.Y.U.C.C. § 5-114, commentary at 686-89 (McKinney 1964).