Liberty, Trade, and The Uniform Commercial Code: When Should Default Rules Be Based on Business Practices?

Kerry Lynn Macintosh
LIBERTY, TRADE, AND THE UNIFORM COMMERCIAL CODE: WHEN SHOULD DEFAULT RULES BE BASED ON BUSINESS PRACTICES?

KERRY LYNN MACINTOSH*

The last several years have been a time of revision and renewal for the Uniform Commercial Code (the "Code," UCC) and its drafters. The American Law Institute (ALI) and the National Conference of Commissioners on Uniform State Laws (NCCUSL) have added two entirely new articles,1 extensively revised four others,2 and presently are redrafting two more.3

* Associate Professor of Law, Santa Clara University School of Law. B.A. 1978, Pomona College; J.D. 1982, Stanford University.

Thanks are due to Professor Arthur Travers of the University of Colorado School of Law, and Professors June Carbone and Leslie Griffin of Santa Clara University School of Law, for their valuable suggestions. I also thank Justin Hovey, J.D. 1997, Renee Lacey, J.D. 1996, Tom Benda, J.D. 1995, and Traci Sunderland, J.D. 1995, Santa Clara University School of Law, for their outstanding research assistance.

1. Article 2A, which governs leases of goods, was added to the official text of the Code in 1987, and was amended in 1990. Every state has enacted Article 2A, except Connecticut, Louisiana, and South Carolina. See American Bar Association, Commercial Law Newsletter, UCC Scorecard (March 1997) [hereinafter "UCC Scorecard 1997"]. Article 4A, which regulates funds transfers was added in 1989, and has been adopted in every state. See American Bar Association, Commercial Law Newsletter, UCC Scorecard (June 1996).

2. Extensive revisions to Articles 3 (Negotiable Instruments) and 4 (Bank Deposits and Collections) were completed in 1990. Since then, every state except Massachusetts, New York, Rhode Island, and South Carolina has enacted the revisions into law. UCC Scorecard 1997, supra note 1.

In 1994, Article 8 (Investment Securities) was revised and reissued in a new Official Text. More recently, the ALI and NCCUSL completed a thorough revision of Article 5 (Letters of Credit) in 1995. Although relatively new, these revised Articles already have been enacted in many states. See id.

3. The ALI and NCCUSL are working on extensive revisions to Articles 2 (Sales of Goods) and 9 (Secured Transactions). For a sampling of literature on the revision process, see Gail Hillebrand, The Redrafting of UCC Articles 2 and 9: Model Codes or Model Dinosaurs? 28 LOY. L.A. L. REV. 191 (1994); Howard Ruda, Article 9 Works—How Come? 28 LOY. L.A. L. REV. 309 (1994); Richard E. Speidel, Article 2 and Relational Sales Contracts, 26 LOY. L.A. L. REV. 789 (1993); Symposium: The
These new and revised articles reflect a strong trend toward choosing default rules that codify existing business practices. This is particularly true of the recent revisions to Articles 3 (Negotiable Instruments), 4 (Bank Deposits and Collections) and 5 (Letters of Credit).

At first glance, this trend may seem unremarkable; after all, scholars have long suggested that Karl Llewellyn, the principal draftsman of Article 2, intended the Code as a codification of business practices—a simple reaffirmation of the "morals of the marketplace." However, consumer advocates have protested

---

4. In this Article, the term "default rules" refers to legal rules that fill the gaps in incomplete contracts. Contracting parties have the freedom to contract around default rules. See Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 YALE L.J. 87, 87 (1989). For example, the parties to a contract for the sale of goods can disclaim implied warranties and exclude consequential damages. See U.C.C. §§ 2-316, 2-719(3) (1995).

By contrast, "immutable rules" are those that parties cannot change by agreement. See Ayres & Gertner, supra, at 87. Returning to the foregoing example, the parties to a contract for the sale of goods cannot exclude consequential damages when it would be unconscionable to do so. Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable. See U.C.C. § 2-719(3).

5. In this Article, the term "business practices" is used to refer to practices that emerge over time as countless market participants exercise their freedom to engage in profitable transactions. For an account of the evolution of business practices, see infra Part II. As used here, "business practices" is broader and less technical than "trade usage," which the Code narrowly defines as "any practice or method of dealing having such regularity of observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to the transaction in question." U.C.C. § 1-205(2).

6. See, e.g., Richard Danzig, A Comment on the Jurisprudence of the Uniform Commercial Code, 27 STAN. L. REV. 621, 626-29 (1975). According to Professor Danzig, the Code assumes that ethical "values have an objectively ascertainable existence and near universal acceptance and thus can be judicially discovered." Id. at 629. He found this assumption disturbing because it "confine[s] the impact of the law to a reaffirmation of the predominant morals of the marketplace," id., and "encourages lawmakers to see law... as a body of devices for the purposes of business instead of as a body of means toward general social ends." Id. at 630 (quoting Roscoe Pound, The Call for a Realist Jurisprudence, 44 HARV. L. REV. 697, 708 (1931)).

Professor Zipporah Wiseman has offered a somewhat different view of the Code and of Llewellyn in her comprehensive study of the merchant rules found in Article 2. She acknowledged that Llewellyn advocated merchant reality as being an ideal standard in an effort to endorse marketplace norms of speed and efficiency. See
loudly the recent revisions and their probusiness orientation,\(^7\) sometimes to the point of jeopardizing legislative enactment.\(^8\)

This controversy invites reexamination of the relationship between business practices and the default rules of the UCC.

Economists long have argued that contract and commercial law should establish default rules reflecting what the parties would have chosen if bargaining were costless.\(^9\) As Professor Zipporah B. Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 Harv. L. Rev. 465, 492 (1987). "His vision also encompassed a normative belief that the law should encourage the better practices and control the worst abuses of the market." Id.; see also Ingrid M. Hillinger, *The Article 2 Merchant Rules: Karl Llewellyn's Attempt To Achieve the Good, the True, the Beautiful in Commercial Law*, 73 Geo. L.J. 1141, 1181 (1985) (arguing that Llewellyn designed sound, rational commercial rules reflecting ideal, rather than actual, business conduct). As Professor Wiseman conceded, many of Llewellyn's original proposals were rejected, perhaps because merchants rebelled against Llewellyn's normative vision of "better" merchant practices. See Wiseman, supra, at 471-72, 519-38. For her complete critique of Danzig's views, see id., at 468-69 n.13.

In contrast to both Danzig and Wiseman, Professor Hal Scott has strongly disputed the prevailing "conception that commercial law embodies the law merchant and that the Uniform Commercial Code merely furnishes businessmen with a clear statement of their rules." Hal S. Scott, *The Risk Fixers*, 91 Harv. L. Rev. 737, 737 (1978). He argued that commercial legislation is regulatory in nature; it is designed to change, rather than codify, existing allocations of risk. See id. at 738-39, 761-76.


8. See infra notes 292-298 and accompanying text.


More recently, Professors Ian Ayres and Robert Gertner have asserted that efficient outcomes sometimes may be better achieved by imposing rules that the parties would not choose: so-called "penalty" defaults that require a party with superior information to reveal that information during the bargaining process. See Ayres & Gertner, supra note 4, at 98.

For an alternative account of default rules that does not rely on economic principles, see Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 Va. L. Rev. 821 (1992). Professor Barnett has argued that the common law of contract should provide default rules that reflect the norms of fairness and efficiency embodied within the "common sense" of the community. See id. at 906-11. In his view, adoption of such "conventionalist" default rules would have two advan-
Mitchell Polinsky has explained, "[s]ince the parties would have included contract terms that maximize their joint benefits net of their joint costs—both parties can thereby be made better off—this approach is equivalent to designing contract law according to the efficiency criterion." Building on this tradition, the drafters have argued that revised Articles 3, 4, and 5 reduce transaction costs and make payment systems more efficient. Consumer advocates have argued their case using similar economic terms, but have concluded that the same revisions are not efficient.

Although this economic debate has been informative in many ways, it also has proven inconclusive. More importantly, the economic debate has focused on the merit of specific rules that are based on business practices, and not on the more general question of whether business practices are an appropriate source of commercial default rules, and if so, why.

This Article provides a normative account of the relationship between business practices and the default rules of the UCC. The thesis is that business practices are a legitimate source of

tages. First, conventional understandings provide the best evidence of any subjective, tacit assumptions that the parties may have made while bargaining. See id. at 880-81. Thus, conventionalist default rules conform most closely to the subjective agreement of the parties. See id. at 874-85. Second, when parties are not equally knowledgeable about contract law, a default rule that reflects the common sense expectation of the reasonably ignorant party gives the better-informed party incentive to share his superior knowledge as necessary to contract out of the rule. See id. at 894-95. In this manner, conventionalist default rules reduce the incidence of subjective disagreement about terms not reflected in the parties' manifested assent. See id. at 875, 885-94. Interestingly, Professor Barnett has identified trade usage and course of dealing as possible sources of information regarding the common sense expectations of the community. See id. at 906-07.

10. POLINSKY, supra note 9, at 27. The word "efficiency" can be used in many ways. For example, a situation is said to be pareto efficient or pareto optimal when there is no change from that situation that can better one person's existence without worsening another's. See id. at 7 n.4.

This Article is not intended as a formal exposition of economic principles. Accordingly, I follow Professor Polinsky's excellent example in choosing a more intuitive definition for expositional simplicity: A situation will be termed "efficient" if its aggregate benefits outweigh its aggregate costs. See id. at 7.

11. See infra Parts IV and V.


13. See infra Part V.C.
default rules, to the extent that those practices are the product of free choice by market participants. In other words, default rules should be based on business practices as a means of respecting individual liberty.

In developing this theory of commercial law, this Article reasons by analogy to works of political philosophy. Part I explains Robert Nozick’s theory of the evolution of the minimal state. Nozick has theorized that individuals in a state of nature will exercise their liberty to develop voluntary protective associations capable of protecting members against others who would threaten their lives, health, liberty, or property. Emerging over time, a dominant protective association may exercise a de facto monopoly over the use of force, and have a moral obligation to extend its services to individuals within its boundaries. Thus, a minimal state can arise through an “invisible hand” process.

Part II employs similar reasoning to develop a theoretical model of commercial law. Individuals who enjoy freedom and who own property will trade goods and services with each other, and, across countless transactions, business practices will begin to emerge. Individuals may choose to band together in voluntary trade associations, enforcing contractual promises and relevant business practices through a system of arbitration and private sanctions. As a voluntary association comes to dominate a certain trade or geographical area, it will have the de facto power to enforce arbitration decisions—and underlying business practices—against members and nonmembers alike. Through this “invisible hand” process, business practices may come to approach the status of law.

Part III of this Article explores the policy implications of my theoretical model of commercial law for the UCC. Drawing upon Articles 1 and 2 of the Code, this Article documents several ways in which the UCC codifies business practices. Then, reasoning by analogy to the theoretical model, I explain that existing business practices are generated when individuals use their freedom of contract over the course of many commercial transac-

15. See id. at 15-17.
16. See id. at 18-22.
tions. Thus, when the Code adopts such business practices, it respects the liberty of the individuals who helped to create those practices. The Code further safeguards liberty by allowing individuals to agree to vary the effect of its default provisions.

Part IV furthers my theoretical model by applying it to specific developments that have occurred in letter of credit law. Both the original and the revised Article 5 are based on letter of credit practices that ensure operational efficiency. Such practices, however, have more than economic benefits. They also embody the free choices made by individual issuers, beneficiaries, and applicants over many years and transactions. By incorporating default rules based on letter of credit practices, revised Article 5 respects the liberty of issuers, beneficiaries, and applicants.

Finally, Part V examines controversial rules within revised Articles 3 and 4 that affect the rights and obligations of banks and their customers. In theory, checking account practices reflect the free choices of both banks and customers. Problems arise, however, in applying this theory to consumer checking accounts. Consumers lack the knowledge and power to bargain effectively with banks, and have few alternative payment mechanisms available to them. Unfortunately, this lack of meaningful choice within a significant segment of the market makes it hard to justify the codification of checking account practices on liberty grounds.

This Article concludes that liberty has important normative implications for the content of commercial law. Often, business practices embody principles of freedom. As a general rule, the drafters should adopt business practices as law in order to respect commercial judgment and protect free choice. Nevertheless, I recognize that this reasoning has limits. Practice-based default rules are justifiable on liberty grounds only when affected individuals have a reasonable opportunity to participate in the development of underlying practices. Too often, consumers lack the knowledge and bargaining power necessary to participate in the evolution of consumer-friendly practices. Thus, the drafters should be cautious in extending practice-based rules beyond their commercial roots. The drafters should continue to adopt business practices as the general framework for the Code, but also should stand ready to carve out specific rules as neces-
necessary to accommodate consumer interests.

I. ANARCHY, STATE AND UTOPIA

Some twenty years ago, Robert Nozick published his masterpiece of political theory, Anarchy, State and Utopia. Arguing that state of nature theory packs "explanatory punch and illumination," Nozick expounded a theory of the state that owed much to John Locke's Second Treatise of Government.

Nozick began his analysis by repeating several of Locke's fundamental observations. The cornerstone of the Lockean state of nature is the liberty of the individual. Individuals are in "a state of perfect freedom to order their actions and dispose of their possessions and persons as they think fit, within the bounds of the law of nature, without asking leave, or depending upon the will of any other man." The bounds of nature impose minimal restraints upon this liberty: "[N]o one ought to harm another in his life, health, liberty, or possessions."

Within the Lockean state of nature, each individual has the right to enforce the law of nature: "[E]very one has a right to...

---

17. NOZICK, supra note 14. In more recent years, Nozick has questioned the adequacy of the political philosophy that he presented in Anarchy, State and Utopia, at least to the extent that it fails to address the importance of political action as a symbolic expression of our social ties and concerns. See ROBERT NOZICK, THE EXAMINED LIFE 286-92 (1989) [hereinafter NOZICK, EXAMINED LIFE]; ROBERT NOZICK, THE NATURE OF RATIONALITY 32 (1993). Nozick, however, has been careful to note that these self-critical remarks are not intended as an alternative theory to the one that he presented in Anarchy, State and Utopia. See NOZICK, EXAMINED LIFE, supra, at 287. More importantly, once a great work has been released into the marketplace of ideas, it is difficult for anyone—even the author himself—to recall it. The logic, vision, and continuing popularity of Nozick's original work justifies its use here.

18. NOZICK, supra note 14, at 8-9. Nozick argued that a fundamental theory describing how a state would arise from a state of nature serves important explanatory purposes, even if no actual state ever arose that way:

We learn much by seeing how the state could have arisen, even if it didn't arise that way. If it didn't arise that way, we also would learn much by determining why it didn't; by trying to explain why the particular bit of the real world that diverges from the state-of-nature model is as it is.

Id. at 9.


20. See NOZICK, supra note 14, at 10.


22. Id. § 6, at 5.
punish the transgressors of that law to such a degree, as may hinder its violation. 23 When an individual enforces his own rights, however, self-interest can lead to biased judgment and disproportionate punishment. 24 Moreover, execution of judgment may be impossible for the weak, and difficult and dangerous even for the strong. 25 Because of such drawbacks, men will abandon the absolute freedom found in a state of nature, preferring instead to unite in society to protect their lives, liberties, and estates. 26

A. The Rise of Protective Associations

Working from these basic premises, Nozick theorized that individuals in a state of nature will form protective associations. 27 These associations will provide services (including detection of misdeeds and apprehension, adjudication, punishment, and recovery of compensation from wrongdoers) that protect members from each other and from outsiders. 28 To discourage private retaliation, associations will refuse protection against counterretaliation launched by outsiders or other members. 29

Over time, several different protective associations may arise in the same geographical area. 30 What happens when different agencies reach different decisions? Nozick identified three possibilities. First, when competing agencies engage in battle, one is always stronger, and therefore, always wins. 31 Eventually the losing agency falls apart, as clients leave to do business with the winner. 32 Second, different agencies do exist, but are located within entirely separate geographical areas, so that little conflict results. 33 Third, competing agencies that fight evenly and often

---

23. Id. § 7, at 5-6; see also id. § 8, at 6 (arguing that the extent of proper punishment is that which is required for retribution and deterrence).
25. See id. § 127, at 63.
26. See id. § 123, at 62.
27. See NOZICK, supra note 14, at 12.
28. See id. at 13.
29. See id. at 15.
30. See id.
31. See id. at 16.
32. See id.
33. See id.
create mechanisms to help resolve conflicting judgments, such as separate jurisdictions, choice of law rules, or perhaps a unified judicial system with appellate courts. "Out of anarchy, pressed by spontaneous groupings, mutual-protection associations, division of labor, market pressures, economies of scale, and rational self-interest there arises something very much resembling a minimal state or a group of geographically distinct minimal states."

B. The Evolution of the Minimal State

Does this system of private protective associations actually amount to a minimal state? Nozick defined the "ultraminimal" state as being one that maintains a monopoly over all use of force except that which is necessary for immediate self-defense, thus excluding private retaliation. Protective associations apparently will not exercise such complete control, because some individuals ("independents") can refuse to join such agencies. These independents then will administer their own procedures of justice, adjudicating and exacting punishment for violations of their natural rights. Nozick reasoned, however, that a protective association legitimately can defend its clients against unreaible procedures of justice—those which are too likely to punish

34. See id.
35. Id. at 16-17.
36. See id. at 26. Locke also identified as a key attribute of the state the ability to hold a monopoly over the use of force:
Man . . . hath by nature a power not only to preserve his property—that is, his life, liberty, and estate—against the injuries and attempts of other men, but to judge of and punish the breaches of that law in others as he is persuaded the offence deserves, even with death itself, in crimes where the heinousness of the fact in his opinion requires it. But because no political society can be nor subsist without having in itself the power to preserve the property, and, in order thereunto, punish the offences of all those of that society, there, and there only, is political society, where every one of the members hath quitted this natural power, resigned it up into the hands of the community in all cases that exclude him not from appealing for protection to the law established by it.
LOCKE, supra note 19, § 87, at 42-43.
37. See NOZICK, supra note 14, at 54.
38. See id. at 54-55.
the innocent or overpunish the guilty. The association also can object when independents attempt to administer unknown procedures of justice that have not been shown to be reliable and fair. If a protective association is dominant within a particular geographical area, its power will allow it to occupy a unique position. This dominant association will have so much power that it freely can prohibit any procedures that it determines to be defective. Thus, even if a protective association does not have a de jure monopoly on the use of force, its dominant position can give it a de facto monopoly that no independent would dare to challenge.

Nozick’s work acknowledged that the dominant protective association does not have absolute control over the use of force—if one independent enforces justice against another, and both are satisfied with the procedure employed, the dominant association has no right to intervene. According to Nozick, however, this limitation does not preclude the possibility that the dominant protective association is a state, because citizens can, and do, choose to opt out of a state’s judicial apparatus, thus acting as independents.

Nozick’s theory includes defining the minimal state as the “night-watchman state of classical liberal theory, limited to the functions of protecting all its citizens against violence, theft, and fraud, and to the enforcement of contracts.” To move beyond the ultraminimal state and achieve the minimal state, the state must provide protection for every person living within its geographical boundaries. Private protective associations seeming-

39. See id. at 88, 101.
40. See id. at 102. The person seeking to enforce his procedure of justice need only provide information sufficient to show that the procedure is reliable and fair. See id. The consent of the protective association to the administration of justice (which could be withheld arbitrarily) is not required. See id. at 101.
41. See id. at 16.
42. See id. at 108.
43. See id. at 108-09.
44. See id. at 109.
45. See id. at 109-10.
46. See id. at 110.
47. Id. at 26.
48. See id. at 26-27.
ly are obliged to provide services only to those who pay for protection. Nozick theorized, however, that once the dominant protective association has prohibited independents from enforcing their own "unreliable" procedures of justice, the independents will be unable to protect themselves from harm, and thus will become disadvantaged in their daily activities and lives. Because some independents could have carried out their own brand of justice without violating anyone's rights, the members of the dominant protective association will be morally obligated to compensate independents for these disadvantages. Nozick further theorized that dominant associations can compensate independents at the least cost to themselves by supplying protective services against their own clients. When an independent cannot afford such protective services, the members of the dominant association must make up the difference between the monetary costs of independent enforcement, and the cost of an adequate protective policy.

Through this course of reasoning, Nozick offered what he (following Adam Smith) termed an "invisible hand" explanation of the rise of the minimal state. Self-interested and rational persons acting in a Lockean state of nature form protective agencies, which, over time, come to dominate geographical territories, and assume de facto monopoly over the use of force, without conscious intent. From this ultraminimal state, a minimal state can emerge, when members of the dominant protective association honor their moral obligation to provide independents with protective services. Because the dominant protective as-

49. See id. at 24-25.
50. See id. at 110.
51. Nozick based this conclusion on his separately derived principle of compensation. See id. at 78-79, 81-84. According to this principle, those who prohibit acts that involve risk—but actually might have turned out to be harmless—must compensate affected persons for the disadvantages imposed upon them by the prohibition. See id. at 82-83. A complete explanation of how Nozick derived this principle is beyond the scope of this Article, but can be found in id. at 78-87.
52. See id. at 110.
53. See id. at 110-12.
54. For Nozick's explanation of the term "invisible hand," see id. at 18-22.
55. See id. at 118.
56. See id. at 119.
association asserts a monopoly on force within its territory, and has an obligation to protect everyone within its borders, it satisfies the two crucial conditions for being a minimal state.\textsuperscript{57}

II. LIBERTY, TRADE, AND COMMERCIAL LAW

Although Nozick's work belongs within the realm of political philosophy, his theoretical account of the spontaneous rise of the minimal state resonates with historical accounts of the spontaneous evolution of the law merchant,\textsuperscript{58} the distant ancestor of the UCC.\textsuperscript{59} In brief, as trade increased during the eleventh century, merchants began to develop common business practices that facilitated their profitable trade. At first, these practices were localized, but over time, as transregional trade increased, merchants began to carry their practices from region to region.\textsuperscript{60} Practices that were consistently observed, and that promoted trade most effectively, spontaneously evolved into transregional, and sometimes transnational, rules of conduct.\textsuperscript{61} Disputes were resolved in speedy, informal arbitration proceedings refereed by fellow merchants.\textsuperscript{62} This system was self-enforcing; those who did not comply with a judgment not only risked their reputation, but also could be excluded or boycotted from trading in certain markets.\textsuperscript{63}

\textsuperscript{57} Id. at 118-19.

\textsuperscript{58} "Law merchant" or "lex mercatoria" is a term used to describe those rules encompassing the trading practices of the international merchant community. See Michael T. Medwig, Note, The New Law Merchant: Legal Rhetoric and Commercial Reality, 24 LAW & POL’Y INT’L BUS. 589, 590 (1993). Here, I use the term in an historical sense, to refer to medieval trading practices.

\textsuperscript{59} For an account of historical developments from the medieval law merchant to the UCC, see Bruce L. Benson, The Spontaneous Evolution of Commercial Law, 55 S. ECON. J. 644, 646-56 (1989). The drafters of the UCC have acknowledged that the Code is "in large part a reformulation and restatement of the law merchant and of the understanding of a business community which transcends state and even national boundaries." U.C.C. § 1-105 cmt. 3 (1995).


\textsuperscript{61} See id. at 11; Benson, supra note 59, at 648.


\textsuperscript{63} See Benson, supra note 59, at 649; Bernardo M. Cremades & Steven L. Plehn, The New Lex Mercatoria and the Harmonization of the Laws of International Com-
Inspired by this history of the spontaneous evolution of the law merchant, this Article adapts Nozick's state-of-nature theory to develop parallel theory of the rise of commercial law. Moving beyond historical accounts of the law merchant, this Article identifies liberty as the foundation of a spontaneously evolved commercial law. Later, this Article uses this theory as a model by which to assess actual developments in the UCC.

A. The Rise of Business Practices and Trade Associations

Through the mechanism of free trade, individuals can exercise their "perfect freedom to order their actions and dispose of their possessions and persons as they think fit." A person who owns desirable goods or services can sell them to others, in exchange for goods, services, or (eventually) a common medium of exchange. Ultimately, individuals will realize that a variety of circumstances—such as the nature of their products, location of trading partners, transportation needs, and evolving technology—affect the structure and profitability of their deals. Each rational individual will exercise his or her freedom to select contractual solutions that maximize profit, often by minimizing transaction costs. Over time, and with repeated transactions, patterns will emerge within trades. Words within particular trades assume common meanings, which minimize costly misunderstandings. Moreover, efficient delivery and transportation practices arise, risks are allocated to persons best able to minimize them, and remedies that redress breach without significantly disrupting continuing trade relationships become established as usage. Such practices are not static; as circumstances


64. At this point in the Article, the objective is only to provide a theoretical account, not to assert that modern commercial law has, in fact, evolved from a state of nature.

65. LOCKE, supra note 19, § 4, at 4.

66. See generally POSNER, supra note 9, at 82-85.

67. See Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 VA. L. Rev. 757, 787 (1995) (outlining the evolutionary process of testing, interpretation, and adjustment of certain contract forms through which the uncertainty of the forms is reduced).

68. See generally POSNER, supra note 9, at 91-94.
change and new problems arise, individuals (including those newly arrived in the world of trade) will exercise their liberty to develop new agreements and new practices, always taking profit as their lodestar. Any custom that does not facilitate commercial transactions should fall quickly by the wayside, to be superseded by more profitable practices.

In this manner, business practices arise as the product of economic goals, chosen as the most efficient means of allowing individuals to engage in profitable transactions. More fundamentally, however, such business practices are the product of liberty, exercised by many individuals over many years and many transactions. Without freedom, individuals could not develop rational business practices in the pursuit of profit. When one looks at a business practice, one sees the reflection, the echo, of individual choices made over time. Business practices, as the products of liberty, have an inherent moral legitimacy.

Before continuing this analysis, it is necessary to confront and resolve one possible distinction between the political realm that Nozick envisioned and the commercial world addressed in this Article. When Nozick spoke of "individuals" who exercise their natural rights to evolve the minimal state, he meant natural persons—that is, human beings. Of course, many actors in the commercial world are natural persons, doing business alone or in partnership with each other. The commercial world, however, also involves "persons" who are not human beings, such as corporations and banks. Assertions that corporations do not have natural rights are abundant, probably such claims derive

69. Cf. Amy H. Kastely, Stock Equipment for the Bargain in Fact: Trade Usage, "Express Terms," and Consistency Under § 1-205 of the Uniform Commercial Code, 64 N.C. L. Rev. 777, 800 (1986) (stating that fair trade practices "frequently represent efficient ways to handle . . . problems"); Medwig, supra note 58, at 592 (noting that medieval law merchant embodied practices "that best promoted commerce and prosperity").

70. Milton Friedman has argued passionately and persuasively that economic freedom is an indispensable means by which to achieve political freedom. MILTON FRIEDMAN, CAPITALISM AND FREEDOM 7-21 (1982). Here, I make the converse point: Political freedom (as embodied in natural rights of liberty) is a prerequisite and foundation of economic freedom.

71. See 6 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2476 (perm. ed. rev. vol. 1996); MICHIE ON BANKS AND BANKING, ch. 2, § 1 (1986) ("A banking corporation is wholly a creation of statute,
from nineteenth century corporate theory, which envisioned the
corporation as an artificial entity owing its very existence to the
state.\footnote{As one author has explained, "critics of corporations use this 'entity' idea in
asserting that corporations have no rights. Rights, after all, apply to individuals or
groups of individuals (such as partnerships) but not to imaginary 'entities'." Robert
Hessen, A New Concept of Corporations: A Contractual and Private Property Model, 30
HASTINGS L.J. 1327, 1328 (1979). For an historical account of the artificial entity theo-
ry, see William W. Bratton, Jr., The New Economic Theory of the Firm: Critical Per-
spectives from History, 41 STAN. L. REV. 1471 (1989); Michael J. Phillips, Reappraising
the Real Entity Theory of the Corporation, 21 FLA. ST. U. L. REV. 1061 (1994).}

Modern corporate theory, however, teaches that a cor-
poration is nothing more than a "nexus of contracts" formed be-
tween shareholders, managers, employees, creditors, suppliers,
and customers.\footnote{See, e.g., Henry N. Butler & Larry E. Ribstein, Opting Out of Fiduciary Du-
ties: A Response to the Anti-Contractarians, 65 WASH. L. REV. 1 (1990); Frank H.
(1989); Hessen, supra note 72, at 1330; Kenneth E. Scott, Corporation Law and the
For a critique of "nexus of contracts" theory, see William W. Bratton, Jr., The
(1989); Phillips, supra note 72, at 1090-97, 1111-13. Despite such criticism, the
"nexus of contracts" theory generally is acknowledged as the dominant legal theory
of the corporation today. See Phillips, supra note 72, at 1061.}

According to this view, even if a corporation
as such does not have natural rights, the human beings who act
through the device of the corporation retain the natural rights
held by all human beings.\footnote{See Hessen, supra note 72, at 1330.} Thus, even when some individuals
choose to associate and transact business through the corporate
form, the practices that evolve from free contracting remain
grounded in a natural right to liberty.

So far, this discussion has assumed a somewhat amorphous
commercial world, one in which individuals do business with
other individuals, linked only by their involvement in a common
trade. Eventually, however, businesspersons, particularly those
who work in the same industry, might choose to band together
in voluntary trade associations. These associations can serve a
variety of purposes: shaping and standardizing business
practices into trade codes; exchanging information about supply
and demand needs; providing an informal network for the discussion of ways by which to improve goods and services; creating new ways of effecting payment and extending credit; and, perhaps most significantly, establishing mechanisms such as arbitration to resolve disputes between members. Arbitral awards can be enforced through a variety of sanctions, ranging from damage to business reputation to expulsion from the trade association (and thus exclusion from its benefits) and possibly trade boycott.

Most disputes between association members presumably will involve enforcement of a commercial agreement. Does a voluntary trade association have the right to enforce such

75. Medieval legal history offers some fine examples of merchant-evolved payment and credit devices. For example, as commerce increased during the 13th and 14th centuries, Italian merchants invented the contract of cambium, a contract to transport and exchange the currency of one country for another. See WILLIAM E. BRITTON, HANDBOOK OF THE LAW OF BILLS AND NOTES 4 (1943). From this humble beginning, merchants developed the bill of exchange (known in modern terms as the draft). See id. at 5. To illustrate the benefits of the bill of exchange, suppose A wanted to purchase goods or services from B, who was located in a distant land. Rather than send cash that could be stolen en route, A could purchase and send a bill of exchange from his local bank that would order a correspondent bank in the correct location to pay B. In this manner, the bill of exchange facilitated commerce by serving as an effective payment system. See CHARLES P. NORTON, HANDBOOK OF THE LAW OF BILLS AND NOTES 1-6 (2d ed. 1896).

76. See Cremades & Plehn, supra note 63, at 325.

77. See Benson, supra note 59, at 657. Once again, this description of voluntary trade associations is intended to serve only as a theoretical model. Within the real world, some of the activities described above could, under certain conditions, violate sections 1 or 2 of the Sherman Act, 15 U.S.C. §§ 1-7 (1994), and/or state antitrust and unfair competition laws. For example, the imposition of an association's standardized contract terms on unwilling customers could amount to an illegal concerted refusal to deal. See Paramount Famous Lasky v. United States, 282 U.S. 30 (1930); United States Trotting Ass'n v. Chicago Downs Ass'n, 665 F.2d 781, 789 n.12 (7th Cir. 1981). Competitors who exchange information must take care, lest their actions be used as evidence of an illegal agreement to fix prices or limit production. See, e.g., United States v. Container Corp., 393 U.S. 333 (1969); United States v. Socony-Vacuum Oil Co., 310 U.S. 150 (1940); Miller v. Hedlund, 813 F.2d 1344 (9th Cir. 1987); Northern Cal. Pharm. Ass'n v. United States, 306 F.2d 379 (9th Cir. 1962). Last, but certainly not least, trade association policies that exclude competitors from membership, expel members for failure to comply with association rules, or use boycotts as punishment for noncomplying members, may be characterized as illegal group-boycotts under certain circumstances. See Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co., 472 U.S. 284 (1985); Silver v. N.Y.S.E., 373 U.S. 341 (1963); Associated Press Co. v. United States, 326 U.S. 1 (1945).
agreements? If, as Locke suggested, every individual has a right to punish another who injures his liberty, then individual members should be able to assign their enforcement rights to the association. Why does enforcement of commercial agreements vindicate liberty? As Professor Charles Fried explained, the convention of promising maximizes individual autonomy. By committing to particular courses of action, individuals can participate in the projects of others who must depend upon their future conduct. Applying this reasoning to a hypothetical voluntary trade association, the convention of promising serves to increase the freedom of association members who thereby are enabled to participate in profitable transactions with other members who, in turn, must rely upon their future conduct. Broken promises threaten not only the liberty of affected promisees (who are left without any means of effectuating their plans), but also the liberty of other association members, who may lose confidence in the very convention of promising. Accordingly, by enforcing the promises contained within commercial agreements, the association vindicates the liberty interests of its members.

In the absence of state-made law, what norms should govern contractual disputes between members of a voluntary trade association? First, as explained above, when a member makes and breaks a promise to another member, the association may enforce the specific promise made. Second, when express promises are unclear, or do not address the dispute at hand, voluntary trade associations may recognize relevant business practices as being implied terms within a specific agreement, or (taking the analysis one step further), fashion those practices into generally applicable norms. The use of business practices to resolve disputes is consistent with the liberty of members, who freely choose to join the association and follow its rules. Moreover, as

---

78. See LOCKE, supra note 19, § 7, at 5-6.
79. See CHARLES FRIED, CONTRACT AS PROMISE 13-14 (1981). Although promising may seem to restrict autonomy, the restrictions involved in promising increase future options and thus are consistent with the principle of autonomy. See id. at 14.
explained above, the business practices themselves are created when countless individuals exercise their freedom to order their own lives and property. Thus, a decision to use business practices to resolve disputes respects the freedom of the individuals who create those standards—many of whom may be members of the association.

Suppose a business conflict arises between members of different trade associations—each of which apply different practices and reach different outcomes. What then? Following Nozick, three scenarios are possible. First, assuming that one trade association is much more successful (profitable) than the other, and that both are doing business in the same trade and geographical area, conflicts of this kind may recede on their own, as traders leave the weaker association to do business with the more profitable group. Members of the more successful (and now-dominant) trade association will use their own freely-developed business practices to resolve intra-association disputes.

In the second scenario, many potential conflicts are avoided entirely because different associations ply different trades, or are active within different geographic areas. Within its own area or trade, each association reigns supreme, again implementing its own voluntary system of practices and usages.

The third, and most challenging, scenario assumes that trade associations remain in conflict, perhaps because each serves the same geographic area and trade. In these cases, members of competing trade associations might agree upon some method of resolving inevitable conflicts. Each group may agree to assume jurisdiction over certain categories of dispute, or the groups can jointly adopt a unified system to resolve inter-association disputes. Either solution reflects the right of individual members to freely order and dispose of their persons and property—in this case, through the development of mechanisms that resolve disputes and thereby facilitate profitable business transactions.

81. See supra text accompanying notes 27-57.
B. The Evolution of Commercial Law

Nozick, in developing a state-of-nature theory of the state, asked whether a system of private protective associations amounts to a minimal state.\(^2\) Reasoning by analogy, consider a somewhat different question: Does a private association that uses business practices to resolve disputes create commercial "law?"

Interestingly, this question echoes an ongoing debate over the true nature of the modern law merchant. Several commentators have argued that the law merchant is best understood as an autonomous body of law.\(^3\) Others have asserted vigorously that the law merchant can never be "law" as such, contending that international trade practice and custom must be relegated to the status of *principia mercatoria*, business principles, at best.\(^4\)

A complete investigation of the nature of law, or the law merchant, is beyond the scope of this Article. Nevertheless, the same jurisprudential theories that international scholars have used to assess the law merchant are relevant to this discussion because they help to determine whether the spontaneously evolved business practices described in this theoretical model can be fairly characterized as "law."

The jurisprudence of positivism assumes that national law is based on the will of the sovereign state, and that international law derives from the wills of many sovereign states.\(^5\) Thus, some commentators argue that the law merchant *as such* can never be law, because it represents nothing more than the common understanding of the international trading community.\(^6\)

\(^2\) See supra notes 47-57 and accompanying text.


\(^5\) See Medwig, supra note 58, at 614-15.

\(^6\) See Berman & Dasser, supra note 83, at 22; Stoecker, supra note 62, at 107-
Other jurisprudential theories, however, are flexible enough to accommodate the notion of the law merchant as law. For example, commentators have argued that the law merchant could be recognized as the product of natural law, because parties to international trade contracts are and should be free to conclude contracts based on the overriding principles of *bona fides* and *pacta sunt servanda* and on their own will. Applying this same reasoning to the theoretical model presented in this Article, the business practices generated when individuals exercise their right to liberty similarly can be recognized as the product of natural law.

Moving beyond general jurisprudential theories to specific characteristics of "law," international scholars have argued that the law merchant must be *enforceable* in order to qualify as law. Again, reasoning by analogy, a voluntary trade association may resolve disputes between members by enforcing contractual promises and related norms based on business practices. The association can enforce its arbitral awards through a system of private sanctions (damage to reputation, expulsion, boycott), thereby creating a privately designed justice system that operates within the association.

Positivists (those who insist that the state is the only source of true law) may argue that arbitration awards are meaningless without the ultimate threat of enforcement by the state.

---

08, 118; Medwig, supra note 58, at 614-15.

87. See Berman & Dasser, supra note 83, at 28-29. *Bona fides* and *pacta sunt servanda* denote the principles of good faith and adherence to mutual agreement. See BLACK'S LAW DICTIONARY 176, 1109 (6th ed. 1990).

88. See, e.g., Hight, supra note 84, at 624; Stoecker, supra note 62, at 105.

89. See Benson, supra note 59, at 656-67.

90. See, e.g., Hight, supra note 84, at 620; Stoecker, supra note 62, at 105. Currently, the United States enforces both domestic and international arbitral awards. The Federal Arbitration Act provides that written provisions for arbitration of future controversies in contractual transactions involving commerce or maritime transactions are to be held "valid, irrevocable and enforceable." 9 U.S.C. § 2 (1994). The federal courts have the power to enforce arbitration agreements by affirming arbitral awards. See id. § 9. The United States Supreme Court has held that the Federal Arbitration Act preempts any state law that would undermine the enforcement of an arbitration agreement. See Southland Corp. v. Keating, 465 U.S. 1, 16 (1984).

In addition, the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 21 U.S.T. 251, 7 U.N.T.S. 330, has been implemented in the United States. See 9 U.S.C. §§ 201-208. The Convention, which specifically
Even if voluntary trade associations must count on the state to help execute some disputed awards, private sanction can effectively encourage compliance in other cases. Also, where one association becomes so dominant within a geographical area or trade that private sanctions weigh particularly heavily upon disobedient members, enforcement may approach near-optimal levels. Thus, just as Nozick's dominant protective association could possibly exercise a de facto monopoly on force, a dominant trade association may enjoy a de facto power to enforce its own arbitral awards—and, by extension, the decisional norms on which those awards are based. In this manner, the business practices generated under my theoretical model can acquire a near-legal status.

As a voluntary trade association becomes more dominant, non-members (independents) who wish to engage in profitable trade will have fewer alternatives to contracting with members of the association. Thus, when a member of a dominant trade association does business with an independent, the member may have enough bargaining power to insist that the independent agree to arbitrate disputes pursuant to the dominant association's rules. In this way, the business practices recognized within the dominant trade association may come to be enforced beyond its immediate membership.

What happens when disputes arise between independents? If two independents ply the same trade as do members of the dominant trade association, they already may follow similar practices.

If, however, the dominant trade association consciously chooses to adapt and improve existing practices, subtle but important changes, or even an independent trade code may result. Then, because association practices do not apply to disputes between

---

encompasses the provisions of the Federal Arbitration Act, was implemented in order to "encourage the recognition and enforcement of commercial arbitration agreements in international contracts and to unify the standards by which agreements to arbitrate are observed and arbitral awards are enforced in the signatory countries." Scherk v. Alberto-Culver Co., 417 U.S. 506, 520 n.15 (1974).

91. See NOZICK, supra note 14, at 16.

92. Cf. Berman & Dasser, supra note 83, at 32; Cremades & Plehn, supra note 63, at 329, 333; Goldman, supra note 83, at 20-22 (stating that the lex mercatoria constitutes a form of law, even though the state serves as the ultimate source of enforcement).
independents, those practices lack *general applicability*, another key attribute of law according to law merchant scholars. Persons engaged in similar transactions, in the same trade and in the same geographical area, will be subject to entirely different rules when conflicts arise. Because *another* key attribute of law is *fairness*—and because fairness under the law often requires that like things be treated alike—lack of uniform application is a difficult problem to surmount. Once again, however, Nozick's political reasoning offers lessons for the commercial realm. Perhaps independents can choose to opt out of the "law" established by the dominant trade association—just as citizens are (often) free to reject statutory provisions in favor of alternative contractual solutions. This argument gains in force as the dominant trade association gains power and members. The fewer independents left outside the association, the more universal, and therefore more law-like, the association's business practices become.

Returning one last time to law merchant scholarship as a source of information and inspiration, some scholars question whether the law merchant is accessible, clear, consistent, complete, and predictable enough to qualify as "law." Other scholars, however, question the *degree* to which these qualities must be established before a set of concepts, standards, principles, rules, procedures, and institutions can be said to constitute law. They point out that even statutes and case precedents (both of which are undeniably "law") are all too often inaccessi-

---

93. *Cf.* Stoecker, supra note 62, at 124-25 ("Due to the constantly changing methods, the number of tradesmen being part of this community and the geographically different understanding of how business is to be performed, the *lex mercatoria* is too uncertain a set of rules to be regarded as a law that is binding for everyone.").

94. *See, e.g.*, Berman & Dasser, supra note 83, at 26-27; Hight, supra note 84, at 624.

95. *See* Hight, supra note 84, at 624.


97. *See* Nozick, supra note 14, at 110. For example, the effect of UCC provisions may be varied by agreement, except as provided otherwise, and except that obligations of good faith, diligence, reasonableness and care may not ever be disclaimer. *See* U.C.C. § 1-102(3) (1995).

98. *See, e.g.*, Hight, supra note 84, at 624.

ble, vague, inconsistent, incomplete, and unpredictable.\textsuperscript{100}

Unfortunately, the hypothetical business practices generated by my theoretical model could take any form, and thus cannot be evaluated directly for their accessibility, clarity, consistency, completeness, and predictability. Nevertheless, law merchant scholars have cited an interesting example that strongly suggests that business practices could be as accessible, clear, consistent, complete, and predictable as are many recognized legal regimes. Consider the \textit{Uniform Customs and Practice for Documentary Credits} 500 (1994) (UCP 500), published by the International Chamber of Commerce.\textsuperscript{101} Although the UCP 500 does not pretend to resolve every possible letter of credit issue, its articles are accessible through widespread ICC publication, easy to read, internally consistent, thorough as to issues addressed, and rendered predictable through extensive commentary and published ICC decisions. As a result, the UCP 500 enjoys nearly universal acceptance in international letter of credit transactions and is used in many domestic letter of credit transactions as well.\textsuperscript{102}

\textbf{C. Summary}

Like Nozick’s account of the rise of the minimal state, the foregoing account of the rise of commercial law can also be understood as an “invisible hand” process.\textsuperscript{103} Self-interested and rational persons, who enjoy a natural right to liberty, will trade goods and services with each other. Over time and after the completion of many transactions, business practices will begin to emerge. Individual traders may choose to band together in voluntary trade associations, resolving disputes in arbitration pro-

\textsuperscript{100} See id.
\textsuperscript{101} See id.
\textsuperscript{102} See AMERICAN LAW INSTITUTE, \textit{UNIFORM COMMERCIAL CODE REVISED ARTICLE 5, LETTERS OF CREDIT: PROPOSED FINAL DRAFT} xxii (1995). Some might argue that the UCP 500 is not law—or even law merchant—but rather acts as a term of a contract, because it applies only when incorporated into the text of the letter of credit. UCP 500, Article 1. However, because the vast majority of letters of credit do incorporate the UCP in one version or another, see infra text accompanying note 250, its characterization here as a type of law merchant approximating law is appropriate.
\textsuperscript{103} See Benson, supra note 59, at 660 (“Thus, evolving trade practices provided the primary rules of evolving commercial law.”).
ceedings in which business practices serve as decisional norms. When a trade association comes to dominate a trade or geographical area, its power to implement arbitration decisions through private sanctions will increase until its decisions—and their underlying norms—are de facto enforceable. In this manner, business practices may approach the status of law—all without any conscious design or government involvement.

III. Liberty, Trade, and the Uniform Commercial Code

The UCC is law in the positivist sense: uniform legislation enacted by every state legislature in the United States.104 In searching for the policy foundations of the Code, can anything be learned from the foregoing account of voluntary trade associations creating their own commercial “law”? If so, what lessons should be drawn?

A. Commerce and the Code

The UCC is firmly grounded in business practices. Article 1, which contains general provisions that apply throughout the Code, sets the tone. The UCC is “in large part a reformulation and restatement of the law merchant and of the understanding of a business community which transcends state and even national boundaries.”105 Thus, the Code finds its substantive roots in the trading practices of the international merchant community.106 Furthermore, the Code expressly provides that principles of law and equity, including the law merchant, supplement its provisions.107 Thus, if the Code—which already is based on the law merchant—does not provide an answer, the law merchant must be consulted directly.

104. See 1 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 1, at 5 (3d ed. 1988) (“Louisiana is the only state not to have adopted the entire Code[,] however, [Louisiana] did enact Articles 1, 3, 4, 5, 7, and 8.”).
105. U.C.C. § 1-105 cmt. 3 (1995); see Benson, supra note 59, at 655; Danzig, supra note 6, at 626; Juenger, supra note 83, at 219. But see Scott, supra note 6, at 737-39 (positing that the Code represents not law merchant, but rather regulation that shifts risks).
106. See Medwig, supra note 58, at 590.
Section 1-102 identifies three key purposes and policies underlying the Code: "(a) to simplify, clarify, and modernize the law governing commercial transactions; (b) to permit the continued expansion of commercial practices through custom, usage and agreement of the parties; (c) to make uniform the law among various jurisdictions."\(^8\)

The Official Comment to section 1-102 elaborates upon this theme:

This Act is drawn to provide flexibility so that, since it is intended to be a semi-permanent piece of legislation, it will provide its own machinery for expansion of commercial practices. It is intended to make it possible for the law embodied in this Act to be developed by the courts in the light of unforeseen and new circumstances and practices.\(^9\)

Thus, consistent with the notion that the Code reflects current business practices, the Code was designed to be flexible so that it might evolve in connection with future business practices.

Significantly, the Code also allows merchants to agree to vary the effect of its provisions, except as otherwise provided in the Code.\(^{10}\) In other words, most Code provisions act as default rules, unless expressly indicated otherwise.\(^{11}\) Code obligations of good faith, diligence, reasonableness, and care cannot be disclaimed under any circumstances.\(^{12}\) Parties to a contract, however, may agree upon standards by which to determine whether

---

108. *Id.* § 1-102(2) (emphasis added).
109. *Id.* § 1-102 cmt. 1.
110. *See id.* § 1-102(3).
111. It is not always easy to determine whether a particular rule should be classified as a default rule that can be changed by agreement, or an immutable rule that cannot be changed. Some Code provisions expressly state that they can be varied by agreement, but others explain in statutory language or commentary that variation is not permitted. *See id.* § 1-102 cmt. 2 (1996). Many other provisions are entirely silent.
such obligations have been met, so long as the standards are not manifestly unreasonable.113

According to basic Code definitions, an *agreement* is "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance."114 A *course of dealing* "is a sequence of previous conduct between the parties to a particular transaction . . . [that] establish[es] a common basis of understanding."115 A *usage of trade* "is any practice or method of dealing having such regularity of observance in a place, vocation or trade as to justify an expectation that it will be observed with respect to the transaction in question."116 "A course of dealing between parties and any usage of trade in the vocation or trade in which [the parties] are engaged or of which they are or should be aware give particular meaning to and supplement or qualify terms of an agreement."117 Further, when a contract for sale of goods involves repeated occasions for performance by either party, and the other party knows the nature of the performance and can object, a *course of performance* is relevant to determine the meaning of the agreement.118 By recognizing such implied terms, the Code seeks to effectuate the parties' actual expectations, which may extend far beyond the written terms of the agreement. As one author has noted, the Code "assumes that in many instances the parties' actual expectations may be based more on trade practices than on the standard form contracts they sign."119

Thus, when the Code directs a certain legal outcome, that outcome may mean very little unless it is consistent with the will of the parties and business practices. Any two individuals can change the legal consequences that the Code purports to impose, either by adopting an express term to the contrary, or by engaging in a course of performance or course of dealing that estab-

113. *See id.*
114. *Id.* § 1-201(3).
115. *Id.* § 1-205(1).
116. *Id.* § 1-205(2).
117. *Id.* § 1-205(3).
118. *See id.* § 2-208(1).
lishes a contrary implied term. Furthermore, multiple individuals engaged in the same trade can develop patterns of conduct known as trade usages that will constitute implied terms, and these implied terms also can change legal outcomes otherwise prescribed by the Code.

In other words, the Code consciously attempts to devise legal rules that are consistent with business practices. When Code rules are inconsistent with business practices, resolution of the conflict is simple: Business practices trump the Code.120

A glance at Article 2 reinforces the conclusion that business

120. Even bedrock principles are not sacred. To be sure, the Code imposes obligations of good faith, diligence, reasonableness, and care that cannot be disclaimed. See U.C.C. § 1-102(3). However, the parties can agree on the standards by which performance of such obligations is measured, so long as their standards are not manifestly unreasonable. See id. Again, such agreement may be demonstrated through course of dealing, trade usage, or course of performance. See id. § 1-102 cmt. 2.

To give a striking example of the primacy of agreement over law, consider the core principle that every contract or duty within the Code imposes an obligation of good faith in its performance or enforcement. See id. § 1-203. To resolve recent controversy over the proper application of this principle, the Permanent Editorial Board for the Uniform Commercial Code added the following language to the Official Comment:

This section does not support an independent cause of action for failure to perform or enforce in good faith. Rather, this section means that a failure to perform or enforce, in good faith, a specific duty or obligation under the contract, constitutes a breach of that contract or makes unavailable, under the particular circumstances, a remedial right or power. This distinction makes it clear that the doctrine of good faith merely directs a court towards interpreting contracts within the commercial context in which they are created, performed, and enforced, and does not create a separate duty of fairness and reasonableness which can be independently breached.

Id. § 1-203, cmt. (West Supp. 1996) (emphasis added).

How does a court interpret a contract within the commercial context? Further commentary provides guidance. Because a party acts in good faith relative to the agreement of the parties, the court must determine the substance of that agreement, including not only express terms, but also such elements as course of dealing and trade usage. See Permanent Editorial Board Commentary No. 10 (Feb. 10, 1994), reprinted in U.C.C. app. II (West Supp. 1996). A party who acts consistently with the agreement, as properly understood in light of reasonable commercial practice, acts in good faith. See id.

This commentary erodes the obligation of good faith and leaves it empty. The parties already are obliged to perform their agreement, as properly understood in light of course of dealing and trade usage. If “the correct perspective on the meaning of good faith performance and enforcement is the Agreement of the parties,” id., then § 1-203 adds nothing.
practices have strongly influenced the Code. The provisions of Article 2 make business practices and commercial standards the legal norm. For example, section 2-103 defines "good faith" by a merchant\footnote{121} as requiring honesty in fact \emph{and} the observance of reasonable commercial standards of fair dealing in the trade.\footnote{122} Consider also section 2-302, the controversial provision that gives courts the power to strike down contracts or clauses within contracts as unconscionable.\footnote{123} Comments emphasize that the basic test of unconscionability involves determining whether a contract or clause is unconscionable "in the light of the general commercial background and the commercial needs of the particular trade or case."\footnote{124} The parties must be allowed to present evidence regarding the commercial setting, purpose, and effect of the contract or clause—\footnote{125} an important reminder to the court that, to a large extent, commerce defines conscionability.

Other Article 2 provisions make commercial reasonableness the standard for determining various issues related to contract performance. For example, when reasonable grounds for insecurity exist with respect to the performance of either party, the other party may demand adequate assurances of due perfor-

\footnote{121} According to § 2-104(1), a "merchant" means:

\begin{quote}
[A] person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.
\end{quote}

U.C.C. § 2-104(1) (1995). Article 2 of the Code includes several other sections that apply to or between merchants. \textit{See}, e.g., \textit{id.} §§ 2-201(2), 2-205, 2-207(2), 2-209(2), 2-312(3), 2-314, 2-327(1)(c), 2-402(2), 2-403(2), 2-509(3), 2-603, 2-605(1)(b), 2-609(2). Many of these provisions, however, go far beyond codifying existing commercial practice. For example, the merchant exception to the Statute of Frauds, and the rule binding merchants to additional terms when they fail to object, have been cited as clear examples of Karl Llewellyn's concern for establishing \textit{new} legal norms of fairness among merchants. \textit{See} Wiseman, \textit{supra} note 6, at 505-06.

\footnote{122} The merchant's obligation of good faith cannot be disclaimed. \textit{See} U.C.C. § 1-102(3). The parties, however, can agree upon standards for measuring good faith, so long as those standards are not manifestly unreasonable. \textit{See id.}

\footnote{123} Professors White and Summers identified § 2-302, along with other Article 2 provisions that prohibit unconscionable terms, as a nonvariable term. \textit{See} 1 WHITE \& SUMMERS, \textit{supra} note 104, § 3-10, at 184.

\footnote{124} U.C.C. § 2-302 cmt. 1.

\footnote{125} \textit{See id.} § 2-302(2).
mance, and, if commercially reasonable, suspend his own performance. 126 Section 2-615, which excuses sellers from performance that has become impracticable, also indicates through its comments that impracticability must be judged by prevailing commercial standards. 127

Commercial reasonableness also is relevant when assessing damages under Article 2. When the buyer breaches the contract, the seller may resell the goods in a commercially reasonable manner, and recover the difference between the resale price and the contract price from the buyer. 128 Incidental damages for both aggrieved sellers and buyers are defined in terms of commercially reasonable charges. 129

Most importantly, course of dealing, trade usage, and course of performance play important roles within Article 2. Several sections that prescribe reasonableness as the relevant legal standard explain in comments that reasonableness may be determined by course of dealing, trade usage, and course of performance. 130 Certainly, throughout Article 2, comments remind the reader that “agreements” include not only express terms, but also course of dealing, trade usage, and course of performance. 131 In sum, as one author has noted, “[t]he Code embodies the beliefs that the reasonable practices and standards of the commercial community are an appropriate source of legal obliga-

---

126. See id. § 2-609(1). Between merchants, the reasonableness of grounds for insecurity and the adequacy of any assurance offered also must be determined according to commercial standards. See id. § 2-609(2); see also id. § 2-610(a) (providing that when either party repudiates the contract, the other may await performance for a commercially reasonable time).

Professors White and Summers identified § 2-609(1) as a nonvariable rule intended to prevent one party from taking undue advantage by unfairly upsetting justifiable reliance. See 1 WHITE & SUMMERS, supra note 104, § 3-10, at 184 n.8.

127. See U.C.C. § 2-615 cmts. 1, 2, 6 & 10 (1995); see also id. § 2-614 (providing that when an agreed manner of delivery becomes commercially impracticable, a commercially reasonable substitute must be tendered and accepted).

128. See id. § 2-706(1).

129. See id. §§ 2-710, 2-715(1).

130. See id. § 2-503(1)(a) cmt. 3 (discussing reasonableness of time and manner of tender); § 2-508(2) cmt. 2 (outlining reasonable grounds to believe nonconforming tender would be acceptable); § 2-513 cmt. 3 (discussing reasonable time, place, and manner for buyer's inspection of goods).

131. See, e.g., id. at §§ 2-202 cmt. 2, 2-301 cmt., 2-308 cmt. 4, 2-309 cmt. 1, 2-501 cmt. 3, 2-504 cmt. 2, 2-509 cmt. 5, 2-615 cmt. 8.
tion and that these practices create actual expectations which should be given full effect in the law." The question then becomes whether a Code that relies so heavily on business practices has an adequate foundation in policy.

B. Liberty

Under the theoretical model of commercial law set forth in Part II above, respect for individual liberty supports the use of business practices as decisional norms. Can respect for individual liberty support the codification of business practices within the UCC?

Unlike the decisional norms employed in the theoretical model, the Code is not the product of a state of nature. Nevertheless, enough parallels exist between the theoretical model and the Code to make reasoning by analogy both plausible and informative.

The theoretical model first assumes that individuals within a state of nature enjoy the right to liberty. Of course, we do not live in a state of nature; however, we do live within a culture that recognizes individual liberty as one of our highest values. More specifically, within the commercial realm, the law has enshrined liberty in the fundamental principle of freedom of contract. This freedom gives businesspersons the opportunity not only to enter into agreements, but also to adopt terms that minimize transaction costs and maximize profits.

According to the theoretical model, when individuals trade freely over many years and transactions, business practices evolve. Similarly, over time and repeated transactions, businesspersons use their freedom of contract to generate courses of performance, courses of dealing, and most importantly, trade usages. By adopting default rules based on business practices, the Code respects the liberty of countless individuals whose choices originated those practices. Moreover, flexible legal standards linked to business practices (such as commercial rea-

132. Kastely, supra note 69, at 780.
133. See Macintosh, supra note 80, at 517-18.
134. See U.C.C. § 1-102(3), cmt. 2 (stating that freedom of contract is a basic principle of the Code).
sonableness) respect not only past exercises of freedom, but also current choices that shape business practices through ongoing transactions.

So far, analysis reveals that freedom of contract is crucial in analogizing between the theoretical model and the Code. Contract law suggests that freedom of contract exists when the individual has a reasonable opportunity to bargain over and understand contract terms. Thus, the analogy to the theoretical model is strongest in contexts where most individuals enjoy such opportunity.

To present a paradigm case under Article 2, imagine a wholesale market for goods, peopled by merchants who deal primarily with each other. Assume that the merchants possess sophisticated knowledge of the goods and the trade and also hold roughly equal bargaining power. Under these circumstances, when each merchant bargains with the other, she can be expected to exercise her knowledge and bargaining power consciously to select contractual terms that maximize her profit. Over time, efficient patterns of conduct will emerge that most merchants within the trade observe regularly. The Code will recognize these trade usages as being implied terms of agreements under Article 1, and use them to flesh out Article 2 default standards based on commercial reasonableness. Drawing its foundation from practices that result from such freely made choices, the Code stands on solid policy ground. Rather than imposing an alien framework upon the commercial world, the Code most nearly replicates the type of commercial "law" that the merchants could have fashioned themselves. At the same time, the Code provides advantages associated with statutory law, such as uniformity, clarity, and predictability in commercial affairs.

135. Modern doctrine teaches that unconscionable contracts or terms are unenforceable. See RESTATEMENT (SECOND) OF CONTRACTS § 208 (1979); U.C.C. § 2-302 (1995). In determining unconscionability, one factor that courts have considered is whether the weaker party had a reasonable opportunity to bargain over contract terms. See E. ALLAN FARNSWORTH, CONTRACTS § 4.28, at 332-33 (2d ed. 1990); Jeffrey C. Fort, Understanding Unconscionability: Defining the Principle, 9 LOY. U. CHI. L.J. 765, 794-95 (1978). Similarly, the courts have invalidated contracts in cases in which one party had no reasonable opportunity to understand hidden or incomprehensible contract terms. See FARNSWORTH, supra at 332-33; Fort, supra, at 787-92.

136. As explained above, business practices can evolve to the point at which they
Conversely, in contexts involving many individuals who do not have a reasonable opportunity to bargain over and understand contract terms, the analogy to the theoretical model weakens. As explained above, business practices evolve in response to key factors—such as the nature of the goods or services, location of trading partners, transportation needs, and available technology—that affect the profitability of transactions. When an individual does not know or have a reasonable opportunity to learn key facts, she cannot make choices based on those facts, and thus, cannot contribute to the development of business practices. Moreover, even a person who has full knowledge of key facts cannot make "choices" based on those facts unless she has a meaningful opportunity to select freely. As her bargaining power and alternatives diminish, business practices are less the product of her free choices. If one multiplies her experience by thousands of similarly disadvantaged market participants, then the libertarian argument for the codification of business practices loses its force.

Before concluding this segment of analysis, one must compare a final feature of the theoretical model with the Code. The model suggests that a voluntary trade association could choose business practices—perhaps embodied in a trade code—as the means of resolving disputes. This would respect not only the liberty of those who generate business practices over time, but also the freedom of the specific, individual member who, by joining the association, freely chooses those standards as her own.

Unlike the traders in the hypothetical model, commercial actors in the real world may not have joined any formal trade associations or consciously adopted any trade usages or codes. How, then, does the Code protect the liberty of those who, for whatever reason, disagree with the business practices embodied in the Code and wish to devise their own? The solution imposed by the UCC is simple but effective: A party may contract out of most Code rules, either expressly, or impliedly through course of performance or course of dealing.137

---

achieve goals that are characteristic of "law," including uniformity, clarity, and predictability. See supra text accompanying notes 98-102. The point is that enactment of the Code may effect such goals more swiftly and surely.

137. See supra notes 110-20 and accompanying text. The Code establishes the
C. The Individual vs. Society: A False Dichotomy?

The foregoing analysis casts some interesting light on recent scholarship addressing the relationship of liberty to default rules in general, and business practices in particular. First, Professor Richard Craswell has argued that many philosophical theories of promising do not have strong implications for the content of contract law. As a key example, Craswell cited the contract theory of Charles Fried, which roots the moral force of promises in respect for individual liberty. According to Craswell, the principle of liberty has no implications for the content of default rules. Any default rule would be consistent with individual freedom, so long as the parties were allowed to change the rule by agreement. Thus, the law must invoke some other principle to decide which default rules to adopt. Interestingly, as an example of such other principle, Craswell cited the use of sociological data—like business practices—to determine which rule most parties already expect in various circumstances.

Certainly any set of default rules could be consistent with individual freedom, so long as the parties enjoyed true freedom of contract. However, it does not follow that liberty has no implications for the content of default rules themselves. Business practices are more than just sociological data concerning expectations within a particular trade. Under the right conditions, business practices are the products of countless acts of free persons performed over time. By codifying such practices, the UCC adopts default rules that find their origin as well as their justification in individual freedom. In other words, liberty provides a process-oriented policy rationale for the decision to select busi-

following hierarchy: express terms reign supreme, followed by course of performance (which is specific to a transaction) and course of dealing (which is specific to contract parties). Trade usage, the most general of the three implied terms, carries the least weight in case of conflict. See U.C.C. §§ 1-205(4), 2-208(2).


139. See id. at 514 (citing FRIED, supra note 79, at the first, unnumbered, table in his preface).

140. See id. at 515.

141. See id. at 505-08, 515.
ness practices as default rules.  

Second, Professor Amy Kastely has argued that the UCC establishes trade usage as a primary element in contractual obligations. In her view, the primacy of trade usage reflects a move away from the traditional, individualistic model of contract toward a more modern, communal model that recognizes individuals as social products operating within the trade community and governed by its norms.  

On the one hand, this argument states the obvious: Merchants operate in a world defined largely by their trade community. On the other hand, this argument goes too far in supposing that the mere existence of a merchant community is inconsistent with individual freedom. As Nozick suggested, human beings can come together in a community without abandoning their rights or their identity as individuals.  

What matters is the process by which the community is formed and norms are chosen. As we have seen, business practices are themselves the product of individual choices, past, present, and future. By adopting business practices as default rules, the Code resolves the false dichotomy between individual and community, and reveals the essential harmony between the two.

To summarize Part III, the drafters have crafted the Code as a vehicle for the growth, development, and application of business practices. Reasoning by analogy to the theoretical model of commercial law presented by this Article, I conclude that liberty stands as the bedrock moral foundation of the drafters’ momen-
tous decision to allow individuals to govern their own commercial affairs.

IV. ARTICLE 5: LETTERS OF CREDIT

As noted above, the UCC is experiencing upheaval, with nearly every article having been, or about to be, extensively revised. Revised Article 5 (Letters of Credit) provides what is perhaps the most dramatic example of practice-driven lawmaking. As more fully explained below, the drafters have chosen statutes that mirror practice, in a conscious effort to ensure the efficient function of the letter of credit device.

More is at stake here, however, than the efficient operation of letters of credit. Revised Article 5 offers the opportunity to test the general theory that commercial laws based on practice can be justified on liberty grounds. Letter of credit practices, as explained below, can be characterized as the evolutionary product of free choices, made by issuers, beneficiaries, applicants, and other individuals who play a role within the letter of credit world. Accordingly, it follows that the practice-based norms within Article 5 can be justified on liberty grounds.

A. History of Article 5

The letter of credit is a unique and ancient commercial specialty that serves two primary functions in modern transactions: first, the commercial letter of credit effects swift and certain payment in sale of goods transactions; second, the

---

145. See supra notes 1-3 and accompanying text.
147. See Kerry L. Macintosh, Letters of Credit: Curbing Bad-Faith Dishonor, 25 UCC L.J. 3, 5 (1992). The following example of a transaction involving a commercial letter of credit may be helpful:

[Suppose Seller wants to sell goods to Buyer, a new customer in another state or foreign country. . . . So that the deal may go forward, Buyer applies to his own bank for issuance of a commercial letter of credit naming Seller as beneficiary. As issuer of the credit Buyer's bank promises to honor Seller's draft or other demand for payment in the amount of the purchase price, upon presentation of documents specified in the letter of credit. These documents may include an invoice, a document of title]
standby letter of credit secures proper performance of contractual obligations. 148

For decades, the letter of credit was governed by common law decisions149 and by the Uniform Customs and Practice for Documentary Credits (UCP), a statement of international custom and practice as observed in the letter of credit operations community. 150 During the 1940s and 1950s, however, the drafters of the UCC undertook to regulate the letter of credit. 151 When first proposed, Article 5 of the Code was highly controversial; in particular, the banking community objected that codification would ossify the law and undermine the flexibility that the letter of credit needed in order to be responsive to changing commercial needs. 152 Following an extensive review of early drafts, the New York Law Revision Commission wrote a detailed report criticizing individual provisions of Article 5 and questioning whether codification truly was necessary. 153

[evidencing shipment of the goods, certificates of insurance and inspection, and other documents intended to assure Buyer that he will indeed receive the goods ordered. After Seller presents the required documents and receives payment, Buyer, as letter-of-credit customer, must reimburse his bank. Upon receiving reimbursement, Buyer’s bank releases the documents to Buyer, so that he can retrieve the goods from the carrier.

Id. at 5-6 (footnotes omitted).

148. See id. at 6. Again, the following description of a transaction involving a standby letter of credit is instructive:

[Suppose Owner wants Contractor to build a skyscraper, but worries that Contractor might fail to complete construction in accordance with the contract terms. To reassure Owner, Contractor obtains a standby letter of credit from his bank naming Owner as beneficiary. As issuer of the credit, Contractor’s bank promises to honor Owner’s draft or other demand for payment of a specified amount of liquidated damages, upon presentation of a document certifying that Contractor has defaulted on his contract obligations. . . . If Owner claims default and draws on the standby credit, Contractor’s bank must make payment, and Contractor must reimburse his bank.

Id. (footnotes omitted).

149. Trimble, supra note 146, at 986-1003.


151. See Byrne, supra note 150, at 17 & n.8.

152. See id. at 18-22.

153. See id.; see generally 1 N.Y. LAW REVISION COMM’N, REPORT OF THE LAW REVISION COMMISSION FOR 1954 AND RECORD OF HEARINGS ON THE UNIFORM COMMER-
Perhaps in response to such concerns, the drafters produced a supremely flexible letter of credit law that respected freedom of contract. The phrase “unless otherwise agreed” appeared fifteen times throughout original Article 5’s seventeen provisions. As if that were not enough, the drafters included the following cautionary provision:

This Article deals with some but not all of the rules and concepts of letters of credit as such rules or concepts have developed prior to this act or may hereafter develop. The fact that this Article states a rule does not by itself require, imply or negate application of the same or a converse rule to a situation not provided for or to a person not specified by this Article.

Official commentary elaborated on this theme:

Subsection (3) recognizes that in the present state of the law and variety of practices as to letters of credit, no statute can effectively or wisely codify all the possible law of letters of credit without stultifying further development of this useful financing device. . . . The second sentence of subsection (3) makes explicit the court’s power to apply a particular rule by analogy to cases not within its terms, or to refrain from doing so. Under section 1-102(1) such application is to follow the canon of liberal interpretation to promote underlying purposes and policies. Since the law of letters of credit is still developing, conscious use of that canon and attention to fundamental theory by the court are peculiarly appropriate.

---

155. See id. Professors White and Summers argued that only a handful of original Article 5’s provisions are nonvariable, including section 5-106(4), section 5-109(1) (obligating issuer to deal with customer in good faith), section 5-114(1) (requiring issuer to honor complying demand for payment), and section 5-116(2) (allowing beneficiary to assign right to proceeds). See id.
157. Id. cmt. 2.
Despite such accommodations, New York—the most important center of letter of credit practice—remained skeptical. New York reluctantly adopted Article 5 in 1962, but only after adding a non-uniform amendment to section 5-102, the provision governing the scope of Article 5.\textsuperscript{158}

Unless otherwise agreed, this Article 5 does not apply to a letter of credit or a credit if by its terms or by agreement, course of dealing or usage of trade such letter of credit or credit is subject in whole or in part to the Uniform Customs and Practice for Commercial Documentary Credits fixed by the Thirteenth or by any subsequent Congress of the International Chamber of Commerce.\textsuperscript{159}

Given New York's importance as a commercial center, and the fact that most letters of credit incorporate the UCP (whether expressly or pursuant to course of dealing or usage of trade),\textsuperscript{160} this non-uniform amendment seriously undermined the drafters' efforts to achieve a uniform letter of credit law.\textsuperscript{161}

Decades later, in 1986, the Letter of Credit Subcommittee of the Uniform Commercial Code Committee of the Business Law section of the American Bar Association appointed the Task Force on the Study of U.C.C. Article 5, charging members with the task of examining Article 5 and recommending changes.\textsuperscript{162}

\textsuperscript{158} See Byrne, supra note 150, at 20-21.

\textsuperscript{159} N.Y. U.C.C. § 5-102(4) (Consol. Supp. 1996). Alabama and Missouri have added similar nonconforming amendments to their versions of section 5-102. See ALA. CODE § 7-5-102(4) (1993); Mo. ANN. STAT. § 400.5-102(4) (West 1994).


\textsuperscript{161} Over the years, New York courts have softened the blow, applying Article 5 principles by analogy to resolve issues not addressed by the UCP. See Task Force on the Examination of U.C.C. Article 5, An Examination of U.C.C. Article 5 (Letters of Credit), reprinted in 45 BUS. LAW. 1521, 1559 (1990) [hereinafter Task Force Report]. For example, under established common law principles, the applicant could obtain an injunction against payment when a beneficiary presented fraudulent documents. Original Article 5 codified these principles in section 5-114. Because the UCP does not address injunctive relief in case of fraud, the New York courts have felt free to apply section 5-114 by analogy. See United Bank Ltd. v. Cambridge Sporting Goods Corp., 360 N.E.2d 943, 947 & nn.2-3, 948-52 (1976).

\textsuperscript{162} See Task Force Report, supra note 161, at 1527.
Professor James Byrne served as Chairman of the Task Force, which released a lengthy and detailed Report in 1989. Among other issues, the Task Force considered whether Article 5 should expressly refer to the UCP. The Task Force quickly raised several reasons for clarifying the "uneasy" relationship between the Code and the UCP, including bringing New York back into the fold of uniform law, educating judges as to the importance of the UCP, and resolving conflicts that existed between Article 5 and the UCP.

Having considered the problem thoroughly, the Task Force issued the following Opinion:

There is much wisdom in the dual scheme which has emerged by which rules of practice are articulated by a non-legislative body in intimate contact with the letter of credit industry, on the one hand, and statutory rules are of a more skeletal character. The two approaches complement one another and permit maximum flexibility without compromising basic concerns regarding the character of legal obligations, rights, and duties which are necessary to provide certainty and predictability.

As a result, any revisions should preserve this balance, strengthening the foundational character of the statute and welcoming clarification of trade practices where appropriate.

As a general drafting principle and rule of construction, it is wise and desirable to limit the number of overt conflicts with the U.C.P. and to smooth those which exist.

Commentary which makes explicit reference to the significant role played by trade codes in letter of credit practice would be most helpful. While it would be inappropriate for a statute to prejudge this matter, a comment for guidance would be useful to the effect that 'the incorporation of the Uniform Customs and Practice for Documentary Credits in letters of credit is routinely respected by courts'.

164. See id. at 1558.
165. See id. at 1559-60.
166. The Report noted four areas of conflict: (1) time for honor; (2) the effect of a decision to honor; (3) transfer and assignment; and (4) credits silent as to irrevocability. See id. at 1560.
167. See id. at 1559-60.
can also indicate where variation is permissible in U.C.C. Article 5. This approach would ease concerns regarding the relationship of the U.C.C. with the U.C.P., would assist lawyers in drawing the attention of courts to the U.C.P., and move toward greater international harmonization.  

Thus, the Task Force recognized that Article 5 played an important role in articulating basic legal rights and obligations. The Task Force recommendations regarding the UCP were relatively modest: first, whenever possible, Article 5 and the UCP should be consistent, and, second, whenever possible, Article 5 should include commentary to direct courts to respect the UCP. Shortly after the Task Force released its Report, NCCUSL agreed to revise Article 5. Meanwhile, in 1989, the International Chamber of Commerce's Commission on Banking Technique and Practice authorized a revision of the UCP. As a result, the UCP and Article 5 underwent revision at approximately the same time. The UCP revision process moved fast-

168. Id. at 1560-61.


At about the same time, Professor Byrne, formerly the Chairman of the ABA Task Force, penned a symposium article recommending strategies for revision success. "In retrospect, the great failure of [the original] U.C.C. article 5 was its inability to attract the adherence of the world's banking center, New York," he lamented. Byrne, supra note 150, at 13. The fundamental problem leading to this failure was simple:

[T]he drafters failed to grasp the significance of the U.C.P. Even though there was no prior statutory scheme, letter of credit law could not be written on a tabula rasa. The field was occupied in large part by the U.C.P., which articulated the understanding of the international banking community as to the character and nature of the undertakings involved.

Id. at 17.

Having offered this diagnosis, Byrne offered his prescription for a successful revision of Article 5: the drafters should work toward a model law stating universal principles, based on letter of credit practice. "[T]his practice, warts and all, is the only authentic basis available for the legislative exercise," he opined. Id. at 29. "What must be elicited are rules founded on the ideal or best practice of bankers." Id.


171. AMERICAN LAW INSTITUTE, UCC REVISED ARTICLE 5. LETTERS OF CREDIT PROPOSED FINAL DRAFT xv-xvii, xii-xxiii (1995) (stating the reason for revision was to conform the Article 5 rules to current international customs and practices reflected
er, however, and was completed first. The Commission approved the "Uniform Customs and Practice for Documentary Credits—1993 Revision," made effective on January 1, 1994. Known as the UCP 500, this document made a number of important changes and clarifications in letter of credit practice and policy. Playing catch-up, the UCC's drafters completed and released an Official Text of revised Article 5 in 1995.

B. Revised Article 5 and the Uniform Customs and Practice for Documentary Credits

Like its predecessor, revised Article 5 embraces freedom of contract. With the exception of a few nonvariable terms, revised Article 5 is composed of default rules, the effect of which can be varied by agreement or provisions incorporated in the letter of credit. Thus, when a letter of credit expressly incorporates the UCP 500, to the extent that any conflict exists between the UCP and variable provisions of Article 5, the UCP governs.
If parties do not "agree otherwise," what results then? What kind of default rules have the drafters chosen for Article 5, and why? As explained above, the ABA Task Force recommended that any revision of Article 5 should limit and smooth over existing conflicts with international rules and practices as reflected in the UCP.\footnote{178} This recommendation was both admonitory and neutral in tone. The Task Force did not mandate the elimination of all conflicts, nor did it command that Article 5 be the one to change and conform.\footnote{179} Examination of the new Official Text of Article 5, however, suggests that the drafters went beyond the Task Force's modest recommendation.

Many of the revisions to Article 5 have a copycat look, suggesting that the UCP has become the dominant party in the uneasy relationship between the two.\footnote{180} Perhaps the dominance of the UCP results from a subtle shift in philosophy. Although the UCC's drafters emphasized the need for uniformity, their arguments seem more directed at achieving conformity with international practice:

Letters of Credit are a major instrument in international trade, as well as domestic transactions. To facilitate its usefulness and competitiveness, \textit{it is essential that U.S. law be in harmony with international rules and practices}, as well as flexible enough to accommodate changes in technology and practices that have, and are, evolving. Not only should the

---

The history of section 5-116(c) is interesting. In June 1993, when the Article 5 revision was already in its seventh draft, the U.S. Council on International Banking, Inc. (USCIB), an industry association composed of domestic and international banks, indicated that it could not support the revision as it was. \textit{See} Rapson, \textit{supra} note 160, at 268. USCIB objected that the draft failed to recognize the importance of the UCP, relegating it to mere incorporated contract language that could not displace any Code obligation of good faith, diligence, reasonableness, or care. \textit{See id.} Concerned about USCIB's withdrawal of support, the drafting committee responded by adding section 5-116(c), which emphasizes the UCP's dominance over virtually all Article 5 provisions. \textit{See id.} at 269.

Not everyone is pleased with section 5-116(c). \textit{See id.} at 271. One author has complained that section 5-116(c) "ced[es] to an international group—here, the International Chamber of Commerce—the right and ability to make rules governing issuer liability over which state law would have no control." \textit{Id.}

\footnote{178} \textit{See supra} text accompanying notes 164-68.

\footnote{179} \textit{See Task Force Report, supra} note 161, at 1560-61.

\footnote{180} \textit{See infra} notes 183-200 and accompanying text.
rules be consistent within the United States, but they need to be substantively and procedurally consistent with international practices.

Thus, the goals of the drafting effort were:
* conforming the Article 5 rules to current customs and practices;
* accommodating new forms of Letters of Credit, changes in customs and practices, and evolving technology, particularly the use of electronic media;
* maintaining Letters of Credit as an inexpensive and efficient instrument facilitating trade; and
* resolving conflicts among reported decisions.  

In making their case for enactment, the drafters further asserted that "[r]evisions have been made to Article 5 to coordinate the Article 5 rules with current international practice," as reflected in the UCP 500. Official commentary added that "Article 5 is consistent with and was influenced by the rules in the existing version of the UCP."  

Many specific provisions illustrate this influence. For example, the UCP 500 provides that credits are deemed irrevocable unless clearly indicated otherwise. Revised Article 5 achieves the same result with different language: A letter of credit is revocable only if its terms so provide.

181. AMERICAN LAW INSTITUTE, supra note 171, at xvi-xvii (emphasis added).
182. Id. at xxii-xxiii (emphasis added).
184. See U.C.P. 500, art. 6(c) (1994), reprinted in WUNNICKE & WUNNICKE, supra note 150, at 53, 59 [hereinafter U.C.P. 500]. This is an about-face; former international practice provided that a letter of credit was deemed revocable unless it clearly indicated otherwise. See Uniform Customs and Practice for Documentary Credits—1983 Revision, art. 7 (1983) [hereinafter UCP 400]. The UCP 400 presumption of revocability was unpopular; because most credits were intended to provide irrevocable commitments, the presumption undermined letter of credit reliability. See UCP 500 & 400 COMPARED, supra note 172, at 14.
Other parallels are even more striking. Under the UCP 500, when a beneficiary demands payment, an issuer must examine his documents with reasonable care to determine whether they appear to comply with the terms and conditions of the letter of credit.\textsuperscript{186} Whether the stipulated documents comply on their face with the terms and conditions of the credit is now determined by international standard banking practice as reflected in the UCP.\textsuperscript{187}

Similarly, revised Article 5 states that an issuer must honor a presentation that appears on its face \textit{strictly} to comply with the terms and conditions of the letter of credit.\textsuperscript{188} Strict compliance must be determined by the standard practice of financial institutions that regularly issue letters of credit.\textsuperscript{189} Commentary explains that standard practice includes international practice set forth in or referenced by the UCP, as well as other practice rules published by banking associations, and local and regional practices.\textsuperscript{190}

To give a final example, the UCP 500 allows an issuer a reasonable time, not to exceed seven banking days following the day on which documents are received, to examine the documents of this basic principle within revised Article 5 can be characterized fairly as an attempt to conform American law to international practice. \textit{See AMERICAN LAW INSTITUTE, supra} note 171, at xxi-xxiii (giving Article 5's addition of an irrevocability provision as an example of conformity between the UCC and international practice).

\textsuperscript{186} \textit{See U.C.P. 500, art. 13(a).}

\textsuperscript{187} \textit{See id.}

\textsuperscript{188} \textit{See U.C.C. § 5-108(a).} By contrast, the original Article 5 provided only that an issuer has an obligation to honor a draft or demand for payment which complied with the terms of the letter of credit. \textit{See U.C.C. § 5-114(1) (1994).} Failure to define compliance led to a confusing proliferation of different standards, ranging from "strict" (requiring mirror-image compliance) through "substantial" (requiring only reasonable compliance). \textit{See Carolyn Hotchkiss, Strict Compliance in Letter-of-Credit Law: How Uniform Is the Uniform Commercial Code?, 23 UCC L.J. 288 (1991); Macintosh, supra} note 147, at 25-28.

\textsuperscript{189} \textit{See U.C.C. §§ 5-108(a)-(e) (1995).} Whether the issuer has observed standard practice is a matter of interpretation for the court, which must offer parties a reasonable opportunity to present evidence of standard practice. \textit{See id.} § 5-108(e). Revised Article 5 authorizes the courts, rather than juries, to determine the standard practice and thus should encourage consistent outcomes and speedier resolution of disputes. \textit{See id.} cmt. 1.

\textsuperscript{190} \textit{See id.} cmt. 8.
and decide whether to accept or refuse them. If the issuer decides to refuse the documents, it must give notice to the presenting bank or beneficiary without delay, but must do so no later than the close of the seventh banking day following the day of receipt of the documents. Such notice must state all discrepancies that justified rejection of the documents; otherwise, the issuer cannot claim in a subsequent wrongful dishonor suit that the documents do not comply with the credit.

Unlike prior law, revised Article 5 is deliberately consistent with the UCP approach. An issuer has a reasonable time after presentation—up to seven business days after the day on which documents are received—to honor, or to dishonor with notice of discrepancies. An issuer is strictly precluded from asserting as a basis for dishonor any discrepancy if timely notice is not given, or any discrepancy not stated in a notice timely given. The requirement that the issuer send notice of

191. See U.C.P. 500, art. 13(b).
192. See id. art. 14(d)(i).
193. See id. art. 14(d)(ii).
194. See id. art. 14(e). These provisions are largely consistent with earlier statements of international custom. UCP 400 provided for inspection within an (unspecified) reasonable time, prompt notice of documentary defects, and strict preclusion against any issuer who failed to give proper notice. U.C.P. 400, art. 16(c)-(e).
195. Under the original Article 5, the issuer did not have a “reasonable time,” but rather three banking days following receipt of documents to decide whether to honor or dishonor. See U.C.C. § 5-112(l)(a) (1994). Moreover, the original Article 5 did not expressly require the issuer to identify documentary defects that compelled dishonor, leaving the beneficiary unsure as to what he had to do to cure the documents and make a complying presentation before the credit expired. See MacIntosh, supra note 147, at 30. Supplementing the Code with equitable doctrine, some courts held that an issuer who failed to notify the beneficiary of documentary defects waived those defects. See id. at 31. Because the doctrine of waiver applied, however, only when the beneficiary could have cured the defects, it differed from the UCP, which enforces strict preclusion against the issuer regardless of whether the beneficiary suffered detriment. See id.
196. See supra note 182 and accompanying text.
197. Official commentary notes that “[t]he outside limit of [reasonable] time is measured in business days under the UCC and in banking days under the UCP, a difference that will rarely be significant.” U.C.C. § 5-108 cmt. 2 (1995). Neither business nor banking days are defined in Article 5. See id.
198. See id. § 5-108(b). The seven-day period is not a safe harbor; an issuer must give notice in the lesser of a reasonable time, or seven business days. See id. What is a “reasonable time” must be determined with reference to the actions of those in the business of examining documents, mostly banks. See id. cmt. 2.
199. See id. § 5-108(c). Thus, revised Article 5 rejects prior decisions holding that
the discrepancies or be precluded from asserting them is taken from the similar provision in the UCP 500, and is intended to promote certainty and finality.200

To summarize, letter of credit law has internalized letter of credit practice. In effect, revised Article 5 has become a vehicle for the legislative and judicial recognition of the UCP 500, and any other commercial practices that may develop over time.

C. Efficiency

Does policy justify the Code's reliance on international practice as reflected in the UCP 500? Or, have the drafters simply knuckled under, in the fear that banks otherwise might lobby against the legislative enactment of revised Article 5?201

The letter of credit is a valuable and popular commercial device for two reasons: first, the credit assures the beneficiary of receiving prompt and reliable payment from a financial institution,202 and second, credits are appealingly inexpensive.203 Thus, anything that interferes with the issuer's decision to pay, by making it slower, less certain, or more expensive, strikes at the very heart of the letter of credit device, and seriously undermines its commercial utility.204 To put it another way, the letter of credit is particularly sensitive to transaction costs. Anything that interferes with the issuer's decision to pay, and that increases transaction costs, correspondingly decreases the efficiency of the letter of credit.205

Given these basic truths, it comes as no surprise that operational efficiency is one of the major concerns in letter of credit

---

discrepancies are waived only if the beneficiary could have cured them, given proper notice. See id. cmt. 3. The advantage of the new, strict preclusion rule is that it forecloses litigation about reliance and detriment. Id.

200. See id.

201. See Rapson, supra note 160, at 277-81.

202. See Macintosh, supra note 147, at 6.

203. The average charge for issuing a commercial letter of credit is a mere one percent of the total face amount. Standby letters of credit cost somewhat more: the charge hovers from one to three percent of the total face amount of the credit. See Vincent Maulella, Quicker to the 'Green': Standby Letters of Credit Extend Business Drive, CORP. CASHFLOW MAG., Sept. 1994, at 21.

204. See Macintosh, supra note 147, at 7.

205. See Maulella, supra note 203, at 21.
practice. The desire to achieve such efficiency underlies many UCP provisions, and thus serves as the foundation for counterpart provisions in revised Article 5.

The importance of operational efficiency to letter of credit practice and law can be illustrated with one key example. A variety of standards for determining documentary compliance proliferated under original Article 5. The predominant standard, the mirror image rule, required issuers to reject documents even when discrepancies were trivial. Studies released while the UCP was in the process of revision indicated that up to ninety percent of documents initially presented for payment under letters of credit did not comply with stated terms and conditions. The same studies confirmed that most letters

206. See Jean-Charles Rouhen, Foreword to U.C.P. 500, reprinted in Wunnicke & Wunnicke, supra note 150, at 54.

207. Another example of the drive toward operational efficiency can be found in UCP 500's approach to nondocumentary conditions. See U.C.P. 500, art. 13(c). One of the most fundamental premises of letter of credit practice is that all parties deal with documents, and not with goods, services, or other performances to which the documents may relate. U.C.P. 500, art. 4. In other words, payment depends on paper, not facts. Despite this fundamental truth, the commercial realm has been bombarded in recent years with letters of credit that include nondocumentary conditions—in other words, conditions that require issuers to go beyond the documents to verify that certain events have occurred, or that certain facts are true. See Janis Penton Soshuk, The Consequences of Nondocumentary Conditions, 56 Brook. L. Rev. 33, 34-5 (1990). By requiring issuers to go beyond the world of paper, nondocumentary conditions introduce operational uncertainty and expense. See id.

UCP 500 resolves this problem by adding a new practice: if a credit contains nondocumentary conditions, banks will deem the conditions as not stated and will disregard them. U.C.P. 500, art. 13(c). Commentary indicates that the ICC considered two solutions: allowing banks to accept documents reflecting satisfaction of the condition, or treating the nondocumentary condition as surplusage that could be disregarded. The latter solution was chosen for its conceptual simplicity and operational ease. See UCP 500 & 400 COMPARED, supra note 172, at 43.

Similarly, revised Article 5 provides that an issuer shall disregard nondocumentary conditions and treat them as if they were not stated. See U.C.C. § 5-108(g) (1995). According to the comments, nondocumentary conditions have no place in a regime where the issuer's basic obligation is to examine documents and make a prompt decision to honor or dishonor. See id. cmt. 9. The new rule, appearing for the first time in Article 5, has a further advantage: "[i]n requiring that nondocumentary conditions in letters of credit be ignored as surplusage, Article 5 remains aligned with the UCP." Id.

208. See supra note 188.

209. See Macintosh, supra note 147, at 7.

210. See id. at 3.
of credit were honored eventually, either because applicants waived documentary defects, or because beneficiaries cured the defects and made a second, more successful presentation.\textsuperscript{211} This system suffered from high transaction costs as banks hustled to obtain waivers from applicants and notify beneficiaries of required corrections while beneficiaries were consigned to the purgatory of correcting meaningless typographical errors.\textsuperscript{212} The system also undermined the business community's confidence in the reliability of the letter of credit.\textsuperscript{213}

The UCP 500 seeks to improve operational efficiency by choosing a new standard: Documentary compliance is now determined by international standard banking practice, as reflected in the UCP 500.\textsuperscript{214} For example, although the description of the goods in a commercial invoice \textit{must} correspond precisely with the description as set forth in the letter of credit, the UCP 500 provides that in all other documents, the goods may be described in general terms not inconsistent with the description in the letter of credit.\textsuperscript{215} A bank thus can make payment against a bill of lading that describes the goods generally as "cats," even though the description in the letter of credit specifies Abyssinian or Russian Blue cats.

In support of this new standard, the UCP drafters have argued that the mirror image rule did not provide a functional standard, resulting in a proliferation of litigation and costly uncertainty throughout the letter of credit world.\textsuperscript{216} Further, competitive banking ensures that international standard banking custom and practice is both honest and predictable.\textsuperscript{217} Thus, the new standard is intended to enhance the letter of credit device by making it easier for banks to make payment, without obtaining waivers or correction of documentary defects that international standard banking practice recognizes as being in-

\textsuperscript{211} \textit{See id.}
\textsuperscript{213} \textit{See id. at 49.}
\textsuperscript{214} \textit{See U.C.P. 500, art. 13(a).}
\textsuperscript{215} \textit{See id. art. 37(c).}
\textsuperscript{216} \textit{See UCP 500 & 400 COMPARED, supra} \textit{note} \textit{172, at 100.}
\textsuperscript{217} \textit{See id. at 39.}
significant.

The ABA Task Force Report, which examined and recommended changes to Article 5 before the revision process began, expressed similar views. Documentary compliance standards had proliferated and were applied in a confusing manner. According to the Task Force, the mirror image rule (described as a "hyper-technical" interpretation of the strict compliance standard) did not reflect the realities of practice, harmed letter of credit operations, and discredited the letter of credit as a reliable device. The Task Force proposed a new compliance standard, based on banking practices. As explained above, this thinking ultimately made its way into revised Article 5, which now measures strict compliance by the standard practice of letter of credit issuers. Like the UCP 500, then, the Code now allows banks to pay without obtaining waivers or correction of defects that standard practice recognizes as minor. The UCC's drafters hope that, by making payment faster and cheaper, the new compliance standard will lower transaction costs, and enable the letter of credit device to function more efficiently.

219. See id. at 1608.
220. See id. at 1609.
221. See id. at 1609-10. The standard was couched in terms somewhat different from those chosen by UCP 500, and employed in the current version of revised Article 5. "Strict compliance means what a knowledgeable diligent document checker would have accepted as being in facial compliance with the terms of the credit," the Report asserted. Id. at 1609. The basic thrust of the ABA standard, however is the same: discrepancies should be determined in accordance with banking practice. See id. at 1609-10.
223. For example, the comments indicate that obvious typographical errors, clear abbreviations, and failure to capitalize letters can be overlooked. See id. cmt. 1.
224. See id. Skeptics may question how banks can know what standard practice is. Indeed, this is an all-important question. The more uncertain the content of standard practice is, the less simple payment decisions become. At an extreme, such uncertainty could render the new compliance standard costlier than the old mirror image rule, as banks frantically research the answers necessary to determine whether they should pay against defective documents (to avoid the beneficiary's wrongful dishonor lawsuit) or dishonor (to protect themselves against the applicant's refusal to reimburse). The drafters have tried to minimize such concerns in two ways. First, commentary indicates that there are already several sources of standard practice, including the UCP 500, practice rules published by banking associations, and local and regional practices. See U.C.C. § 5-108 cmt. 8 (1995). For example, the
D. Liberty

The letter of credit community has not attempted to justify the Article 5 revisions on grounds other than operational efficiency. This Part presents an argument that liberty grounds can also justify the codification of letter of credit practice within revised Article 5.

This analysis begins by briefly sketching the letter of credit world and its participants. Whether commercial or standby, a typical letter of credit transaction involves at least three parties: the issuer, beneficiary, and applicant. A commercial letter of credit is a device used to pay for goods. The buyer applies to the issuer for the issuance of a letter of credit in favor of the seller as beneficiary. A standby letter of credit can be used in any transaction in which one contract party feels insecure about the performance of the other. The party whose performance is in doubt asks the issuer to issue a letter of credit in favor of the party who wants security, as beneficiary. Thus, the universe of letter of credit beneficiaries, and applicants may be extremely broad, including sellers of goods, buyers of goods, and other persons involved in a wide assortment of commercial transactions. Because use of the letter of credit spans every trade under the sun, from artichokes to zippers, beneficiaries and applicants are too diverse to easily form associations representing letter of credit users.

USCIB has been working to compile “white books of documentary practice” that would establish national standards of document examination. See Kozolchyk, supra note 212, at 75-76. Second, the provision authorizes courts to determine what constitutes standard practice, after offering parties a reasonable opportunity to present evidence. See U.C.C. § 5-108(e). The drafters hope that allowing courts, rather than juries, to determine standard practice will encourage consistent outcomes and speedier resolution of disputes. See id. cmt. 1.

225. See generally 3 White & Summers, supra note 154, § 26-2, at 112-13 (giving a basic understanding of a letter of credit transaction).

226. For a fuller explanation of the commercial letter of credit, see supra note 147.

227. See generally 3 White & Summers, supra note 154, § 26-1(b), at 108 (describing standby letters of credit as a “back-up”).

228. For a fuller explanation of the standby letter of credit, see supra note 148.

229. See Rapson, supra note 160, at 267. Indeed, the ABA Task Force noted that there were no organized trade groups for letter of credit applicants and beneficiaries in the United States. See Task Force Report, supra note 161, at xvi.
By contrast, letter of credit issuers are relatively homogeneous; banks issue most letters of credit. Moreover, there are many banking associations worldwide, including the United States Council on International Banking, Inc. (USCIB), which represents more than 530 banks throughout the United States. In addition to issuers, beneficiaries and applicants, the letter of credit world boasts a cast of supporting characters, such as insurance and transportation companies, who generate the insurance policies, bills of lading, and other documents that beneficiaries must present in order to receive payment. Within each supporting industry, companies may have their own practices, forms, and voluntary associations.

Applying the general theory of commercial law developed in this Article to the letter of credit realm thus described, the following theoretical paradigm emerges. Imagine thousands upon thousands of letters of credit negotiated, presented, and paid over many years. As applicants, beneficiaries, and issuers learn which operations are most efficient, they exercise their liberty to bargain over letter of credit terms. Over time, these terms generate patterns of conduct that come to be recognized and adopted as letter of credit practices. Letter of credit practices reflect choices made by countless individuals, whether acting alone or in association with others in bank or corporate form. These practices may endure for some time, or evolve further as changes in the business world precipitate renewed bargaining over terms. Therefore, when revised Article 5 incorporates letter of credit practice, the law honors the exercise of individual liberty, past, present, and future.

To what extent does reality mirror—or diverge from—this theoretical paradigm?

As a preliminary challenge, some critics might argue that

---

230. See Rapson, supra note 160, at 267.
233. As explained above, even though banks and other corporations may not have natural rights of their own, they can be viewed as associations of individuals who enjoy liberty and property. For a more complete explication of this view, see supra text accompanying notes 72-74.
letter of credit practices cannot reflect the free choices of individuals who own and operate banks, given the extensive regulation that banks generally endure. This argument proves too much. Even if banks are regulated, it does not follow that individuals associated with banks have had no free choices in developing the operational practices incorporated in revised Article 5. Indeed, a survey of federal law reveals primarily a concern with the effect that outstanding letters of credit have on a bank’s lending limits, capital ratios, and insolvency.

More significantly, the paradigm could be criticized for its assumption that banks (as issuers) and businesses (as beneficiaries and applicants) play equal roles in developing letter of credit practices. Indeed, the reality is somewhat more complex. As issuers, banks primarily are responsible for letter of credit operations, which include everything from advising the terms of the credit, to determining documentary compliance and making payment. As providers of letter of credit services, banks are best situated to play a proactive role, developing and offering credits on terms that facilitate efficient operation. Over time, these bank-generated terms can evolve into letter of credit practices.

Buoyed by their superior organization and key role in letter of credit operations, banks have emerged as the primary force be-

234. For examples of the ways in which banks are regulated, see infra notes 235-37 and accompanying text.
235. For example, the National Bank Act establishes the maximum dollar amount of loans that a nationally chartered bank can loan to a single entity. See 12 U.S.C. § 84 (1994). Standby letters of credit must be counted towards the maximum. See DOLAN, supra note 232, ¶ 12.04[1].
236. In recent years, the Federal Reserve Board, Comptroller of Currency, and Federal Deposit Insurance Corporation have issued regulations that require banks to count both standby and commercial letters of credits as loans when computing their capital ratios. See DOLAN, supra note 232, ¶ 12.03[3].
237. For example, the National Bank Act regulates the distribution of assets when national banks become insolvent, including payment of outstanding letters of credit. See 12 U.S.C. §§ 91, 194 (1994); see generally DOLAN, supra note 232, ¶ 12.02 (discussing rules that have arisen to deal with bank insolvencies).
238. See generally James E. Byrne, Preamble to Task Force Report, supra note 161, at 1536 (recognizing a need to attempt to solicit input on the UCC from trade groups or businesses).
239. See id.
240. See id. (explaining that banks are in the position of fair brokers because they play continuous and multiple roles).
hind the articulation of letter of credit practices, particularly in the UCP, which represents the "understandings and practices of internationally active bank [letter of credit] departments on a worldwide basis." Not surprisingly, when the time came to restate letter of credit practices in the form of the UCP 500, the task fell primarily to banking association representatives, including a USCIB representative, who served on the International Chamber of Commerce's Commission on Banking Practice and Technique.

Banks have taken the lead in fashioning and articulating letter of credit practices, not only because they have the power and organization to do so, but because they generally are perceived as being "fair brokers" as far as letter of credit issues are concerned. Banks often play multiple roles within letter of credit transactions, serving not only as issuers, but applicants and beneficiaries as well. Moreover, banks have a general interest in maintaining the viability of the products and services that they sell, including letters of credit. For both these reasons, banks have an incentive to promote practices that are fair to applicants and beneficiaries and that ensure the letter of credit offers a good value for its price.

Even though banks have taken the lead, other beneficiaries and applicants still can play a significant, albeit less direct, role in the development of letter of credit practices. The letter of credit is a mercantile device used to facilitate commercial, rather than consumer, transactions. Beneficiaries and applicants are businesspersons who presumably have the financial incentive and means to educate themselves regarding the effect of letter of credit terms. When banks, as issuers, offer letters of credit.

242. See UCP 500 & 400 COMPARED, supra note 172, at ix. Banks have also played a major role in the Article 5 revision process, working in the absence of any identifiable interest groups representing applicants or beneficiaries. See Rapson, supra note 160, at 267-68.
243. See Byrne, supra note 238, at 1536.
244. See id.
245. See id.
246. See id.
247. See DOLAN, supra note 232, ¶ 6.02.
credit on specific terms, beneficiaries and applicants are free to accept or reject those terms and bargain for other, more favorable, terms. In this manner, beneficiaries and applicants can indirectly influence the development of letter of credit practices, even if they do not originate those practices.

Some might argue that beneficiaries and applicants do not have the knowledge or bargaining power necessary to make free choices regarding letter of credit terms. For example, one commentator has asserted that businesspersons routinely receive and accept letters of credit without consulting attorneys, and without ever realizing that the boilerplate incorporates the UCP 500. Beneficiaries and applicants who have enough money and power to use letters of credit in multi-million dollar transactions, however, do have a reasonable opportunity to hire lawyers and to educate themselves regarding the effect of credit terms. Moreover, even though most letters of credit incorporate the entire UCP 500 through boilerplate language, beneficiaries and applicants can bargain with issuers for any specific terms that are necessary to accommodate the circumstances of their specific transactions. If issuers will not bargain, beneficiaries and applicants can restructure their transactions to eliminate letters of credit. Bonds and guarantees can substitute for standby letters of credit, and payment can be effected via electronic wire transfer, rather than through the use of commercial letter of credit. Given these opportunities, it is fair to

248. See Rapson, supra note 160, at 272-73.
249. See id.
250. Of course, businesspersons should be careful to select a lawyer who specializes in commercial transactions, and understands the basics of the Uniform Commercial Code. See Kerry L. Macintosh, We Have Met the Enemy and He Is Us, 26 LOY. L.A. L. REV. 673, 678 (1993).
251. See Rapson, supra note 160, at 273.
252. Admittedly, these and other alternatives sometimes may create problems that letters of credit could have ameliorated. For example, suppose Seller ships goods, and then, acting through a collecting bank, presents a demand for payment along with shipping documents to Buyer. To obtain the documents necessary to pick up the goods, Buyer must make payment, perhaps via electronic wire transfer. The disadvantage of this transactional structure is that Seller must trust Buyer to make payment. A commercial letter of credit would have solved the problem by substituting the commitment of a solvent financial institution. There may, however, be another solution. As informational networks continue to expand beyond national bound-
say that beneficiaries or applicants who accept letters of credit, even those who act without reading or bargaining over terms, have exercised their freedom to choose the resulting terms.

Specific default rules can illustrate this general analysis. Revised Article 5, for example, now provides that an issuer must honor a presentation that strictly complies with the terms and conditions of the letter of credit; compliance is determined by the standard practice of financial institutions that regularly issue letters of credit. As the formulation “standard practice of financial institutions” suggests, banks likely will take the lead in fashioning the specific, detailed practices that determine documentary compliance. Aside from the international practices enshrined in the UCP, however, the “standard practice of financial institutions” is not etched in stone; indeed, there are frequent disagreements among banks, even those within the same geographical region. Such disagreements create an opportunity for beneficiaries and applicants to shop among issuers based on their varying standards. Thus, market forces should ensure that beneficiaries and applicants influence the evolution of specific practices.

More importantly, the very custom of judging documentary compliance by the standard practice of financial institutions is itself the product of beneficiary and applicant choice. The drafters of the UCP 500 articulated this new compliance standard

aries, sellers can deal with buyers who have established international credit reputations. Indeed, if enough sellers and buyers become dissatisfied with letters of credit, the development of such informational alternatives could accelerate. The message for banks is clear: Businesspersons engaged in multi-million dollar transactions can be expected to exercise their commercial freedom, one way or another. If businesspersons view letter of credit terms as being unfair and unalterable, the market will generate alternatives to letters of credit.

253. It is instructive to note that failure to read a contract does not vitiate consent. See Farnsworth, Contracts § 4.26 (2d ed. 1990).


255. See id. § 5-108(e) (emphasis added).

256. See Kozolchyk, supra note 212, at 75. In an effort to achieve greater consistency, the USCIB has been working to compile “white books of documentary practice” that would establish national standards of document examination. See id. at 75-76. Even if these white books help to standardize practice, however, they likely will never eliminate entirely disagreements among issues regarding documentary compliance.
because they believed that the mirror image rule was dysfunctional, generating costly litigation and uncertainty. The new standard is meant to restore the trust of businesspersons, who otherwise might abandon the letter of credit and choose other, more reliable payment systems. In other words, the freedom and bargaining power of individual beneficiaries and applicants helped to shape the new compliance standard. By adopting the same standard, the drafters of revised Article 5 demonstrated their respect for the liberty of beneficiaries and applicants, as well as for issuers.

One last point: What happens when practice-based rules do not meet the needs of a particular transaction? Revised Article 5 gives beneficiaries and applicants freedom of contract. To continue with the same example, even though the Code now determines documentary compliance by the standard practice of financial institutions, the parties to a letter of credit can override undesirable practices by agreement or course of dealing. By granting freedom of contract, revised Article 5 further reinforces and strengthens the liberty of letter of credit participants.

E. Summary

To summarize, revised Article 5 is heavily based on letter of credit practices, particularly as embodied in the UCP. To justify this foundation, the drafters have emphasized the need to ensure operational efficiency of letters of credit. The decision to codify practice can be justified on another, independent, ground, as discussed in the preceding Part of this Article. Letter of credit practices evolve when individuals use their freedom to structure letter of credit transactions. Banks (and the individuals associated with them) play a dominant role in originating and articulating letter of credit practices; however, beneficiaries and applicants usually have enough sophistication and bargaining power to shape practices indirectly. By adopting these market-generat-

257. See UCP 500 & 400 COMPARED, supra note 172, at 39.
258. See id. at 49.
259. See supra text accompanying note 252.
260. See supra note 175.
ed practices, revised Article 5 respects the individual liberty of letter of credit issuers, beneficiaries, and applicants alike.

V. ARTICLES THREE AND FOUR: PAYMENT SYSTEMS

Article 3 on Negotiable Instruments and Article 4 on Bank Deposits and Collection were revised in 1990.262 Like revised Article 5, revised Articles 3 and 4 have a strong banking orientation, frequently incorporating provisions that are based on banking practices.263 Unlike revised Article 5, however, revised Articles 3 and 4 have drawn fire, particularly from consumer advocates.264

To date, much of the battle over revised Articles 3 and 4 has taken place on economic turf. The drafters have fired off efficiency rationales in support of the revisions,265 and opponents have shot back with their own competing economic analyses.266

This economic controversy is outlined briefly below in order to contrast its theoretical underpinnings with this Article's theory, which asks a very different question: Can revisions that are based on banking practices be justified on liberty grounds? This Part concludes that the revisions to Articles 3 and 4 pose the strongest challenge to the thesis that a practice-based Code respects individual liberty.

A. Historical Background

The revisions to Articles 3 and 4 are easier to understand if placed in their historical context. Unlike original Article 5, which represented the first codification of letter of credit law, original Articles 3 and 4 were based on two prior uniform laws.267 Charged with the task of drafting Article 3, William Prosser268 produced a statute that eschewed innovation in fa-

262. See Rubin, supra note 7, at 780.
263. See Rubin, supra note 12, at 557-60.
264. See infra notes 292-97 and accompanying text.
266. See Rubin, supra note 12, at 561-70.
267. See id. at 552-56.
268. William Prosser was a famous law professor and author in the area of torts. See
vor of refining doctrines already prescribed in the Negotiable Instruments Law, a uniform act promulgated in 1896 and adopted in every state. Meanwhile, Fairfax Leary became the first person assigned to draft Article 4. His innovative draft, which attempted to balance industry needs with consumer interests, provoked wholesale rebellion by banking interests, who demanded that Article 4 be eliminated. The Leary effort quickly was withdrawn, and bankers were enlisted to help draft a new version of Article 4. This version was heavily based on the Bank Collection Code, an earlier uniform law drafted by the American Bankers Association that had met with limited success. Some scholars attacked the new law as "an unfair piece of class legislation" that favored banks at the expense of customers. Nevertheless, Article 4 was adopted by all fifty states.

Based on prior uniform acts, Articles 3 and 4 were never on the cutting edge of law or technology, even when first offered for enactment during the 1950s. As the decades flew by, Articles 3 and 4 became ever more antiquated, especially when contrasted with developing check-collection technologies and entirely new payment systems, such as credit cards and electronic fund transfers.

Not surprisingly, by the late 1970s, the ALI decided that Ar-

---

WILLIAM PROSSER & WILLIAM KEeton, THE LAW OF TORTS xix (5th ed. 1984). His expertise in the area of commercial law was limited. See Rubin, supra note 12, at 553.

269. See Rubin, supra note 12, at 552-53.


271. See Rubin, supra note 12, at 555.

272. See id.

273. When the drafting process for the Uniform Commercial Code began, the Bank Collection Code had been adopted by only 19 states. See id.


276. See Patchel, supra note 7, at 105; Rubin, supra note 12, at 556.

277. See Rubin, supra note 12, at 555-55.

278. See id. at 557-58.
Articles 3 and 4 must be revised. An ambitious New Payments Code was drafted to bring all payment systems—checks, credit cards, and electronic funds transfers—under one statutory umbrella. Recognizing that credit cards and electronic funds transfers already were governed by federal consumer protection legislation, the law extended consumer protection to the checking system. Bankers objected loudly, as did consumer advocates who believed that the draft had diluted existing protection for credit card transactions. The controversial consumer provisions were removed, but opposition to the New Payments Code continued, eventually causing the ALI to terminate the entire project.

Chastened by this traumatic experience, in 1985, NCCUSL and the ALI launched two new law reform projects: the revision of Articles 3 and 4 and the creation of an entirely new Article 4A to regulate wholesale wire transfers. This time, the drafters had only modest goals: While preserving existing terminology and structure, the Article 3 and 4 revisions would clear up conflicting interpretations and incorporate substantive changes, as necessary, to account for technological developments and changes in business practices. For the most part, this limited agenda was honored. True, the provisions of Article 3 were entirely rewritten, rearranged, and renumbered, but for a limited purpose: to modernize and clarify statutory language. As for Article 4, some important changes were made to accommodate

279. See id.
280. See id. at 557.
282. See Rubin, supra note 12, at 557-58.
283. See id.
286. See Miller, supra note 284, at 409-10.
287. See id. at 412.
developing technology, particularly in the area of bank-customer relationships.\textsuperscript{288} Other than authorizing check truncation,\textsuperscript{289} however, the drafters left the check-collection process virtually untouched. Because the Expedited Funds Availability Act\textsuperscript{290} pre-empts state law on many check-collection issues,\textsuperscript{291} much of revised Article 4 is now a dead letter.

In the drafters' haste to avoid controversy, they made one nearly-fatal error. Despairing of finding agreement on the "consumer agenda," the drafting committee decided not to rework the Code from the consumer perspective.\textsuperscript{292} Consumer advocates and sympathizers who were involved in the revision project argued that the Article 3 and 4 revisions perpetuated and exacerbated the anti-consumer bias of the original Code.\textsuperscript{293} Their critique developed late in the drafting process, however, and did not flower until the ALI and NCCUSL already had promulgated the revisions.\textsuperscript{294} Those who were unhappy with the perceived anticonsumer bias tried to persuade state legislatures to reject revised Articles 3 and 4.\textsuperscript{295} Perhaps the most serious challenge came from Professor Edward Rubin, who had participated in the drafting process as Chair of the American Bar Association subcommittee assigned to review the Article 3 and 4 revi-

\textsuperscript{288} For examples of these changes, see infra text accompanying notes 306-38.

\textsuperscript{289} See infra note 331.

\textsuperscript{290} In 1987, Congress enacted the Expedited Funds Availability Act, Pub. L. No. 100-86, 101 Stat. 635 (1987) (codified as amended at 12 U.S.C. §§ 4001-4010 (1994)), which the Federal Reserve Board has implemented through Regulation CC. 12 C.F.R. pt. 229 (1996). The Expedited Funds Availability Act requires banks to release deposited funds in accordance with specified timetables. See id. §§ 229.10-.13. The Act also regulates the check-collection process in order to facilitate quick release of funds. See id. §§ 229.30-.42. For example, banks must give final credits during forward collection, see id. § 229.36(d), so that bounced checks can be returned expeditiously to depositary banks. See id. § 229.31.

\textsuperscript{291} The Expedited Funds Availability Act and Regulation CC supersede inconsistent state law, including the Uniform Commercial Code. See 12 U.S.C. § 4007(b) (1994).

\textsuperscript{292} See Warren, supra note 285, at 820-21.

\textsuperscript{293} For a sampling of their views, see Hillebrand, supra note 7, at 717-19, and Rubin, supra note 12, at 592.

\textsuperscript{294} See Warren, supra note 285, at 819-20. Since then, scholars have argued that the drafters should consciously try to involve consumer representatives earlier in the drafting process. See, e.g., Patchel, supra note 7, at 126-45, 156-57; Rubin, supra note 7, at 759-67, 781-87.

\textsuperscript{295} See Rubin, supra note 7, at 782-87.
Concerned that the revisions did not adequately account for consumer needs, Professor Rubin ultimately resigned as Chair of the subcommittee and campaigned against revised Articles 3 and 4 in California and other states. If California had rejected the revisions, many other states might have followed suit. In the end, however, the Article 3 and 4 revisions were adopted by nearly all fifty states.

B. Revised Articles 3 and 4 and Checking Account Practices

As elsewhere within the Code, freedom of contract is an important foundational principle for revised Articles 3 and 4. Revised Article 4 expressly authorizes parties to vary the effect of its default provisions by agreement. Similarly, the effect of Article 3 provisions can be varied by agreement, except where the Code provides otherwise. Although few provisions in Article 3 expressly permit variation by agreement, the absence of such language does not imply that the effect of other provisions may not be varied by agreement.

Absent agreement otherwise, the default rules found within revised Articles 3 and 4 bind the parties. Many of these rules are based on checking account practices. Although not every parallel between law and practice can be documented here, a few key examples are helpful to the analysis.

296. See id. at 743-44.
297. For a more complete and highly personal account of Professor Rubin's involvement in the revision process, see Rubin, supra note 7.
298. See supra note 2.
299. See U.C.C. § 4-103(1) (1995). A bank cannot disclaim its obligations to act in good faith and exercise ordinary care, nor may it limit damages if it fails to meet these obligations. See id. The parties, however, can agree on standards for determining whether the bank has met its obligations, so long as those standards are not manifestly unreasonable. See id.
300. See id. § 1-102(3).
301. See id. §§ 3-107, 3-112, 3-116, 3-117, 3-203(c), 3-310(a).
302. See id. § 1-102(4).
303. Many other Article 3 and 4 provisions are based on practice. For example, variable interest rates commonly were employed by lenders as a hedge against inflation during the 1980s. To accommodate this practice, revised Article 3 authorizes variable rates, see id. § 3-112, thereby overturning prior decisions holding that notes with variable interest rates were not negotiable. See, e.g., Desmond v. FDIC, 798 F. Supp. 829, 840 (D. Mass. 1992); In re Gas Reclamation, Inc., 741 F. Supp. 1094,
First, consider the example of the postdated check. Under original Article 4, customers could defer having their accounts charged by postdating their checks. If a payor bank wrongfully paid a check before the postdate, thereby causing other checks to bounce, the bank was liable to its customer for wrongful dishonor. Revised Article 4 reverses this outcome, expressly providing that a bank may charge a postdated check against the customer's account. To prevent such payment, the customer must take the initiative, giving the bank a special notice of the postdating that describes the check with reasonable certainty. Only when the bank wrongfully ignores such a special notice are damages for wrongful dishonor of other items available. Comments reveal that this new rule is consistent with existing practice. Because automated check processing systems cannot easily identify postdated checks, banks usually pay checks without respect to their dates.

Second, consider the example of check fraud. Under the original Code, a forged check could not be charged against the customer's account, because it was not properly payable. In theory, customer negligence shifted

---

1102 (S.D.N.Y. 1990).

The wrongful dishonor statute further illustrates the influence of practice. As a general rule, banks check account balances only once before bouncing checks. To validate this existing practice, the Code now provides that a payor bank may determine whether funds are sufficient to cover a check any time between receipt of the check and dishonor, but the bank need only make the determination once. See U.C.C. § 4-402(c) & cmt. 4 (1995). Once the account balance has been determined, the bank can dishonor without worrying about whether sufficient funds later come into the account. See id.

305. For a discussion of the effects of prior law, see id.
306. See id. § 4-401(c).
307. See id.
308. See id.
309. See id. cmt. 3.
310. In this Article, the term “forged check” refers to a check bearing the forged signature of the drawer. Forged payee indorsements are subject to different rules. See U.C.C. § 3-405(2) (1995).
312. See Hovey, 412 N.E.2d at 893. The payor bank could not shift the loss to
the loss back to the customer, but only if the bank paid the forged check in good faith and in accordance with reasonable commercial standards.\textsuperscript{313} Reasonable commercial standards required banks to compare checks against signature cards,\textsuperscript{314} a practice that has long since been abandoned as impractical in the context of automated check processing.\textsuperscript{315} Therefore, despite customer negligence, most forged check losses fell on banks. Banks chafed under the perceived unfairness of this outcome,\textsuperscript{316} reasoning that they should not be branded as unreasonable for adopting automated processes that provided consumers with fast and inexpensive service.

Revised Articles 3 and 4 retain the general rule that payor banks cannot charge forged checks against the customer's account.\textsuperscript{317} Also, as before, an exception shifts the loss to any cus-

prior banks in the collection chain because no presentment warranty had been breached. See U.C.C. § 3-417(1)(b) (1989). Moreover, even though the payment was mistaken, it was final and could not be recovered from holders in due course or persons who in good faith changed position in reliance on the payment. See id. § 3-418.

The rule placing forged check losses on drawees dates back to the 18th century. See Price v. Neal, 3 Burr. 1354, 97 Eng. Rep. 871 (K.B. 1762). The traditional explanation is that the payor bank is best able to prevent the loss by checking the forged signature against the customer's signature card. See U.C.C. §§ 3-417 cmt. 4, 3-418 cmt. 1 (1989).

\textsuperscript{313} See U.C.C. § 3-406 (1989).
\textsuperscript{315} See JAMES V. VERGARI & VIRGINIA V. SHUE, CHECKS, PAYMENTS & ELECTRONIC BANKING 16-17, 290-91 (1986).
\textsuperscript{316} Cf. Rubin, supra note 12, at 567.
\textsuperscript{317} A payor bank can charge only properly payable items against the customer's account. See U.C.C. § 4-401(a) (1995). Checks are properly payable only when the customer has authorized the payment, and the payment does not violate any agreement between the bank and customer. See id. cmt. 1. Thus, a check bearing a forged drawer's signature is not properly payable because the customer never authorized payment.

Once saddled with this loss, the payor bank has no claim against an innocent payee or collecting bank for breach of presentment warranty, see id. §§ 3-417(a)(3), 4-208(a)(3), and cannot assert a claim for restitution of money paid by mistake against a person who took the check in good faith and for value, or "who in good faith changed position in reliance on the payment." Id. § 3-418(c). Thus, the Code continues to enshrine the basic rule of Price v. Neal, 3 Burr. 1354, 97 Eng. Rep. 871 (K.B. 1762), which places forged check losses on payor banks. See U.C.C. § 3-417 cmt. 3 (1995).
tomer whose negligence substantially contributes to the making of the forged signature. If the payor bank, however, also fails to exercise ordinary care, the loss no longer falls entirely on the bank; rather, the loss is allocated between the customer and bank according to their relative fault.

More importantly, the Code has redefined ordinary care for businesspersons as requiring the observance of reasonable commercial standards prevailing in the relevant business and geographical area. This general principle is noteworthy in and of itself. Once again, the Code displays a reverence for commercial practice. More specifically, the definition provides:

In the case of a bank that takes an instrument for processing for collection or payment by automated means, reasonable commercial standards do not require the bank to examine the instrument if the failure to examine does not violate the bank's prescribed procedures and the bank's procedures do not vary unreasonably from general banking usage not disapproved by this Article or Article 4.

The Code therefore now allows banks to process and pay checks through automated systems without checking signature cards. Because a payor bank's failure to check signature cards no longer amounts to negligence, many, if not most, forged check losses will fall entirely on customers.

Once again, the drafters have chosen to validate a practice related to automated check processing. The attitude behind the new definition is clear: Because payor banks no longer compare checks against signature cards, the law should not require them to do so. The law imposes only two limits: The payor bank

319. See id. § 3-406(b).
320. See id. § 3-103(a)(7).
321. Id. An obligation of ordinary care is an immutable rule because it cannot be disclaimed. See id. § 1-102(3). A bank can, however, along with its customer, establish standards by which care is measured, so long as the standards are not manifestly unreasonable. See id. Thus, a private agreement could establish a standard of ordinary care that required banks to compare checks with signature cards. To this extent, section 3-103(a)(7) is a default rule.
322. See U.C.C. § 3-103(a)(7).
323. See id.
324. See id.
must act in accordance with its own procedures and do so in a manner consistent with general banking usage.  

Last, but not least, consider the example of a customer's obligation to review her account statement. Under the old Code, a customer had to examine her account statement and accompanying checks carefully, and promptly notify the bank of her unauthorized signature or any alterations. Failure to comply with these duties precluded the customer from asserting unauthorized signatures or alterations against the payor bank, unless the payor bank failed to exercise ordinary care in paying the forged or altered items, as by failing to check signature cards. Under this framework, customers were protected in two significant ways. First, customers received full information, because account statements were accompanied by paid checks. Second, even when customers failed to discover and report wrongdoing, resulting losses were likely to fall on payor banks, who could be found negligent simply for having used automated check processing systems that were incapable of comparing checks against signature cards.

Evolving technology and practice have prompted important changes in this statutory scheme. Some payor banks have implemented check retention plans, saving time and money by retaining paid checks and returning bare account statements to customers. To accommodate this practice, revised Article 4 pro-

325. See id.
327. To benefit from the preclusion, the bank had to prove that it had suffered loss as a result of the customer's failure to discover and report the problem. See id. § 4-406(2)(a). A related provision held the customer responsible for subsequent forgeries or alterations committed by the same wrongdoer more than 14 days after the customer received a statement reflecting the first forgery or alteration. See id. § 4-406(2)(b).
328. See id. § 4-406(3).
329. See supra note 314 and accompanying text.
331. See Rubin, supra note 12, at 574. The drafters have been tantalized by visions of a more radical form of check truncation, whereby depositary banks would present checks to payor banks via the transmission of electronic data. In an effort to facilitate the development of radical check truncation, revised Article 4 recognizes that agreements, clearing-house rules, and Federal Reserve regulations may provide that checks can be presented by transmission of electronic images or data, rather than by delivery of the actual checks. See U.C.C. § 4-110(a) (1995). To accommodate
vides that a bank either must return paid checks with the account statement, or provide the customer with sufficient information to allow her to reasonably identify paid checks.\textsuperscript{332} The Code does provide a safe harbor: Information is sufficient when the bank describes checks by number, amount, and date of payment.\textsuperscript{333} The drafters chose this safe harbor because it is consistent with existing technology and practice: Computers already can recover the check number, amount, and date of payment.\textsuperscript{334}

Faced with this limited information, the customer still must review her statement in order to determine whether any payment was not authorized because her signature was unauthorized, or the item was altered. If, based on the information provided, she reasonably should have discovered an unauthorized payment, then she must notify the bank promptly.\textsuperscript{335} The rules such agreements, revised Article 4 provides that presentment is made when the electronic presentment notice is received, and further stipulates that the electronic notice is the equivalent of an item or check in Code terminology. See id. § 4-110(b), (c). The purpose of these minimal amendments is to clarify that the Code does not prohibit electronic presentment. See id. cmt. 3.

332. Once check retention is implemented, customers who need checks to establish tax deductions or other claims must give banks a reasonable time either to return originals or send legible copies, at whatever cost to the customer the bank chooses within the boundaries of conscionability and good faith. See id. § 4-402(b) cmt. 3.

333. See id. § 4-406(a).

334. Computers can recover this information with the aid of Magnetic Ink Character Recognition (MICR). When checks are printed, payor banks add numbers, printed in magnetic ink, that identify the payor bank, account number, and item number. When a check is deposited, the depositary bank encodes the amount of the check on the bottom right-hand side, also in magnetic ink. See Rubin, supra note 7, at 757 n.43.

Customers, however, are left without other, critical information, such as the date of issue and payee name. Comments explain this reduction in service as necessary in order to make check retention plans feasible. Date of issue and payee name can be recovered only through expensive and time-consuming physical examination. See U.C.C. § 4-406 cmt. 1 (1996).

The comments note that technological advances such as image processing may allow banks to give customers more information in the future, in a manner that is consistent with automation or check retention systems. Thus, if and when technology and practice change, the Permanent Editorial Board stands ready to conform the law accordingly. See id.

335. See id. § 4-406(c). Comments note that exceptional circumstances may exist if the customer cannot discover forgeries or alterations. The example given assumes that a wrongdoer has altered the name of the payee; without return of the original item or a statement listing payee names, the customer would have a difficult time detecting this type of fraud. See id. § 4-406 cmt. 1. Thus, the comments tacitly admit that the safe harbor rule provides such limited information that the
LIBERTY, TRADE, AND UCC

1997]

governing preclusion, however, have changed. If the customer and payor bank are both negligent, they must share losses in proportion to their fault. More importantly, the payor bank is presumed to have acted reasonably in paying checks through automated processes without comparing signature cards. A customer who negligently fails to discover and report an alteration or forgery is therefore likely to bear any loss that results.

C. Efficiency

The foregoing analysis demonstrates that the drafters have adopted rules that accommodate, and even incorporate, practices related to automated check processing systems. Why?

Sorting and paying checks through automated processes is faster and cheaper than sorting and paying checks by hand. When operating costs drop, banks can pass resulting savings through to the customers who use the system. As a general rule, automated systems therefore are economically efficient, because they impose fewer transaction costs on payments. Legal rules that are sensitive to the needs of automated systems help to ensure the efficiency of the check as a payment device.

Again and again the drafters have made this argument, justifying rules in terms of the efficiency of the check collection system. Payor banks are authorized to honor checks before customer's obligation to discover and report may not be triggered.

336. See id. § 4-406(e).
337. Article 4 adopts the same definition of ordinary care given in Article 3, and discussed supra at notes 320-25. See U.C.C. § 4-104(c) (1995).
338. See id. § 4-406(d)(1). Similarly, the customer is responsible for subsequent forgeries or alterations committed by the same wrongdoer more than 30 days after the customer received a statement reflecting the first forgery or alteration. See id. § 4-406(d)(2).
339. See id. § 4-406 cmt. 4.
340. See id. § 4-406 cmt. 1.
341. See generally Rubin, supra note 12, at 561 (discussing elements of efficient payment markets).
342. For brevity's sake, only three examples are discussed in the text. Others abound. For example, economic concerns underlie the new statute allowing payor banks to dishonor checks for insufficient funds, after having checked account balances only once. See U.C.C. § 4-402(c) (1995). The drafters decided that banks should not be required to check account balances twice, even though a second look
their postdates (consistent with existing practice) because automated check-collection systems cannot accommodate postdated checks.\textsuperscript{343} Similarly, banks are authorized to pay checks without looking at signature cards (consistent with existing practice)\textsuperscript{344} because automated systems process checks at a lower cost to all customers.\textsuperscript{345} Banks can provide customers with account statements that include only limited information about paid checks because that information is available through existing automated processes.\textsuperscript{346} Banks need not engage in expensive manual searches for other information that is already available to customers who carefully maintain checkbook ledgers. The comments' reason is that this policy results in less cost to the check-collection system, and thus, less cost to all customers of the system.\textsuperscript{347}

Unfortunately, default rules that are justified on efficiency grounds always are vulnerable to critics who argue that alternative rules would be \textit{more} efficient. Professor Edward Rubin has strongly criticized the Article 3 and 4 revisions on efficiency grounds.\textsuperscript{348} Without repeating his entire analysis, one key example can be used to illustrate his views.

Professor Rubin has argued that, "\textit{[i]f efficiency is the goal, these legal rules should be designed to reallocate costs in a manner that approximates the contract that the parties would have reached had they possessed the necessary information.}"\textsuperscript{349} Toward this end, liability for clearly avoidable losses should fall on the party responsible for the loss, while liability for other losses should be allocated between the customer and

would allow many checks to be paid, rather than bounced. The reason is that automated processing cannot distinguish checks that have been presented only once (thus deserving a second chance), from checks that have been presented twice and must be bounced. \textit{See} Rubin, \textit{supra} note 7, at 758-59.\textsuperscript{343} \textit{See} U.C.C. § 4-401(c) cmt. 3 (1995).\textsuperscript{344} \textit{See id.} § 3-103(a)(7).\textsuperscript{345} \textit{See id.} § 4-406 cmt. 4.\textsuperscript{346} \textit{See id.} § 4-406(a) cmt. 1.\textsuperscript{347} \textit{See id.} § 4-406 cmt. 1.\textsuperscript{348} \textit{See} Rubin, \textit{supra} note 12; Rubin, \textit{supra} note 7.\textsuperscript{349} Rubin, \textit{supra} note 12, at 562. This method is consistent with the general approach that many economists have taken in determining appropriate default rules. \textit{See supra} text accompanying notes 9-12.
financial institution.350

More specifically, Professor Rubin argued that the Code's
"fault principle" (which effectively imposes the entire loss from a
forged check on the negligent customer)351 is inconsistent with
these basic economic principles. According to Professor Rubin,
most customers will take adequate precautions against check-
book theft when faced with a small, but meaningful loss (in his
example, a hundred dollars), coupled with the inconvenience of
closing the old checking account and opening a new one.352 Be-
cause carelessness can never be completely eliminated, imposing
any further loss on the customer simply punishes him without
producing a corresponding reduction in loss.353 Instead, the
bulk of the loss should be allocated to payor banks who can use
account fees to spread the loss among all customers using the
system.354

According to Rubin, "the fault principle deviates from econom-
ic efficiency ... by ignoring the role of systematic planning." Banks, not customers, design the check-collection system and
thus are the best situated to develop new technologies that could
reduce check fraud loss. For example, banks are experimenting
with optical scanning devices that ultimately may allow them to
compare checks with signature cards, even within an automated
system.356 Ultimately, under Rubin's analysis, such precautions
may provide the most cost-effective means of loss reduction.357

Comparing revised Articles 3 and 4 with Rubin's arguments,
one realizes that efficiency analysis can produce different opin-
ions regarding choice of default rules. Like Rubin, the drafters
have relied on the basic principle that losses should be allocated
to the least-cost avoider. The "fault principle," which allocates

350. See Rubin, supra note 12, at 564.
351. See id. at 566-67.
352. See id. at 568.
353. See id.
354. See id. at 564. Rubin argued that most people are risk-averse, meaning that
they "will pay small amounts to avoid a small chance of losing a large amount." Id.
at 564-65. The cost of imposing a heavy loss upon one unlucky customer therefore is
greater than the cost of spreading the same loss among all customers. See id.
355. Id. at 568.
356. See id. at 569.
357. See id. at 568-69.
losses to negligent customers, is just another way to identify the least-cost avoider. Although Rubin believes that small losses would adequately deter carelessness in customers, the drafters have reached a very different conclusion, placing the entire loss on the negligent customer.

The difference in assessment of payor bank responsibility is even more striking. In concluding that payor banks are the least-cost avoiders, Rubin considers future events, including the development of new technology. By contrast, the drafters have decided that banks are not least-cost avoiders, because existing automated processes cannot compare checks with signature cards. To ensure that banks are not saddled with losses that they cannot avoid presently, the drafters have added the new definition of ordinary care.

D. Liberty

Economic analysis has yielded conflict, rather than clear answers regarding appropriate choice of default rules for Articles 3 and 4. It is time to open up the debate over these controversial revisions and examine other policy considerations. The theoretical model presented in this Article teaches that business practices can be viewed as the product of countless exercises of individual liberty, so that codification of business practices becomes a means of respecting liberty. Can the incorporation of practice-based default rules within revised Articles 3 and 4 similarly be justified on liberty grounds?

To begin, those individuals who generate the practices enshrined in the revisions to Articles 3 and 4 must be identified. Because most of the revisions discussed above involve the check-collection process, it may be helpful to identify the parties involved in a hypothetical checking transaction. Suppose a drawer writes a check on his checking account in payment for goods or services. The drawer may be a consumer, a corporation, or another business entity. The payee (who also can be either a natural person or a business entity) receives the check and deposits it in his checking account. The depositary bank forwards the check, possibly through a series of collecting banks, to the payor bank, which examines the drawer's account for sufficiency of funds and either pays or dishonors the check.
What this hypothetical reveals is that check transactions are conducted by banks and their customers, who can be either natural persons or natural persons associated through formal or informal business entities. Based on their participation in countless transactions, banks identify and implement efficient account terms and operational practices that allow them to provide checking services at a good profit. Meanwhile, customers affect the development of banking practices indirectly, by seeking out checking services that are fast, cheap, and technologically advanced. According to this theoretical paradigm, checking account practices represent the sum of thousands of individual free choices made by banks and customers alike.

Again, the key question emerges: To what extent does reality mirror—or diverge from—this theoretical paradigm?

Banks have somewhat less free choice in developing checking account practices than the model suggests. In 1987, Congress enacted the Expedited Funds Availability Act, which the Federal Reserve Board has implemented through Regulation CC. Under Regulation CC, depositary banks must release deposited funds to customers relatively quickly, in accordance with specified timetables. To ensure that depositary banks can release funds with confidence, Regulation CC imposes deadlines upon payor banks for the expeditious return of dishonored checks to depositary banks. Rules like these increase the

359. 12 C.F.R. pt. 229 (1996); see also supra notes 290-91 (describing the operation of the Expedited Funds Availability Act and Regulation CC).
360. A complete explanation of these complex timetables is beyond the scope of this Article. Generally, however, when a customer deposits a local check, the depositary bank must make funds available for withdrawal on the second business day following the banking day on which the funds were deposited. When a customer deposits a nonlocal check, the depositary bank must make funds available for withdrawal on the fifth business day following the banking day of deposit. See 12 C.F.R. pt. 229.12; see also BARKLEY CLARK & BARBARA CLARK, REGULATION CC: FUNDS AVAILABILITY AND CHECK COLLECTION ¶ 2.02[1] (1988).
361. These regulations are intimidatingly complex, but here is a simplified description of one method of expeditious return. A two-day rule applies to local checks. A payor bank must send a returned check in a manner such that the check normally would be received by the depositary bank no later than 4:00 p.m. of the second business day following the banking day on which the check was presented to the payor bank. A four-day rule applies to nonlocal checks. The payor bank must send a
pressure on depositary and payor banks to process checks as quickly as possible, thereby increasing the need for banks to adopt the fastest possible automated systems and complementary practices. In this manner, Regulation CC narrows, but does not entirely eliminate, the choices that owners and operators of banks may make. Liberty remains a valid policy objective supporting the legitimacy of banking practice, but its importance is somewhat blunted within the regulated world that banks must occupy.362

More significantly, banks and customers do not play equal roles in the development of banking practices. As the providers of checking services, banks necessarily take the lead in developing and managing their own products. Banks employ bankers, economists, lawyers, and other technicians who evaluate checking services and the current state of technology, and recommend cost-effective strategies for operating those services. Granted, customers can influence checking account practices indirectly, by choosing services that employ efficient practices. As a group, customers have enormous purchasing power, and thus, would seem to have a significant opportunity to affect the contour of checking account practices. Unfortunately, many checking account customers are consumers, who, as individuals, lack reasonable opportunity to make free choices regarding practices.363

The problems consumers face are twofold. First, most consumer account holders do not understand the details of check processing and its related technology, making it hard for them to choose among competing checking account services (and associated practices) on those specific grounds.364 Moreover, unlike letter of credit beneficiaries and applicants, consumers do not have the financial incentive and means with which to hire a spe-

362. The foregoing reasoning merely assesses the role that liberty plays within the context of existing regulation. This analysis does not imply any normative judgment that the liberty interests of individuals associated with banks are appropriately subordinated to whatever policies support Regulation CC, or any other banking regulation.

363. See Rubin, supra note 12, at 561-62.

364. See infra notes 365-70 and accompanying text.
cialist to explain check processing and related practices to them.\footnote{365}

Of course, consumers should tend to prefer account services that cost the least and make funds available most rapidly. Because automated check collection is inexpensive and fast, a preference for low cost and high speed could translate into a preference for automated check collection. By selecting account services that offer automated check collection, consumers could effectively "choose" the practices necessary to automated systems. Even this surrogate choice may be more theoretical than real. Consumer advocates allege that consumers do not receive standardized information about account charges, and thus cannot effectively comparison-shop.\footnote{366} To the extent that this allegation is true, consumer choices do not necessarily reflect a preference for inexpensive, automated technology.\footnote{367}

Second, consumers face personal and institutional barriers to free contracting. As a group, consumers have enormous purchasing power; however, consumers do not bargain as a collective. Consumers bargain as individuals who have little power and thus have little choice but to take or leave the terms offered them by banks. Meanwhile, banks have little incentive to offer alternatives to their standard account provisions.\footnote{368} In the con-

\footnote{365. Granted, bank clerks do assist consumers in opening checking accounts. It seems doubtful, however, that the average clerk would have a solid understanding of automated check processing and associated practices. Moreover, even if clerks do have such information, consumers may not be sophisticated enough to ask the right questions. For example, to ask intelligent questions about check processing, a consumer would have to know that automated systems with specific technological limitations were being used.}

\footnote{366. See Hillebrand, \textit{supra} note 7, at 717-19; Rubin, \textit{supra} note 12, at 562. Consumer advocates have urged that banks should be required to disclose information about standard account terms and charges. The Uniform Commercial Code does not require such disclosure. See Hillebrand, \textit{supra} note 7, at 717-19; Rubin, \textit{supra} note 12, at 563.}

\footnote{367. Instead, many consumers likely choose account services based on factors that do not implicate check processing, like advertising or bank location. The more prevalent such irrelevant choices are, the weaker the argument becomes that consumers have "chosen" automated systems and accompanying practices.}

\footnote{368. Banks sometimes do offer alternative services for alternative prices. For example, some banks currently offer truncated checking accounts as a standard service. See Rubin, \textit{supra} note 12, at 574. For an additional fee, the bank may send customers paid checks together with the account statement as a matter of regular
text of automated check processing, such alternatives often would be hopelessly impractical. To function properly, an automated system must be able to process a high volume of checks, without having to distinguish among items. Any contract that required a bank to single out the checks of certain customers for special treatment (for example, providing comparisons with signature cards) would undermine the efficiency of the entire system.

Furthermore, unlike beneficiaries and applicants who can exercise their liberty by restructuring business transactions to replace letters of credit with alternative payment systems, consumers cannot easily restructure their personal transactions to eliminate checks. The prospect of loss or theft makes payment in cash too risky, especially when the debt is large or the creditor is located far away. Not everyone qualifies to receive a credit card and some businesses do not accept them. Electronic funds transfers allow safe, fast, and reliable payment, but have not yet supplanted paper checks, perhaps because many people do not understand and may even fear the underlying technology. In any event, many electronic funds transfers (for example, ATM withdrawals, direct deposits and withdrawals, and point-of-sale transfers) rely upon existing checking accounts.\footnote{369}

To illustrate the foregoing analysis, consider the default rules that allocate losses caused by forged checks. Even though the revisions adopt the principle of comparative negligence, customers likely will bear the entire loss of forged checks. This is so because the new definition of ordinary care absolves payor banks course. \textit{See id.} Nothing in the Code, however, requires banks to provide such alternative services.

369. This liberty-oriented analysis helps to explain why economic principles have produced conflicting accounts of the Article 3 and 4 revisions. Many economists argue that the law should establish default rules that reflect what the parties would have chosen, if bargaining were costless. \textit{See supra} text accompanying notes 9-11. The rule that losses should be allocated to the least-cost avoider is simply one application of this basic principle. \textit{See Ayres \\& Gertner, supra} note 4, at 89 n.18. If checking account practices were truly the product of informed and free choices by banks and customers alike, such practices would be good proxies for the terms that the parties would have chosen, and commentators would agree that the Article 3 and 4 revisions were efficient. If banks create checking account practices, and impose them upon customers, however, then practices are not necessarily good proxies for efficient laws.
of negligence by declaring that banks can pay checks without examining them. This definition is consistent with existing practice, under which banks pay checks without examining signature cards.370

Does this practice reflect the free choices of banks and customers? Certainly, the practice reflects the needs of automated check processing systems, which cannot compare checks against signature cards. Both banks and customers also might be expected to choose automated check processing, which is faster and cheaper than processing by hand.

Because the federal government has imposed strict timetables for the release of deposited funds and the return of dishonored checks, however, the decision of bank owners and operators to employ automated check processing systems seems less than free. More importantly, consumers who hold checking accounts lack the sophistication and financial resources necessary to investigate and understand automated check processing and its concomitant practices. As individuals, consumers also lack the power necessary to bargain for alternative account terms that would require banks to compare checks against signature cards. Therefore, when the Code recognizes the common practice of paying checks without comparing signature cards, the Code adopts a default rule that respects the liberty of many banks, but few consumers.

A final point to consider is whether consumers371 can preserve their liberty by contracting out of default rules that do not meet their needs. Revised Article 3 provisions are subject to the general rule that allows parties to vary the effect of Code provisions by agreement, except where otherwise provided by the Code.372 Moreover, revised Article 4 expressly authorizes par-

370. See supra text accompanying notes 320-25.

371. Consumers, and not banks, would benefit most from the freedom to contract out of Code solutions. As a group, bankers have the legal knowledge and bargaining power necessary to vary the effect of existing rules. They have little incentive to do so, however, given that the revisions closely track existing banking practice. Bank owners and operators already have made the best choices they can, operating within the limitations imposed by governmental regulation. To further enhance the liberty of individuals associated with banks, elimination of regulation, and not freedom of contract, would be necessary.

372. See U.C.C. § 1-102(3) (1995). Code obligations of good faith, diligence, reason-
ties to vary the effect of its terms by agreement. As explained more fully above, however, lack of sophistication and bargaining power may render this freedom of contract illusory for most consumers.

E. Summary

In sum, many provisions within revised Articles 3 and 4 draw their inspiration from checking account practices related to automated check processing. In support of this foundation, the drafters have argued that these practices are efficient because automated check processing imposes fewer transaction costs on payments. Consumer advocates have challenged the revisions, arguing that the drafters have chosen inefficient solutions to common problems that checking account customers face.

Looking at the problem from a different angle, this Article has posed the question of whether the Article 3 and 4 revisions can be justified on liberty grounds. In theory, checking account practices result from free choices made by banks and their customers. In reality, banks originate practices, leaving customers to react through the exercise of their purchasing power. Many of these customers are consumers who lack the sophistication and financial resources necessary to learn about automated check-collection systems and related practices. Moreover, as individuals, consumers lack the bargaining power necessary to overcome established practices and standardized account terms. Because checking account practices are not the product of meaningful consumer choice, it is hard to justify the Article 3 and 4 revisions on liberty grounds.

VI. CONCLUSION

This Article has theorized that business practices emerge as byproducts when individuals exercise their natural right to liber-

ableness, and care cannot be disclaimed by agreement, but the parties may determine the standards by which performance of such obligations is measured, so long as these standards are not manifestly unreasonable. See id. Thus, in theory, a private agreement could establish a standard of ordinary care that required banks to compare checks with signature cards.

373. See id. § 4-103(a).
ty. Adopted by voluntary trade associations and enforced by private sanction, such practices could assume a status akin to law, without the involvement of the state.

Although this theory may seem abstract, it has important implications for a world in which the state regulates commercial affairs through legislation. After more than forty years of existence, the UCC is still going strong. What is the key to its continuing vitality?

To maintain a healthy commerce, the United States must have a basic commercial law that is responsive to the needs of business. Generally, the drafters of the Code have achieved this goal by adopting legal rules and principles that are based on business practices. Just as importantly, by selecting practice-based default rules, the drafters have found a means of respecting the liberty of individuals within the business community, whose free choices helped to evolve the underlying practices. In this manner, practice-based rules become a vehicle for resolving the apparent tension between individual and community. Moreover, to the extent that any tension remains, the Code preserves individual liberty by allowing disgruntled parties to contract out of unfavorable rules. Eventually, if enough individuals contract out of a disfavored rule, a new practice will emerge. The drafters therefore have crafted a Code that is flexible enough to accommodate changing practices and technology.

The recent revision of Article 5 supports my theory that practice-based default rules can be justified on liberty grounds. The drafters codified letter of credit practices because they believed that those practices represented the most efficient means of operation. Going beyond this economic reasoning, this Article explained that letter of credit practices are generated when issu-

374. In two recent symposia, academics and practitioners had the chance to assess the vitality of the Code. Although opinions varied, most authors agreed that the Code should, and would, continue to play a vital role in commercial affairs. See Symposium, Is the UCC Dead, or Alive and Well? Practitioners' Perspectives, 28 LOY. L.A. L. REV. 89 (1994); Symposium, Is the UCC Dead, or Alive and Well?, 26 LOY. L.A. L. REV. 535 (1993).

375. See Miller, supra note 284, at 413 (stating that the ability to change the former Article 4 by agreement allowed that provision, "promulgated at the beginning of the machine processing of checks, to survive without . . . revision for over 30 years").
ers, beneficiaries, and applicants exercise their freedom to engage in letter of credit transactions. Codification of letter of credit practices thus respects the liberty of market participants. Letter of credit users who are dissatisfied with the default rules provided in revised Article 5 can preserve their freedom by bargaining for alternative terms.

Conversely, the libertarian argument for practice-based default rules is least persuasive in contexts involving large numbers of market participants who lack a reasonable opportunity to understand or bargain over contract terms. For example, many checking account customers are consumers who lack the knowledge or bargaining power needed to make meaningful choices among checking account services and related practices. Revised Articles 3 and 4, which codify checking account practices, are therefore hard to justify on liberty grounds. Unfortunately, the same lack of knowledge and bargaining power makes it difficult for consumers to preserve their liberty by contracting out of these default rules.

Given these conclusions, what course should the drafters steer as they continue to revise the UCC? As a first cut, the drafters should remain true to their commercial vision and continue to draft new and revised articles that are based on business practices. Otherwise, liberty could be undermined within the commercial realm.

At the same time, however, the drafters should recognize that business practices are not necessarily the best drafting model for consumer transactions. The drafters should structure future articles that are flexible enough to allow variation from practice where necessary to ensure fairness to consumers. In crafting solutions to consumer problems, the drafters surely will not lack for inspiration. In the turbulent wake of the Article 3 and 4 revisions, many commentators have urged the drafters to involve consumer advocates in future projects, from the earliest stages of the drafting process through the enactment of final legislation.376 Already, the process of revising Articles 2 and 9 has shown that consumer advocates are ready and willing to make

376. See, e.g., Patchel, supra note 7, at 126-45, 156-57; Rubin, supra note 7, at 759-87, 781-87.
suggestions regarding laws that meet consumer needs. By giving such suggestions a fair hearing, the drafters can provide consumers with their last, best hope for shaping the law that governs them.