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Documentary Credit WORLD

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22 FEATURE

BANK SECRECY AND ANTI-MONEY LAUNDERING

U.S. regulatory agencies as well as those in other countries are beginning to focus on trade letters of credit and seeking to determine if issuing, advising, confirming, and negotiating banks are exercising due diligence for evidence of money laundering or terrorist financing. The expanded overview of Trade Finance Activities is included in this issue. The International Financial Services Association (IFSA) and the Bankers' Association for Finance and Trade (BAFT) have recently written letters on behalf of the LC industry regarding these new requirements. In Hong Kong, the Hong Kong Monetary Authority (HKMA) has issued a letter, aiming to clarify its supervisory standard and approach.

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Documentary Credit World
20203 Goshen Road., No. 343
Gaithersburg, MD 20879 USA
phone: +1-301-330-1970
fax: +1-301-926-1265
e-mail: info@doccreditworld.com
website: www.doccreditworld.com

Editor-in-Chief
Professor James E. Byrne

Contributing Editor
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Managing Editor
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ARTICLE

ATTORNEY'S FEES IN LETTER OF CREDIT CASES UNDER U.S. UCC SECTION 5-111(E)

By Carter H. Klein*

Revised Article 5 of the U.S. Uniform Commercial Code promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and the American Law Institute (ALI) in 1995, has been adopted in all U.S. states but Wisconsin. Section 5-111 is titled "Remedies." Subsection 5-111(a) deals with the beneficiary's damages remedies for the issuer's wrongful dishonor and repudiation of a draw on a letter of credit. Subsection 5-111(b) deals with applicant's damages and remedies for an issuer's wrongful dishonor and wrongful honor of demand for payment under a letter of credit. Subsection 5-111(c) deals with damages caused by a breach of letter of credit obligations by an advisor, confirmer, or other nominated person and the breach of obligations by an issuer not covered in subsections (a) or (b). Each of these subsections (a)-(c) prevent recovery of consequential or punitive damages, but generally do not require the beneficiary to mitigate its damages once the issuer has wrongfully dishonored or repudiated. Subsection 5-111(d) provides for the payment of interest on the amount owed by an issuer, nominated person, or advisor who is found liable under subsections (a), (b), or (c) of Section 5-111. Subsection 5-111(f) allows for liquidated damages by agreement.

Section 5-111(e). Subsection 5-111(e) provides for reasonable attorney's fees and litigation expenses to be awarded to the prevailing party in an action under Article 5:

> Reasonable attorney's fees and other expenses of litigation must be awarded to the prevailing party in an action in which a remedy is sought under this article.

* Carter H. Klein is a partner at Jenner & Block LLP where he has practiced commercial law for the past 31 years. He is a member of the American College of Commercial Finance Lawyers, Chair of the American Bar Association's Letter of Credit Subcommittee, Editor, Uniform Laws Annotated – Uniform Commercial Code Forms Annotated (Thomson/West), and a member of the Editorial Advisory Board of *Documentary Credit World*. He participated in the drafting of the International Standby Practices (1998) and Revised Article 5 of the Uniform Commercial Code and is a frequent speaker and articles contributor on letter of credit and Uniform Commercial Code topics. His e-mail is: *cklein@jenner.com*

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Documentary Credit WORLD

20203 Goshen Road, No. 343
Gaithersburg, MD 20879 USA
Telephone: 1 (301) 330-1970
Facsimile: 1 (301) 926-1265
info@doccreditworld.com
www.doccreditworld.com

Official Comment 6 to Section 5-111 amplifies and gives examples of the application of subsection (e):

> The court must award attorney's fees to the prevailing party, whether that party is an applicant, a beneficiary, an issuer, a nominated person, or advisor. Since the issuer may be entitled to recover its legal fees and costs from the applicant under the reimbursement agreement, allowing the issuer to recover those fees from a losing beneficiary may also protect the applicant against undeserved losses. The party entitled to attorneys' fees has been described as the "prevailing party." Sometimes it will be unclear which party "prevailed," for example, where there are multiple issues and one party wins on some and the other party wins on others. Determining which is the prevailing party is in the discretion of the court. Subsection (e) authorizes attorney's fees in all actions where a remedy is sought "under this article." It applies even when the remedy might be an injunction under Section 5-109 or when the claimed remedy is otherwise outside of Section 5-111. Neither an issuer nor a confirmer should be treated as a "losing" party when an injunction is granted to the applicant over the objection of the issuer or confirmer; accordingly neither should be liable for fees and expenses in that case.
>
> "Expenses of litigation" is intended to be broader than "costs." For example, expenses of litigation would include travel expenses of witnesses, fees for expert witnesses, and expenses associated with taking depositions."

As Official Comment 6 suggests, and as discussed below, a literal reading of Section 5-111(e) allows for an expansive application of the right to attorney's fees in letter of credit cases. See also Official Comment 7 to Section 5-109 ("loss" to be protected against under Section 5-109(b)(2) includes "legal fees that might be incurred by the beneficiary or issuer in defending against an injunction action").

Fee Awards Are Mandatory. The award of attorney's fees under Section 5-111(e) is not discretionary, it is mandatory. A primary purpose of this provision is to discourage frivolous or opportunistic litigation brought by applicants or beneficiaries in letter of credit transactions and to encourage issuers to make correct decisions in honoring or dishonoring a draw on a letter of credit. (See James E. Byrne: Section 5-111(e) "was intended to introduce further rigor into the system" and keep banks from avoiding "making hard LC decisions that are part of their business" (2002 ANNUAL LETTER OF CREDIT LAW & PRACTICE, page 238)).

Many times an applicant makes a bad bargain in the underlying transaction, thinks that it did not breach the underlying contract or believes that the wording of the letter of credit is not carefully drafted to prevent its use in situations it did not intend. These are not grounds to enjoin a conforming draw on the letter of credit because no fraud is involved, only a contractual dispute with the beneficiary. Without fraud, no injunction should issue. UCC Section 5-109. Any such proceeding should fail. Nevertheless, experience has shown that actions to enjoin letters of credit for insufficient reasons are repeatedly brought in the hopes that at least a lower court will allow the applicant to buy some time to negotiate a better result. If, however, there are consequences to the applicant's seeking an injunction or bringing some other action which lacks sufficient merit, then the party contemplating the action will think twice

before bring it. (Cf. *Lueker v. First National Bank of Boston (Guernsey), Ltd.*, 82 F.3d 334 (10th Cir. 1996)(attorney's fees were awarded to issuing bank of letter of credit wrongfully enjoined under New Mexico law which allows such an award when the injunction is dissolved). If parties are discouraged from bringing an action under Article 5 to enjoin draws when grounds do not justify it, letters of credit will better live up to their billing as a reliable, efficient device to assure payment. The phrase "pay first, litigate later" will be supported. See *In re Sabratek*, 257 B.R. 732 (Bankr. D. Del., Nov. 16, 2000).

Besides discouraging the nonprevailing party from bring lawsuits in questionable cases, the award of attorney's fees to the prevailing parties will compensate the prevailing parties for the extra costs they incur in having to deal with a suit that should not have been brought. Letter of credit operations by issuers are run on tight margins. Letter of credit fees are only a tiny fraction of the amount at stake, and certainly do not compensate the issuer for incurring substantial attorney's fees in a lawsuit that is essentially a dispute between the applicant and the beneficiary and probably should not have been brought against the issuer in the first place. If letters of credit are to be relatively cost efficient, again, parties who use them properly should not have to pay attorney's fees to exercise their rights.

> ***"If letters of credit are to be relatively cost efficient, ... parties who use them properly should not have to pay attorney's fees to exercise their rights."***

Drafting Process. Early drafts of Revised Article 5 provided that issuers could be liable for consequential damages for wrongful honor or dishonor. Also, punitive damages were not expressly disclaimed, and attorney's fees were not mandatory. The banking community and the Federal Reserve raised concerns about large verdicts. Corporate users of letters of credit were concerned that without some incentive to comply with their duties banks could dishonor with impunity. A compromise was reached – issuers would not be liable for consequential or punitive damages, but would mandatorily be liable for attorney's fees if they acted improperly when processing draw requests. See Sandra Stern, "Varying Article 5 of the UCC by Agreement," 114 Banking L.J. 516 (1997). If mandatory attorney's fees are awarded to the prevailing party, the applicant or beneficiary is benefited because the issuing bank will have to pay them if it commits a wrongful dishonor or wrongful honor and refuses voluntarily to compensate for or correct its error. According to Professor J.J. White, the Reporter for Revised Article 5:

> [S]ubsection [5-111(e)] responds to the complaints of beneficiaries who noted that in absence of such a rule issuers could stiff them with impunity. Since neither consequential nor punitive damages may be recovered, an issuer who does not have to pay the beneficiary's lawyers' fees might actually save money by declining to honor — even in the face of an obviously complying presentation. In response to that fear, the beneficiary gets its lawyers' fees and not merely "costs" but "expenses" of litigation. The Comment notes that "expenses" was intentionally chosen to be broader than costs and was designated to include items such as expert witness fees and the like,

which might not be included in the standard term "court costs." The provision also protects the issuer from frivolous litigation, for a victorious issuer also recovers its lawyers' fees from the other side."

James J. White, "Trade Without Tears, or Around Letters of Credit in 17 Sections," UCC Law Bulletin (Dec. 1995); See also John F. Dolan, The Law of Letters of Credit ¶9.02[5][c], fn. 149 (A.S. Pratt rev'd ed).

State Variations. In the process of statewide adoption of Revised Article 5, objections were voiced to the mandatory award of attorney's fees on the ground that even meritorious actions for wrongful honor or dishonor or injunction by beneficiaries or applicants would be discouraged. As a result, a handful of states have either deleted or made discretionary the award of attorney's fees under Section 5-111(e). See Margaret L. Moses, "The Impact of Article 5 on Small and Mid-Sized Exporters," 29 U.C.C.L.J. 390 (1977)("Section 5-111(e) ... may effectively prevent smaller companies from bringing a lawsuit against a bank, because of the risk of having to pay the bank's attorney's fees if they lose."). These states include Alabama, Connecticut, New Jersey and Texas (word "must" changed to "may" making award discretionary with the court), New York (5-111(e) omitted so no attorney's fees are awardable in the absence of an agreement providing for their recovery), and Wyoming (word "must" replaced with "shall" and "party" replaced with "plaintiff" creating a one-way fee shift). In those states, the legislatures were concerned about overdeterrence and avoiding a chilling effect on meritorious litigation if the English rule that attorney's fees are always recoverable were adopted.

Applicability. Under the choice of law principles of Article 5, the law stated in the letter of credit, or in the absence of such a provision, the law of the place of the issuer governs an action against the issuer for its actions or omissions under or with respect to the letter of credit. Section 5-116. Accordingly, actions filed under Article 5 involving a letter of credit governed by New York law should not result in a mandatory fee award since New York does not have Section 5-111(e) in its version of Revised Article 5.

In addition, the letter of credit must have been issued after the adoption of Revised Article 5 in the relevant state for the attorney's fees provision of Section 5-111(e) to apply to an action or proceeding concerning it. See Revised Article 5 transition provisions. A letter of credit issued prior to the effective date of Revised Article 5 for the particular parties involved will not give rise to an attorney's fees provision. *Eastman Software, Inc. v. Texas Commerce Bank, N.A.*, 28 S.W.3d 79 (Tex. App. 2000)(trial court erroneously awarded attorney's fees to the issuer under Section 5-111(e); on appeal, the issuer conceded that Revised Article 5 was not in effect so that it was not entitled to attorney's fees). Some standby letters of credit with evergreen renewal provisions can be and have been in effect for many years. Disputes or actions involving these older letters of credit may not involve attorney's fees awards if they were issued prior to the adoption of Revised Article 5 in the state whose law governs the letter of credit.

Even if Section 5-111(e) does not apply, there may be another statute or agreement that can serve as a basis for an attorney's fees award in a letter of credit case. See, e.g., *Voest-Alpine Trading USA Corporation v. Bank of China*, 288 F.3d 262 (5th Cir. 2002)(award of US$266,000 in trial attorney's fees and $25,000 attorney's fees for appeal upheld against issuer based on

Texas Civil Practice and Remedies Code).

Judicial Discretion. Even though Section 5-111(e) is mandatory that reasonable attorney's fees must be awarded, a court could reduce a prevailing party's rights to attorney's fees by finding the amount requested is "unreasonable" in light of the facts and circumstances of the case. Courts have traditionally regarded the award of attorney's fees as within their discretion even though a contractual provision requires their award. They may take the same position in practice in some letter of credit cases.

Scope of Actions. As Official Comment 6 to Section 5-111 expressly states, the award of attorney's fees is not limited to actions of the kind described in Section 5-111 such as wrongful dishonor or wrongful honor. Rather, when a remedy is sought in an action under Article 5, the prevailing party is entitled to attorney's fees and costs. While Section 5-111 is the remedies section for Article 5, on the basis of the broader language of Subsection 5-111(e), a court is directed to award attorney's fees in actions under the entire Article 5 and not just those actions specifically described in Section 5-111. Thus in addition to actions for wrongful honor or dishonor, a court could read Section 5-111(e) to require it to award attorney's fees to the prevailing party in other actions brought under various sections of Article 5. This could include an injunction action under Section 5-109 (the Official Comment expressly mentions this section as an example); a wrongful cancellation under Section 5-106; a mis-advice of the terms of a letter of credit under Section 5-107; breach of warranty under Section 5-110; a failure to effect or recognize a transfer under Sections 5-112 or 5-113; a failure to accept an assignment of proceeds or a payment to the wrong assignee under Section 5-114; or a subrogation action under Section 5-117.

Actual Case Law Experience is Minimal. The incidence of reported letter of credit cases in which attorney's fees have been awarded to the prevailing party under Section 5-111(e) is surprisingly sparse. To date, only a few cases have raised or mentioned the attorney's fees provision of Section 5-111(e). This could be due to a lack of familiarity with letters of credit and the law governing them, especially since Revised Article 5 is still relatively new. Unless an attorney reads the Official Comment about the provision, he or she may not realize that that provision applies to injunction actions, and not just wrongful honor or dishonor cases. If attorneys do not request attorney's fees based on Section 5-111(e), judges will not raise the issue on their own.

First National Bank of Chaska v. Shakopee Gravel, Inc., 46 UCC Rep. Serv. 2d 511 (Minn. App. 2001) (unpublished). A letter of credit to secure a settlement agreement was dishonored by the issuer and it filed an interpleader. Allegations were made of a breach of warranty under UCC Section 5-110 in making the presentment in violation of the settlement. The trial court held the dishonor proper and awarded the applicant attorney's fees under Section 5-111(e) against the beneficiary. On appeal, the dishonor was determined improper, but because the letter of credit was not honored, the court determined that no presentment warranty was breached. As a result, the appellate court reversed the attorney's fees award. The case is not well- written or reasoned, but represents one of the first decisions mentioning UCC 5-111(e). Not an auspicious start.

DBJJJ, Inc. v National City Bank, 19 Cal. Rptr. 3d 904, 55 UCC Rep. Serv. 2d 126 (Cal. App. 2004). Beneficiary sued the issuer for wrongful

dishonor and delay in waiting to give notice of dishonor of a draw under a documentary letter of credit until the seventh business day after presentment, on the ground that it had sought a waiver from the applicant. The trial court in this case held for the issuer on summary judgment, and awarded attorney's fees of $116,112.91 under Section 5-111(e). The beneficiary claimed that the issuer was not entitled to collect attorney's fees under the UCC because the letter of credit was subject to the UCP. The trial court rejected this argument because the attorney's fees provision in Section 5-111 awards attorney's fees "in the action in which a remedy is sought under this article" and not merely in an action in which the article is ultimately held to be applicable to a claim of relief. On appeal the case was reversed with no discussion of the attorney's fees issue. It is being further appealed to the California Supreme Court.

Amwest Surety Ins. Co. v. Concord Bank, 248 F.Supp.2d 867 (E.D. Mo. 2003). In this case, the bank wrongfully refused to honor a draw on a letter of credit posted to a surety company which had issued a surety bond for the applicant for a city construction contract. When the surety drew, the bank claimed that the surety knew that the city had misdirected funds and therefore released the bonding company from liability on the bond so that it was not entitled to draw on the letter of credit. The bank failed to give notice of dishonor for 15 days and failed to return documents altogether, although they were only a draft and a certificate. The court found there was no fraud in the draw and the bank was precluded from dishonoring. It awarded prejudgment interest at 9% and attorney's fees under Section 5-111 of the UCC. It however refused to award attorney's fees until a proper showing and justification for them had been submitted:

> In an action for wrongful dishonor of a letter of credit, "reasonable attorney's fees and other expenses of litigation must be awarded to the prevailing party ...". §400.5-111(e). An award of fees is mandatory. In the instant case, plaintiff seeks a large amount of fees based upon a generalized invoice documenting fees in this litigation. ... The Court has reviewed the plaintiff's exhibit in support of its claim for attorneys' fees and finds same inadequate. Attorneys' fees will be awarded; however, such award will be made upon the proper presentation of documents in support of such fees. Plaintiff shall submit affidavits of education background, litigation experience in similar cases as this one, and standard hourly rate for each attorney and paralegal who performed work in this matter. Furthermore, legal fees shall be limited to those hours spent on plaintiff's claim for wrongful dishonor and conversion, not on plaintiff's claim for punitives. Finally, each attorney and paralegal's hours expended in this case shall be specifically identified. 248 F.Supp.2d at 884-885

J.P. Morgan Trust Company, N.A. v. U.S. Bank, N.A., 381 F.Supp.2d 865 (E.D. Wisc. 2005). This case shows the power of the issuing bank's reimbursement agreement. Even though the applicant had nothing to do with the draw by JPMorgan as beneficiary-trustee for bondholders and even though the issuing bank was successful in defeating the wrongful dishonor claim, it had to go through a lawsuit to get that result. Under Wisconsin's Prior Article 5 of the UCC, the issuer had no express right to attorney's fees from JPMorgan. It did have that right against its applicant

under the bank's reimbursement agreement. That agreement provided in pertinent part:

> **"Reimbursement/ Indemnities**. Except for … [the Bank's] own willful misconduct or wanton disregard of the Applicant's rights hereunder, Bank shall have no responsibility to, and Applicant unconditionally and irrevocably indemnifies Bank against each and every claim, demand, liability, loss, cost or expense which the Bank may incur (or be entitled to collect) arising out of the issuance and handling of any Credit and any transactions related to the Credit, the collection of any Drafts or documents under the Credit, or any act or omission by the Bank in connection with this Agreement ..., however and whenever arising. Applicant hereby waives any claim, defense, setoff, deduction and/or suspension of performance regarding Applicant's obligations under this Agreement or regarding any Credit based upon any actions or inactions of the Bank or any third party, except the Bank's willful misconduct or wanton disregard of Applicant's rights hereunder.
>
> * * *
>
> **"Expenses and Attorneys' Fees.** Applicant will reimburse the Bank for all attorneys' fees and all other costs, fees and out-of-pocket disbursements (including fees of the Bank's inside counsel and outside counsel) incurred by the Bank in connection with any Credit, and the enforcement of this Agreement and the collection of any monies due the Bank hereunder."

The Applicant argued that she was not liable to reimburse the Bank for its attorney's fees because of the Bank's willful misconduct in erroneously interpreting the letter of credit.

The court denied the applicant's defense to the issuing bank's claim for attorney's fees for two principal reasons. First, unlike the indemnity provision, the attorneys' fees provision in the reimbursement agreement did not contain a carve-out for willful or wanton conduct. "Thus, even if the Bank committed willful misconduct or acted in wanton disregard of [the applicant's] rights, [the applicant] would still be liable for the Bank's expenses and attorneys' fees." In addition, the court pointed out that no duty the bank may have owed the applicant was breached or wantonly disregarded.

Finally, the court held JPMorgan liable to the applicant for breach of warranty under Prior UCC Section 5-111(1) which states that a beneficiary by presenting a documentary draft or demand for payment warrants to all interested parties that the necessary conditions of the credit have been complied with. The court held that this provision enables an applicant to proceed against a beneficiary who falsely certifies that the conditions of the credit have been satisfied. Because the court found that JPMorgan did falsely certify, the court held it liable for the applicant's damages which included the attorney's fees applicant was required to pay to U.S. Bank as issuer. The court reserved ruling on the applicant's claim for her own attorney's fees. Had Revised UCC Article 5 applied, under UCC Sec. 5-111(e) the applicant undoubtedly would have received those as well.

Schnappup v. Yauck, 701 N.W.2d 653, 2005 WL 1398546 (Wis. App. 2005)(Unpublished). In this case, Yauck agreed to post a letter of credit to secure 120 months of settlement payments. The LC posted had a one- year expiration date but was automatically renewable and drawable if notice of nonrenewal were sent. Notice

of nonrenewal was sent at the end of the first year of the settlement. For some unexplained reason, Schnappup did not draw on the LC, but after it expired filed suit for specific performance requiring an LC to be posted by Yauck for the full remaining term of the settlement sufficient to cover the payments yet to be made under it. Yauck argued that the language of the settlement agreement only required it to post a letter of credit sufficient so that Schnappup could draw on it and receive payment for the entire settlement amount and that if Schnappup failed to draw when he could have done so when notice of nonrenewal was sent, that was not Yauck's problem because he had already fulfilled his obligation to supply a letter of credit as required by the settlement agreement. The trial court agreed with that argument, but on appeal the appellate court did not. A fair reading of the settlement agreement required Yauck to provide an LC to secure his settlement payments for the duration of the settlement. In the settlement agreement, Yauck agreed to pay Schnappups' attorney's fees and costs "if a dispute arises under the irrevocable letter of credit, regardless of the nature of the dispute and regardless of whether or not the Schnappups prevail in whole or in part." The court awarded attorney's fees to the Schnappups as well.

Western Surety Company v. North Valley Bank, 2005 WL 1545775 (Ohio App. 2005). The applicant caused North Valley Bank to issue an automatically renewable standby governed by the UCP in favor of a surety company in consideration of surety's issuance of a bond to the state lottery commission to secure the applicant-grocer's right to sell lottery tickets. The letter of credit provided that upon receipt by the beneficiary of a notice of nonrenewal, the surety could present its draft on the LC for the full amount if accompanied by a certification that the surety has not been released from past and future liability on its bond. Three years after the bond was issued, the issuing bank sent notice of nonrenewal, the surety attempted to draw on the letter of credit, certifying that it had not been released from liability on its bond. The issuing bank refused the draw. At trial, the issuing bank supplied affidavits to the effect that the surety had not incurred any liability and had not shown any claims had been made against it such that its bond would be in jeopardy. The trial court entered summary judgment against the issuer and awarded attorney's fees. The appellate court upheld that award, citing the independence principle for upholding the trial court's decision on the merits, and Section 5-111(e) for upholding the trial court's award of attorney's fees. ■