COURT OF APPEALS
DECISION
DATED AND FILED

June 28, 2013

Diane M. Fremgen
Clerk of Court of Appeals

NOTICE

This opinion is subject to further editing. If published, the official version will appear in the bound volume of the Official Reports.

A party may file with the Supreme Court a petition to review an adverse decision by the Court of Appeals. *See* WIS. STAT. § 808.10 and RULE 809.62.

Appeal No. 2012AP879 **Cir. Ct. No. 2011CV1**

STATE OF WISCONSIN **IN COURT OF APPEALS**
DISTRICT III

FLORENCE COUNTY

FLORENCE COUNTY FORESTRY AND PARKS,

PLAINTIFF-RESPONDENT,

V.

STATE BANK OF FLORENCE,

DEFENDANT-APPELLANT.

APPEAL from a judgment of the circuit court for Florence County: LEON D. STENZ, Judge. *Affirmed*.

Before Hoover, P.J., Mangerson, J., and Thomas Cane, Reserve Judge.

¶1 PER CURIAM. The State Bank of Florence appeals a money judgment entered following a bench trial at which the circuit court determined the

Bank wrongfully dishonored two letters of credit held by Florence County Forestry and Parks. The Bank asserts the court should have found fraud in the transaction and erred when it denied the Bank's request to call the Florence County corporation counsel as a witness. We reject the Bank's arguments and affirm.

BACKGROUND

¶2 Between 1980 and 2005, Florence County agreed to approximately seventy-nine timber sales contracts with Randolph Turrie under his business name, Turrie Forest Products, Inc. In 2005, the County took bids for its fall timber sales. Turrie was the successful bidder for three contracts: the Ski Hill contract, the Bradles Boulevard South contract, and the Dog Leg contract. Each contract required completion by December 31, 2009.

¶3 The County required Turrie, as the successful bidder, to obtain irrevocable letters of credit, with the County designated as beneficiary. In October 2005, the Bank issued three letters of credit, one for each logging contract. On the Ski Hill contract, the Bank issued a letter of credit for $23,872.50. On the Bradles Boulevard South and Dog Leg contracts, the Bank issued letters of credit for $10,300.50 and $10,552.50, respectively. Each letter of credit was payable by a sight draft accompanied by a County officer's statement that: "Sums claimed are due and payable as Turrie Forest Products, Inc., has not performed as per agreement (identify and enclose agreement) with the Florence County Forestry & Parks."

¶4 Turrie commenced logging under the Ski Hill contract in winter of 2006. He subsequently defaulted by failing to timely pay required stumpage fees. On September 14, 2006, the County notified Turrie by letter that it would be cashing in the Ski Hill letter of credit. This left an outstanding balance of $22,469.90, which the County required to be paid before Turrie would be allowed to log under the Bradles Boulevard South and Dog Leg contracts. Turrie made several $1,000 payments, but an $18,000 balance remained as of March 2010, and Turrie was never permitted to begin the other contracts.[1]

¶5 On January 4, 2010, the County requested payment of the Bradles Boulevard South and Dog Leg letters of credit. After corresponding with the Bank, the County resubmitted the demands on March 15, 2010, stating that its losses on the two sales exceeded $93,000. The County also observed that the Bradles Boulevard South and Dog Leg contracts were lump sum contracts, which required Turrie to pay for a portion of the sale in advance of cutting. In both instances, the Bank refused to honor the letters of credit, asserting that the County had committed fraud by preventing Turrie from performing on the contracts until the Ski Hills balance was paid.

¶6 The County filed suit on January 4, 2011. The court held a bench trial at which the sole issue was whether there was fraud in the transaction. There was no dispute that there was a proper presentment to the Bank or that Turrie defaulted. After extensively reviewing the purpose of letters of credit, the court determined that it was immaterial whether Turrie performed on the underlying contracts. The court concluded the Bank was presented with a proper demand and

[1] There is some dispute as to whether Turrie's debt was discharged by a 2007 bankruptcy proceeding. The bankruptcy proceeding is immaterial to our decision.

failed to establish a fraudulent transaction to justify withholding payment under WIS. STAT. § 405.114(2).[2]

DISCUSSION

¶7 An understanding of the basic principles of standby letters of credit is essential to our review. "Letters of credit have been used in commercial transactions for a very long time." ***Admanco, Inc. v. 700 Stanton Drive, LLC***, 2010 WI 76, ¶17, 326 Wis. 2d 586, 786 N.W.2d 759 (citation omitted). "Standby" letters of credit guarantee the performance of an obligation; they reduce (or more accurately, shift) the risk of nonperformance, "standing by" to perform in the event that the person primarily liable to perform does not. ***Id.***, ¶¶19, 24.

> There are three parties to a standby letter of credit: (1) the applicant [or customer] who requests the letter of credit; (2) the beneficiary to whom payment is due upon the presentation of documents [identified] by the letter of credit; and (3) the issuer who obligates itself to honor the letter of credit by paying up to a stated amount ... when it is presented with documents the letter of credit requires[.]

Id., ¶21 (citing WIS. STAT. §§ 405.102(1)(b), (c) & (i); 405.108 (2007-08)).

¶8 "All parties to a letter of credit benefit from its use." ***Id.***, ¶25. The customer uses the letter of credit as a financial inducement to get the beneficiary to enter into a business arrangement. ***Id.*** The issuer receives a fee for the risk and usually receives a security interest from the customer in the event the issuer is required to honor the letter of credit. ***Id.*** Finally, the beneficiary obtains "the gold standard of payment assurance for commercial transactions." ***Id.***

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[2] All references to the Wisconsin Statutes are to the 2003-04 version unless otherwise noted.

¶9 ***Admanco*** applied a slightly different statutory scheme than we apply in this case. WISCONSIN STAT. ch. 405, which governs letters of credit, was repealed and recreated in 2005. *See* 2005 Wis. Act 213, § 3. The revisions took effect in 2006. The transactions at issue here occurred in 2005, and are governed by the pre-revision statutes. The parties agree that the 2003-04 version of chapter 405 controls.

¶10 One consistent precept in both versions of WIS. STAT. ch. 405 is the independence principle. The independence principle provides that the "obligation of an issuer to pay upon presentation of proper documentation is an obligation independent of any other claim that may exist among the parties to the letter of credit contract." ***Admanco***, 326 Wis. 2d 586, ¶22 (citing WIS. STAT. § 405.103(4) (2007-08)). The purpose of a letter of credit is to avoid complex disputes about how much beneficiaries are really owed. ***Id.*** In short, the independence principle requires that the issuer "pay now, argue later." ***Id.*** (quoted source omitted). Upon presentation of the agreed-upon documents, the issuer must honor the letter of credit, with few exceptions. The independence principle is "key to the commercial vitality of the letter of credit" and a "fundamental" aspect of the law governing that instrument. ***Colorado Nat'l Bank v. Board of Cnty. Comm'rs***, 634 P.2d 32, 36-37 (Colo. 1981).

¶11 Prior to revision, the independence principle was codified at WIS. STAT. § 405.114(1), which provided that an issuer "must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract … between the customer and the beneficiary." Similarly, WIS. STAT. § 405.109(1)(a) provided that an issuer did not automatically assume any liability or responsibility for performance of the underlying contract or other transaction between the customer and beneficiary. The revised statute makes the independence principle slightly more explicit, providing that "[r]ights and obligations of an issuer to a beneficiary … under a letter of credit are independent of the existence, performance, or nonperformance of a contract or arrangement out of which the letter of credit arises or which underlies it …." WIS. STAT. § 405.103(4) (2011-12).

¶12 The Bank appears to argue that WIS. STAT. ch. 405 did not recognize the independence principle prior to the 2005 revision. We disagree. In ***Federal Deposit Insurance Corp. v. Freudenfeld***, 492 F. Supp. 763, 770 (E.D. Wis. 1980), the district court interpreted WIS. STAT. § 405.114(1) precisely as we have. There, the customer, from whom the FDIC sought indemnification, argued the FDIC should have declined payment of a letter of credit because it supposedly knew of breaches in the underlying contract by the beneficiary. ***Id.*** The court deemed this argument meritless, observing that § 405.114(1) "obligated [the issuer] to pay the beneficiary when the appropriate draft with supporting documents is presented." ***Id.*** The FDIC was legally bound to pay notwithstanding any breaches of the duties involving the underlying transaction. ***Id.*** An even earlier case, ***Werner v. A. L. Grootemaat & Sons, Inc.***, 80 Wis. 2d 513, 522, 259 N.W.2d 310 (1977), arguably also recognized the principle as codified in § 405.114(1). Thus, we are unpersuaded by the Bank's argument as to the principle's recent vintage.

¶13 Here, the Bank does not dispute that it was presented with a proper demand for each of the two outstanding letters of credit. At that point, the Bank's obligation was simply to determine whether the documents presented appeared on their face to be in accordance with the terms of the credit. *See* ***Werner***, 80 Wis. 2d at 522 (citing WIS. STAT. § 405.109 (1973)).[3] "Having fulfilled this duty, it must honor a complying draft or demand regardless of whether the documents conform to the underlying contract between the [customer and beneficiary]." ***Id.*** (citing WIS. STAT. § 405.114(1) (1973)).

¶14 The Bank argues that a "fraud in the transaction" exception to the independence principle applies to this case. Under WIS. STAT. § 405.114(2), an issuer may occasionally be relieved of its obligation if a document is, for example, forged or fraudulent, or if there is "fraud in the transaction[.]" In these circumstances, the issuer must nonetheless honor the demand for payment if made by a holder in due course. *See* WIS. STAT. § 405.114(2)(a); ***Werner***, 80 Wis. 2d at 522. "In all other cases as against its customer, an issuer acting in good faith may honor the … demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor." WIS. STAT. § 405.114(2)(b).

¶15 The Bank notes that the term "fraud" is not defined by the statute and, at bottom, argues that the circuit court set the bar too high by requiring elements of bad faith, intentional conduct, and economic benefit. We observe that the standard for fraud under WIS. STAT. § 405.114(2) does appear to be quite high. *See* ***Werner***, 80 Wis. 2d at 523 (discussing fraud standards applied by other courts). Fraud is not merely a synonym for breach of contract. ***Id.*** In interpreting a nearly identical statute, the Colorado Supreme Court stated the fraud "must be of

[3] The ***Werner*** court did not identify precisely which version of the statutes it was applying, but we assume that it applied the 1973 version since that is when the transactions at issue took place. *See* ***Werner v. A. L. Grootemaat & Sons, Inc.***, 80 Wis. 2d 513, 259 N.W.2d 310 (1977). The 1973 and 2003-04 versions of WIS. STAT. § 405.109(2) do not materially differ.

such an egregious nature as to vitiate the entire underlying transaction so that the legitimate purposes of the independence of the bank's obligation would no longer be served." ***Colorado Nat'l Bank***, 634 P.2d at 39. Fraud generally includes an element of intentional representation that is manifested in the documents themselves. ***Id.*** at 39-40. The alleged fraud in this case would not meet this high standard, but we perceive a more basic problem.

¶16 "Fundamentally, 'fraud in the transaction' … must stem from conduct by the beneficiary of the letter of credit as against the customer of the bank." ***Id.*** at 39. WISCONSIN STAT. § 405.114(2)(b) therefore permits an issuer, by implication, to refuse to honor a demand for payment when it has been notified by its customer of these defects. *See* ***Colorado Nat'l Bank***, 634 P.2d at 39. Here, the Bank concedes that Turrie did not furnish it with any notice of fraud in the transaction. Instead, the Bank asserts it was aware in 2006 that the County was requiring Turrie to pay the Ski Hill contract before permitting him to commence performance on other contracts.

¶17 Under WIS. STAT. § 405.114(2)(b), the Bank's own suppositions about the existence of fraud in the transaction between the beneficiary and the customer cannot provide a basis for refusal to honor a letter of credit. Again, the independence principle requires that an issuer "pay now, argue later." ***Admanco***, 326 Wis. 2d 586, ¶22. Permitting a bank to speculate as to the existence of fraud in the underlying transaction and dishonor a letter of credit on the basis of that speculation would effectively eviscerate the independence principle, without which the bank improperly becomes a surety or guarantor of another party's performance. *See* ***Colorado Nat'l Bank***, 634 P.2d at 37. The customer, not the issuer, is in the better position to assess whether inequitable conduct has occurred. In addition, the customer, whose property is usually collateralized, will generally have additional incentive to ensure that no fraudulent demands are honored. Thus, consistent with § 405.114(2)(b), any fraud in the underlying transaction must be called to the bank's attention by the customer. That was not done here.

¶18 The Bank also argues the circuit court erred when it denied the Bank's request to call the Florence County corporation counsel as a witness. The Bank contends counsel is a fact witness because he provided legal advice, submitted a memorandum to the trial court that allegedly contained hearsay facts, corresponded with the Bank, and received paperwork regarding Turrie's bankruptcy proceeding. Essentially, the Bank contends counsel was a necessary witness, and should have been disqualified from representing the County under SCR 20:3.7 (2012).

¶19 A party seeking disqualification based on SCR 20:3.7 bears the burden of proving the necessity that the lawyer testify. ***State v. Gonzalez-Villarreal***, 2012 WI App 110, ¶8, 344 Wis. 2d 472, 824 N.W.2d 161. "The circuit court 'possesses broad discretion in determining whether [attorney] disqualification is required in a particular case, and the scope of our review is limited accordingly.'" ***Id.*** (quoting ***Schloetter v. Railoc of Ind., Inc.***, 546 F.2d 706, 710 (7th Cir. 1976)). Courts usually should not permit an attorney-advocate to testify in a trial, especially where that testimony is on a small or collateral issue. ***State v. Foy***, 206 Wis. 2d 629, 643-44, 557 N.W.2d 494 (Ct. App. 1996).

¶20 Here, any confidential communications related to counsel's representation of Forest County would have been privileged. *See* WIS. STAT. § 905.03 (2011-12). The memorandum of law supposedly containing hearsay facts was withdrawn by counsel and not considered by the court at trial. The court determined any relevant evidence could be obtained from witnesses other than counsel. We conclude the circuit court properly exercised its discretion.

By the Court.—Judgment affirmed.

This opinion will not be published. *See* WIS. STAT. RULE 809.23(1)(b)5. (2011-12).