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**Abstract**

The research question addressed in this thesis is: Would an expansion of judicial intervention (that recognises unconscionability as a separate and independent ground from that of fraud) in the enforcement of on-demand guarantees in Sri Lanka, be useful in mitigating the risk of unfair and opportunistic advantage taking on the part of the beneficiaries calling under on-demand guarantees in Sri Lanka? The problem of beneficiaries’ fraudulent or opportunistic, unfair advantage taking conduct in calling under on-demand guarantees – identified as unfair demands under on-demand guarantees – arises due to the nature of such guarantees which gives the beneficiaries the right to demand payment without having to prove the applicants’ default under the underlying contract. This inherent characteristic of on-demand guarantees gives the beneficiaries a strong position in relation to payment under such guarantees and the potential for misuse and unfair advantage taking in the guarantee market.

Whilst the Sri Lankan courts have recognised the need for intervention in the enforcement of on-demand guarantees in circumstances where the beneficiaries’ demands are fraudulent, they have not yet recognised a mechanism to mitigate beneficiaries’ opportunistic and unfair advantage taking which is a form of unconscionable conduct in seeking the enforcement of these guarantees. This thesis examines this legal position in Sri Lanka which recognises limited scope for judicial intervention in the enforcement of on-demand guarantees, and which has led to a protection gap for the applicants of on-demand guarantees.

This thesis is significant in that it is the first academic work that explores the phenomenon of beneficiaries taking unfair and opportunistic advantage of the situational disadvantages of applicants in the Sri Lankan guarantee market, using qualitative research methodology and proposing legal and structural reform which will be useful for mitigating the adverse consequences of this phenomenon. Drawing upon the developments of the law in Singapore and Australia that recognise unconscionability as a separate ground from that of fraud for restraining beneficiaries’ demands under on-demand guarantees, this thesis proposes an equity-based model for law reform and practical mechanisms for achieving the proposed law reform in Sri Lanka. It also draws on qualitative research which focusses on the nature of demands
under on-demand guarantees in the export and construction industries in Sri Lanka, and an extensive review of the relevant literature provide the methodology for developing practical solutions to address the problem of unfair and opportunistic advantage taking in the enforcement of such guarantees. In developing these practical solutions, this thesis identifies the manner in which the applicants could reduce the subjective power of on-demand guarantees in the hands of the beneficiaries to ensure that those guarantees are not called in a manner that amounts to an opportunistic advantage taking. It also proposes structural and policy changes that the financial institutions could implement toward achieving this outcome.

The legal solution proposed in this thesis, that is, including unconscionability as a ground for judicial intervention in restraining beneficiaries from making demands under on-demand guarantees, is informed by a law and economics theoretical framework that assesses its suitability as a model for law reform in Sri Lanka. This theoretical framework supports equity’s intervention to protect against unconscionable conduct in the guarantee market and is informed by: (1) the theory of exploitation used in this thesis to contend that unconscionable conduct in the guarantee market is a wrongful exploitation that calls for judicial or regulatory intervention; (2) the doctrine of freedom of contract which provides theoretical justification for the thesis’s contention that non-compliance with fairness and equity-based principles, and hence unconscionability on the part of the beneficiary calling under the guarantee, provide justification for judicial or regulatory intervention in the enforcement of demand guarantees; and finally (3) the economic principles of (a) cost-benefit which provides a guide in terms of the legal analysis of the potential costs and benefits of unconscionability as a legal restriction on the enforcement of on-demand guarantees and (b) least-cost risk avoider principle which provides a useful avenue for examination of the question: who could avoid the risk of harm that results from an unconscionable demand at the lowest cost?

The need for protection against unconscionable conduct in the on-demand guarantee market, and hence regulation of unfair trade practices, derives its support from economic rationales supporting the regulation of unfair advantage taking; that such unfair advantage taking can lead to negative impacts on the market activity such as reduced participation, investments and liquidity due to the diminished confidence in the market. Hence, the proposed judicial or legislative intervention in the
enforcement of on-demand guarantees will be useful not only to protect the applicants against beneficiaries’ unfair, opportunistic advantage taking in the guarantee market but also to regulate unfair trade practices in the Sri Lankan guarantee market.
Statement of Originality

This work has not previously been submitted for a degree or diploma in any university. To the best of my knowledge and belief, the thesis contains no material previously published or written by another person except where due reference is made in the thesis itself.

Thanuja Krishanthi Rodrigo
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List of Publications arising from this Thesis

Refereed Journal Articles


Chapter One- The Background, Research Problem, Aims and Methodology

Background to the research problem

This thesis examines unfair demands under on-demand guarantees in Sri Lanka – a phenomenon of beneficiaries demanding payment under on-demand guarantees in circumstances where their conduct amounts to fraudulent or opportunistic, unfair advantage taking of situational disadvantages of applicants of such guarantees. No other academic study has sought to explore the nature and adverse consequences of, nor offer a legal response and practical strategies to address, the phenomenon of opportunistic, unfair advantage taking in the guarantee market in Sri Lanka. This thesis aims to fill that gap through qualitative research undertaken in the export and construction industries in Sri Lanka, where demand guarantees are used as security for contractual performance.

To begin I will describe the problem of unfair and opportunistic advantage taking on the part of the beneficiaries calling under demand guarantees that motivates this research. There has been an increased use of demand guarantees in international trade and construction projects and limited protection available to the exporter or the contractor who procures such guarantees payable on the demand of the beneficiaries. The literature indicates that on-demand guarantees in international transactions have gained importance since the 1960s as a result of the expansion of world trade and the implementation of big projects in the Middle East and oil rich countries. These on-demand guarantees have represented 90 percent or more of all of the guarantees issued internationally to date. At

1 Please note that the referencing style used in this thesis is, Melbourne University Law Review Association Inc, Australian Guide to Legal Citation (3rd ed, 2010).
2 For a brief description of the nature and operation of on-demand guarantees, see Appendix 1; This thesis will use the terms ‘on-demand guarantees’, ‘performance bonds’, ‘bank guarantees’ and ‘demand guarantees’, interchangeably; the terms ‘unfair calling’, ‘unfair demands’ will also be used interchangeably; Note that chapter two of the thesis will elaborate on the term ‘unfair demands’; Note that the literature has sometimes referred to this phenomenon as an ‘abusive calling’; See, eg, Seung Chong, ‘The Abusive Calling of Performance Bonds’ [1990] Journal of Business Law 414.
present, the use of on-demand guarantees is widespread and the total volume has expanded dramatically.  

It has been reported that in Europe, Africa, Asia and the Middle East, on-demand bank guarantees have become critically important in a wide variety of commercial transactions. In the Sri Lankan context, a variety of commercial transactions use on-demand guarantees as security instruments. The focus of the qualitative research undertaken for the purpose of this thesis has been on the exports and construction (domestic and international) industries, which are two vital components of the Sri Lankan economy and which rely on on-demand guarantees as security instruments.

Both in the port development projects and in the reconstruction of buildings and infra-structure in the war affected areas in Sri Lanka demand guarantees have become an important security instrument which ensures performance of construction contracts, undertaken by both local and foreign entities. These guarantees ensure against any risk of non performance, delayed performance or defective performance of the contractor’s obligations such as failure to do the work which the builder has contracted to carry out or failure to supply materials to another contractor working on the same project. If the employer (that is the beneficiary of the demand guarantee) is unhappy with the performance under the contract, justifiably or not, the on-demand character of the demand guarantee gives the employer the ability to demand payment on it. This position has led to financial institutions in certain other jurisdictions refusing to provide contractors with demand guarantees, with unfortunate consequences for the construction industry. For example, in 2009 it was reported that the Dubai banks refused to issue demand guarantees, but that as a result the construction industry in Dubai struggled to win new business.

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7 Note that domestic and international trade, construction, supply of material, agency and redistribution of goods or materials are some examples of the variety of commercial transactions that use demand guarantees as security instruments.
8 Note that in Sri Lanka demand guarantees are issued by commercial banks and insurance companies. A special advantage to the construction industry is that these guarantees can also be obtained through an institution named the ‘Construction Guarantee Fund’ which provides guarantees to construction contractors when they are called upon to provide bid bonds, performance bonds and such other securities when undertaking construction contracts; See Construction Guarantee Fund (Sri Lanka) <http://www.cgf.lk>.
Further, on-demand guarantees play a significant role as security instruments in Sri Lankan export contracts, some involving permanent exports such as apparel garments, tea, rubber, agriculture crops; and some involving temporary exports such as gems and jewellery in order to secure the exporter’s performance. Export demand guarantees secured through financial institutions are commonly used as security in permanent exports, and hence this thesis will examine the nature of unfair and opportunistic advantage taking in the enforcement of on-demand guarantees in the permanent exports category.

Arguably, given the competition in the export market and the pressures on the small and medium scale exporters to ‘export or expire’ the importing countries are in a better bargaining position in insisting on on-demand guarantees as security for export performance. This has created a conducive environment for the importers to procure demand guarantees in the Sri Lankan guarantee market. This means that the financial institutions that issue demand guarantees assume an obligation to pay upon simple demand of the importer without proof of default of export performance. Arguably the nature of this obligation creates considerable scope for unfair opportunistic advantage taking on the part of the importers.

In the recent past, the Sri Lankan economy has experienced a gradual expansion of export trade and construction projects. The increased activity in these sectors is evident in Sri Lanka’s Gross Domestic Production. Reports indicate that in 2011 the export sector in the Sri Lankan economy had grown by 22.4 per cent compared to the 3.4 per cent growth in the previous year benefiting from developments in the international market. Similarly, the construction sector had expanded significantly by 14.2 per cent in 2011 compared to a lower growth of 9.3 per cent in 2010 and 5.6 per cent in 2009.

This thesis argues that with this increased activity in the export and construction sectors in Sri Lanka comes the increased use of demand guarantees, and in turn an increase in the incidence of demands for payment. The data obtained from the financial institutions that participated in the qualitative research undertaken for the purposes of this thesis amply demonstrates this trend towards increased use of demand guarantees in the

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10 See Appendix 2.
11 Ibid; Note that in the case of temporary exports the security instrument used is known as ATA carnet.
export and construction industries and the significant number of claims that have been received under those guarantees, particularly over the last three years.\(^{13}\)

Whilst this thesis argues that unfair and opportunistic advantage taking in the enforcement of on-demand guarantees relates back to the very nature of on-demand guarantees, it does not advocate that these guarantees should be eliminated in the guarantee market.\(^{14}\) The fact that these demand guarantees can be called and paid even in the absence of proof of non-performance, delay in performance or defective performance reflects the fact that to a large extent the guarantee is autonomous from the underlying contract.\(^{15}\) The issuer thus undertakes an absolute obligation to pay the beneficiary according to the terms of the guarantee, irrespective of performance under the underlying contract. Arguably, this inherent characteristic of demand guarantees coupled with the issuers’ absolute obligation to honour the beneficiary under the guarantee places the applicant of the guarantee at a disadvantageous position in the guarantee market.

The beneficiary not only obtains security for performance of the underlying contract, but also, the right to demand payment without having to prove the applicant’s default under the underlying contract. Such demand guarantees are, therefore, properly described as being ‘virtually promissory notes payable on demand’,\(^{16}\) and they leave the door wide open to unfair advantage taking on the part of the beneficiary calling under these guarantees. It is hardly surprising that many bankers refer to such guarantees as ‘suicide bonds’ meaning that their obligation to pay the beneficiary arises on first demand without proof of default.\(^{17}\) Thus, the issuers of demand guarantees are in a position to treat the instrument as one payable upon a simple demand. The beneficiary’s simple call alone would be sufficient to trigger payment under the guarantee. ‘Guarantees in such

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\(^{13}\) See finding (1) and related conclusion (1) of my qualitative research discussed in chapter four.

\(^{14}\) See discussion under ‘The theory of exploitation’ in chapter two.


\(^{16}\) Author of Paget’s Law of Banking, referring to Lord Denning’s description of performance bonds as ‘virtually promissory notes payable on demand’, observes that this is a description which has been cited in numerous authorities in common law jurisdictions worldwide; See Mark Hapgood, *Paget’s Law of Banking* (13\(^{th}\) ed, 2007) 865.

unqualified terms seem astonishing, but I am told that they are by no means unusual’ commented Mr. Justice Kerr in a leading English case, *RD Harbottle (Mercantile) Ltd v National Westminster Bank Ltd*, who went on to note that ‘such guarantees are sometimes drawn upon partly or wholly without any or any apparent justification.’ Arguably, the very nature of demand guarantees has encouraged the beneficiaries to see the guarantee as a means of putting pressure on the applicants, because the very nature of the guarantee ensures that the beneficiaries receive payment even if the applicants object to it.

There is historical evidence of the harmful economic consequences that can arise as a result of the use of on-demand guarantees in commerce. During the Iranian revolution, political tension between Iran and America led to Iranian banks’ open hostility to the United States government which led to Iranian beneficiaries calling under the guarantees given by the American contractors. Despite this political tension and despite many American contractors seeking injunctions following demands by the Iranian beneficiaries, the very nature of demand guarantees required the American financial institutions involved to honour the Iranian beneficiaries without requiring them to prove default under the underlying contracts.

This thesis argues that the issuer’s obligation under the guarantee to honour the beneficiary upon his first demand indicates the strong position of the beneficiary in relation to payment under the guarantee and the potential for misuse and unfair advantage taking. At the same time, the applicant who procured the demand guarantee is exposed to a maximum risk of undeserved payment. It is highly questionable whether some beneficiaries of demand guarantees are even aware that the demand guarantee does not constitute payment itself and that it only offers a means of security for performance of the underlying contract. It is argued that the nature of this security arrangement which creates

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19 Ibid 150.
the risk of unfair and opportunistic advantage taking in the guarantee market is harsh and burdensome for applicants and disproportionately beneficial to the beneficiaries.

Faced with this harsh reality, the courts have recognised the need for legal intervention in the enforcement of demand guarantees. A review of the relevant case law indicates that Sri Lankan law restrains the beneficiary from making calls under on-demand guarantees only in cases of established fraud. The onerous task of pleading fraud in common law has resulted in the applicant failing to obtain injunctions restraining payment on the guarantee in the majority of cases. A review of case law also indicates that in cases where the beneficiary’s demand for payment is not fraudulent, but amounts to an unfair advantage taking of situational disadvantage of the applicant or a harsh or oppressive insistence of the right to demand payment in circumstances to take an unfair advantage of the guarantee and hence, unconscionable form of conduct, the applicant is left without recourse to an injunction restraining payment on the guarantee. This thesis argues that an inability to seek equitable intervention through the courts has resulted in applicants becoming the ultimate victims of such calls by beneficiaries. Only when Sri Lankan exporters and building contractors who provide demand guarantees in international trade and the construction industry are given the opportunity to raise equitable grounds for interim relief restraining the enforcement of such guarantees, will the Sri Lankan courts be able to play a role in mitigating the risk of unfair and opportunistic advantage taking in the guarantee market.

**The aims and significance of this thesis**

This thesis aims to explore unfair demands under on-demand guarantees in the Sri Lankan guarantee market and to propose solutions to mitigate the problem of those unfair demands that fall within the realm of opportunistic and unfair advantage taking. The solutions that I suggest are twofold: legal and structural reform.

In exploring a legal solution to the problem, this thesis examines the main commercial law issues that typically arise in the context of restraining demands under demand guarantees in Sri Lanka. The objective of this analysis is to identify the inadequacy of Sri Lankan law to protect the applicants of demand guarantees. The legal

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21 For an analysis of the Sri Lankan common law position, see chapter three.
22 Note that the terms fraudulent and unconscionable are defined in chapter two.
solution that I suggest draws on key legal developments relating to demand guarantees in Australia and Singapore, that is, the recognition of unconscionability as a separate ground from that of fraud for judicial intervention in the enforcement of demand guarantees. Unconscionability as a ground for judicial intervention in restraining beneficiaries from making calls under on-demand guarantees, will then be analysed within a law and economics theoretical framework, with a view to assess its suitability as a model for law reform in Sri Lanka.

Based on the qualitative research results and review of the relevant literature, this thesis will identify possible structural reform aimed at the financial institutions that issue on-demand guarantees and the applicants who procure them in the Sri Lankan guarantee market. These reforms will be useful for mitigating the risk of beneficiaries taking unfair advantage by demanding payment under on-demand guarantees and raising defences against such demands. Thus, this thesis poses and answers the question: why and how would it be legally and economically feasible to restrain unfair advantage taking in the enforcement of on-demand guarantees in the Sri Lankan market?

This thesis does not evaluate in any detail whether the suggested reforms would be economically efficient, that is, whether the aggregate value of the benefits to those impacted by those reforms would exceed their costs to the community in economic terms. Evaluation of economic efficiency through quantitative data and analysis is beyond the scope of this thesis. However, the potential costs and benefits of restraining unconscionable demands under on-demand guarantees will be analysed in general terms using basic economic principles.

The significance of this thesis lies in its proposed contribution to the scholarly literature, law, commercial practice and policy development in Sri Lanka. This thesis makes an original contribution to the scholarly literature on demand guarantees. It does so in two contexts: firstly, in the context of qualitative research that explores the phenomenon of unscrupulous beneficiaries calling under demand guarantees in the export and construction industries in Sri Lanka; and secondly, in advocating for legal and structural reform underpinned by law and economics theory. The findings of the qualitative research and the suggested reforms will contribute to an under-researched area.

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23 See chapter five.
of Sri Lankan law and will offer optimal strategies for mitigating the risk of unfair advantage taking in the enforcement of on-demand guarantees in Sri Lanka.

**Research questions and methods**

The primary research question which this thesis seeks to answer is: Would an expansion of judicial intervention (that recognises unconscionability as a separate ground from that of fraud) in the enforcement of demand guarantees in Sri Lanka, be useful in mitigating the risk of beneficiaries’ opportunistic behaviour seeking unfair advantage in calling under on-demand guarantees in Sri Lanka?

To shed light on the primary research question, the following sub-questions will be addressed. They are:

Q (1) Are beneficiaries calling under on-demand guarantees a prevalent phenomenon in the export and construction industries in Sri Lanka? Do issuers also complain and/or acknowledge the problem?

Q (2) What is the nature of the demands under on-demand guarantees that the exporters and builders in Sri Lanka are faced with?

Q (3) How does commercial law in Sri Lanka operate to restrain demands under on-demand guarantees? Under what circumstances will the Sri Lankan courts intervene in the enforcement of demand guarantees?

Q (4) What benefits does the current legal system accrue to the participants of on-demand guarantees in Sri Lanka and does the current legal system facilitate the protection of the rights and obligations of parties to a demand guarantee? Which parties benefit the most?

Q (5) Does the current legal system hinder the protection of rights and obligations of any of the parties to on-demand guarantees in Sri Lanka? If so, which party/s is /are affected? Are there any protection gaps in the law?

Q (6) In what manner should the law be reformed to mitigate the problem of unfair advantage taking on the part of the beneficiaries calling under on-demand guarantees in Sri Lanka? Following are some of the questions that need to be addressed in this regard:

(i) From a theoretical perspective, how is the expansion of judicial intervention (that is, an introduction of unconscionability as a separate ground from that of fraud) in restraining demands for payment justified;
(ii) From an economic perspective what are the potential costs and benefits of the expansion of judicial intervention in restraining demands for payment?

(iii) From an economic perspective which party to the demand guarantee will be the ‘least-cost risk avoider’ of unconscionable demands?

Q (7) What are the practical strategies that can be adopted to mitigate the risk of unfair advantage taking in the enforcement of on-demand guarantees?

In order to address the research questions I have undertaken a review of the relevant literature and qualitative interviews with a sample of representatives from financial institutions, and the export and construction industries in Sri Lanka. In order to answer sub-question (6) above, and undertake a theoretical analysis, it was also necessary for me to review the literature on the theory of exploitation, doctrine of freedom of contract and economic principles of cost-benefit and least-cost risk avoider. Thus, the premise of, and arguments put forward in my thesis are informed by the following methods:

**Literature reviews**

I have undertaken extensive reviews of the legal literature on the recent developments of the law applicable to restraining calls under on-demand guarantees in Singapore and Australia. These resource materials have been used to adopt a comparative analysis of the grounds upon which demands under on-demand guarantees can be restrained in Singapore and Australia as compared with the grounds recognised under Sri Lankan law, which follows English common law principles.

This comparative analysis has enabled me to argue, in chapter two, for the adoption of a conceptual framework for defining the scope of unfair demands under on-demand guarantees and to identify, in chapter three, a protection gap in the current Sri Lankan law. Additionally, literature on theory of exploitation will be drawn upon and referred to in chapter two and literature on the doctrine of freedom of contract and economic principles will be drawn upon and referred to in chapter five.
Qualitative interviews

Empirical research typically involves surveys and/or interviews. Qualitative interviews as opposed to quantitative surveys were appropriate to achieving my objectives, as I was interested in the viewpoints and experiences of those involved in the issue of on-demand guarantees and those who procure them as a security instrument in the export and construction industries in Sri Lanka, with respect to unfair advantage taking in the enforcement of on-demand guarantees. Therefore it appeared appropriate to focus on in-depth interviews with a sample of representatives from the banking, export and construction industries in Sri Lanka.

The aim of my qualitative research was to examine the phenomenon of beneficiaries calling under on-demand guarantees in the export and construction sectors in the Sri Lankan guarantee market. The interviews also proved useful in assessing the participants’ perspectives on the current legal position in Sri Lanka. I have provided a comprehensive discussion and analysis of the qualitative research results in chapter four. These results have been drawn upon and utilised in my arguments in chapters five and six.

Theoretical analysis

Every substantive or procedural law can be explained in terms of its theoretical underpinnings. The law governing on-demand guarantees is no exception. In this part, an overview of the main theories and approaches that will be used to explain the legal and economic arguments are examined in brief. These theories and approaches have been comprehensively discussed in chapters two and five.

The theory of exploitation

Reviewing the literature on theory of exploitation enabled me to provide theoretical support for the recognition of unconscionable demands as a type of unfair demands under on-demand guarantees. Drawing upon this theory I have argued that the beneficiaries who make unconscionable demands under on-demand guarantees are taking an unfair advantage of the situational disadvantage or vulnerability of applicants in the guarantee market. I have also argued that what is characteristically vulnerable about the victims of

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24 See especially chapter two.
unconscionable demands is that they are parties who have ‘at least partly renounced playing for advantage themselves’ by agreeing to issue a guarantee payable on-demand, or they are ‘unable to play in games of advantage’ for reasons of competitiveness in the market in that they simply had no choice but to agree to procure a guarantee payable on-demand. Therefore, unconscionable conduct of the beneficiary calling on the guarantee amounts to a ‘wrongful exploitation’ of the applicants which calls for judicial intervention.

**The doctrine of freedom of contract**

The recognition of unconscionability under Singaporean and Australian law as a ground for restraining calls under on-demand guarantees provides a model for law reform in Sri Lanka. This thesis analyses the approach taken by the Singaporean and Australian courts in the enforcement of demand guarantees, in terms of the doctrine of freedom of contract. The Singaporean courts have recognised unconscionability as a separate ground from that of fraud for restraining calls under on-demand guarantees. Arguably, this approach has expanded judicial discretion to intervene in the enforcement of on-demand guarantees. Similarly, Australian courts have recognised the possibility of expanding its judicial discretion to intervene in the enforcement of on-demand guarantees in circumstances where the beneficiary has acted unconscionably. However, this approach does not mean that the Australian courts have adopted a liberal interventionist approach to restraining demands under on-demand guarantees. This is evident in the limited number of decisions in which the Australian courts have actually restrained the beneficiary calling under a demand guarantee. It is argued that the recent developments of unconscionability provisions under the *Australian Consumer Law* indicate that the courts in Australia now have wider powers to apply and develop this concept as a ground for restraining the beneficiary calling under a demand guarantee.

It is argued that this approach does not conflict with the doctrine of freedom of contract in the enforcement of contractual obligations, as that doctrine operates in any event under certain limitations recognised in law, such as compliance with public laws, public policy and principles of fairness and justice. It will be argued that unconscionability on the part of the beneficiary in demanding payment can be construed as an instance where enforcement of the demand guarantee is against public policy and principles of fairness and justice. Evaluation of these competing legal principles, that is,

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25 See especially chapter five.
freedom of contract, public policy and fairness and justice, provides a strong theoretical justification for the legal solution proposed in this thesis.

**The principles of cost-benefit and least-cost risk avoider**

As on-demand guarantees are a feature of commercial practice, this thesis argues that any development of the law governing the enforcement of on-demand guarantees should be analysed in terms of economic impacts. The economic analysis used in this thesis will concentrate on the economic consequences of restraining unconscionable demands.

Chapter five of this thesis will refer to two basic economic principles: cost-benefit and least-cost risk avoider, in order to provide an economic basis for the proposed legal reforms. The issues arising under research question (6) will be examined using a cost-benefit approach. In particular the cost-benefit approach will be used to examine the costs and benefits of restraining unconscionable demands under on-demand guarantees. This analysis of the negative effects (costs) and positive effects (benefits) of restraining such unconscionable demands together with the analysis of the least-cost risk avoider principle provide an economic basis for the recommendations for reforming the law applicable to demand guarantees in Sri Lanka, proposed in chapter six.

The cost-benefit analysis adopted in this thesis involves a general examination of the potential costs and benefits associated with a proposed legal solution, that is, an expansion of judicial intervention in the enforcement of demand guarantees through the recognition of unconscionability as a ground for such intervention.

This thesis seeks to establish that the expansion of law’s intervention in the demand guarantee contract is not only consistent with established principles in contract law, but might lead to economically efficient outcomes. This is demonstrated through an analysis of potential costs and benefits of restraining unconscionable demands and through identifying the least-cost risk avoider of unconscionable demands under on-demand guarantees, which in essence is an analysis of whose actions can reduce the harm at the lowest cost, so that which ever the party is the least-cost risk avoider should take measures to avoid the risk of harm.

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26 Ibid.
The proposed solutions

The proposed legal solution to the problem of unfair and opportunistic advantage taking in the enforcement of on-demand guarantees in Sri Lanka requires the recognition of unconscionability as a separate ground from that of fraud for restraining the beneficiary calling under the guarantee, as drawn from developments of the law in Singapore and Australia.

From a global perspective, there are several reasons for taking Singapore and Australia as models for legal reform in Sri Lanka. Arguably, nations are increasingly law takers (adopting law from other countries) as much as law makers. In relation to the adoption of foreign law one commentator has said:

One can not resist such a proposal simply because it is foreign and *ipse factum* unacceptable. To those who object to the “foreignness” of importations, Rudolf Jhering has given the conclusive answer: “the reception of foreign legal institutions is not a matter of nationality, but of usefulness and need. No one bothers to fetch a thing from afar when he has one as good or better at home, but only a fool would refuse quinine just because it didn’t grow in his back garden.”

Arguably, when countries look to developments elsewhere they seek the best possible legislative framework to facilitate commerce. There is a utility to be served in adopting an approach similar to Singaporean and Australian law in order to mitigate unfair advantage taking in the enforcement of on-demand guarantees in Sri Lanka. As another commentator has pointed out ‘there has been a general awareness that guarantees are an international phenomenon and that national law should be finely attuned to developments elsewhere. Indeed case law and legal writing in the various countries have drawn on developments elsewhere.’

I argue that the transnational use of demand guarantees in commercial transactions provides a strong basis for adopting foreign laws in order to mitigate unfair advantage taking in the enforcement of demand guarantees in Sri Lanka.

Australia and Singapore as Commonwealth countries share ties of tradition with Sri Lanka as well as commercial relationships between their citizens, which make them

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28 Bertrams, above n 5, 10.
logical jurisdictions on which Sri Lanka might draw in considering law reform. It is also significant to note that the judicial approach in Australia and Singapore to the problem of beneficiaries calling under on-demand guarantees, while not yet being uniform, is fundamentally similar, in that both countries have recognised equitable intervention to prevent unconscionable demands in addition to fraudulent demands under those guarantees. While Australian courts have recognised unconscionability in the context of on-demand guarantees from a statutory standpoint – via the unconscionability provisions in the *Australian Trade Practices Act 1974* (Cth) which was recently amended as the *Australian Consumer Law (Competition and Consumer Act 2010*) (Cth) sch 2 read with *Competition and Consumer Amendment Act 2011*), and underlying judge-made law – the recognition and development of unconscionability in the context of on-demand guarantees under Singapore law can be traced back to the developments under its common law. In view of this background, the choice of Singapore and Australia as model laws seems appropriate to address the protection gap under Sri Lankan law.

In chapter six, I will outline the practical mechanisms for achieving the proposed law reform in Sri Lanka, as well as practical strategies to mitigate the harmful consequences of unfair and opportunistic advantage taking in the enforcement of on-demand guarantees. Drawing upon the findings of my qualitative research results and an extensive review of the relevant literature, I will propose that the use of instruments in lieu of on-demand guarantees in the Sri Lankan market, the issuance of demand guarantees subject to the latest revision of the *International Chamber of Commerce’s Uniform Rules for Demand Guarantees* (entered into force on 1 July 2010), and the incorporation of a fast-track adjudication clause in the guarantee itself are useful practical strategies to mitigate the harmful consequences of unfair and opportunistic advantage taking in the enforcement of on-demand guarantees. This chapter will also outline a

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29 See, eg, *Annual Report 2010* (Central Bank of Sri Lanka); this report has identified Singapore and Australia as the 10th and 11th largest export destinations, respectively. In the financial year 2009-10, the export trade between Singapore and Sri Lanka has doubled from US $87 million to US $184 million. For the same financial year, the export trade between Australia and Sri Lanka indicates an increase from US $82 million to US $102 million.

30 As noted by Chan Sek Keong, Chief Justice of Singapore in his opening address at the Singapore Academy of Law Conference 2011, ‘in 1995, the Court of Appeal (Singapore) in *Bocotra Construction v Attorney General*, introduced the doctrine of unconscionability from the Australian law as the basis for restraining unfair calls on performance bonds – a departure from the trite English position which requires fraud to be clearly established before a call on a performance bond can be restrained’; Chan Sek Keong, ‘Developments in Singapore Law 2006-2010: Trends and Perspectives’ (Speech delivered at the Singapore Academy of Law Conference 2011, 24 February 2011) <http://app.supremecourt.gov.sg/data/doc/ManagePage/3704/Opening%20Address%20by%20Chief%20Justice%20at%20the%20SAL%20Conference%202011.pdf>.
proposal for policy changes impacting upon the activities of the financial institutions, and a proposal for establishment of insurance against unfair and opportunistic advantage taking of unscrupulous beneficiaries in calling under on-demand guarantees in Sri Lanka.

**Overview of the thesis**

I began this introductory chapter by explaining the background to my research problem. Growing commercial activities in the export and construction sectors in the Sri Lankan economy has lead to an increased use of on-demand guarantees as security instruments. However, the very nature of on-demand guarantees, which requires financial institutions to pay the beneficiary upon a simple demand without proof of default under the underlying transaction, has given rise to the problem of these beneficiaries taking unfair and opportunistic advantage in the enforcement of such guarantees. This is the problem I examine in my thesis. When referring to *opportunistic or unfair advantage taking* on the part of the beneficiary, in this thesis, it is argued that such conduct can be identified in circumstances where the beneficiary calls on the guarantee, not because there is a genuine default under the underlying contract but because the on demand character of the guarantee enables him to extract some advantage by calling on the guarantee. This conduct does not amount to a fraud – the sole ground upon which the Sri Lankan law intervenes in the enforcement of demand guarantees. Arguably, to allow such opportunistic and unfair conduct is to allow the beneficiary to engage in exploitation of the applicant. Therefore, judicial intervention is necessary to protect the applicants against such exploitative conduct. This thesis is the first academic work undertaken to explore the phenomenon of unfair advantage taking in the enforcement of on-demand guarantees in Sri Lanka and addresses not only a legal solution but also practical, structural reforms to mitigate this problem.

In order to clarify the defining scope of unfair demands under on-demand guarantees, I will provide a conceptual analysis of this term in chapter two. When referring to ‘unfairness’ in the enforcement of demand guarantees, chapter two will argue that in the Sri Lankan context, it is appropriate to identify not only demands made in circumstances where the beneficiary’s conduct in calling under the guarantee is fraudulent but also an unfair, opportunistic advantage taking – a form of unconscionable conduct in the enforcement of on-demand guarantees. For the purpose of developing this
framework chapter two will include detailed discussion of the literature pertaining to concepts of fraudulent demands and unconscionable demands.

Thus, chapter two will argue that not only fraudulent demands, but also demands that fall short of fraud but amount to unconscionable demands, fall within the meaning of ‘unfair demands’. Drawing upon the theory of exploitation I argue that incorporation of unconscionable demands into the concept of unfair demands is theoretically sound as unconscionable demands under on-demand guarantees are a case of wrongful exploitation which provides for a strong *prima facie* case for judicial intervention in the enforcement of those guarantees.

In the analysis to follow in chapter three I argue that in the interests of Sri Lankan exporters and builders, there is a need for judicial intervention in circumstances where the beneficiary’s conduct in calling the guarantee constitutes unfair, opportunistic advantage taking and hence unconscionable conduct. In arguing this, I examine the legal position in Sri Lanka which recognises limited scope for judicial intervention in the enforcement of on-demand guarantees, and which has led to a protection gap for the applicants of on-demand guarantees. Upon a critical examination of the rationales for the Sri Lankan approach, chapter three will argue that there is a need to expand law’s intervention in the enforcement of demand guarantees in Sri Lanka. This need is further strengthened when one considers the negative impacts that might result in allowing for unfair advantage taking in the guarantee market. Drawing upon the economic rationales supporting the regulation of unfair advantage taking that such conduct promotes lower volume, leads to trading declines and depresses participation and investments, I argue that there is economic benefit in supporting legislative or regulatory intervention to protect the applicants against beneficiaries’ unfair, opportunistic advantage taking in the guarantee market.

How does the phenomenon of unfair advantage taking in the enforcement of demand guarantees manifest itself in Sri Lanka? Chapter four of this thesis, using qualitative research methods, will identify and examine this phenomenon with which exporters and contractors in Sri Lanka are currently faced. It will also answer a number of sub questions of my research. This chapter will culminate with a comprehensive discussion and analysis of the qualitative research results.
Having identified the phenomenon of unfair advantage taking in the guarantee market in Sri Lanka, I will turn in chapter five to an analysis of theoretical justifications for the proposed law-based solution – unconscionability as a ground for restraining demands under on-demand guarantees. The legal and economic theories and approaches discussed above (freedom of contract, cost-benefit and least-cost risk avoider) will provide theoretical support for my arguments.

Finally, in chapter six, I will propose how best unconscionability as a separate ground from that of fraud can be recognised and developed in Sri Lankan law as a legal strategy to mitigate unfair advantage taking in the enforcement of on-demand guarantees in Sri Lanka. Based on my qualitative research results I will then propose some practical, structural reforms for mitigating the harms of such conduct in the Sri Lankan guarantee market.
Chapter Two- A Conceptual Analysis of Unfair Demands

Introduction

The objective of this chapter is to present a conceptual analysis of the types of conduct that can be identified as unfair demands under on-demand guarantees. The literature indicates that the scope of unfair demands varies between jurisdictions in terms of the law that applies to the demand guarantee. For example, both in the United Kingdom and Sri Lanka fraud on the part of the beneficiary known to the issuer is the established ground for restraining the enforcement of demand guarantees. Therefore, in those jurisdictions only fraudulent demands are treated as unfair demands. In contrast, both Singaporean and Australian laws have recognised the necessity to restrain not only fraudulent but also unfair advantage taking of vulnerabilities of applicants and hence unconscionable conduct in the enforcement of such guarantees, which means that in those jurisdictions the concept of ‘unfairness’ encompasses both fraudulent and unconscionable demands. Drawing support from the Singaporean and Australian approach to restraining beneficiaries’ calling under demand guarantees, it is argued that ‘unfairness’ in the enforcement of on-demand guarantees can appropriately be identified when it encapsulates not only the beneficiary’s fraudulent but also unfair advantage taking and hence unconscionable conduct towards the applicant calling under the guarantee. This chapter explores the meaning of both fraudulent and unconscionable in the context of on-demand guarantees so as to identify the scope of unfair demands proposed to be used under Sri Lankan law.

With reference to judicial pronouncements I will examine the concept of fraud and/or fraudulent in the context of demand guarantees as a ground for restraining demands under on-demand guarantees. It will be shown that this concept entails the lack of honest belief on the part of the beneficiary calling under the guarantee and that

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1 Note that the Sri Lankan common law position is discussed in chapter three.
2 The authors of Schmitthoff’s Export Trade refer to fraudulent demands as unfair demands under the English law; See Leo D’arcy, Carole Murray and Barbara Cleave, Schmitthoff’s Export Trade: The Law and Practice of International Trade (10th ed, 2000) 222.
the meaning of fraud or fraudulent in the context of demand guarantees is confined to its meaning in common law to the exclusion of unconscionable conduct which is a species of equitable fraud.

Then I will focus more directly on the concept of unconscionability in Singapore as a separate ground from that of fraud for restraining demands under on-demand guarantees and will also refer to the equivalent Australian jurisprudence. I will survey the literature through case examples and examine s 20(1) of the Australian Consumer Law to illustrate the genesis and development of unconscionability as a ground for restraining the beneficiary calling under a demand guarantee. The analysis will include the cases that represent the more controversial judgments of the appellate courts in Singapore and Australia, as well as those judgments in which unconscionability on the part of the beneficiary calling under the guarantee was alleged, but in which the courts decided that it was not present. Hence, its objective is primarily to consider the judicial pronouncements that invoke the application of unconscionability as a separate ground from that of fraud for restraining the enforcement of demand guarantees and the manner in which they contribute to the understanding of unconscionable conduct in the context of on-demand guarantees.

In defining this equitable concept in the demand guarantees’ context, it is important to examine its defining indicators in equity and their flow-back relevance to demand guarantees. Although relief against unconscionable conduct evolved in the equity jurisdiction as a protection mechanism against exploitation of vulnerability of people with a special disability (constitutional disadvantage), over time courts have recognised its broader application to include people with situational disadvantage or vulnerability due to the superior power or position of the other party. Drawing upon the idea of a situational disadvantage this chapter will argue that:

(a) Although the competition in the market to secure the underlying contract of export or construction, makes the applicant of a demand guarantee vulnerable to agree to the terms of the beneficiary, or place the applicant at a situational disadvantage vis-à-vis the beneficiary in the guarantee market, by entering into a demand guarantee contract the beneficiary does not engage in unconscionable conduct. Mere inequality of bargaining power between two

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competent parties is not on its own accepted as a ground for intervention in commercial contracts such as demand guarantees.

(b) After the contract is made the applicant once again becomes vulnerable – vulnerable to honour the beneficiary’s demand for payment under the guarantee upon a simple demand without proof of default under the underlying contract. Whilst the beneficiary is entitled to make such demands, it is the expectation of the applicant (and perhaps the implicit agreement on the part of the beneficiary) that the beneficiary would resort to such demands only in the event of non performance, late performance or defective performance of the contract. If the beneficiary makes a demand in circumstances where there is no real risk to him, and particularly in circumstances where his conduct amounts to opportunistic and unfair advantage taking of the applicant’s situation, then such a demand for payment is unconscionable. The idea of a vulnerability or situational disadvantage thus plays an important role in this second argument.

In order to develop a conceptual analysis of unconscionable conduct this chapter will also make reference to the case law on unconscionable dealing. Notably, the concept of unconscionable dealing has typically been used to determine whether there was some form of procedural unfairness in the bargaining process. It will be shown in this chapter that the Australian courts have drawn upon the concept of unconscionable dealing in its interpretation of unconscionable conduct in the context of demand guarantees. Additionally, the equitable principle of ‘insistence upon strict legal rights in circumstances which make that insistence harsh or oppressive’ has also been drawn upon as a link to interpretation of unconscionable conduct in the context of demand guarantees.

Hence, this chapter will argue that ‘exploitation of vulnerability or situational disadvantage’ and ‘insistence upon rights in circumstances which make that insistence harsh or oppressive’ provide useful links to the conceptual analysis of unconscionable demands under on-demand guarantees. Based on the underlying criteria of these strands of unconscionability, it will be argued that the law’s intervention with unconscionable demands will protect the applicants against exploitation of vulnerability arising from the relative superior position of the beneficiaries in the guarantee market.
As an additional layer to my conceptual analysis of unconscionability, drawing on the theory of exploitation, I will argue that unconscionability on the part of the beneficiary demanding payment is a wrongful exploitation of the vulnerable position of the applicants in the guarantee market. I do not argue that on-demand guarantees are in themselves contracts of exploitation and that the law should intervene to prohibit such instruments being used in the guarantee market. Rather, unconscionable demands under on-demand guarantees conceptually involve a form of exploitation, although the source of the applicants’ vulnerability – the exploitable circumstances – is quite unique in the case of on-demand guarantees. The problem with on-demand guarantees lies in the opportunistic and unfair advantage taking of the applicant’s vulnerability in the guarantee market. Hence the moral force of exploitation justifies prohibition of unconscionable demands under on-demand guarantees.

**Defining fraudulent demands**

Sri Lankan law in conformity with English law principles, has recognised the need for intervention in circumstances where the beneficiaries of demand guarantees call on the guarantees fraudulently.\(^5\) The review of case law indicates that none of the Sri Lankan judgments on this subject has gone into a definition of fraudulent demands or what constitutes a fraudulent demand under demand guarantees. In those cases where the parties have invoked judicial intervention in the enforcement of the on-demand guarantee, the Sri Lankan courts have used the term ‘fraud on the part of the beneficiary’, ‘fraudulent demand’ or ‘fraudulent calls’, but without an in-depth examination of what constitutes fraudulent or fraud in the context of such guarantees.

However the tendency in those cases was to refer most often to the famous English case, *Edward Owen Ltd v Barclays International Bank Ltd*,\(^6\) which established the lack of honest belief criterion in establishing fraudulent demands under demand guarantees and the subsequent decisions of the English courts that followed the formula set out in that judgment.\(^7\) The reason for the absence of explanation in relation to the meaning of fraudulent demands appears to be that by

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5 For a discussion of the Sri Lankan common law position relating to demand guarantees, see generally chapter three.
6 [1978] 1 All ER 976 (‘Edward Owen’).
7 For a discussion of this criterion in the judgments of the English courts, see below.
direct reference to judgments of the English courts, the Sri Lankan courts have adopted its meaning and application under English law. Hence, the meaning of fraud under Sri Lankan law is well understood and builds upon the meaning of that term under English law. The nature of fraud at English common law is described by Lord Herschell in the famous House of Lords decision in *Derry v Peek*, as follows:

First, in order to sustain an action of deceit, there must be proof of fraud, and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states (emphasis added). To prevent a false statement being fraudulent, there must, I think, always be an honest belief in its truth. And this probably covers the whole ground, for one who knowingly alleges that which is false, has obviously no such honest belief.

Lord Herschell’s position is that a person commits fraud when that person makes a statement without belief in its truth. That is to say, that fraud involves intentional dishonesty, the intent being to deceive another person. Therefore, it is argued that the beneficiary’s fraud or fraudulent conduct contemplated in on-demand guarantees can be interpreted in substantial accord with the views of Lord Herschell. If the applicant fails to prove the mental element, that is, the beneficiary had an intention to deceive the applicant, then as was the case in *Derry*, application to restrain the beneficiary must be dismissed. The practical problem for the applicants is of course proving the beneficiary’s state of mind or the knowledge on the part of the issuer. In my next chapter, I will discuss the judicial approach to fraudulent demands under on-demand guarantees in Sri Lanka, in some detail.

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8 [1889] UKHL 1 <http://www.bailii.org/uk/cases/UKHL/1889> (‘*Derry*’).
9 Ibid; See also Frederick Pollock, ‘Derry v Peek in the House of Lords’ (1889) 5 Law Quarterly Review 410; William Anson, ‘Derry v Peek in the House of Lords’ (1890) 6 Law Quarterly Review 72.
10 See Peter Gillies, *Business Law* (Federation Press, 12th ed, 2004) 253. By reference to the concept of fraud in *Derry*, Gillies states that ‘it must be shown that the representor acted without a belief in its truth – that is with knowledge with its falsity, or recklessly (i.e., knowing that it may not be true)’; See also Peter Gillies and Niloufer Selvadorai, *Law of Contract* (Federation Press, 2009) 131.
It is important to note that the *Penal Code* of Sri Lanka does not provide a definition of fraud,¹¹ but defines the term ‘fraudulently’ in s 23 as ‘A person is said to do a thing fraudulently if he does that thing with intent to defraud, but not otherwise.’¹² The intent to defraud is a state of mind which could be established through factual circumstances of the case.¹³ The term fraudulent derived from the *Penal Code* is applied to both criminal and civil wrongs and therefore, the common law meaning of fraud read with s 23 of the *Penal Code* clarifies the term fraudulent under Sri Lankan law. Therefore, in the context of on-demand guarantees, it is argued that fraudulent denotes an intentional deceptive conduct of the beneficiary to gain an advantage by calling on the guarantee.

Returning to Lord Denning’s criterion in the old English case of *Edward Owen*,¹⁴ the nature of fraud in demand guarantees was established in that case as a lack of honest belief on the part of the beneficiary that the event upon which the bank guarantee was intended to be payable has occurred. Lord Denning in that case said: ‘So long as the [beneficiary] makes an honest demand, the banks are bound to pay: and the banks will rarely, if ever, be in a position to know whether the demand is honest or not. At any rate they will not be able to prove it to be dishonest. So they will have to pay.’¹⁵ Lord Denning’s criteria of establishing a fraudulent demand encompass two elements; first, that the beneficiary’s demand under the guarantee was dishonest; secondly, the bank was aware of the beneficiary’s dishonest conduct in calling the guarantee. Applying this criteria to the facts of that case, the court noted that the conduct of the beneficiary ‘may be suspicious, it may indicate the possibility of sharp practice, but there is nothing in those facts remotely approaching true evidence of fraud or anything which makes fraud obvious or clear to the bank’.¹⁶ Thus, the mental element for establishing dishonest belief on the part of the beneficiary and knowledge of that dishonest belief on the part of the issuer is vital to a finding of a fraudulent demand under demand guarantees.

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¹¹ Note that the Legal Dictionary defines fraud as a misrepresentation or concealment with reference to some fact material to a transaction that is made with knowledge of its falsity and with the intent to deceive another and is reasonably relied on by the other who is injured thereby. <http://dictionary.reference.com/browse/fraud>.


¹⁵ Ibid 983.

¹⁶ Ibid.
As will be shown in the case law examples cited below, fraud as lack of honest belief has been repeatedly affirmed in subsequent decisions. In the case of *State Trading Corp of India Ltd v ED & F Man (Sugar) Ltd*,17 Lord Denning quoted from *Edward Owen*.18 Referring to the facts before him, Lord Denning went on to state that ‘the only term which is to be imported is that the buyer, when giving notice of default, must honestly believe that there has been a default on the part of the seller. Honest belief is enough. If there is no honest belief, it may be evidence of fraud. If there is sufficient evidence of fraud, the court might intervene and grant an injunction, but otherwise not. So long as the buyer honestly believes there is a default on the part of the seller that is regarded as sufficient ground for a notice of default to be given.’19

Subsequently, the English Court of Appeal in *Bolivinter Oil SA v Chase Manhattan Bank*,20 quoted Lord Denning’s definition of fraud as lack of honest belief on the part of the beneficiary calling the guarantee.21 Similarly, the case of *Potton Homes Ltd v Coleman Contractors Ltd*,22 included a discussion of fraud as lack of honest belief and a reference to this principle as set out in *Edward Owen* and *State Trading Corp*.23 In considering the issue of a fraudulent demand, the Court of Appeal once again in *United Trading Corp SA and Murray Clayton Ltd v Allied Arab Bank Ltd*,24 turned to *Edward Owen* and quoted ‘the lack of honest demand’ as the criterion for determining a fraudulent demand under the guarantee.25

Similarly, the notion of dishonesty or the lack of honest belief appeared in Hirst J’s judgment in *Turkiye Is Bankasi AS v Bank of China*.26 The court cited both *Edward Owen* and *United Trading* and stated that: ‘Mere allegations of fraud or dishonesty (as were advanced by both the sub contractor and BOC) without any supporting evidence (as was also the case here), fall far short of the necessary requirements.’27

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17 [1981] Comm LR 235 (‘*State Trading Corp*’).
18 Ibid 236.
19 Ibid.
20 [1984] 1 Lloyd’s Rep 251 (‘*Bolivinter Oil*’).
21 Ibid 255.
22 [1984] 28 BLR 19 (‘*Potton Homes*’).
23 Ibid.
24 [1985] 2 Lloyd’s Rep 554 (‘*United Trading*’).
25 Ibid 558.
27 Ibid 189.
Fraud as lack of honest belief was once again raised in the case of *Balfour Beatty Civil Engineering v Technical and General Guarantee Company Ltd*. The Court of Appeal referred to *Edward Owen* and stated that the issue on the facts before the court was whether ‘when the demand was made the persons acting on behalf of the plaintiffs knew that the sum claimed was not due from Leadrail, and dishonestly made a demand despite that knowledge.’ Answering this question in the negative that the evidence did not demonstrate that the beneficiary’s demand was dishonest, the Court of Appeal concluded that, ‘on the material before the court, at this stage, it is not even arguable that an inference should be drawn that the plaintiffs were dishonest.

The English Court of Appeal in *Manx Electricity Authority v JP Morgan Chase Bank*, emphasised and applied *Edward Owen* and *Bolivinter Oil* and stated that ‘that language of ...“honestly believes” presumably takes its shape from the underlying law regarding such performance guarantees, which makes them effectively into obligations to pay on demand within the terms of the guarantee, irrespective of the rights and wrongs of any dispute between beneficiary and principal under the terms of their separate contract, subject only to fraud.’

The criteria for identifying a fraudulent demand set out in the *United Trading* case was more recently considered by the English Court of Appeal in *Banque Saudi Fransi v Lear Siegler*: The question before the Court of Appeal was whether on the material available the only realistic inference was that the beneficiary could not honestly have believed in the validity of its demand on the performance bond.

Thus, the line of cases cited above indicates that the English courts have continuously applied lack of honest belief criterion in deciding whether the demand under the guarantee was fraudulent. The emphasis in common law fraud is on the proof of intentional deception or the lack of honest belief on the part of the beneficiary calling under the guarantee. In contrast, fraud in equity is a wider concept.

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29 Ibid 261.
30 Ibid 264.
31 [2003] EWCA Civ 1324.
32 Ibid [31].
33 2006 WL 3910199; See also *Uzinterimpex JSC v Standard Bank Plc* [2008] EWCA Civ 819, wherein the English Court of Appeal referred to lack of honest belief criterion in deciding a case involving a demand under an advance payment guarantee.
34 Ibid.
than that of fraud or fraudulent under the common law.\textsuperscript{35} Equitable fraud – which is otherwise known as ‘constructive fraud’,\textsuperscript{36} falls short of deceit as the defendant’s knowledge of the relevant facts is not required to establish equitable fraud. A useful explanation of the distinction between fraud in common law and fraud in equity can be found in the old English case of \textit{Nocton v Lord Ashburton}:\textsuperscript{37}

When fraud is referred to in the wider sense in which the books are full of the expression, used in Chancery in describing cases which were within its exclusive jurisdiction, it is a mistake to suppose that an actual intention to cheat must always be proved. A man may misconceive the extent of the obligation which a Court of Equity imposes on him. His fault is that he has violated, however innocently because of his ignorance, an obligation which he must be taken by the Court to have known, and his conduct has in that sense always been called fraudulent, even in such a case as a technical fraud on a power. It was thus that the expression “constructive fraud” came into existence.\textsuperscript{38}

According to this judicial pronouncement, equity’s intervention in cases of alleged fraud is not limited to proof of dishonest intention. A person may commit fraud with or without actual intention to cheat. Thus, fraud in equity is known as constructive fraud. However, the Sri Lankan courts have not referred to equitable fraud in the interpretation of fraudulent demands under demand guarantees. The Sri Lankan courts have applied the common law meaning of fraudulent to the exclusion of the meaning of fraud or fraudulent in equity and in particular to the exclusion of unconscionable conduct as a ground for restraining calls on such guarantees.\textsuperscript{39}

Overall, when calling on the guarantee, if the beneficiary had no honest belief of default under the underlying contract, it may be evidence of fraud. Evidence of dishonest belief on the part of the beneficiary is required to establish a case of fraud at common law. Therefore, an argument can be made that such a definition does not provide a remedy where the beneficiary’s conduct in demanding under the guarantee

\textsuperscript{35} See Michael Evans, \textit{Equity and Trusts} (2\textsuperscript{nd} ed, 2009) 187; \textit{Snell’s Equity} in John Meghee (ed) (Sweet & Maxwell, 31\textsuperscript{st} ed, 2005) 197.
\textsuperscript{36} See Gino Dal Pont and Tina Cockburn, \textit{Equity and Trusts in Principle} (2\textsuperscript{nd} ed, 2008) 104; Roderick Meagher et all, \textit{Equity Doctrines and Remedies} (LexisNexis, 4\textsuperscript{th} ed. 2002) 445-64.
\textsuperscript{37} [1914] AC 932.
\textsuperscript{38} Ibid 954; See also Frederick Pollock, ‘Nocton v Lord Ashburton’ (1915) 31 \textit{Law Quarterly Review} 93.
\textsuperscript{39} For a discussion of the Sri Lankan cases, see chapter three.
falls short of fraud but amounts to an unfair advantage taking of vulnerability and hence a form of unconscionable conduct in equity.

**Defining unconscionable demands**

The Singaporean and Australian courts have now expressly deviated from the traditional approach to restraining calls under demand guarantees, in that unconscionability has been accepted as a separate ground from that of fraud for restraining the enforcement of such guarantees. This significant development of the Singaporean and Australian laws and the academic debates surrounding the different meanings that can be attributed to unconscionable conduct in equity jurisprudence provide the need for deeper reflections on the concept of unconscionable conduct in the context of demand guarantees.

Hence, in defining unconscionable demands, I will first survey the literature through case examples and statutory provisions that illustrate the genesis and development of unconscionability as a separate ground from that of fraud for restraining beneficiaries calling under on-demand guarantees in these jurisdictions. The cases I have chosen for the purpose of this analysis fairly represent the genesis and development of unconscionability in demand guarantee cases in those jurisdictions, and they will therefore prove useful to my conceptual analysis of unconscionable demands. Secondly, I will examine the flow-back relevance of both the case law analysis and the relevant equity jurisprudence to my conceptual analysis of unconscionable demands under demand guarantees.

**Recognition of unconscionability in the enforcement of on-demand guarantees under Singaporean law**

Unconscionability in the context of demand guarantees has been the subject of considerable litigation over ten years in Singapore. A review of the line of cases and various criticisms of the case law that brought about this concept under Singapore law will be instructive in understanding not only the defining factors of unconscionability but also the reasons the judiciary in Singapore embarked on a new ground for restraining demands under on-demand guarantees. Inadequacy of the fraud exception to combat the problem of unfair calling under on-demand guarantees coupled with the difficulty of establishing fraud, which was the sole ground on which a beneficiary could be prevented from calling on the guarantee, has paved the way for the new
ground of unconscionability to be recognised in Singapore. It will be shown in the
next chapter that these are the identical issues that are frequently encountered by the
Sri Lankan courts which continue to adopt the English common law principles in
restraining beneficiary demands under on-demand guarantees.

The genesis of the unconscionability exception in Singaporean jurisprudence
can perhaps be traced back to the statement of Eveleigh LJ, in Potton Homes,\(^\text{40}\) that
there could be some circumstances apart from fraud when a beneficiary would be
restrained from making a claim on the guarantee. It is worth quoting Eveleigh LJ in
\textit{Potton Homes} in order to appreciate the rationale in the early cases of the Singapore
courts that sought to justify a new ground for restraining payment under performance
guarantees: ‘As between the buyer and the seller, the underlying contract cannot be
disregarded so easily. If the seller has lawfully avoided the contract \textit{prima facie}, it
seems to be he should be entitled to restrain the buyer from making use of the
performance bond. Moreover, in principle \textit{I do not think it possible to say that in no
circumstances whatsoever, apart from fraud, will the court restrain the buyer}
(emphasis added).\(^\text{41}\) It should be noted that although Eveleigh LJ’s statement suggests
that fraud on the part of the beneficiary calling under a performance guarantee should
not be the only ground upon which the courts intervene in the enforcement of such
guarantees, it makes no direct reference to unconscionability as a possible ground
upon which a court may intervene. The suggestion there was merely of the possibility
of restraining the beneficiary in circumstances other than fraud.

The Singaporean Courts have now expressly deviated from the traditional
fraud exception. The Singapore Court of Appeal decision in the \textit{Bocotra Construction
Pte Ltd v Attorney General},\(^\text{42}\) marks the beginning of the divergence of the Singapore law.\(^\text{43}\) Consequently, this decision has been subject to extensive academic review in

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\(^{40}\) \textit{Potton Homes} [1984] 28 BLR 19; See also Alexi Fedotov, ‘Abuse, Unconscionability and Demand Guarantees: New Exception to Independence’ (2008) 11 \textit{International Trade and Business Law Review} 49, 68 wherein Fedotov opines that \textit{Potton Homes} is an English authority and has been applied to extend the ground upon which calls under performance bonds can be restrained in Singapore; See also Locknie Hsu ‘Autonomy of Performance Bonds in Singapore’ [1992] \textit{Lloyd’s Maritime and Commercial Law Quarterly} 297.

\(^{41}\) Ibid 28 (Eveleigh LJ). On the facts in \textit{Potton Homes}, the Judge found no ground for granting an injunction.

\(^{42}\) [1995] 2 SLR 733 (‘\textit{Bocotra Construction}’).

the recent past. An examination of the facts and the rationale behind this decision and its potential divergence from the celebrated English authorities follows.

The case involved a construction contract under which Bocotra Construction were the contractors commissioned by the Public Works Department to undertake certain engineering works involving the central expressway. A performance guarantee was issued to the Public Works Department by a bank on the instructions of Bocotra Construction. Bocotra Construction failed to complete the works according to schedule and a dispute ensued between the parties. However, Bocotra Construction claimed that the delay was due to two factors: first, errors contained in the Public Works Department’s drawings and specifications; and second, maladministration on the part of the Public Works Department. The Public Works Department counterclaimed for the cost of remedial works necessary to rectify defects in the construction of the tunnel. Both matters were referred to arbitration in accordance with the arbitration clause in the construction contract. Before determination of the dispute by the arbitrator, the Public Works Department notified Bocotra Construction and the bank of its intention to call for payment on the guarantee. Bocotra Construction then sought and obtained from the arbitrator a restraining order requiring the Public Works Department to desist from making a call on the performance bond. The Public Works Department appealed against the said order.

The Court of Appeal of Singapore considered the grounds upon which a call on a performance bond can be restrained. One of the issues before the Court of Appeal was whether the establishment of fraud was a precondition to restraining a call on the performance bond. Karthigesu JA delivering the collective judgment of the Court of Appeal made reference to Royal Design Studio Pte Ltd v Chang Development Pte Ltd, wherein LP Thean J heavily relied on the statements made by Eveleigh LJ in Potton Homes, and went on to state as follows:

These statements suggest that the court, in exercising its equitable jurisdiction to grant an injunction restraining a call or payment on performance bonds, should not be precluded from adopting a broad approach, if the facts warrant it, to examine disputes

45 [1990] SLR 1116.
relating to the underlying transaction as well. From the above statements, it was clear that LP Thean J felt that all the circumstances of the case, including the dispute relating to the underlying transaction could be considered...In this connection, there was a conscious departure... that the sole exception to the general rule denying injunctions in such circumstances is where fraud is established.46

Karthigesu JA appears to suggest that by adopting a broad approach that recognises equitable intervention to grant an injunction restraining the enforcement of performance guarantees, the Singapore courts have now deviated from the traditional approach that recognised fraud as the sole exception to the general rule denying injunctions. Karthigesu JA then made reference to the Kvaerner Singapore Pte Ltd v UDL Shipbuilding (Singapore) Pte Ltd,47 and ruled that, ‘whether there is fraud or unconscionability is the sole consideration in applications for injunctions restraining payment or calls on bonds to be granted...the applicant will be required to establish a clear case of fraud or unconscionability in interlocutory proceedings. It is clear that mere allegations are insufficient.’48

It is important to note that Bocotra Construction is the first time in the Singaporean jurisprudence that the term unconscionability was specifically mentioned as a ground for restraining a demand on a performance bond.49 However, the emphasis was on ‘fraud or unconscionability’. What the Court of Appeal in this case appears to have done is to dispense with the application of the traditional fraud rule as the sole ground for restraining payment on performance bonds and required the applicant to prove one of following: (a) that the beneficiary was acting fraudulently; or (b) that there is a seriously arguable, clear and convincing case of non entitlement so as to make it unconscionable for the beneficiary to make a call on the guarantee. Dismissing the appeal, the Court of Appeal concluded that Bocotra Construction failed to satisfy the court as to its entitlement to an injunction restraining the Public Works Department from calling under the guarantee. In particular it had not shown, and indeed had conceded that it could not show, that fraud or unconscionability was present on the facts. Whilst this judicial pronouncement marks the Singaporean courts’ recognition of equitable intervention in the enforcement of demands under

performance guarantees, it fails to explain the meaning and relevance of the equitable concept of unconscionability in the context of on-demand performance guarantees.

Consequent to this ruling in *Bocotra Construction*, the concept of unconscionability was invoked by Lai Kew Chai J in *Min Thai Holdings Pte Ltd v Sunlabel Pte Ltd*. A brief examination of the facts of this case will prove useful to identify the context in which the unconscionable conduct was applied to a call under an on-demand guarantee: Min Thai agreed to supply 50,000 metric tons of white rice of Chinese origin to Sunlabel. Under this contract Min Thai procured an on-demand performance guarantee in favour of Sunlabel. The relevant clause in the underlying contract which required this performance guarantee stated that the ‘ultimate seller (Min Thai) is required to post 2% (two percent) of contract value performance bond to buyer bank to activate the letter of credit, such performance bond is payable to buyer upon default of seller to deliver the rice contracted within the agreed delivery schedule. (Attached is a bank guarantee format under annex A which will form part of the LC to be issued to Min Thai Holdings as our supplier).’ There was also a *force-majeure* clause in that contract which provided grounds of relief from liability.

Subsequent to the issue of the performance guarantee China was subject to severe floods caused by typhoon and Min Thai promptly informed Sunlabel of the impediment of the flooding. Min Thai even offered an alternative performance – supply of rice with maximum 30% broken rice. A meeting was scheduled to explore the practical solutions to the flood problems. However, before this scheduled meeting, unknown to Min Thai, Sunlabel made a demand under the performance guarantee. Lai Kew Chai J concluded that it was unconscionable for Sunlabel to demand payment under the performance bond because, the areas from which white rice were to be supplied were affected by severe flooding, which China had not experienced in the last 100 years (and flooding was one of the exceptions specified in the *force-majeure*

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50 [1999] 2 SLR 368 (‘Min Thai’); See also Lai Kew Chai J in the High Court decision in *Raymond Construction v Low Yang Tong* [1996] SGHC 136 referred in *Min Thai*. Note that *Raymond Construction* was the first Singaporean case on performance guarantees (after *Bocotra Construction*) adjudicated purely on the ground of unconscionability.

51 Ibid.

52 Ibid; *Force-majeure* clause read as follows: ‘A party is not liable for a failure to perform any of his obligations in so far as he proves: that the failure was due to an impediment beyond his control; and that he could not reasonably be expected to have taken the impediment and its effects upon his ability to perform into account at the time; and that he could not reasonably have avoided or overcome it or at least its effects. An impediment within paragraph (1) above, may result from events such as the following, this enumeration not being exhaustive:…natural disasters such as violent storms, cyclones, earthquakes, tidal waves, floods, destruction by lightning.’
clause); there was evidence that Min Thai attempted to provide substitute white rice; and the demand on the performance guarantee was made despite the force-majeure clause in the contract.

Thus, this decision represents an instance where the Singaporean High court considered the application of unconscionability in the context of demand guarantees. Arguably, a call stemming from non delivery of goods due to natural disasters despite a force majeure clause in the underlying contract could amount to unconscionability as defined in this case.

On 14\textsuperscript{th} August 1999, the Singapore Court of Appeal consisting of two judges hearing an interlocutory appeal handed down their Judgment in \textit{GHL Pte Ltd v Unitrack Building Construction Pte Ltd}, and affirmed that a separate ground of unconscionability (apart from fraud) exists under Singapore law for restraining the beneficiary of an on-demand guarantee from enforcing it. This case represents another judicial assertion of the recognition of unconscionability, that is, equitable intervention in the enforcement of performance guarantees, but once again without delving into its meaning in equity or the context in which it applies to demand guarantees.

In GHL, the appellants, GHL awarded a building contract for the construction of a boarding house to Unitrack Building Construction. The contract sum for the project was S$5,781,400 which included a sum of S$3,820,000 for sub contract works. Under the contract, Unitrack were required to procure, and duly procured, a performance bond in GHL’s favour from AGF Insurance (Singapore) for 10\% of the contract sum. A year after the construction works began, the parties agreed to a written variation of the contract whereby GHL would receive payment directly from the sub contractors. The main contract sum was correspondingly revised downwards.

\textsuperscript{53} Another subsequent case in which unconscionability was approved as a separate ground from that of fraud for injunctive relief against a beneficiary is the High Court decision of \textit{Sin Kian Contractor Pte Ltd v Lian Kok Hong} [1999] 3 SLR 732 in Wong above n 44, 166. Wong also expresses a contrary view that in previous decisions – particularly, \textit{Raymond Construction} – there is no conscious departure from the fraud exception.
\textsuperscript{54} Ibid 173; Wong argues that \textit{Min Thai} is also open to the same criticisms as \textit{Raymond Construction}.
\textsuperscript{55} [1999] 4 SLR 604 (‘\textit{GHL}’); See also Loh and Wu, above n 49.
\textsuperscript{56} This affirmation removes any doubt which might have arisen concerning \textit{Bocotra Construction} after the High Court ruling in \textit{New Civilbuild Pte Ltd v Guobena Sdn Bhd} [1999] 1 SLR 374 referred in \textit{GHL}, where it was stated that fraud was the only exception on which injunctive relief may be sought and that the word fraud was used interchangeably with unconscionability in \textit{Bocotra Construction}. 41
to S$1,961,400 but the performance bond remained at 10% of the initial sum, S$5,781,400. A dispute arose between the parties and GHL attempted to call on the performance guarantee for the full amount. The Court of Appeal found that in the light of the revision of the contract sum, GHL’s call on the performance bond for the full amount was unconscionable.

In coming to this conclusion, the Singapore Court of Appeal took the opportunity to review the law and restate the law with regard to performance guarantees. The Court of Appeal stated unequivocally that unconscionability was a separate ground for restraining the call of a performance bond. Referring to the *Bocotra* ruling the court stated that:

We should add that the concept of ‘unconscionability’ was adopted after deliberation, and was not inadvertently inserted as a result of a slip; nor was it intended to be used synonymously or interchangeably with ‘fraud’…we accept that to that extent, Bocotra is a departure, and if we may respectfully say so, a conscious departure, from the English position. 57

*Bocotra Construction* which marks the recognition of unconscionability in the context of performance guarantees is a conscious departure from the English common law position. This statement of the Court of Appeal reaffirms that the introduction of unconscionability as a ground for equitable intervention in the enforcement of demand guarantees is well recognised under Singapore law.

Beyond GHL there are a number of cases both in the Court of Appeal and the High Court of Singapore where the courts encountered the issue of deciding whether a particular circumstance fell within the scope of unconscionability recognised under Singapore law. 58 Analysis of all High Court decisions that have followed unconscionability as a ground for restraining the beneficiary of a demand guarantee, are beyond the scope of this case analysis. However, the recent Court of Appeal

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57 *GHL* [1999] 4 SLR 604, 610 (Thean JA).
decisions in *Dauphin Offshore Engineering & Trading Pte Ltd v The Private Office of HRH Sheikh Sultan bin Khalifa bin Zayed Al Nahyan*,\(^{59}\) *Eltraco International Pte Ltd v CGH Development Pte Ltd*,\(^{60}\) *Samwoh Asphalt Premix Pte Ltd v Sum Cheong Piling Pte Ltd*,\(^{61}\) *JBE Properties Pte Ltd v Gammon Pte Ltd*,\(^{62}\) and *BS Mount Sophia Pte Ltd v Join-Aim Pte Ltd*,\(^{63}\) which reiterate unconscionability as a separate ground from that of fraud for restraining the beneficiary calling on the guarantee are discussed below.

In *Dauphin Offshore*, Dauphin were shipbuilders who entered into a contract with HRH, a corporation established under United Arab Emirates. The contract was to build a luxury motor yacht for HRH. Dauphin was required to furnish an irrevocable confirmed bank guarantee upon the receipt of the first instalment. This was a guarantee for the repayment of the first instalment in case Dauphin failed to fulfil their contractual obligations. On HRH’s part, they were required to furnish an irrevocable letter of credit to secure payment of the full amount of the contract price. The parties honoured their contractual obligations with regard to the first instalment in that Dauphin procured a bank guarantee issued by Bank of America and HRH opened a letter of credit. However, a dispute arose as to the payment of the second instalment. Instead of making the payment of the second instalment, HRH gave notice of termination of the underlying contract citing several instances of breaches and made a demand on the performance guarantee. Dauphin obtained an ex-parte interim injunction restraining HRH from making a call on the guarantee. HRH were successful in getting an order from the Judicial Commissioner discharging this injunction. The Judicial Commissioner discharging the injunction was of the view that there was no fraud when HRH made the call on the performance guarantee and he did not think that there was a separate exception of unconscionability apart from fraud. It is surprising to note that the Judicial Commissioner’s attention had not been drawn to the landmark *GHL* case. Dauphin then appealed to the Court of Appeal against the said order. The Court of Appeal took the opportunity of re-examining this issue once again.

Thus, one of the issues before the Court of Appeal was whether HRH’s conduct was unconscionable in making the demand under the guarantee. The Court of

\(^{59}\) [2000] 1 SLR 657 (‘*Dauphin Offshore*’).

\(^{60}\) [2000] 4 SLR 290 (‘*Eltraco International*’).


\(^{62}\) [2011] SLR 47 (‘*JBE Properties*’).

\(^{63}\) [2012] SGCA 28 (‘*Mount Sophia*’).
Appeal delved into an examination of the unconscionability exception under Singapore law despite its own admission that it was firmly established in the *GHL case*.

After a somewhat detailed analysis of the Singaporean case law on the matter, the Court of Appeal affirmed the views expressed in *GHL* that in Singapore unconscionability has been accepted as and is a separate ground in itself for granting injunctive relief in so far as a performance guarantee is concerned. The Court of Appeal then considered what would constitute unconscionability in the context of performance guarantees and stated as follows:

We do not think it is possible to define ‘unconscionability’ other than to give some very broad indications such as lack of bona fides. What kind of situations would constitute unconscionability would have to depend on the facts of each case. This is a question which the court has to consider on each occasion where its jurisdiction is invoked. There is no predetermined categorisation.

The Court then referred to a statement of Lai Kew Chai J in *Raymond Construction v Low Yang Tong* which attempts to identify the ambit of unconscionability: ‘The concept of ‘unconscionability’ to me involves unfairness, as distinct from dishonesty or fraud or conduct of a kind so reprehensible or lacking in good faith that a court of conscience would either restrain the party or refuse to assist the party. Mere breaches of contract by the party in question would not by themselves be unconscionable.’

On this view, the concept of unconscionability in the context of demand guarantees is not susceptible to definition, other than to say that it involves unfair conduct. The question whether the beneficiary has acted unconscionably in calling under the guarantee would depend upon the factual circumstances of each case. However, in an attempt to identify the constituent elements of unconscionability in the context of demand guarantees, the court made an important observation- ‘a conduct of a kind so reprehensible or lacking in good faith’ would come under the broad heading of unconscionable conduct in equity.

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64 Ibid 666 (Chao Hick Tin JA); The Court delved into such an examination in spite of its own admission that it is quite unnecessary to traverse this area of the law all over again in view the decision in *GHL* case.
65 Ibid 668.
66 Ibid.
67 [1996] SGHC 136 [5]. This case was cited with approval in the *Dauphin Offshore* and *Min Thai*. 
Coming back to the facts of the case, the Court of Appeal held that the evidence indicated that HRH was clearly unhappy with various aspects of the construction of the yacht and sought to terminate the contract pursuant to its common law rights upon fundamental breach on the part of Dauphin. Therefore, the call under the guarantee was not considered to be unconscionable.

The Singapore Court of Appeal decision in *Eltraco International* reiterates the extent to which unconscionability on the part of a beneficiary can be used to restrain payment under a demand guarantee. Eltraco were engaged by CGH as the main contractors for the construction of a super-structure for a proposed serviced apartment and shopping development. They procured an on-demand guarantee favouring CGH as security for their performance under the contract. After the completion of the project Eltraco submitted a progress claim for an amount representing the work done up to completion. The claim was not certified by the architect as required by the underlying contract, because Eltraco had not fully rectified certain defective works in the construction. CGH then demanded the full amount under the guarantee even though they held a certain amount in retention moneys. Eltraco sought to restrain CGH from claiming under the guarantee on two grounds; first, that CGH had to show Eltraco were in breach of the underlying contract before they are entitled to demand under the guarantee; second, that CGH’s demand for payment was unconscionable in the circumstances.

As regards the first ground, the Court of Appeal held that the guarantee in question was an on-demand guarantee that did not require the beneficiary (CGH) to establish breach of contract before it demanded payment under the guarantee. The Court of Appeal further confirmed that the two grounds upon which a court would grant an injunction are where there is fraud or unconscionability on the part of the beneficiary. Considering the definition of unconscionability so far adopted, Chao Hick Tin JA observed that:

> The appellants would appear to suggest that based on this opinion, unfairness, per se, could constitute “unconscionability”. We do not think it necessarily follows. Lai Kew Chai J said the concept of “unconscionability” involves unfairness. We agree.
That would be so. In every instance of unconscionability there would be an element of unfairness. But the reverse is not necessarily true. It does not mean that in every instance where there is unfairness it would amount to “unconscionability”. 68

On this statement, unconscionability is one type of unfairness and every instance of unconscionable conduct amounts to unfair conduct, although the reverse is not necessarily true. In relation to the second ground, the Court of Appeal was of the view that unconscionable conduct on the part of CGH demanding full amount of the guarantee would not necessarily have the effect of striking down the entire demand:

It must be borne in mind that the court in restraining a beneficiary from calling on a bond on the ground of unconscionability is exercising an equitable jurisdiction. We are unable to see why in the exercise of this jurisdiction the court may not limit the restraint to only that part which was clearly excessive and allow the other part which would not be unconscionable to remain, bearing in mind that under the terms of the bond, the beneficiary is entitled to make calls from time to time and for such sums as may be appropriate. To restrain the entire call when part of it is clearly not unconscionable would be inconsistent with the object of the jurisdiction which is to ensure that there is no injustice or abuse. To say that the restraint must be on the entire call would surely cause injustice to the beneficiary. The object of this jurisdiction is not to punish the beneficiary for making an excessive call but to achieve equity and justice. 69

Thus, in the above statements, the Court of Appeal made a distinction between unconscionability and unfairness; unconscionability is just one type of unfairness. Hence, unconscionable conduct on the part of the beneficiary calling under the guarantee indicates unfair conduct on his part. The objective of equity’s intervention to protect against unconscionable conduct on the part of the beneficiary calling under the guarantee is to ensure that ‘there is no injustice or abuse’ caused to either party. In order to achieve equity and justice, the court would intervene to restrain only the part of the demand under the guarantee which is unconscionable. Applying this rationale, the court decided that it should take into account the uncertified claims which would have given CGH ample security. CGH was therefore to be restrained from receiving moneys in excess of that claim which was S$600,000. Thus, the court in the exercise of its equitable jurisdiction restrained only that part of the demand which was

68 *Eltraco International* [2000] 4 SLR 290 [29]-[30].

69 Ibid 300 (Chao Hick Tin JA).
unconscionable and allowed CGH’s demand in respect of the part which was not unconscionable.

The Court of Appeal decision in *Samwoh* once again reaffirms the Singapore courts’ recognition of unconscionability in the context of on-demand performance guarantees. The brief facts of this case are as follows: Gim Chuan, a sub contractor, further sub contracted some works under a construction project to Samwoh (the appellants). Samwoh furnished a performance guarantee to SC Piling issued by ECICS Guarantee Co. (Singapore) for the due performance of the sub contract. The performance guarantee therefore was intended to guarantee the due performance by Samwoh of the subsidiary sub contract and not to secure the due performance of the principle sub contract entered into by Gim Chuan. Samwoh alleged that due to the excessive water content in the sub soil, it could not carry out the work under the subsidiary sub contract. Samwoh’s position was that it was the responsibility of Gim Chuan to remedy the situation but despite several requests neither Gim Chuan nor the main contractors, SC Piling, addressed the problem. This resulted in termination of the subsidiary sub contract between Gim Chuan and Samwoh. Thereafter, the main contractors, SC Piling and Samwoh entered into negotiations with a view to having a contract made directly between them. While the negotiations were in progress, Samwoh at the request of SC Piling carried out certain works at the site for a few days. However, the negotiations were not successful, as the parties could not agree on certain terms on which Samwoh would take over the contract. Samwoh had to stop the work at the site which they had started under the temporary arrangement. SC Piling then made a demand on the performance guarantee furnished by Samwoh.

After a detailed examination of the facts the Court of Appeal concluded that the call for payment by SC Piling under the performance guarantee was not based on any bona fide claim that it had against Samwoh. The clear inference was that it had invoked the performance guarantee as a bargaining chip to compel Samwoh to agree to its terms. In all the circumstances, SC Piling had acted unconscionably in calling for payment under the performance guarantee. Addressing the main issue before the Court of Appeal, whether Samwoh had acted unconscionably in calling on the performance guarantee, LP Thean J observed thus:
In Singapore, unconscionability on the part of the beneficiary in calling for payment on a performance guarantee is a separate and distinct ground from fraud for seeking injunctive relief: In determining this issue it is necessary to examine all the relevant facts and circumstances of the case including the facts leading up to the demand for payment under the performance guarantee.  

On this statement, the presence of unconscionable conduct in the context of demand guarantees would depend on the facts of each case. Once again the Singaporean Court of Appeal emphasised that ‘the court would intervene and grant an injunction where the applicant for the guarantee establishes that there was a case of fraud or unconscionability on the part of the beneficiary.’

Disagreeing with the High Court Judge, Thean JA held that the demand made by SC Piling was utterly lacking in bona fides and that it had acted unconscionably in calling on the performance guarantee. This statement suggests that lack of bona fides on the part of the beneficiary calling under the guarantee may amount to unconscionable conduct on his part.

The Court of Appeal decision in *JBE Properties*, is another case that represents the Singapore courts’ affirmation of unconscionability as a separate ground from that of fraud for restraining the beneficiary calling under the guarantee. The case involved a building contract under which Gammon was the builder of a residential building for JEB. Gammon’s obligations under the contract were secured by a performance bond issued by BNP Paribas Singapore. The cladding of the building turned out to be defective but the completion certificate identified those defects as ‘minor’ defects. Before Gammon could rectify the cladding defects, JBE solicited bids from other contractors to do the same. Four bids were received, quoting prices between $2.2m and $2.7m. The bids were made on the basis of replacing the existing cladding of the building and installing new cladding. JBE accepted the lowest bid and then made a call on the bond. Gammon applied to restrain JEB’s call on the

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71 Ibid [20].
72 Ibid; The High Court Judge opined that it was the conduct of the plaintiffs [Samwoh] that was unconscionable. It was unconscionable because in order to procure the contract they arranged for the performance guarantee. Without the performance guarantee they would not have been awarded the contract. Having procured the contract they acted in a manner that would have left SC Piling in a lurch in a situation where time was very important; HC Judge’s reasoning of the case is reported in *Sum Cheong Piling Pte Ltd v Samwoh Asphalt Premix Pte Ltd* [2001] 3 SLR 447.
bond. The High Court directed Gammon to obtain bids for rectifying the defects and the highest quotation obtained indicated that the defects could have been rectified with $0.56m. The High Court decided that the bond was an on-demand bond and granted an interim injunction restraining the call on the grounds of unconscionability bordering on fraud. JBE appealed.

Referring to *Bocotra Construction* and *GHL* cases, Chief Justice Chan Sek Keong, noted that it is now well established under Singapore law that, ‘apart from fraud (which is the traditional ground for restraining a call on a performance bond) unconscionability is separate and independent ground for the court to grant an interim injunction restraining a beneficiary from making a call on a performance bond. This is wider than the English position, which requires fraud to be clearly proved before a call on a performance bond can be restrained.’ Chief Justice went on to explain the basis for this judicial approach to restraining calls on performance bonds:

The juridical basis for adopting unconscionability as a relevant ground (separate from and independent of fraud) lies in the equitable nature of the injunction. Considerations of conscionability are applicable in relation to the use of the injunction in other areas of the law, and there is no reason why these considerations should not be applied for the purposes of determining whether a call on a performance bond should be restrained so as to achieve a fair balance between the interests of the beneficiary and those of the obligor.

On this view, if the law recognises the operation of ‘conscience’ or ‘conscionability’ as a relevant consideration for injunctive relief in other areas of the law, in principle there can not be any reasons for refusing its application in the context of performance guarantees. This is so, as the equitable intervention to restrain the unconscionable conduct on the part of the beneficiary calling under the guarantee, aims to achieve a fair balance of interests between the applicant and the beneficiary of the guarantee. Whilst this decision emphasises the functional and commercial reasons which justify judicial intervention to prevent unconscionable conduct in the guarantee

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74 Ibid 51.
75 Ibid 54; See also *Mount Sophia* [2012] SGCA 28 wherein the Court of Appeal emphasised and followed the rationale for adopting unconscionability in the context of demand performance guarantees stated in *JBE Properties*. 

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market, it is devoid of what constitutes unconscionability in the context of demand guarantees, other than a passing reference to ‘where a call is made in bad faith’. 

The Court of Appeal dismissed the appeal against the High Court decision to grant the interim injunction and held that the JBE’s call on the performance bond was unconscionable given the grossly inflated costs given by it. The court noted that ‘given the cladding defects were described as minor and not proven to be otherwise, it was incongruous for JBE to rely on quotations for replacing the cladding of the whole building. Even if this was necessary, the costs were prima facie grossly inflated in the light of the quotations obtained by Gammon.’

Mount Sophia, is the latest of the string of cases that represents Singapore courts’ recognition of unconscionability as a separate ground from that of fraud for restraining the enforcement of demand guarantees. The brief facts of this case are as follows. Mount Sophia (a property developer) employed Join-Aim (a builder) to construct a residential condominium in Singapore. As security for the performance obligations under the contract, Join-Aim provided a performance bond payable on-demand. A dispute arose between the parties relating to the time for completion of the construction works. Mount Sophia made a call on the bond alleging that it was entitled to liquidated damages from Join-Aim for delay in the completion of the works allegedly caused by Join-Aim. Join-Aim argued that Mount Sophia was not entitled to any liquidated damages because the Delay Certificate was not issued in accordance with the contract and that any delays were caused by Mount Sophia or its consultants. It also argued that the demand under the guarantee was made in bad faith and for a collateral purpose because it was made in retaliation to the request for arbitration. It further argued that it was unfair for Mount Sophia to call under the guarantee when a progress claim remained due and outstanding. The High Court judge granted an ex parte interim injunction restraining Mount Sophia from calling under the guarantee.

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76 Ibid 52; Chan Sek Keong CJ made a distinction between performance guarantees (payable on-demand) and letters of credit and stated that ‘the Singapore courts’ rationale in applying unconscionability as a separate and independent ground for restraining a call on a performance bond… is that a performance bond serves a different function from a letter of credit’ and that ‘a performance bond is not the lifeblood of commerce, whether generally or in the context of the construction industry specifically’; See also the discussion of the Singapore courts’ rationale in departing from the English position discussed in chapter three.

77 Ibid 53.

78 Ibid 61.

79 Ibid.

The interim injunction was granted on the ground of unconscionable conduct on the part of Mount Sophia calling under the guarantee.

Dismissing the appeal, the Court of Appeal was of the view that there was a strong *prima facie* case of unconscionability justifying the continuance of the injunction restraining the call under the guarantee. Leong JA delivering the grounds of decision stated that ‘it is settled law that unconscionability, as distinct from fraud, is a ground upon which the court can grant an injunction restraining a beneficiary of a performance bond from calling on the bond.’\(^{81}\) In relation to the elements that constitute unconscionability in the context of demand guarantees Leong JA observed as follows:

Unconscionability is a distinct and separate ground from fraud, and as stated earlier (at [19]), includes conduct such as unfairness and abuse that are broader than the conduct that would constitute fraud. In other words, the availability of unconscionability acknowledges that conduct exhibited by the beneficiary other than fraud might be sufficiently reprehensible to justify relief on the part of the obligor. For example, unfairness is an element of unconscionability, but it would not make logical sense to say that a beneficiary had thereby acted in such an egregiously unfair manner as to amount to fraud. This is because the concept of unfairness admits of other dimensions beyond the fraudulent dimension, and is assessed on different parameters from those with which we assess fraud. The most we can say is that such conduct does not necessarily constitute fraud.\(^{82}\)

On this statement, conduct such as ‘abuse’ on the part of the beneficiary calling under a guarantee amounts to unconscionable conduct on his part. In other words, unconscionability is a type of unfair conduct that does not amount to fraud. The Court of Appeal went on to emphasise that ‘broadly speaking, unconscionability is a label applied to describe unsatisfactory conduct tainted by bad faith. A precise definition of the concept would not be useful because the value of unconscionability is that it can capture a wide range of conduct demonstrating a lack of *bona fides*.\(^ {83}\) It appears that under Singapore law, it is now well settled that non-compliance with

\(^{81}\) Ibid [18].  
\(^{82}\) Ibid [23].  
\(^{83}\) Ibid [36]; See also para [45] wherein the Court of Appeal stated that ‘a finding of unconscionability is a conclusion applied to conduct which the court finds to be so lacking in *bona fides* such that an injunction restraining the beneficiary’s substantive rights is warranted. Sufficient reasons must be given to the court to enable it to come to such a conclusion, and it is necessary that these reasons are drawn from a thorough consideration of the relevant facts as viewed in the entire context of the case, taking into account the parties’ conduct leading up to the call on the bond.’
principles of good faith is the defining indicator of unconscionability in the context of demand performance guarantees, and that a definition of this concept is unlikely to be forthcoming because the value of the current indicator of unconscionability – ‘the lack of bona fides’ – is that it can capture a wide range of call scenarios. However, this thesis argues that a link can be established between the criteria for defining unconscionability under the law of equity and its application in the context of demand guarantees.84

Overall, the case law analysis leads to the conclusion that it is clear beyond doubt that in Singapore unconscionability is a ground over and above fraud for restraining the enforcement of demand guarantees. This analysis also illustrates the defining elements of unconscionability under the common law in Singapore. The courts in applying this concept to demand guarantees have not made reference to its meaning in equity jurisprudence but have stated that they are exercising equitable jurisdiction. However, the case law provides ample illustrations of the factual circumstances upon which courts have applied unconscionability in the context of demand guarantees. For example, a demand under a guarantee stemming from non delivery of goods due to natural disasters despite a force majeure clause in the underlying contract amounts to unconscionable conduct (Min Thai case); in the light of the revision of the value of the contract, demand under the performance guarantee for the full amount amounts to unconscionable conduct (GHL case); and prima facie gross exaggeration of the costs of rectification in support of the beneficiary’s call under the guarantee amounts to unconscionable conduct (JBE Properties). The judicial pronouncements in Dauphin Offshore, Eltraco International and Mount Sophia provide some guidance in understanding the defining elements of unconscionable conduct in the context of demand guarantees. These cases indicate that in the context of demand guarantees unconscionability is just one type of unfairness. The courts have uniformly suggested that a beneficiary’s conduct in calling under the guarantee that is ‘so reprehensible or lacking in good faith’ would constitute unconscionable conduct on his part and that the existence of unconscionability depends largely on the facts of each case. This is essentially what Leong JA in Mount Sophia referred to as ‘the entire chronology of the case, viewed in relation to all the relevant factors (set in their context),’85 that established a strong

84 See below the section entitled ‘Defining unconscionable demands in the light of equity jurisprudence’.
85 Ibid [54] (Leong JA)
prima facie case of unconscionability on the part of the beneficiary calling under the guarantee. This background along with the courts’ consistent reference to their equitable jurisdiction provide for deeper reflections on the meaning of unconscionable conduct in equity jurisprudence and the manner in which the concept has been applied in the context of demand guarantees under the Australian law.

**Recognition of unconscionability in the enforcement of on-demand guarantees under Australian law**

The judicial approach in Singapore and Australia to the enforcement of demands under on-demand guarantees, while not yet being uniform, is fundamentally similar, in that both jurisdictions have recognised the possibility of equitable intervention to prevent unconscionable demands under on-demand guarantees. The origin and development of unconscionability in the demand guarantees’ context under Australian law can be traced back to the unconscionability provisions in the *Australian Trade Practices Act 1974* (Cth) which was recently superseded as the *Australian Consumer Law* (the *Competition and Consumer Act 2010* (Cth) sch 2 read with *Competition and Consumer Amendment Act 2011*).

The material part of s 20(1) of the *Australian Consumer Law* states that, ‘A person must not, in trade or commerce, engage in conduct that is unconscionable, within the meaning of the unwritten law, from time to time’. The inclusion of words ‘in trade or commerce’ in the above provision appears to have provided a motive for the Australian courts’ application of unconscionable conduct in cases of on-demand guarantees and standby credits. It is implicit that in the application of this provision the applicant will have to satisfy the court that the beneficiary engaged in unconscionable conduct within the meaning of equity. A review of the Australian cases will indicate the courts’ reliance on the interpretation of unconscionability in equity and the specific meaning that has been attributed to unconscionability in on-demand guarantee cases.

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86 See Australian Consumer Law s 20(1); Trade practices Act 1974 (Cth) s 51AA.
87 Standby letter of credit is a financing instrument developed by the American banks after the end of World War II. They represent an obligation to the beneficiary on the part of the issuer to repay money borrowed by or advanced to the account or to make payment on account of any default by the applicant in the performance of an obligation. In practice standby letter of credit functions almost identically to the on-demand guarantee; See Bernard Wheble, ‘Problem Children – Standby Letters of Credit and Simple First Demand Guarantees’ (1982) 24 *Arizona Law Review* 301; In *Harbottle v National Westminster Bank Ltd* [1978] QB 146, 156 Kerr J drew an analogy with cases dealing with standby letters of credit, suggesting that such cases applied equally to demand performance guarantees.
It is important to note that for s 20(1) neither the previous legislation, *Trade Practices Act 1974* (Cth) nor the current legislation, *Australian Consumer Law* provides a statutory definition or any illustrations of unconscionable conduct. However, the statute makes reference to ‘unconscionable conduct within the meaning of unwritten law’, which in essence is a reference to unconscionable conduct within the meaning of equity jurisprudence. In the absence of a statutory definition, several attempts have been made in the past, to define what constitutes unconscionable conduct under s 51AA of the *Trade Practices Act 1974* (Cth) which is the equivalent of s 20(1) of the *Australian Consumer Law*.88 These attempts have come from a number of academic writings,89 and judicial pronouncements.90

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88 In Australia there had been several attempts in the past to define statutory unconscionability in trade transactions. Several of these attempts of various interested parties which came by way of proposed amendment to the previous *Trade Practices Act 1974* (Cth) but have not been brought into effect under the *Australian Consumer Law (Competition and Consumer Act 2010)* (Cth) sch 2 due to a number of factors; See Commonwealth of Australia, Senate Standing Committee on Economics Report, *The Need, Scope and Content of a Definition of Unconscionable Conduct for the Purposes of Part IVA of the Trade Practices Act 1974* (December 2008) <http://www.aph.gov.au/SENATE/committee/economics_ctte/tpa_unconscionable_08>; See also Australian Government, The Treasury, Department of Innovation, Industry, Science and Research, *Strengthening Statutory Unconscionable Conduct and the Franchising Code of Conduct* (February 2010) <http://www.azcz.paocool.com/documents/1744/PDF/unconscionable_conduct_report.pdf>.

89 See, eg, Ross Buckley, ‘Unconscionability Amok, or Two Readily Distinguishable Cases?’ (1998) 26(5) *Australian Business Law Review* 323, 325. Buckley states that s 51AA was intended merely to import into the *Trade Practices Act 1974* (Cth) the narrow equitable cause of action for unconscionable conduct, which requires one party to be under a special disability which was sufficiently evident to the stronger party to make it unconscientious for that party to accept the weaker party’s assent to the impugned transaction; Another facet to this interpretation has been offered by Horrigan who states that unconscionability may be considered a ‘descriptive theme’ for the grouping together of various strands of doctrine, but the theme itself cannot be used as some kind of overarching test, see Bryan Horrigan, ‘The Expansion of Fairness-based Business Regulation’(2004) 32 *Australian Business Law Review* 169; See also Bob Baxt and Edward Archibald, ‘Consumer and Business Protection: Its Role in a Pro-competition Statute’ in Frances Hanks and Philip Williams, *Trade Practices Act –A twenty Five Year Stocktake* (Federation Press, 2001) 171,174.

90 See, eg, Commercial Bank of Australia Ltd v Amadio (1983) 46 ALR 402 ; In *Commonwealth v Verwayen* (1990) 170 CLR 394, 444, Deane J said that ‘unconsciousness’ was a more accurate term than ‘unconscionable’; In *Hurley v McDonald’s Australia Ltd* [2000] ATPR 41,741, the Full Federal Court said that for conduct to be regarded as unconscionable, serious misconduct or something clearly unfair or unreasonable, must be demonstrated; In *Australian Competition and Consumer Commission v Berbatis* [2001] FCA 757, the Full Federal Court held that to sustain a complaint of unconscionable conduct it would be necessary for the applicant to establish that the special disadvantage resulted in a loss of the weaker party’s capacity to make a judgment about their best interests; The full Federal Court examined s 51AA and the concept of unconscionable within the meaning of unwritten law in some detail in *ACCC v Samton Holdings Pte Ltd* [2002] FCAFC 4, where it was stated that the language of s 51AA requires identification of conduct able to be characterized as unconscionable in a sense known to the unwritten law. In the context of that law as it presently stands, unconscionable conduct is that which supports the grant of relief on the principles set out in specific equitable doctrines; Mansfield J in *Australian Competition and Consumer Commission v Keshow* [2005] FCA 558, stated that the term unconscionable is not defined in the *Trade Practices Act 1974* (Cth). Apart from the guidance given by s 51AB (2), its scope would appear to flow from its ordinary meaning of showing no regard for conscience, irreconcilable with what is right or reasonable; Nicholson J expressed similar views when addressing s 51AC of the *Trade Practices Act 1974* (Cth) in *Glenarriff Holdings Pty Ltd v Tah Land Pty Ltd* [2005] FCA 132; See also *Miller v Gunther and Others* [2005] QSC 90 (27 April 2005), where the term unconscionable conduct was considered by the Queensland Supreme Court.
Australian Courts have broader powers to intervene under ss 21 and 22 of the ACL (previously ss 51 AB and 51AC of the TPA) than they do under s 20(1). In other words, this section is not limited by the unwritten law relating to unconscionable conduct.91

Section 22 provides matters the court may have regard to for the purpose of statutory unconscionability.92 Hence this section provides another avenue for the Australian Courts to apply statutory unconscionability in the context of demand guarantees. It is to be reiterated that the factors relevant to an identification of unconscionable conduct under this provision do not apply to an identification of unconscionable conduct under s 20(1).93

The case law analysis in the previous section indicated that the Singaporean courts have not set out defining indicators of unconscionable conduct but have recognised that unconscionable conduct in the context of demand guarantees can be determined by reference to principles of good faith and by reference to the facts of each case. However, such defining indicators can be found in s 22(2) of the Australian Consumer Law which has set out a list of principles that are relevant to an identification of unconscionable conduct.94 Whilst this list of indicators is not exhaustive it is intended to provide guidance in determining whether conduct in relation to a business transaction is unconscionable.

Thus, the literature suggests that reference to ‘unwritten law’ in s 20(1) of the Australian Consumer Law can be treated as a codification and extension of the equitable principles of unconscionability, that is, the law developed by the courts of common law and equity. In the analysis that follows I will discuss the cases that fairly represent the way in which unconscionability is most typically used in the Australian courts in restraining beneficiaries calling under on-demand guarantees. It is important to note that this analysis has not omitted any cases in which the beneficiary’s unconscionability was alleged, but in which the courts decided that it was not present. Thus, the case sample will represent the full range of Australian cases to date, which

91 See Australian Consumer Law s 21(4) (a).
92 See Australian Consumer Law s 22(2).
93 See generally Alex Bruce, Consumer Protection Law in Australia (LexisNexis, 2011) 109-135.
94 See Australian Consumer Law s 22(2); See also Trade practices Act 1974 (Cth) s 51AC; See generally Stephen G. Corones, The Australian Consumer Law (Lawbook, 2011) 157.
illustrate the court’s approach to unconscionability as a ground for intervention in the enforcement of demand guarantees.

In relation to demand guarantees there are some judicial pronouncements that invite the introduction of unconscionable conduct in s 20(1) of the Australian Consumer Law as a ground for restraining beneficiaries calling under demand guarantees.95 This was first raised by the Victoria Supreme Court in Olex Focas Pty Ltd v Skodaexport Co Ltd:96 ‘The effect of the Trade Practices Act, applying as it did to international trade and commerce, was to work a substantial inroad into the well established common law autonomy of letters of credit and performance bonds and other bank guarantees.’97 Prior to this case, a finding based on unconscionability in the context of performance bonds and bank guarantees had not been made in Australia, although, in Hortico (Australia) Pty Ltd v Energy Equipment Co (Australia) Pty Ltd,98 it had been considered. Justice Young in that case suggested the possibility of applying the unconscionability exception when he stated that ‘[i]t may be that in some cases… unconscionable conduct may be so gross as to lead to exercise of the discretionary power.’99

In Olex Focas, Olex, the sub contractors, agreed to undertake the supply and installation of telecommunications, tele-supervisory and instrumentation systems work for Skodaexport, the head contractor, on a pipeline that was built in India. In order to provide security for the performance of the contractual obligations, Olex provided certain guarantees through Hongkong Bank of Australia. As security for the repayment of the advances, Olex provided unconditional bank guarantees known as mobilisation guarantees. In addition they provided performance bonds by way of bank guarantees. The mobilisation and performance guarantees all contained unconditional undertakings by the bank to pay Skodaexport, the head contractor on demand.

95 See also Trade practices Act 1974 (Cth) s 51AA which was superseded as Australian Consumer Law s 20(1).
98 [1985] 1 NSWLR 545; for an analysis of the facts of this case, see generally Wickrema S. Weerasooria, Bank Lending and Securities in Australia (Butterworths, 1998) 309-11.
99 Ibid 554.
A dispute arose as to the work done by Olex under the contract. Skodaexport called up the full amount of the guarantees. By this time, the greater part of the advances secured by the mobilisation guarantees had already been repaid. Olex sought an injunction alleging that Skodaexport in so doing had made a fraudulent demand under the general law as well as an unconscionable demand under s 51AA of the Trade Practices Act 1974 (Cth).

Applying the rationale of Wood Hall Ltd v Pipeline Authority, Batt J found that under the general law a clear case of fraud by Skodaexport in making the demand under the guarantees and the bank’s knowledge of such fraud at the time of the proposed payment needed to be established. Olex had failed to satisfy the court on that ground. However, the court held that Skodaexport, the head contractor, had made an unconscionable demand and acted in contravention of s 51AA of the Trade Practices Act 1974 (Cth) by demanding the full amount of the guarantees securing advances, the greater part of which had been repaid. Had the head contractor, Skodaexport, simply called up an amount not exceeding the balance still outstanding on the advances, their conduct would not have shown to be open to a serious question of being unconscionable.

In coming to a finding of unconscionable conduct on the part of the beneficiary calling up the full amount of the mobilisation guarantees under s 51AA of the Trade Practices Act 1974 (Cth) (the equivalent of s 20(1) of the Australian Consumer Law), Batt J explored the meaning of unconscionable conduct:

There is discussion in two cases which is helpful in throwing light on the notion of “unconscionable” found in s. 51AA. The first case is Logue v Shoalhaven Shire Council mentioned earlier, at 553-5, where equitable fraud is discussed and where, in substance, it is said that what is involved is a situation or conduct unconscionable so as to invoke the intervention of the court that from the beginning regarded itself as a court of conscience. Fraudulent conduct is linked with unconscientious conduct in many of the cases of equitable fraud and in some of the discussion in Logue’s case. More recently, in the majority judgments in Stern v McArthur (1988) 165 CLR 489, there are to be found statements which, whilst not exhaustive or definitional, exemplify the denotation of the concept of unconscionability. At 526 Deane and

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100 (1979) 141 CLR 443 (‘Wood Hall’).
Dawson JJ said that…“The general underlying notion is that which has long been identified as underlying much of equity’s traditional jurisdiction to grant relief against unconscientious conduct, namely, *a person should not be permitted to use or insist upon his legal rights to take advantage of another’s special vulnerability or misadventure for the unjust enrichment of himself*” (emphasis added).\(^{102}\)

Batt J relied on two case examples to exemplify the notion of unconscionable conduct within the meaning of unwritten law. First, was the judgment in *Logue v Shoalhaven Shire Council* which recognised equity’s role in providing relief against unconscientious insistence of a title at law or under statute.\(^{103}\) Second, was the judgment in *Stern v McArthur* which recognised equity’s role in providing relief against the unconscientious actions of the vendors in insisting on maintaining their rescission and forfeiture of the purchaser’s interest in the land.\(^{104}\) Thus, Batt J seems to suggest that the concept of unconscionable conduct in the context of guarantees can also be linked to the equitable notion that ‘a person should not be permitted to use or insist upon his legal rights to take advantage of another’s special vulnerability or misadventure’, as had been applied in the cases that he cited.

Arguably, the judgment of Batt J, in *Olex Focas* marks a significant departure from the traditional ground of fraud upon which an Australian court would restrain payment under demand guarantees.\(^{105}\) That is, by the decision in *Olex Focas*, the Australian law on demand guarantees had moved to include a new ground upon which an injunction could be granted. Statutory unconscionability had been recognised as a separate ground from that of fraud for restraining payment under demand guarantees.

Again in 2003, the Supreme Court of New South Wales in the case of *Boral Formwork and Scaffolding Pty Ltd v Action Makers Ltd (admin apptd)*,\(^{106}\) examined the applicability of unconscionability to commercial transactions involving an issue of

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\(^{102}\) Ibid 403-4.
\(^{103}\) [1979] 1 NSWLR 537, 554.
\(^{104}\) (1988) 81 ALR 463.
\(^{105}\) Note that some critiques have treated this judgment as signifying a departure from the legal position regarding the applicability of equitable unconscionability in certain types of commercial transactions. See, eg, Jeffrey Browne, ‘The Fraud Exception to Standby Letters of Credit in Australia: Does It Embrace Statutory Unconscionability?’ (1999) 11(1) *Bond Law Review* 98 wherein Browne argues that this case involved two large corporations and therefore it is apparent that the Judge’s application of unconscionability doctrine did not rely upon traditional grounds of identification of a special disadvantage.
negotiability. The issue was raised in the context of a standby letter of credit which, in principle, is similar to a demand guarantee.  

Boral and Action Makers (first defendant) entered into an agreement under which Action Makers was to manufacture and deliver to Boral approximately 48 containers of scaffolding equipment. After inspecting certain equipment as delivered Boral determined that the product was defective in that it did not meet the supply specifications. Boral wrote a letter to Action Makers providing details of the defects and subsequently incurred expenditure in carrying out rectification work on the goods. Under the terms of its supply agreement, Action Makers was the beneficiary of an irrevocable standby letter of credit issued by the bank on behalf of its client, Boral. Administrative receivers were appointed to Action Makers. The receivers as agents for Action Makers, made a demand on the bank for payment of the sum representing the full amount of the invoices rendered by Action Makers for scaffolding equipment supplied. The bank paid that part which Boral admitted to be owing (‘undisputed amount’) but the balance of the amount claimed was alleged by Boral to be the cost of the rectification work (‘the disputed amount’) which Boral claimed to be entitled to deduct from the sum owing.

Boral was held to be entitled to relief on the basis that Action Makers had engaged in unconscionable conduct under ss 51AA and 51AC of the Trade Practices Act 1974 (Cth) when they made a demand on the standby credit for amounts more than due. When the dispute was effectively over and the ‘Disputed Amount’ was no longer owed it was unconscionable for Action Makers to use their rights under the security instrument by certifying for payment of the whole invoice amount. Thus, the Supreme Court of New South Wales decided that it would be appropriate to make an order under s 51AA of the Trade Practices Act 1974 (Cth) there was evidence of unconscionable conduct within the words of s 51AC of the Act (the equivalent of s 22 of Australian Consumer Law).

In exploring the concept of unconscionable conduct within the meaning of unwritten law, Austin J observed that the Full Federal Court in Australian

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107 Standby letter of credit is explained above; See text accompanying n 87.
109 Ibid.
Competition and Consumer Commission v Samton Holdings,\(^{110}\) rejected the view that the operation of unconscionable conduct provisions in the statute is limited to one type of unconscionable conduct (that is, the advantage taking of a special disadvantage of another), applied in Blomley v Ryan,\(^ {111}\) and Commercial Bank of Australia Limited v Amadio.\(^ {112}\) He also noted that the present case clearly was not one where this special disadvantage criterion in the determination of unconscionable conduct would apply. The aspect of unconscionable conduct in equity jurisprudence that was most relevant to the present case was ‘unconscientious reliance on strict legal rights’:

> “Like most of the traditional doctrines of equity, it operates upon legal entitlement to prevent a person from asserting or exercising a legal right in circumstances where the particular assertion or exercise of it would constitute unconscionable conduct” (emphasis added): Muschinski v Dodds (1985) 160 CLR 583, at 619 per Deane J

> “Underlying the approach taken in the Dagenham (Thames) Dock case and Kilmer’s case is an expansive view of the equitable doctrines of jurisdiction to relieve against forfeiture. This in turn conforms to the fundamental principle according to which equity acts, namely that a person having a legal right shall not be permitted to exercise it in such a way that the exercise amounts to unconscientious conduct” (emphasis added): Legione v Hateley [1983] HCA 11; (1983) 152 CLR 406, at 444 per Mason & Deane JJ.\(^ {113}\)

Whilst identifying a particular theme of unconscionable conduct in equity (that is the assertion or insistence of a legal right in circumstances it would constitute an unconscientious conduct) as appropriate to describe unconscionable conduct in the context of demand guarantees and similar instruments like standby credits, Austin J went on to examine s 51AC of the Trade Practices Act 1974 (Cth) (the equivalent of s 22 of Australian Consumer Law): ‘Just as the specified conduct of the administrative receivers is unconscionable within the unwritten law of New South Wales, so it is unconscionable within the words of s 51AC’.\(^ {114}\)

\(^{110}\) (2002) 117 FCR 301, 317 (‘Samton Holdings’).
\(^{111}\) (1956) 99 CLR 362 (‘Blomley’).
\(^{112}\) (1983) 46 ALR 402 (‘Amadio’).
\(^{113}\) Boral [2003] NSWSC 713 [77] (Austin J).
\(^{114}\) Ibid [87].
In relation to the criteria in s 51AC of the Trade Practices Act 1974 (Cth) that provides a list of indicators of unconscionable conduct in business relationships, Austin J stated that:

But in my opinion they do not add materially to the analysis, except to make it clear that the word “unconscionable” in s 51AC is not limited to conduct that would be unconscionable according to equitable principles. Here, in my view, both the equitable principles and s 51AC are applicable. Having regard to s 51AA (2), relief in such circumstances is to be granted under s 51AC to the exclusion of s 51AA.115

Austin J’s reasoning suggests that in determining unconscionable conduct in the context of a business relationship, the court may rely either on the equitable theme of unconscionable conduct that he discussed in the above statement or the list of indicators in s 51AC which was recently superseded as s 22 of the Australian Consumer Law. Austin J opined as follows:

The presumption of autonomy does not provide an adequate discretionary reason for declining declaratory and injunctive relief on the basis of contravention of s 51AC. The position might have been different if this was simply a case of making a call on the irrevocable instruments to apply pressure to resolve the dispute. But here, the dispute was effectively over and the Disputed Amount was no longer owing, and it was unconscionable for Action Makers to use its rights under the letter of credit by certifying for payment of the whole Invoice Amount in those circumstances.116

On this view, a beneficiary’s conduct that contravenes the statutory provisions of unconscionability is an exception to the general principle that the courts give effect to the autonomous nature of the security instrument – that the beneficiary is entitled to payment on-demand without proof of default under the underlying contract. The concluding remarks of Austin J provide further justification for the application of statutory unconscionability in commercial transactions:

The terms of the irrevocable instrument and the underlying contract, properly construed, are highly relevant to the decision whether conduct in connection with those arrangements is unconscionable for statutory or equitable purposes. It is not normally unfair or unreasonable or otherwise unconscionable to exercise commercial

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115 Ibid [90].
116 Ibid [87].
rights under an autonomous commercial contract, even if (for example) for the purpose of applying pressure to resolve a dispute. Even if the conduct is unconscionable, the principle of autonomy is relevant to the exercise of the Court’s discretion to grant injunctive relief or leave the plaintiff to other remedies. Here the circumstances, involving as they do a call on the letter of credit on a false basis, are sufficiently special to overcome the hesitation which the principle of autonomy generates. 117

In view of this judicial pronouncement an argument can be made that in circumstances ‘sufficiently special’ judicial intervention with the autonomous nature of on-demand guarantees and standby credits can be justified. However, there is room for argument that such a standard may raise genuine concerns about the future judicial standard of sufficiently special circumstances which justify the judicial intervention.

The decision in *Clough Engineering Ltd v Oil & Natural Gas Corporation Ltd*, 118 is another example where the Full Court of the Federal Court examined whether the beneficiary’s demand on the bank guarantee was unconscionable. This case was an appeal from a single Judge of the Australian Federal Court to the Full Court of the Federal Court of Australia. The presiding Judges were French, Jacobson and Graham JJ.

The case related to a dispute which arose between Clough, an Australian company and Oil & Natural Gas Corporation Ltd (ONGC), an Indian corporation. Clough entered into a lump sum contract with ONGC for US$215m to develop oil and gas fields in India. Clough was required to provide an irrevocable bank guarantee in the amount of US$21m, being 10% of the contract price. Disputes arose between Clough and ONGC over extensions of time for the works and in relation to the insurance requirements for the works. Consequently, ONGC terminated the contract with Clough and called on the bank guarantee.

Clough claimed that the call on the guarantee was unconscionable and sought relief under s 51AA of the *Trade Practices Act 1974* (Cth) preventing payment on the

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118 [2008] FCAFC 136 (‘Clough Engineering’).
bank guarantee. However, there was evidence that Clough had failed to deliver certificates of insurance and had failed to extend the expiry dates of the performance guarantees and therefore was in technical breach of the underlying contract. Therefore, in calling up the performance guarantees in respect of those breaches ONGC was acting according to a legal right under the guarantee which in the opinion of the court could not be characterised as unconscionable in contravention of the Trade Practices Act 1974 (Cth):

The party in whose favour the performance bank guarantee has been given may be enjoined from acting unconscionably in contravention of s 51AA of the TPA: Olex Focas Pty Ltd v Skodaexport Co Ltd (1998) 3 VR 380 (Olex Focas). On this point, different views have been expressed about the reach of s 51AA: Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd (2003) 214 CLR 51; 197 ALR 153; [2003] HCA 18 at [44]-[45] (CG Berbatis Holdings). In any event, none of the categories of unconscionable conduct recognised in Australian Competition and Consumer Commission v Samton Holdings Pty Ltd (2002) 117 FCR 301; 189 ALR 76; [2002] FCA 62 at [48] (Samton Holdings) apply in this case. 119

The scope of s 51AA was discussed by the Full Court in Samton Holdings. As was pointed out in that case, a party alleging a contravention of s 51AA must be able to identify conduct which is unconscionable in a sense known to the “unwritten law, from time to time, of the States and Territories”. Under the unwritten law, which is the common law of Australia, unconscionable conduct will be such conduct as would support the grant of relief on principles set out in specific equitable doctrines. 120

On this judicial statement it can be argued that a party alleging unconscionable conduct under the Australian Consumer Law is required to establish that such conduct supports the grant of relief under specific equitable criteria. In the course of this judgment the Full Court of the Federal Court made reference to the case of Olex Focas and the equitable understanding of unconscionable conduct that ‘a person should not be permitted to use or insist upon his legal rights to take advantage of another’s special vulnerability or misadventure for the unjust enrichment of himself’ that has been applied in the context of demand guarantees. 121 Thus, this judicial pronouncement strengthens the position under Australian law that unconscionable

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119 Ibid 478.
120 Ibid 492.
121 Ibid 494.
conduct in contravention of s 20 of the *Australian Consumer Law* can be a ground for restraining calls under demand guarantees.

Notably, the court recognised three exceptions where a court may prevent the enforcement of demand guarantees. The three exceptions are: where the claim against the performance guarantee is made fraudulently; where a claim against the performance guarantee constitutes unconscionable conduct in contravention of now superseded s 51AA of the *Trade Practices Act 1974* (Cth) and where the contract contains a qualification on the right to call on the performance guarantee. However, the court expressed concern about the actual scope of the application of unconscionable conduct in this type of case:

As already pointed out, on their proper construction, the performance bank guarantees were unconditioned on any actual breach and did entitle ONGC to call upon them for their full amount. Given the commercial purpose of such guarantees, recognised in *Wood Hall Ltd* 141 CLR 443 assuming the absence of fraud, there would seem to be very little, if any, scope for the application of equitable doctrines of unconscionable conduct to restrain the exercise by a party of its legal rights under such guarantees. There may be extreme cases which would merge into the area of bad faith exercises of the power. However that may be, the present is not a case which, on the materials before his Honour, justified any finding of a serious question to be tried of a contravention of s 51AA. The wide purpose of the performance bank guarantees and their character as reflecting an allocation of risk and a provision of security to their holder militate against any argument as to disproportion in their exercise.\footnote{Ibid [138]; See also, Redline Contracting Pty Ltd v MCC Mining (Western Australia) Pty Ltd (No 2) [2012] FCA 1 [61] wherein Siopis J relied on this statement in *Clough Engineering* to examine whether there was a serious question to be tried, that in calling under the demand guarantee, MCC Mining had acted unconscionably, and hence, in contravention of s 20 of the *Australian Consumer Law*.}

According to this view, given the commercial purpose of demand guarantees,\footnote{See also discussion under ‘Commercial utility’ in chapter three.} the courts should recognise a limited scope for judicial intervention in the enforcement of such guarantees.

It is argued that this statement does not amount to a judicial rejection of the application of unconscionability in the context of demand guarantees. It merely flag
the need for caution in applying this equitable doctrine to commercial contracts such as demand guarantees.\footnote{Note that such cautionary statements have also been made in other decisions involving commercial disputes; see e.g. Leveraged Equities Ltd v Goodridge [2011] FCAFC 3 [417] wherein the court noted that ‘there is nothing unconscionable in a margin lender enforcing its legal rights to protect itself against a fall in the value of its security.’ See also the classic words of Lord Radcliffe in Bridge v Campbell Discount Co Ltd [1962] All ER 385, 396 that ‘unconscionable must not be taken as a panacea for adjusting any contract between competent persons when it shows a rough edge to one side or the other.’}

Notably, the statement above accepts the possibility of equity’s intervention to restrain the ‘bad faith exercises of power’ on the part of the beneficiary insisting his right to payment on-demand. Whilst Australian courts have generally been reluctant to intervene in commercial transactions on the basis of unconscionability, the decision in \textit{Clough Engineering} indicates the possibility of equity’s intervention in extreme cases where one party to the commercial transaction has acted in ‘bad faith’.

The court came to the conclusion that ONGC were not acting fraudulently or in a manner that constituted unconscionable conduct.\footnote{Note that in \textit{Samton Holdings}, it was held that a party alleging contravention of s 51AA must be able to identify conduct which is unconscionable in accordance with the common law of Australia.} This case thus represents another instance of the judicial appraisal of the possibility of adopting unconscionability as a ground upon which demands under demand guarantees be prevented in Australia.

The Supreme Court of Victoria in the most recent decision in \textit{Board Solutions Australia Pty Ltd v Westpac Banking Corporation},\footnote{[2009] VSC 474 (‘Board Solutions’).} reiterated that unconscionable conduct on the part of the beneficiary constitutes a ground upon which a call on a demand guarantee can be restrained in Australia. The factual background in \textit{Board Solutions Australia} was as follows: Board Solutions Australia (BSA) entered into a distribution agreement with Arden Way to distribute magnesium oxide board products in Australia and New Zealand. BSA procured an on-demand bank guarantee issued by its bank, Westpac, as security for interim payments for products provided under the said agreement. Bendigo was named the beneficiary of this guarantee as it provided a trade finance facility to Arden Way for the purpose of fulfilling stock orders from BSA. Subsequently, Bendigo as beneficiary made a demand on Westpac under the said guarantee. However, at the time of this demand, BSA was not in default of payments for orders placed with Arden Way.
The nub of BSA’s argument in the Supreme Court seeking an injunction against Bendigo was that Bendigo and Arden Way had acted fraudulently and/or unconscionably in attempting to enforce the demand bank guarantee. BSA contended that Bendigo and Arden Way knew that the guarantee was limited to the ‘supply of goods’ and that there was no default under the agreement. Forrest J delivering the judgment of the Court said:

On the material adduced on this hearing, I am not satisfied that there is evidence that Bendigo has acted fraudulently. Accordingly, a case can not be made out on the basis of the general law exception to the enforcement of a banker’s undertaking as set out by Batt J in Olex Focas...However, BSA’s case is not confined to fraud. It also relies on unconscionable conduct on the part of Bendigo and Multibond (Arden Way) contrary to s 51AA and/or s 51AC of the TPA...There was no suggestion that the provisions of the TPA did not apply to Bendigo.127

Forrest J referring to both Wood Hall and Olex Focas, noted that Bendigo failed to disclose to BSA its interest in securing the guarantee in the form of security for the trade facility and that Bendigo was aware that BSA wished to limit the scope of its undertaking to the distribution agreement. In concluding that a case had been made out on the basis of a potential breach of s 51AA of the Trade Practices Act 1974 (Cth) (predecessor section to s 20 of the Australian Consumer Law), Forrest J made an important observation in relation to the equitable theme of unconscionable conduct that can be applied in the context of demand guarantees:

Bendigo relied upon the principles set out by Deane J in Commercial Bank of Australia Ltd v Amadio as to unconscionable conduct. However, I do not understand his Honour’s statements to be an exhaustive commentary of what may or may not constitute unconscionable conduct. As was said by the Full Court of the Federal Court in Hurley v McDonald’s Australia: Before sections 51AA, 51AB or 51AC will be applicable, there must be some circumstance other than the mere terms of the contract itself that would render reliance on the terms of the contract “unfair” or “unreasonable” or “immoral” or “wrong”. And by French J in ACCC v Samton Holdings Pty Ltd: The special disadvantage may be constitutional, deriving from age, illness, poverty, inexperience or lack of education - Commercial Bank of Australia Ltd v Amadio. Or it may be situational, deriving from particular features of a

127 Ibid [44]-[45].
relationship between actors in the transaction. *This case, I think, falls within that situational description* (emphasis added).128

Thus, whilst recognising the existence of different categories of special disadvantage (namely, constitutional disadvantage and situational disadvantage) that relates to unconscionable conduct in equity, the Supreme Court of Victoria decided that the applicant of the demand guarantee in the present case was under ‘situational disadvantage’ and that the beneficiary’s conduct in calling the guarantee amounted to a taking advantage of this position as recognised by French J in *Samton Holdings*.129

Thus, *Olex Focas* to *Board Solutions* fairly represent the way in which unconscionability has been most typically used in the appellate courts in restraining beneficiaries calling under on-demand guarantees. It would be interesting to observe the manner in which Australian courts would apply unconscionable conduct in s 20(1) which refers to the meaning of unconscionability in equity or unconscionable conduct in s 22(2) which sets out the list of criteria that the court may have regard to in determining unconscionable conduct in business transactions under the *Australian Consumer Law*, as a ground for restraining demands under on-demand guarantees.

Overall, it can be seen that the Australian courts in applying unconscionable conduct under the *Australian Trade Practices Act 1974* (Cth), now the *Australian Consumer Law* as a ground for restraining the enforcement of demand guarantees have drawn upon the equitable principles of ‘unconscientious reliance or insistence on strict legal rights to take advantage of a special vulnerability’ and ‘unfair advantage taking of a situational disadvantage’ as appropriate in the context of on-demand guarantees. Therefore, further reflections on the equity jurisprudence that describes these criteria in the context of business relationships and their flow back relevance in the context of on-demand guarantees, would prove useful to the conceptual understanding of unconscionable demands under on-demand guarantees.

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128 Ibid [51]-[52].
129 (2002) 117 FCR 301 [48].
Defining unconscionable demands in the light of equity jurisprudence

As discussed in the previous sections, both Singaporean and Australian courts have adopted the equitable concept of unconscionable conduct as a ground for restraining calls under demand guarantees. In the application of this concept in the context of demand guarantees, the courts have made reference to equitable jurisdiction or unwritten law or concepts such as good faith, and have drawn upon the underlying defining criteria of ‘unconscientious reliance or insistence on strict legal rights to take advantage of vulnerability’ and ‘unfair advantage taking of vulnerability arising from a situational disadvantage’. Hence, it would be useful to examine these underlying criteria in equity jurisprudence and their flow-back relevance to demand guarantees as a ground for intervention in the enforcement.

The vast literature on unconscionability in equity jurisprudence indicates that it embraces a variety of categories of conduct which offend equity and good conscience. Among that academic literature, one commentator, Finn has identified two criteria that the law uses in determining whether a party to a relationship or dealing has acted unconscionably: unconscionable conduct as contractual wrongdoing and unconscionable conduct as a tortious wrongdoing. By reference to unconscionable conduct as a wrongdoing in a contractual relationship Finn observes that:

The limits the law has set on what constitutes a contract, on when a contract is created, and on the implications of the contractual terms, leave without contractual force or redress a significant range of actions and interactions by and between parties dealing consensually with each other. Obvious examples are the relied upon voluntary promise (Legione v Hateley (1983) 152 CLR 406); action taken in anticipation of a contract which does not eventuate (for example Waltons Stores (Interstate) Ltd v Maher (1988) 164 CLR 387); a course of conduct over time which is referable to the expectations a party reasonably could entertain of a relationship but which expectations have no foundation in an actual agreement between them (for example Gillies v Keogh [1989] 2 NZLR 327); and the insistence upon contractual

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130 See generally Philip H Clarke et al,’Notion of Unconscionability’ in Paul Vout (ed), Unconscionable Conduct, The Laws of Australia (2nd ed, 2009); this scholarly writing identifies five distinct categories in which unconscionable conduct can be found in equity: (1) Exploitation of vulnerability or weakness; (2) Abuse of positions of trust or confidence; (3) Insistence upon rights in circumstances which make that insistence harsh or oppressive; (4) Inequitable denial of legal obligations; and (5) Unjust retention of property; Ibid 121 [35.5.10]; See also Patrick Parkinson,’The Conscience of Equity’ in The Principles of Equity (2nd ed, 2003) 35.

131 Paul Finn,’Unconscionable Conduct’ (1994) 8 Journal of Contract Law 37, 39.
Thus, the types of situations that Finn has identified as unconscionable conduct are those which ordinarily the law of contract has left without redress or resolution. It is in those situations that equity should intervene to soften the rigidities of the law of contract. Among those situations, ‘the insistence upon contractual rights and freedoms but in a way which is inconsistent with the spirit and intendment of the contractual relationship itself’ can be linked to the conceptual analysis of unconscionable conduct in the context of demand guarantees. Arguably, the beneficiary who insists upon his strict legal right to payment on the guarantee in circumstances inconsistent with the ‘spirit’ of the demand guarantee (that the guarantee is payable only in the event of non-performance, defective performance or late performance of the underlying contract but without having to prove the default) falls within this type of unconscionable conduct. In relation to unconscionable conduct as a tortious wrongdoing, Finn states that:

In those cases where equitable doctrine is invoked to avert or reverse harm occasioned by another, the parties invariably will be in a clear relationship of proximity, be this as persons negotiating a contract, as disputants in litigation, or as parties in a family, social or business relationship. Equally the relative positions of the parties will be such as to place one in a position of vulnerability to the other because of a significant inequality between them such that the one has the power to occasion harm (invariably economic) to the other (emphasis added). And the common issue is whether, having that power and being able to occasion that consequence, the power possessor should be subject to a ‘duty of care’, if I can so describe it, to the other to avert or to refrain from inflicting that harm...what we are witnessing in substance could fairly be said to be the emergence of a new species of economic tort.133

According to Finn, the second criterion of unconscionable conduct may arise in relationships of proximity and in situations where one party to the relationship is placed at a position of vulnerability due to the superior power possessed by the other to inflict an economic loss – this Finn describes as ‘a new species of economic tort’. It

132 Ibid 40.
133 Ibid 42.
is possible to argue that in the context of on-demand guarantees there can be situations where the competition in the market compels the applicant of the guarantee to agree to procure an on-demand guarantee in favour of the beneficiary. Thus, the beneficiary becomes the power possessor who could avert or refrain from inflicting an economic harm to the applicant.

Thus, Finn’s analysis of unconscionable conduct falls into two themes, namely the contract theme and the tort theme, which he describes as follows:

The first, the contract theme, is that: a party should not, for its own advantage or to the other’s detriment, act so as to deny the reasonable expectations the other had, or was entitled to have, in or in consequence of their relationship, whether or not that relationship culminated in a contract.

The second, the tort theme, is that: a party should not, for its own advantage or to the other’s detriment, use its superior relative power or position to exploit the vulnerability of the other, be this by positive acts of manipulation or through inaction.\(^{134}\)

This thesis argues that these themes can be utilised in exploring a conceptual analysis of unconscionable demands under demand guarantees. The contract theme will essentially support the protection against unconscionable conduct on the part of the beneficiary who attempts to take advantage of the on-demand character of the security instrument to the detriment of the applicant and thereby deny the reasonable expectations of an applicant of a demand guarantee that the beneficiary will not misuse the unique character of the guarantee. The tort theme will also provide support for restraining the unconscionable conduct of the beneficiary who attempts to exploit the on-demand guarantee through the use of its superior relative power or position in the guarantee market. Hence, in the analysis that follows, these underlying criteria will be drawn upon and related back to the conceptual analysis of unconscionable demands under on-demand guarantees.

**Exercise of superior power to take unfair advantage of vulnerability**

The nature of unconscionable conduct on the part of the beneficiaries calling under demand guarantees can be explained by reference to the aforementioned underlying notion in equity that exploitation of a person’s special vulnerability amounts to

\(^{134}\) Ibid 45.
unconscionable conduct. Arguably, there are two key components that underpin this notion – ‘power’ and ‘vulnerability. In the context of demand guarantees whilst the ‘power’ may arise from the relatively superior positions of the beneficiaries in the guarantee market, the ‘vulnerability’ of applicants may emanate from their transactionally disadvantaged position. I argue that the presence of these elements in the guarantee market results in a form of exploitation. To quote Finn:

> Historically it [unconscionable conduct] has tended to focus upon protecting a person because of his own weakness. *Today the pressure would seem to be to protect a person because of another’s strength, to curb self-intersted power rather than to aid an inept and incompetent interest* [emphasis added]. This reorientation is a feature of contract review legislation [e.g. section 52A *Trade Practices Act 1974* (Cth); *Uniform Commercial Code*, S 2-302 (U.S.)]...And it provides some explanation both for the growing invocation...and for the espousal of its suitability to dealings in which a person otherwise capable of conserving his own interests nonetheless “transactionally disadvantaged” given the nature of the particular dealing in question.\(^{135}\)

It would not be wrong to identify the applicants of demand guarantees as ‘transactionally disadvantaged’ when they procure a demand guarantee in favour of the beneficiaries who will therefore be entitled to payment upon a simple demand without having to prove the default on the part of the applicants. In extending the application of unconscionable conduct to demand guarantees the courts have demonstrated their willingness to intervene to protect the applicants against beneficiaries pursuing their ‘self-intersted power’ in insisting that the demand guarantee should be honoured in circumstances it would be unconscionable for the beneficiaries to do so.

By reference to equity’s intervention in this type of ‘power and vulnerability’ in business relationships, Finn observes that:

> Equity now plays a major part in sanctioning the more egregious uses of such power. In saying this I should state immediately that we are not having unqualified altruism forced upon us. Save where we are in a fiduciary position, or have by contract bound ourselves to act in a specified way, we are permitted (if not necessarily encouraged) to use self-interstedly the advantages we possess in our relationships and dealings

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with others. *Where the halt is called is where that advantage is used unacceptably to exploit the vulnerability of another* (emphasis added).\(^{136}\)

Thus, Finn’s approach identifies two exceptions to the general acceptance that in business relationships one party is permitted to use his ‘power’ over the other; namely, where there exists a fiduciary relationship or where a party is contractually bound to act in a specified manner. However, in circumstances where the conduct of the party using that power amounts to an ‘egregious use of power’, equity intervenes to restrain that power possessor from exploiting the vulnerability of the other.

Notably, this theme has traditionally been used to explain the exploitation of a person with a special disability (constitutional disadvantage). For example in the case of *Blomley*,\(^{137}\) Fullagar J stated that:

> The circumstances adversely affecting a party, which may induce a court of equity either to refuse its aid or to set a transaction aside, are of great variety and can hardly be satisfactorily classified. Among them are poverty or need of any kind, sickness, age, sex, infirmity of body or mind, drunkenness, illiteracy or lack of education, lack of assistance or explanation where assistance or explanation is necessary. The common characteristic seems to be that they have the effect of placing one party at a serious disadvantage *vis-à-vis* the other.\(^{138}\)

On this statement, only a special class of people would be entitled to equity’s protection against unconscionable conduct; the common characteristic of this special class of people being that they suffer from ‘a serious disadvantage’ (such as poverty or need of any kind, sickness, age, sex, infirmity of body or mind, drunkenness, illiteracy or lack of education, lack of assistance or explanation where assistance or explanation is necessary) *vis-a-vis* the other party. Likewise Kitto J spoke of this category of unconscionable conduct as follows:

> This is a well-known head of equity. It applies whenever one party to a transaction is at a special disadvantage in dealing with the other party because illness, ignorance, inexperience, impaired faculties, financial need or other circumstances affect his

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\(^{136}\) Finn, above n 131, 48.

\(^{137}\) *Blomley* (1956) 99 CLR 362.

\(^{138}\) Ibid 405.
ability to conserve his own interests, and the other party unconscientiously takes advantage of the opportunity thus placed in his hands.\textsuperscript{139}

On this statement, an opportunistic advantage taking of a constitutional disadvantage of a person falls within the traditional identification of unconscionable conduct in equity. Revisiting these statements, the High Court of Australia in \textit{Amadio},\textsuperscript{140} appeared to have confined the application of unconscionable conduct to the special disability or special disadvantage criterion in equity:

But relief on the ground of “unconscionable conduct” is usually taken to refer to the class of case in which a party makes unconscientious use of his superior position or bargaining power to the detriment of a party who suffers from some special disability or is placed in some special situation of disadvantage, eg a catching bargain with an expectant heir or an unfair contract made by taking advantage of a person who is seriously affected by intoxicating drink. Although unconscionable conduct in this narrow sense bears some resemblance to the doctrine of undue influence, there is a difference between the two. In the latter the will of the innocent party is not independent and voluntary because it is overborne. In the former the will of the innocent party, even if independent and voluntary, is the result of the disadvantageous position in which he is placed and of the other party unconscientiously taking advantage of that position.\textsuperscript{141}

The High Court in the above statement was referring to unconscionable in the narrow sense which bears the characteristic of a party taking unconscientious advantage of a special disability (constitutional disadvantage) of the other party. Subsequently, the Full Federal Court in \textit{Samton Holdings},\textsuperscript{142} considered the application of this category of unconscionable conduct as a contravention of s 51AA of the \textit{Trade Practices Act 1974} (Cth) (equivalent of s 20 of the \textit{Australian Consumer Law}). Notably, the Full Federal Court recognised the possibility of extending the traditional application of this category of unconscionable conduct to exploitation of a situation of special disadvantage:

Under the rubric of unconscionable conduct, equity will set aside a contract or disposition resulting from the knowing exploitation by one party of the special

\textsuperscript{139} Ibid 415.
\textsuperscript{140} (1983) 46 ALR 402.
\textsuperscript{141} Ibid 413.
\textsuperscript{142} (2002) 117 FCR 301.
disadvantage of another. The special disadvantage may be constitutional, deriving from age, illness, poverty, inexperience or lack of education: Commercial Bank of Australia Ltd v Amadio. Or it may be situational, deriving from particular features of a relationship between actors in the transaction such as the emotional dependence of one on the other: Louth v Diprose; Bridgewater v Leahy (1998) 194 CLR 457; 158 ALR 66.\(^{143}\)

Equity’s intervention to protect people with special disadvantage was primarily based on the fact that such people are unable to make judgments as to their own best interests. However, in the above statement, the court seems to suggest a broader application of special disadvantage criterion that dispensed with the requirement to establish that the special disadvantage resulted in the innocent party unable to make a judgment as to his own best interests. With respect to these categories of special disadvantage the High Court in Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd,\(^{144}\) observed that:

In the present case, French J said that the lessees suffered from a “situational” as distinct from a “constitutional” disadvantage, in that it did not stem from any inherent infirmity or weakness or deficiency. That idea was developed somewhat in a joint judgment, to which French J was a party, in Australian Competition and Consumer Commission v Samton Holdings Pty Ltd… One thing is clear, and is illustrated by the decision in Samton Holdings itself. A person is not in a position of relevant disadvantage, constitutional, situational, or otherwise, simply because of inequality of bargaining power. Many, perhaps even most, contracts are made between parties of unequal bargaining power, and good conscience does not require parties to contractual negotiations to forfeit their advantages, or neglect their own interests (emphasis added).\(^{145}\)

Thus, the High Court was of the view that in determining unconscionable conduct equity’s recognition of special disadvantage criterion (such as the constitutional disadvantage, formulated by the Judges in the decisions in Blomely, Amadio; or situational disadvantage formulated by the Judges in the decision in

\(^{143}\) Ibid [70]; See also Bryan Horrigan, ‘Unconscionability Breaks New Ground – Avoiding and Litigating Unfair Client Conduct After the ACCC Test Cases and Financial Services Reforms’ (2002) 7 Deakin Law Review 73, 77 wherein Horrigan states that ‘Strong judicial support exists for extending unconscionability in section 51AA beyond its conventional equitable boundaries, with clear potential application to a broad band of commercial conduct beyond Amadio-like situations and to dealings between commercial parties in the public and private sectors.’

\(^{144}\) [2003] HCA 18.

\(^{145}\) Ibid [9]-[11].
Samton Holdings) can not be said to exist in a commercial transaction where there was simply an inequality of bargaining power between the parties. 146 High Court’s emphasis was that mere taking advantage of an inequality of bargaining position in the context of business transactions would not itself attract legal consequences under s 51AA Trade Practices Act 1974 (Cth) (equivalent of s 20 of the Australian Consumer Law). 147 Referring to the categories of special disadvantage – constitutional and situational – Gleeson CJ stated that this distinction is ‘understandable and acceptable’, 148 and went on to state as follows:

There is a risk that categories, adopted as a convenient method of exposition of an underlying principle, might be misunderstood, and come to supplant the principle. The stream of judicial exposition of principle cannot rise above the source; and there is nothing to suggest that French J intended that it should. A problem is that the words “situation” and “disadvantage” have ordinary meanings which, in combination, extend far beyond the bounds of the law referred to in s51AA; and, it may be added, far beyond the bounds of what was explained to Parliament as the purpose of the section. 149

Although Gleeson CJ’s statement highlights the risks of misinterpretation of the term ‘situational disadvantage’, it does not amount to a judicial rejection of the utility of this special disadvantage category in determining whether the conduct alleged was unconscionable. It is important to note that in the same majority Judgement Gummow and Hayne JJ noted the importance of the distinction between

146 Ibid [14].
147 Note that the indicators listed under s 22 of the Australian Consumer Law, and in particular s 22(2)(a) speaks of the ‘relative strengths of the bargaining positions’ of the parties is arguably based on the criteria for determining unconscionable conduct in the equity jurisprudence; Note that neither the Trade Practices Act 1974 (Cth) s 51AC nor the Australian Consumer Law s 22 had been in force at the time Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd [2003] HCA 18 was decided in the High Court.
149 Ibid.
constitutional and situational disadvantages drawn by French J for his reasoning. In a dissenting Judgement Kirby J also noted the distinction and stated that:

While the present appeal was substantially argued by reference to the principles of unconscionable dealing as elaborated in cases such as Blomley and Amadio, the reach of the section, in my view, goes further. Its full scope remains to be elaborated in this and future cases. Having regard to the history and purposes of that provision, and the language of its expression, I could not accept the proposition that s51AA has a limited operation. It is as large as the statutory text and the incorporated unwritten law permit. It has a capacity to expand and apply to new circumstances as the unwritten law evolves “from time to time.”

It is argued that whilst Berbatis has been decided on the basis of constitutional disadvantage category the High Court has not made any affirmative statement that situational disadvantage category can not form the basis of a special disadvantage. Moreover, such an argument is also consistent with the wording of s 20(1) of the Australian Consumer Law which allows for the development of equitable principles ‘from time to time’.

150 Ibid [48] (Gummow and Hayne JJ); Note that the literature also suggests that the approach taken by French J in Samton Holdings as well as in Berbatis (at first instance) has survived the High Court decision in Berbatis. See e.g., Lindsay Trotman and Robert Langton, ‘Much Ado About Very Little: Some Reflections on ACCC V Berbatis’ (2003) 15 (2) Bond Law Review 377; see also Nicole Dean, ‘Cases and Comments – ACCC v Berbatis Holdings (2003) 197 ALR 154’ [2004] Sydney Law Review 256, 256 wherein the author states that:

‘The High Court’s Judgement neither directly counters the idea that s51AA unconscionable conduct can arise between commercial parties as a result of situational disadvantage, nor does it definitively reject the proposition that s51AA may embrace not only the narrow doctrine, but also the broad principle, of unconscionability.’

151 Ibid [77] (Kirby J); Commenting on the different approaches taken by the majority and minority judges in the High Court in Berbatis, one commentator has stated that:

It is regrettable that a case like Berbatis was argued exclusively on the footing that its facts fell within the narrow equitable category of unconscionable dealing. Not only did this allow the High Court to avoid wider analysis and interpretation of s 51AA of the Act, but it also allowed the majority judges especially to approach the case with blinkered vision, causing them to ignore or overlook normatively sensitive features of the ACCC’s claim. By so straight jacketing themselves, counsel and the Court were constrained to conceptualise and dispose of the case entirely in terms of the specific doctrinal criteria of an unconscionable dealing claim – ‘special disadvantage’ and ‘unfair advantage taken of the opportunity thereby arising’ - criteria that remain fairly underdeveloped in Anglo-Australian law. Certainly if the majority judges’ treatment of the ‘special disadvantage’ criterion in the subject case is anything to go by, then the criteria of unconscionable dealing are likely to remain underdeveloped for some time yet. Rick Bigwood, ‘Curbing Unconscionability: Berbatis in the High Court of Australia’ (2004) 23 Melbourne University Law Review 204, 230.
Arguably, it is the notion of situational disadvantage that provides a link to the present analysis of unconscionable conduct on the part of beneficiaries calling under demand guarantees. Overall, the questions arise as to whether the on demand character of the guarantee gives the beneficiary a superior position vis-à-vis the applicant in the guarantee market and hence in a given case the applicant is placed in a situational disadavantage or vulnerability arising from the very on-demand character of the guarantee which makes him vulnerable to honour the beneficiary upon simple demand. My empirical research illustrates vulnerability or situational disadvantages of applicants under which demand guarantees have been called unfairly:152

(a) The industry participants were of the view that even in circumstances where there was full or partial performance of the underlying contractual obligations the applicant is vulnerable to honour a demand for the full amount under the guarantee. Issuer 1 explained this scenario as follows:

‘For example when 90% of the work under the project is complete the beneficiary calls on the guarantee for the full amount alleging that performance under the contract is not satisfactory or the beneficiary terminates the contract without a proper evaluation of the performance and subsequently claim for the full amount on the guarantee which I think is an unfair demand.’ (Issuer 1)

(b) The industry participants were of the view that even in circumstances where non-performance or delay in performance of the underlying contract was due to factors beyond the control of the applicant, such as natural disasters, unavailability of a particular material that caused the delay in construction or supply of the export items the applicant is vulnerable to honour the beneficiary’s demand under the guarantee. Issuer 5 shared industry experience to explain this scenario:

‘Our bank issued a counter-guarantee (payable on-demand) to a Pakistani buyer who has entered into a contract with a Sri Lankan Government Body (applicant) whereby the applicant had to deliver a ship to the buyer (beneficiary of the guarantee) on or before 28th December 2004. However, just two days before this due date of delivery of the ship, the coastal belt was hit by a Tsunami (I am referring to the Indian Ocean earthquake and Tsunami in 2004). Consequent to this natural disaster our customer

152 See finding (2) read with conclusions (2) and (4) of my qualitative research discussed in chapter four.
could not deliver the ship. The overseas buyer made a claim on the performance guarantee, which we believe was an unfair claim.’ (Issuer 5)

However, the very nature of the on-demand guarantee makes the applicant vulnerable to honour a demand under the guarantee even in circumstances where he is placed at a situational disadvantage in the guarantee market. If the beneficiary makes a demand simply to take unfair advantage of a situational disadvantage of the applicant, such a demand for payment is unconscionable and therefore can appropriately be described as an unconscionable demand under the guarantee.

**Harsh or oppressive insistence on strict legal rights to take unfair advantage of vulnerability**

As one commentator said ‘relationships, whatever their type, inevitably give to one or both parties the *de facto* capacity to affect adversely the interests of the other. Expectations can be thwarted, obligations ignored, vulnerability exploited, legitimate interests disregarded, powers exercise harshly, and so on.’¹⁵³ Hence, equity’s underlying criterion which has long been identified in equity jurisprudence to grant relief against unconscionable conduct is that ‘a person should not be permitted to use or insist upon his legal rights to take advantage of another’s special vulnerability or misadventure for the unjust enrichment of himself’.¹⁵⁴

This criterion – the insistence upon rights in circumstances which make that insistence harsh or oppressive, describes another link to defining unconscionability in the context of demand guarantees. In the demand guarantee context, the unconscionability lies in the insistence of the beneficiary’s right under the on-demand guarantee to demand payment, in circumstances where it amounts to an abuse of that right. For instance, the Supreme Court of Victoria in *Olex Focas*,¹⁵⁵ stated that:

> Even if one is acting within one’s rights one may still engage in unconscionable conduct: *Stern v McArthur* (1988) 165 CLR 489 at 527. It must therefore follow that

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¹⁵³ Finn, above n 131, 95.
¹⁵⁴ *Stern v McArthur* (1988) 81 ALR 463, 489 (Deane and Dawson JJ); See Clarke et al, above n 126, 130 [35.5.420] which states that ‘the unconscionability lies in the insistence on strict legal rights in circumstances where to do so is considered to be contrary to equity and good conscience because of the hardship which would thereby be caused to the other party’; Unconscionability in this context has many other applications (such as estoppel, relief from penalties and forfeiture etc); See also Parkinson, above n 126, 39-42.
¹⁵⁵ *Olex Focas* (1998) 3 VR 380,403 (Batt J).
even if one believes, wrongly, that one is acting within one’s rights, one can thereby engage in unconscionable conduct.

To my mind the first defendant’s conduct based on its legal rights, or on its perception of its legal rights, so far as that conduct relates to the mobilisation or procurement advance guarantees is, according to ordinary human standards, quite against conscience. I am bound to say that I regard it as unconscionable.156

Thus, in determining an appropriate definition of unconscionable conduct in the context of demand guarantees, Batt J cited with approval the definition that had been provided in an academic article entitled ‘The Notion of Unconscionability’:157 ‘the insistence upon rights in circumstances which makes that harsh or oppressive’ which causes ‘hardships to others “by violating their reasonable expectations” is a form of unconscionable conduct in equity.’158 Based on Batt J’s reasoning it can be argued that if the beneficiary’s conduct in calling under the guarantee amounts to a harsh or oppressive insistence on his right to payment on-demand, such conduct can be treated as unconscionable and therefore the demand for payment is unconscionable. It can be argued that, this form of unconscionable conduct which imposes a restriction upon a party’s entitlement to insist upon his strict legal rights, is founded upon concepts such as good faith and fair dealing in contracts, and has also been referred to in the Singaporean cases discussed above.159 Similarly, s 22(2) of the Australian Consumer Law which has set out a list of principles that are relevant to an identification of unconscionable conduct in commercial transactions has identified that the court may have regard to the extent to which the parties have acted in good faith,160 and the extent to which the parties have complied with concepts of fair-play, fair-dealing and with any industry codes of conduct.161 It should be noted that good faith as a statutory indicia for determining unconscionability under s 22(2) of the Australian Consumer Law does not provide the basis of determining unconscionability under s 20(1) of the Australian Consumer Law.162 This means that Australian courts have wider powers under s 22(2) to apply notions of good faith and

156 Ibid 405.
157 Patrick Parkinson, ‘The Notion of Unconscionability’ in Philip Clarke and Patrick Parkinson (eds), The Laws of Australia (Lawbook, Sydney 1993) [8].
158 Ibid.
159 See generally the cases discussed above; Note also the German Civil Code that contains general provisions relating unconscionability imposes (under Paragraph 242) a duty to perform contracts in good faith, having regard to good business mores.
160 See Australian Consumer Law s 22(2)(l).
161 Ibid ss 22(2)(g),(h).
162 See above the distinction between the jurisdiction under s 20(1) and that under s 22.
fair dealing in a variety of commercial transactions to determine whether the alleged conduct is unconscionable.\textsuperscript{163}

In this regard it should be noted that although fair dealing is a standard of conduct required by the principle of good faith,\textsuperscript{164} the terms ‘good faith and fair dealing’ are often combined in their usage:\textsuperscript{165}

In many civil law systems, and perhaps in most legal systems outside the common law world, the law of obligations recognises and enforces an overriding principle that in making and carrying out contracts parties should act in good faith. This does not simply mean that they should not deceive each other, a principle which any legal system must recognise; its effect is perhaps most aptly conveyed by such metaphorical colloquialisms as “playing fair”, “coming clean”, or “putting one’s cards face upwards on the table”. It is in essence a principle of fair open dealing.\textsuperscript{166}

On this view, whilst good faith does require compliance with a standard of honesty, it does not mean honesty simpliciter, but rather, suggests compliance with a

\textsuperscript{163} Note that Finn refers to good faith and fair dealing as a central idea in the contractual theme of unconscionability. He states that: ‘to the extent that it regulates the actions of parties to a contract in the exercise of their rights, equity at present is acting, in my view, as a herald to our acceptance of a more general implied contractual duty of good faith and fair dealing in contract performance;’ See Finn, ‘Unconscionable Conduct’ above n 131, 47.

\textsuperscript{164} One of the notions underlying the principles of good faith is that it comprises standards of fair dealing in the performance and enforcement of contracts. As one commentator notes good faith embraces three notions – first an obligation on the parties to cooperate in achieving the contractual objects (loyalty to the promise itself). secondly, compliance with honest standards of conduct and thirdly, compliance with standards of conduct which are reasonable having regard to the interests of the parties; Elizabeth Peden, ‘The Meaning of Contractual Good Faith’ (2000) 116 Law Quarterly Review 235 citing Anthony Mason, ‘Contract, Good Faith and Equitable Standards in Fair Dealing’ (2000) 116 Law Quarterly Review 66

\textsuperscript{165} See, eg, United States Uniform Commercial Code s 2-103(1)(b) which defines good faith as ‘honesty in fact and the observance of reasonable commercial standards of fair dealing’; Australian cases have similarly combined the concepts of good faith and fair dealing; See Jeannie Paterson, ‘Good Faith in Commercial Contracts? A Franchising Case Study’ (2001) 29 Australian Business Law Review 270, 274.

standard of conduct known as fair dealing. In the demand guarantee context it then becomes relevant to consider whether the beneficiary has acted in ‘good faith’ and complied with concepts of fair-play, fair-dealing in the insistence of his strict right to payment under the guarantee.

Overall, the criteria for defining unconscionability that has been adopted in the context of on-demand guarantees are based upon the protection of the vulnerable applicants against the beneficiaries’ unfair advantage taking in the enforcement of guarantees. The theory of exploitation also lends weight to an argument that demands under on-demand guarantees should be restrained in the event of unconscionability as described above.

**The theory of exploitation**

The literature on the general theory of exploitation provides different perspectives or accounts of this theory depending on the discipline (economics, philosophy, law) in which it is rooted. However, as will be shown in the analysis that follows, the core notion across all these accounts of exploitation remains constant: exploitation involves unfair advantage taking of another for one’s own advantage and that unfairness (therefore wrongfulness) in the advantage taking is an inherent feature of the theory of exploitation. Drawing upon this intrinsic feature of the theory of exploitation this thesis argues that unconscionability on the part of the beneficiary calling under the demand guarantee is a wrongful exploitation which calls for judicial intervention. Wertheimer’s work, which defends exploitation from a moral

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167 In this regard Paterson notes that ‘the minimum content of the duty of good faith is generally agreed to require honesty from contracting parties; Jeannie Paterson, ‘Duty of Good Faith: Does It Have a Place in Contract Law?’ (2000) Law Institute Journal 48.

168 See, eg, Alan Wertheimer, *Exploitation* (Princeton University Press, 1996); Wertheimer’s account of exploitation refers to situations where both the exploiter and the exploited gains from the transaction and that the exploited is harmed by the transaction or he gains less than he should (‘mutually advantageous exploitation’); See also Wertheimer’s analysis of exploitation of student athletes and commercial surrogacy which illustrates the elements of his account of exploitation; Ibid 77-96, 96-123; See also Alan Wertheimer, ‘Exploitation and Commercial Surrogacy’ (1996) 74 Denver University Law Review 1215 <http://heinonline.org/libraryproxy.griffith.edu.au/HOL/Page?handle=hein.journals/denlr74&collection=journals&page=1215>.

169 See, eg, Robert Goodin, ‘Exploiting a Situation and Exploiting a Person’ in Andrew Reeve, *Modern Theories of Exploitation* (Sage Publications, 1987) 166, in which Goodin argues that to exploit people is to wrong them, however, much or little they may lose or you may gain from the act.

170 See, eg, Rick Bigwood, *Exploitative Contracts* (Oxford University Press, 2003) in which he explicates a concept of ‘legal contractual exploitation’ which concerns a form of wrongdoing that defines exploitation in the procurement or acceptance of a contract bargain transaction. Note that this account of exploitation draws significantly upon philosophical analyses of exploitation (e.g. Goodin).
perspective (that is, to commit an act of exploitation is to commit a wrong), is a useful guide to understanding the constituent elements of the theory of exploitation:

At least one criterion for a valid exploitation claim will turn out to be a moral criterion: a transaction is exploitative only if it is unfair... A exploits B when A takes unfair advantage of B. Taking unfair advantage could be understood in two ways. First, it may refer to some dimension of the outcome of the exploitative act or relation, and this it seems has two elements: (1) the benefit to A, and (2) the effect on B. We may say that the benefit to A is unfair because it is wrong for A to benefit at all from his or her act or because A’s benefit is excessive relative to the benefit to B. Second, to say that A takes unfair advantage of B may imply that A has been able to turn some characteristic of B or some feature of B’s situation to his or her advantage.171

Wertheimer sees exploitation as ‘taking unfair advantage’ which involves two scenarios: first, taking unfair advantage can be seen in a defective distribution of the total outcome or benefits (that is, an unequal distribution of benefits) that flows from a mutually advantageous transaction;172 second, taking unfair advantage can be seen in circumstances where one person to the transaction takes advantage of a characteristic of the other party to the transaction or some characteristic of his situation in relation to the transaction. It should be noted that Wertheimer calls this exploitation ‘mutually beneficial exploitation’ and ‘consensual exploitation’.173

The idea of taking advantage is central to Goodin’s analysis of the general notion of exploitation:

The general notion of “exploitation” always consists in a certain sort of behaviour in a certain sort of situation. The nub of the matter is invariably taking advantage in one way or another. Exploiting a situation amounts essentially to “taking advantage” of some peculiar features of that situation. Exploiting a person similarly involves taking advantage of some peculiar features of that person or less elliptically, it amounts to taking advantage of some peculiar features of the situation in which exploiters and the

171 Wertheimer, above n 168, 16; see also Joel Feingberg, Harmless Wrongdoing (Oxford University Press, 1990)179.
172 Cf Goodin, above n 169,181 in which he argues that ‘the essence of exploitation must be sought in some characteristic of the process, rather than in some characteristic of the end results. There the ‘unfairness’ lies in the process rather than in the end result.’
173 The idea behind mutually beneficial exploitation is that the exploited gains from the transaction but disproportionately or exorbitantly less than exploiter gains; Wertheimer, above n 168, 16.
exploited find themselves, where the situation is defined so as to include a description of both personal characteristics and impersonal circumstances.\textsuperscript{174}

Whilst Wertheimer’s account of exploitation involves unfair advantage taking from a mutually beneficial transaction, Goodin’s account of exploitation seems to place emphasis the characteristic of advantage taking in particular features of situations and persons. Whilst exploiting a situation (such as crop failures, natural disasters) is to take advantage of the peculiar features of that situation, exploiting a person is to take advantage of the peculiar features of that person and/or the peculiar features of the circumstances or situations in which he finds himself. With reference to this latter form of exploitation, Goodin states that ‘built into the concept of exploiting a person is a notion of “unfairness” (of taking unfair advantage) which is out of place in talking of our treatment of mere situations’.\textsuperscript{175} Goodin’s account of exploiting a person closely resembles the equitable theme that unconscionable conduct in the context of demand guarantees may arise from an exploitation of vulnerability arising from a situational disadvantage: The beneficiary who makes an unconscionable demand is taking unfair advantage of the on-demand character of the guarantee or the situational disadvantage of the applicants which is essentially what Goodin in his analysis of exploitation has described as a ‘turn to advantage’ or ‘mak[ing] use of’ a favouring circumstance.\textsuperscript{176}

Goodin’s account of the theory of exploitation identifies four situations in which it is inappropriate to play for advantage: (i) it is wrong to play for advantage against other players who have renounced playing for advantage themselves; (ii) it is wrong to play for advantage against other players who are unfit or otherwise unable to play in games of advantage at all; (iii) it is wrong to play for advantage against other players who are hopelessly outmatched in terms of bargaining power; and (iv) it is wrong to play for advantage against other players when the relative advantage derives from others’ grave misfortunes.\textsuperscript{177} These situations can also be identified as situations of vulnerability and can arguably be extended to demand guarantees. As in situation (i), the applicants who procure guarantees payable on-demand of the beneficiaries can be seen as parties who have at least partly ‘renounced playing for advantage themselves’. As in situation (ii), the applicants of demand guarantees can be seen as

\textsuperscript{174} Goodin, above n 169,167.
\textsuperscript{175} Ibid.
\textsuperscript{176} Ibid 168.
\textsuperscript{177} Ibid 185-86.
parties ‘unable to play in games of advantage’ not for reasons of constitutional
disadvantage, but for reasons of their situational disadvantage in the guarantee
market. This element can be linked with situation (iii). If the beneficiary of the
guarantee possesses a relatively superior bargaining position in the guarantee market
it is wrong for him to play for his advantage by calling on the guarantee in
circumstances where it is unconscionable to do so; or as in situation (iv), it is wrong
for the beneficiary to play for his advantage specially when that advantage flows from
the situational disadvantage on the part of the applicants owing to changes in
circumstances – e.g., non-performance or delay in performance due to severe weather
conditions, shortage of material necessary for the manufacture/supply of items to the
overseas buyer.

Bigwood speaks to this element of vulnerability when he states that ‘all acts of
exploitation begin with a plaintiff’s peculiar vulnerability’.\textsuperscript{178} He states that:

What is objectionable about exploitation is that a defendant (exploiter) chooses,
freely and knowingly, to benefit from the relative position of power resulting from
such vulnerability, and that the defendant’s (exploiter’s) gain, results from that
power...To be sure exploiter is guilty of disregarding the weaker party’s interests
primarily as a means to pursuing his or her own.\textsuperscript{179}

Here Bigwood appears to suggest that the relative position of power resulting
from vulnerability is what makes an interaction exploitative and that the benefits
accrue to the exploiter is a result flowing from the relatively superior position of that
power.\textsuperscript{180} Bigwood refers to situations of vulnerability or disadvantage, as

\textsuperscript{178} Rick Bigwood, ‘Undue Influence: Impaired Consent or Wicked Exploitation’ (1996) 16 Oxford
Journal of Legal Studies 503, 509.
\textsuperscript{179} Ibid 509-10.
\textsuperscript{180} A similar account of exploitation can be found in John Hill’s Exploitation in which he states that:
Exploitation is sometimes viewed as a function of social disparity, an endeavour on the
offeror’s part, to take advantage of a socially superior position. Marxists, feminists and others
argue explicitly or implicitly that a prerequisite of the exploitative relationship is that the
offending party possess some social advantage over the victim...Exploitation merely requires
the taking advantage of some vulnerability of the other party;
<http://www.lawschool.cornell.edu/research/cornell-law-review/volume-79-number-3.cfm>; Note that
Hill’s argument is that ‘exploitation’ is a psychological rather than a social or an economic concept in
the context of surrogate parenting arrangements, voluntary organ sales and consensual medical
experimentation of prisoners.
‘exploitable circumstances’ that attract equitable relief against unconscionable dealings:

Thus in its modern context the gist of the jurisdiction lies in the abuse of a superior bargaining position and not simply with the notion of inequality of bargaining power...In other words, relief is dependent precisely upon ‘exploitation by one party of another’s position of disadvantage in such a manner that the former [can not] in good conscience [insist on] the benefit of the bargain’.

On this view, a party with superior bargaining position insisting on the benefits of the bargain in circumstances where it amounts to unconscionable advantage taking of a position of disadvantage of the other, is a form of unconscionable dealing. Bigwood identifies this form of unconscionability as conforming to ‘victimization’ or ‘exploitation’ in consensual relations.

Arguably, a form of vulnerability or situational disadvantage of the applicants and relatively superior bargaining position of the beneficiaries are common features of the demand guarantee market. The very nature of the on-demand guarantee makes applicants vulnerable to honour a demand under the guarantee that does not accompany the proof of default. Therefore the beneficiary’s unconscionable conduct in calling the guarantee falls within the realm of exploitation of vulnerability of the applicants or their situational disadvantage in the guarantee market. One should also bear in mind that unconscionable conduct of a beneficiary calling on the demand guarantee is concerned with a unique kind of vulnerability of applicants. Arguably, what is characteristically vulnerable about the victims of unconscionable demands is that they are parties who have “at least partly” renounced playing for advantage themselves, by agreeing to issue a guarantee payable on-demand or ‘unable to play in games of advantage’, because for reasons of competitiveness in the market they

181 Bigwood, above n 170.
182 Ibid 234.
183 Ibid 237; See also Rick Bigwood, ‘Ill-gotten Contracts in New Zealand: Parting Thoughts on Duress, Undue Influence and Unconscionable Dealing-Kiwi-style?’(2011) 42 Victoria University of Wellington Law Review 83
<http://search.informit.com.au.libraryproxy.griffith.edu.au/fullText;dn=091073258933968;res=IELHS S> in which he states that ‘I take it as axiomatic that exploitation is not an accidental or merely causal process of victimization, but rather involves something deliberate on the part of the stronger party: that the superior party acted either purposely or with reckless disregard for the known special vulnerability of the claimant, intentionally turning, actively or passively, the claimant’s relative characteristics or circumstances to his, the superior party’s, own ends’; Ibid 97.
184 Goodin, above n 169,185.
185 Ibid.
simply had no choice but to agree to procure a guarantee payable on-demand. A beneficiary who is making an unconscionable demand on the guarantee is thus ‘taking an unfair advantage’ of the very nature of on-demand guarantees and hence the vulnerability of the applicants as well. This ‘unfairness’ in the advantage taking of the power and/or opportunity is what turns this conduct to a ‘wrongful exploitation’ that calls for judicial intervention.

Can exploitation occur when both parties to the contract benefit? On this point, it is appropriate to consider whether the very nature of on-demand guarantees makes such contracts exploitative and therefore should be prohibited in the guarantee market. In this inquiry one would ask, first, can it be seriously wrong for a beneficiary (for example, an overseas buyer) of an on-demand guarantee to engage in a mutually advantageous and consensual transaction with an applicant (for example an exporter of goods)? Secondly, is the applicant wrong in allowing the beneficiary to take advantage of an unfair situation in the market? Arguably, on-demand guarantees are mutually advantageous contracts. They give the beneficiary security for non-performance, late performance or defective performance of the applicant under the underlying contract and the applicant in return benefits from securing the underlying contract in a competitive market. Considering the high risk of engaging in a contract with an unknown applicant, the beneficiary may argue that it is not unfair for him to require that the guarantee should be payable on his demand without proof of default. If the applicant has consented to the guarantee being payable on-demand of the beneficiary, then, in the absence of ‘unfair advantage taking of unfairness,’ it can not be argued that the on-demand guarantee is an exploitative contract or that by entering into such contracts the beneficiary is engaging in an act of exploitation of the applicant of the guarantee.

Therefore, an argument can be made that on demand guarantees are not inherently exploitative, but unconscionable demands under them are. A beneficiary who requires the applicant to provide an on-demand guarantee is merely ‘taking advantage of an unfair background situation’ in the guarantee market. Particularly in a

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186 Note that conclusion (4) of my qualitative research discussed in chapter four indicates that due to the competition in the market to secure the underlying contract, the applicants in the Sri Lankan guarantee market (especially those in the medium and small scale business) are compelled to procure demand guarantees in favour of the beneficiaries.

187 See also Wertheimer’s analysis of ‘Exploitation of Student Athletes’ in Exploitation, above n 168, 77-95.
competitive market where applicants compete with each other to secure the underlying contract with overseas beneficiaries, the applicants no doubt would agree to the terms of the beneficiary. The relatively weaker bargaining position of the applicants in negotiating on-demand guarantees is an ‘unfair situation’. But it is not wrong for the beneficiary of the guarantee to take advantage of this situation, by requiring that the guarantee be payable on his demand without proof of default. However, such advantage taking does not harm the applicant, rather both the applicant and beneficiary maximizes their interests-gains from the underlying contract. If the applicant consents to the issue of on-demand guarantee to the beneficiary it is inappropriate to condemn the beneficiary for taking advantage of this opportunity. Therefore, it can not be said that these on-demand guarantees are ‘instruments of exploitation’ of applicants in the guarantee market. Hence, it is argued that the reason on-demand guarantees are permitted and enforced is they are considered as mutually advantageous and consensual transactions between commercial parties.

Coming back to the fundamental argument that unconscionable demands under on-demand guarantees are a form of wrongful exploitation, it is apposite to consider the moral objections to such exploitative conduct in the guarantee market. In this context it is worth noting Goodin’s comments that ‘an act of exploiting a person always constitutes a wrong’.\(^\text{188}\)

The wrongfulness of exploiting people is presumably connected, somehow, to its unfairness. After all, only one thing has changed in shifting from the exploitation of things to the exploitation of persons: the qualifier “unfair” has been added to the general formula of “exploitation= taking advantage”. It is in this notion of unfairness that the source of our moral objections to the practice of exploitation is most naturally sought.\(^\text{189}\)

Goodin claims that a moral objection to exploitative conduct is founded upon the wrongfulness or unfairness of the alleged advantage taking. It is wrong to use the vulnerability of people or their situations in certain ways. He attempts to explicate the notion of unfairness by reference to game analogy. To quote Goodin: ‘Fair play is play according to the formal rules and informal ethos of the game. Unfair play is play at variance with those standards. “Taking unfair advantage”, seen in this light, would

\(^{188}\) Goodin, above n 169, 173.  
\(^{189}\) Ibid 174.
consist in availing oneself of strategic opportunities which are denied to one under the rules of ethos of the game at hand.\textsuperscript{190} Therefore, what qualifies as wrongfulness or unfairness of the advantage taking can be determined by the context in which the parties have conducted themselves.

Hence, in the context of demand guarantees, it would be appropriate to impose on the parties a moral responsibility to comply with the accepted standards of conduct in business relationships. This would in turn impose a moral responsibility on the part of the beneficiary to refrain from making unconscionable demands under the guarantee. It is argued that it is morally wrong for the beneficiary of a demand guarantee to behave in an overly self-interested manner through taking unfair advantage of the applicant’s vulnerability even if the parties have agreed that the guarantee is payable on-demand without proof of default, and even if the underlying contract was mutually advantageous. When the beneficiary of the demand guarantee is in a strong position vis-a-vis the applicant, those circumstances impose upon the beneficiary (the stronger party) a moral responsibility to behave in a particular manner.\textsuperscript{191} Hence, the unconscionable conduct on the part of the beneficiary calling on the guarantee is a violation of his moral responsibility toward the applicant which gives a moral reason for the law’s intervention.\textsuperscript{192} The moral reason is that such conduct violates the accepted standards of behaviour (such as fair dealing) of a person who possesses a relatively superior position in the guarantee market.

**Conclusion**

In view of the grounds upon which demands under on-demand guarantees can be restrained in Singapore and Australia, an argument has been made that not only fraudulent but also unfair advantage taking of vulnerability in the enforcement of on-demand guarantees – which is a form of unconscionable conduct – falls within the scope of unfair demands. Such defining criteria encompass a broad spectrum of call

\textsuperscript{190} Ibid 183.

\textsuperscript{191} Note that Goodin in his book *Protecting the Vulnerable: A Reanalysis of Our Social Responsibilities*, argues that the power possessor has an obligation to adhere to the standard canons of decent treatment of others who are vulnerable to his power; See Robert Goodin, chapter five, *Protecting the Vulnerable: A Reanalysis of Our Social Responsibilities* (University of Chicago Press, 1985) 109.

\textsuperscript{192} Wertheimer argues that ‘at least one of the truth conditions of an exploitation claim is itself explicitly moral; a transaction is exploitative only when it is unfair’; Wertheimer, above n 168, 278.
scenarios which applicants would seek to claim as unfair. In this definition ‘fraudulent demands’ involving a lack of honest belief constitutes just one type of unfairness. Hence, the criterion for defining fraudulent demands under Sri Lankan law (which follows the English common law) does not fully encapsulate the scope of unfair demands under on-demand guarantees.

In order to appreciate unconscionability, a type of unfair demands, this chapter delved into a conceptual analysis of unconscionability and its relevance to the enforcement of demand guarantees. The starting point of the conceptual analysis of unconscionable demands under on-demand guarantees was a discussion of the cases and statutory provisions that initially sparked the inclusion of unconscionable conduct as a ground for restraining demands under on-demand guarantees in Singapore and Australia. Placing the cases into a historical context proved useful in identifying the evolution of this concept and how it has been developed over time as a ground for judicial intervention in the enforcement of on-demand guarantees. Whilst Singaporean courts have recognised unconscionability as a concept that entails conduct ‘so reprehensible or lacking in good faith’ and that such conduct represents just one type of ‘unfairness’ which depends on the facts of each case, the Australian courts in reliance on statutory unconscionability (that is, the unconscionable conduct provisions in the *Australian Trade Practices Act 1974* (Cth) which was recently superseded by the *Australian Consumer Law*) and underlying judge-made law, have applied its meaning in equity. Hence it was necessary to explore the meaning of this concept in equity. Drawing upon the relevant equity jurisprudence it was argued that two criteria in equity, namely, ‘exercise of superior power to take an unfair advantage of vulnerability or situational disadvantage’ and ‘harsh or oppressive insistence on strict legal rights to take an unfair advantage of vulnerability or situational disadvantage’ are helpful in defining the concept of unconscionable demands under on-demand guarantees.

Hence, the central argument in the ensuing chapters is that the Sri Lankan law needs to recognise unconscionable conduct as a type of unfair demands, and that therefore as a separate ground from that of fraud for the court’s intervention to

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193 Note that the applicants (as well as financial institutions) participated in my qualitative research opined that a demand for payment under the guarantee is unfair not only when fraud is involved but also when the beneficiary makes a call to take an opportunistic advantage in the guarantee market; See qualitative research finding (2) in chapter four.
restrain beneficiaries from making demands under on-demand guarantees. This would include circumstances which make that conduct an unfair advantage taking of vulnerability or situational disadvantages of applicants or harsh or oppressive insistence on the strict legal right to payment in circumstances that conduct amounts to an unfair advantage taking of vulnerability or situational disadvantages of applicants in the guarantee market.

Focussing on the relevance of the underlying criteria of unconscionability to a broader concern with the theory of exploitation, it was argued that unconscionable demands under on-demand guarantees are a case of wrongful exploitation and that that provides for a strong justification for judicial intervention in the enforcement of on-demand guarantees. However, this chapter did not argue that on-demand guarantees should be prohibited or rendered unenforceable because they represent an ‘unfair situation’ in the guarantee market. Rather, if these guarantees are mutually advantageous and accepted by applicants in a competitive market, they should be accepted and enforced.

In the course of these arguments, a distinction was made between ‘taking advantage of unfairness or misfortune’ and ‘taking unfair advantage’. The beneficiaries who secure on-demand guarantees are merely ‘taking advantage of an unfair situation’ (such as their relatively superior bargaining position, the on-demand character of the guarantee and so forth) in the guarantee market. Therefore, it is not wrong or unfair for the beneficiaries to enter into mutually advantageous transactions with the applicants. And it does not follow that just because beneficiaries of on-demand guarantees are ‘taking advantage’ of a background injustice or unfairness in the guarantee market that these beneficiaries are ‘taking an unfair advantage’. However, the beneficiaries who make unconscionable demands under on-demand guarantees are ‘taking an unfair advantage’ of the vulnerability of applicants in the guarantee market. Therefore, unconscionable conduct on the part of the beneficiary calling under the guarantee amounts to a wrongful exploitation of the applicants.

Thus, the arguments under the theory of exploitation highlighted a more general point: unconscionable demands essentially involve wrongful, harsh or at least an unacceptable, exercise of legal rights and an unfair advantage taking by the beneficiaries over the applicants of on-demand guarantees. Therefore, the principle
aim of prevention of unconscionable demands under on-demand guarantees is to protect the allegedly exploited applicants of on-demand guarantees and thereby ensure fairness and fair dealing in the guarantee market.
Chapter Three- Unfair Demands in Sri Lankan Litigation

Introduction

This chapter examines the adequacy of Sri Lankan law to combat unfair advantage taking on the part of the beneficiary calling under a demand guarantee. For the purpose of this examination, I will revisit a line of judicial decisions of the Sri Lankan courts rendered over a span of nearly two decades, which reiterate the principles that the courts must apply while considering the question of restraining the beneficiary’s demand under a demand guarantee.¹ The Sri Lankan courts have consistently followed English common law principles in matters relating to demand guarantees and they are now well entrenched in the common law of the country. Through this case law analysis I seek to establish that fraud as defined in common law,² provides the sole basis upon which the beneficiary would be prevented from calling on a demand guarantee, and that the Sri Lankan courts have adopted a very stringent application of this rule.

I will then delve into the courts’ justification for the limited scope for judicial intervention in the enforcement of demand guarantees: the commercial usage of demand guarantees and the need to safeguard the reputation and international standing of financial institutions.³ Drawing on critiques on this topic in Singapore and Australia I will examine whether these justifications should stand in cases where the beneficiary’s demand falls short of fraud but is an unfair and opportunistic advantage taking which is a form of unconscionable conduct, as recognised in Singaporean and Australian laws. Through this analysis I will argue in favour of equitable intervention to restrain the beneficiary’s unfair and opportunistic advantage taking in the enforcement of on-demand guarantees, thus expanding legal intervention in the enforcement of demand guarantees in Sri Lanka.

² For a conceptual analysis of fraudulent demands, see chapter two.
Next, I will examine whether a balance of interests can be achieved under the current status quo in Sri Lanka. On this point, I will argue that the result of the current approach is that the law is weighted heavily in favour of the beneficiary of on-demand guarantees and the banking community. The applicant who procures the guarantees has limited protection against unfair demands by the beneficiary when the guarantees are given in on-demand form. It is not easy for the applicant to get the courts to intervene if a call on a guarantee is made unfairly.\(^4\) Rather, fraud has to be shown, and even if there is fraud, to present a convincing case may prove to be impossible due to the nature of the evidence required to establish a fraudulent demand.\(^5\)

My fundamental argument in this chapter will be that the current legal position has created a protection gap and has thereby shown its inadequacy in combating the problem of beneficiary’s unfair and opportunistic advantage taking conduct in the enforcement of on-demand guarantees. Drawing on the critiques and judicial pronouncements behind the decision of the Singaporean courts to adopt unconscionability as a ground for judicial intervention in the enforcement of demand guarantees, I will argue that there are somewhat similar, if not identical, issues currently confronted by the Sri Lankan courts.

Finally, I will argue that imposing restrictions on unconscionable conduct will be a useful step toward regulation of unfair and opportunistic advantage taking in the guarantee market, as this type of activity, promotes trading declines and depresses activity in that market.\(^6\) The theoretical literature on insider trading – the illegal use of non-public information to gain an unfair advantage over less informed investors – will provide support for this argument. It will be argued that as in the case of insider trading, unconscionable conduct and hence unfairness in the guarantee market could lead to an erosion of confidence and a decline of trade activity in the guarantee market.

Thus, this chapter in its entirety will serve as an examination of the adequacy of the Sri Lankan common law to effectively address unfair calls under on-demand guarantees; the rationale of the current law and the manner in which the current law

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\(^4\) For an analysis of the scope of unfair demands, see chapter two.

\(^5\) Note that the inadequacy of the current legal system to provide relief against opportunistic advantage taking in the enforcement of demand guarantees has led to financial difficulties for many exporters and contractors in Sri Lanka; See qualitative research results in chapter four.

\(^6\) See Rodrigo, above n 3.
has created a protection gap and failed to combat unfair and opportunistic advantage taking in the enforcement of on-demand guarantees; the necessity and utility of recognising unconscionability as a separate ground from that of fraud for restraining unfair and opportunistic advantage taking in the enforcement of demand guarantees; and the economic significance of avoiding unfair and opportunistic advantage taking and hence unfair trade activities in the guarantee market.

**The Sri Lankan common law position**

The phenomenon of the beneficiary calling under a demand guarantee has been the subject of commercial litigation in Sri Lanka over two decades. The objective of this section is to examine the cases that have come before the Sri Lankan courts, which illustrate the nature of these calls under on-demand guarantees. For the purpose of this examination I have chosen appellate court decisions that fairly represent the full range of demand guarantee cases that have gone before these courts, in which the applicants have attempted to restrain the beneficiaries calling under these guarantees. This case law analysis will illustrate that the appellate courts in Sri Lanka have firmly established that fraud on the part of the beneficiary, known to the financial institution, has been accepted as the sole ground for injunctive relief to block payment under on-demand guarantees. This approach represents a strict adherence to English common law principles.  

The courts of first instance in Sri Lanka do seem inclined to take a more generous approach in granting preliminary injunctions restraining the beneficiary

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7 Note that fraud refers to the common law definition of fraud; See chapter two; For an analysis of the concept of fraud as the only justification for blocking payment on bank guarantees in various jurisdictions, see generally Roeland F. Bertrams, Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions (Kluwer Law, 3rd revised ed, 2003).

8 The Ordinance titled Introduction of Law of England No. 5 of 1852 as amended by Ordinance No. 17 of 1944 introduced into Sri Lanka the English law to be observed in all commercial matters. Section 3 thereof states that:

> In all questions or issues which may hereafter arise or which may have to be decided in Sri Lanka with respect to the law of…banks and banking…the law to be administered shall be the same as would be administered in England in the like case, at the corresponding period, if such question or issue had arisen or had to be decided in England unless in any case other provision is or shall be made by any enactment now in force in Sri Lanka or hereafter to be enacted.

By virtue of this provision, the courts have been following the English law in matters relating to bank guarantees which comes under ‘banks and banking’. It is also to be noted that this provision free the Sri Lankan courts from relying on the application of English common law, if a new provision ‘is or shall be’ enacted. Nevertheless, this chapter will demonstrate that the Sri Lankan courts have been slow to depart from the English common law position and in fact shown a strict adherence to English decisions relating to restraining of demands under demand guarantees.
calling under a demand guarantee. As set out in s 54 of the *Judicature Act*, these preliminary injunctions are awarded only for a period of two weeks to allow the applicant to take proper action, such as bringing sufficient evidence before court to establish a clear case of fraud. A review of the relevant decisions that I have discussed below indicates that applicants have succeeded in obtaining *ex parte* preliminary injunctions restraining beneficiaries calling under demand guarantees but a majority of them have been discharged upon *inter partes* hearings or on appeal. It appears that the difference in the two stages is due to the difference in the procedure involved: when the applicant alleges fraud in an *ex parte* hearing the courts often tend to accept the alleged fraud subject to the applicant adducing evidence of fraud at the *inter partes* hearing, if he or she wishes to obtain a permanent injunction. The *ex parte* hearing is followed by an *inter partes* hearing where all parties are represented and the *ex-parte* order is reviewed in light of the evidence. In *inter partes* hearings the applicant often fails to satisfy ‘a clear case of fraud’ on the part of the beneficiary calling on the guarantees and therefore fail to obtain permanent injunctions. I will highlight this aspect later in this chapter when I discuss the burden of proof applicable to fraudulent demands and again in chapter four when I discuss the findings of my qualitative research.

In *Indica Traders Pte Ltd v Seoul Lanka Construction Pte Ltd*,<sup>9</sup> and *Hemas Marketing Pte Ltd v Chandrasiri*,<sup>10</sup> the Court of Appeal comprehensively discussed the principles governing when a call on a demand guarantee can be restrained. *Indica Traders* was a revision application from an order of the District Judge of Colombo issuing an injunction restraining payment on an advance payment guarantee,<sup>11</sup> and a performance bond. The facts relevant to this application are briefly as follows. Seoul Lanka was a construction company which entered into a contract with Indica Traders for the construction of a multi-storeyed shopping and residential complex in Colombo. Pursuant to this contract Seoul Lanka provided an advance payment guarantee for two million Rupees furnished by the People’s Bank, guaranteeing to pay back the advance payment and a performance bond issued by Ceylinco Insurance Co.

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<sup>9</sup> (1994) 3 SLR 387 (‘*Indica Traders*’).
<sup>10</sup> (1994) 2 SLR 181 (‘*Hemas Marketing*’).
<sup>11</sup> Note that an advance payment guarantee is supplied by a party receiving an advance payment to the party advancing the payment. It provides that the advanced sum will be returned if the agreement under which the advance was made cannot be fulfilled: *Business Dictionary* <http://www.businessdictionary.com/definition/advance-payment-bond.html>.
as security for the due performance of all terms and conditions under the construction contract.

A dispute arose between the parties which resulted in termination of the underlying contract and Indica Traders making a demand on the advance payment guarantee. The two primary matters that came up for consideration in this appeal were:

(a) whether the contract for construction entered into between Seoul Lanka and Indica Traders was wrongfully terminated by Indica Traders or whether it was terminated by Seoul Lanka; and

(b) whether the demand on the guarantee had been made without any basis and fraudulently as alleged by Seoul Lanka.

With regard to the second matter, Seoul Lanka argued that in the circumstances the claim made by Indica Traders was fraudulent. The fraud alleged was based on the fact that the advance payment in respect of which the bank guarantee was furnished had already been fully recovered as against the bills submitted by Seoul Lanka. The Court of Appeal was not prepared to go into the issue of breach of the underlying contract, which in the opinion of the court would disturb the long respected autonomy principle that demand guarantees should be honoured upon simple demand without having to prove the default under the underlying contractual performance.12 Focussing on the issue of fraud, the Court of Appeal reiterated the principles enunciated in the famous English case of Edward Owen Ltd v Barclays International Bank,13 and the subsequent decision in Bolivinter Oil S.A. v Chase Manhattan Bank,14 which adopted a similar approach. The Court of Appeal cited in verbatim what Lord Denning had said in the Edward Owen case:

A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof

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12 See generally Raymond Jack, Ali Malek and David Quest, Documentary Credits – The Law and Practice of Documentary Credits Including Standby Credits and Demand Guarantees (Butterworths, 3rd ed, 2001); See also Queensland Full Court in Burleigh Forest Estate Management Pty Ltd v Cigna Insurance Australia [1992] 2 Qd R 54.
13 [1978] QB 159 (‘Edward Owen’).
14 [1984] All ER 351, 352 (‘Bolivinter Oil’).
or conditions. The only exception is when there is a clear fraud of which the bank has notice.\textsuperscript{15}

This statement suggests that the Sri Lankan courts would respect the on-demand character of the guarantee and hence, intervene in the enforcement of such guarantees only in cases of clear fraud. The then President of the Court of Appeal, Silva J. stated that the law on this aspect was settled in the brief and cogent judgment of Sir Donaldson MR in the case of \textit{Bolivinter Oil}. The Court of Appeal then quoted passages from the judgment of Donaldson MR: ‘The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made which may thereafter be made will clearly be fraudulent. But the evidence must be clear, both as to the fact of fraud and as to the bank’s knowledge.’\textsuperscript{16} Applying fraud as the exceptional ground for restraining payment on a demand guarantee, the Court of Appeal went on to explain its scope and ambit in these words:

A mere plea of fraud put in for the purpose of bringing the case within this exception and which rests on the uncorroborated statements of the applicant will not suffice. An injunction may be granted only in circumstances when the court is satisfied that the bank should not effect payment. Therefore, an injunction may be granted on the ground of fraud only where there is clear evidence as to: the fact of fraud and the knowledge of the bank as to the facts constituting the fraud.

In any event, a default or a violation of a contract or even the receipt of an overpayment do not constitute fraud. Fraud as contemplated in the exception stated above carries a far more serious connotation. It is such fraudulent conduct on the part of the beneficiary as would strike at the very root of the transaction and vitiate the bond, guarantee or letter. The allegation of the plaintiff taken at its highest falls far short of this requirement.\textsuperscript{17}

On this judicial pronouncement, the Court of Appeal in strict adherence to English legal principles would intervene only in established cases of fraud which in the opinion of the courts is a ‘serious connotation,’ and that they would not intervene where the conduct of the beneficiary in calling under the guarantee falls short of fraud. I argue that this adherence to English legal principles will not provide justice to

\textsuperscript{15}\textit{Indica Traders} (1994) 3 SLR 387, 396.
\textsuperscript{16} Ibid 397.
\textsuperscript{17} Ibid 398.
the applicant in circumstances where the beneficiary’s call on the guarantee is an unfair advantage taking of vulnerability of the applicant – a form of unconscionable conduct as defined in chapter two – though it may not amount to a clear case of fraud in common law. The Court of Appeal’s approach to burden of proof of fraudulent demands also emphasises the English approach that a heavy burden rests on the applicant to establish a fraudulent demand: the burden rests on the applicant to establish the fact of fraud and the knowledge of the bank as to the facts constituting the fraud.

The limited scope for judicial intervention in the enforcement of demand guarantees was unanimously adopted by Justices Ranaraja and S.N. Silva in the case of Hemas Marketing. The Court of Appeal reiterated the English law principles relating to fraudulent demands under bank guarantees. The issue in the Hemas Marketing case arose in relation to an agreement that Hemas Marketing had entered into with Chandrasiri, wherein the latter’s company Erandis was nominated as the agent for the re-distribution of some of the export-products of Hemas. Erandis had procured two bank guarantees as security for their performance under the underlying contract. Erandis, on its part, was unable to pay for the goods supplied by Hemas on time. Erandis entered into a settlement agreement with Hemas to pay the sums due on the goods delivered. A few days later, Hemas Marketing terminated the underlying contract, requested Erandis to hand over the stocks in their custody to another agent and demanded payment on the bank guarantees.

It was argued that the conduct of Hemas Marketing in demanding payment under the bank guarantees could not be reconciled with their having entered into a settlement agreement just days before; as the facts indicated, within a few days of the settlement agreement and despite the fact Erandis had paid sum of Rs 286, 312.22 under the settlement agreement, Hemas had terminated the distribution agreement, appointed another agent and made a demand under the guarantee. However, the Court of Appeal was guided by the principles set out in Edward Owen. The court held that no allegations of actual fraud had been proven against Hemas Marketing for demanding payment on the bank guarantees.

18 Note that fraud refers to the common law definition of fraud; See chapter two.
20 Ibid 186-7.
Intertec Contracting A/S v Ceylinco Seylan Development Ltd,\textsuperscript{21} once again affirms the application of English law principles in restraining the beneficiary calling under a demand guarantee. Intertec contracted to carry out certain construction work for Ceylinco and as security for the performance of the construction work furnished a demand performance guarantee from the People’s Bank. A dispute arose between Intertec and Ceylinco with respect to the construction work which resulted in Ceylinco making a demand under the performance guarantee. The Court of Appeal reviewed the decision of the primary court that refused to grant an injunction restraining Ceylinco or the People’s Bank. Noting that the primary court had relied on English law principles and in particular the principles set out in Edward Owen and the Sri Lankan Court of Appeal decision in Indica Traders, Udalagama J. stated that:

Perusing an authority cited by the learned Counsel for the 1st defendant-respondent, namely, Edward Owen Engineering Ltd v Barclays Bank International Ltd referred to above which authority was also relied on by the learned District Judge, I would with approval concur with Lord Denning when he observed therein that:

“A bank which gives performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relation between the supplier and the customer nor with the question whether the supplier had performed his contractual obligation or not, nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand if so stipulated, without proof or condition. The only exception is when there is a clear fraud of which the bank has notice.”\textsuperscript{22}

This judicial pronouncement further strengthened the common law position that Sri Lankan courts will continue to follow the criteria for restraining the enforcement of demand guarantees as pronounced in the English courts and consistently followed by the Sri Lankan appellate courts with utmost fidelity.

The subsequent decision of the Court of Appeal in Nestle Lanka Ltd v Ribya Teas Ltd and National Development Bank of Sri Lanka,\textsuperscript{23} also confined the restraint of bank guarantee demands to cases of established fraud. Nestle Lanka was an exporter of the products of Ribya Teas. In order to provide security for the performance of Nestle Lanka, Ribya Teas had requested that Nestle Lanka furnish a bank guarantee to

\textsuperscript{21} (2002) 2 SLR 246.
\textsuperscript{22} Ibid 251.
\textsuperscript{23} [2002] CA 461 (22 January 2004) (‘Nestle Lanka’).
the value of three million rupees. At the instance of Nestle Lanka their Bank had issued an unconditional bank guarantee, payable on demand, for three million rupees. Subsequent to Nestle Lanka performing under the said agreement disputes arose between them and Ribya Teas which culminated in Ribya Teas calling under the demand guarantee. The District Court issued the interim injunction sought by Nestle Lanka in its claim to prevent Ribya Teas from demanding payment upon the bank guarantee. Ribya Teas appealed.

In emphasising the applicable legal principles, the Court of Appeal followed the rationale in *Indica Traders* and *Hemas Marketing* and reiterated that an injunction should be granted only on the ground of fraud in circumstances where the court is satisfied that there is clear evidence as to the fact of fraud and the knowledge of the bank as to the facts constituting that fraud. The applicant in this case was unsuccessful in maintaining the interim injunction, as the evidence did not amount to a clear case of fraud.

There has since been before the Court of Appeal the case of *Colombo Municipal Council v KPC Builders Pte Ltd and Bank of Ceylon*. This is another judgment which justified confining the availability of injunctions restraining calls under demand guarantees to cases of fraud. The brief facts of the case are: The KPC Builders entered into a contract with the Municipal Council of Colombo for the construction of a housing scheme at Church Street, Colombo. According to the terms of the contract, KPC Builders had to provide security for their performance for which the National Insurance Corporation issued a performance bond. Additionally KPC Builders was to provide a bank guarantee as security for the advance payment made to them. Accordingly, their bankers, Bank of Ceylon, issued a bank guarantee in favour of the Municipal Council of Colombo. Both guarantees were the products of the construction contract. Though works commenced and advance payment was made by the Municipal Council, works on the site were abruptly terminated and KPC Builders alleged that they were compelled to terminate the contract due to the fault of the Municipal Council. The Municipal Council then required the Bank of Ceylon, the bankers of KPC Builders to pay the full amount on the bank guarantee. Thereafter, the contractors filed an action in the District Court and obtained an injunction preventing the Bank of Ceylon from paying any money to the Municipal Council on the bank guarantee.

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24 Ibid.
guarantee. The question the Court of Appeal was called upon to determine was whether the KPC Builders were entitled to an injunction restraining the payment on the bank guarantee. Speaking for the Court of Appeal, Rohini Perera J reiterated the legal position as being that, ‘the Guarantee in this case was a demand guarantee which had to be honoured on a simple demand. The Court will not grant an injunction unless the demand was tainted by fraud and the bank had knowledge of the fraud.’ The Court of Appeal noted that the applicant in this case failed to meet the ‘established case of fraud’ on the part of the beneficiary calling under the guarantee and overturned the earlier decision of the primary court:

Such a bank guarantee is effectively as valuable as a promissory note and is intended to affect the “tempo” of the party’s obligations...On an application for an injunction, it is, therefore, not pertinent that beneficiary may be wrong to have claimed the bank guarantee because the Court would be frustrating the “commercial purpose” of the bank guarantee.

On this view, the courts will not grant an injunction unless the demand under the guarantee was tainted by fraud. The justification for this lies in the commercial objectives of a demand guarantee. It is argued that this decision reinforces the position that the Sri Lankan courts are reluctant to intervene in the enforcement of demand guarantees unless there is established fraud on the part of the beneficiary calling under the guarantee and the bank had knowledge of the fraud. It is likely that fraud as recognised in common law will remain the principal tool upon which demands under on-demand guarantees can be restrained in Sri Lanka.

**Rationale behind the Sri Lankan approach**

I argue that the approach of the Sri Lankan courts in adopting a limited scope for judicial intervention is based on two key grounds: the commercial utility of demand guarantees and the reputation of the financial institutions that issue demand guarantees. Hence my objective in this section is to undertake a critical examination of these two grounds as rationales or justifications for the current legal position in Sri

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26 Ibid.
27 Ibid.
Lanka. In the course of this analysis I will question the validity of these grounds in cases where the beneficiary’s conduct in calling under the guarantee falls short of fraud but is clearly an unfair advantage taking in the enforcement of the guarantee – a form of unconscionable conduct.

**Commercial utility**

As one commentator said ‘demand guarantees are seen by the commercial community as “iron-clad securities”,’\(^\text{28}\) apparently meaning that the main role of this instrument is to offer security to the beneficiary in the event of non-performance, or late or defective performance, but without having to prove the default under the underlying contract.\(^\text{29}\) These demand guarantees operate as instruments subject to prompt and inevitable payment if the beneficiary makes demands on them. This inevitability and reliability is the reason for this instrument being referred to as equivalent to ‘cash in hand’.\(^\text{30}\) The Sri Lankan courts have recognised this commercial utility of demand guarantees as a rationale for the limited scope for judicial intervention in the enforcement of demand guarantees. For example, in *Indica Traders* the Court of Appeal considered the demand guarantee in question as ‘virtually a promissory note payable on-demand’;\(^\text{31}\) in the case of *Hemas Marketing* the Court of Appeal treated

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\(^{30}\) See, eg, Donaldson and Ackner JJ in *Intraco Ltd v Notis Shipping Corporation of Liberia* (1981) 2 Lloyd’s Rep 256, 257 (‘The Bhoja Trader’) stated that, ‘thrombosis will occur if, unless fraud is involved, the courts intervene and thereby disturb the mercantile practice of treating rights there under as being equivalent to cash in hand’; Similarly, Lord Denning in *State Trading Corp Ltd v ED & F Man (Sugar) Ltd* [1981] Comm LR 235 stated that: ‘I may say that performance bonds fulfill a most useful role in international trade…The courts must see that these performance bonds are honoured’; In the Australian case of *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443,457, Stephen J observed the significance of demand guarantees operating as an instrument similar to cash in hand: Once a document of this character ceases to be the equivalent of a cash payment, being instantly and unconditionally convertible to cash, it necessarily loses acceptability. Only so long as it is “as good as cash” can it fulfill its useful purpose of affording to those to whom it is issued the advantages of cash while involving for those who procure its issue neither the loss of use of an equivalent money sum nor the interest charges which would be incurred if such a sum were to be borrowed for the purpose. Being “as good as cash” in the eyes of those to whom it is issued is essential to its function.

See also Charles Debattista, ‘Performance Bonds and Letters of Credit: A Cracked Mirror Image’ [1997] *Journal of Business Law* 289, 289 where the author makes an opening remark that it has become a truism to say that a performance bond is the equivalent of cash in hand.

\(^{31}\) See *Indica Traders* (1994) 3 SLR 387, 396.
the demand guarantee as ‘means of payment equivalent to cash in trade and commerce’; and in Colombo Municipal Council the Court of Appeal once again emphasised the commercial purpose of demand guarantees and indicated that the court’s intervention in the enforcement of these guarantees might prove dangerous to their continued use in international trade and the construction industry. In view of this judicial reasoning, any argument to expand the grounds upon which payment on demand guarantees can be restrained under Sri Lankan law is likely to be subject to a fair amount of criticism. In the Australian and Singaporean contexts, there is a line of authority that examines the conflict between commercial utility of demand guarantees and the expansion of judicial intervention in restraining payment under demand guarantees. Some of these commentaries are examined below.

One commentator, Bill Dixon, writes in relation to the effect of judicial intervention in the enforcement of demand bank guarantees and in particular the highlights of the decision of Austin J in Boral Formwork and Scaffolding Pty Ltd v Action Makers Ltd (admin apptd) To explore whether bank guarantees and unconditional performance bonds should continue to be accepted in lieu of cash retentions, he examines both common law and statutory grounds upon which enforcement of such instruments can be restrained. The fraud exception, restrictions arising from the terms of the underlying contract, and statutory unconscionability are the three main grounds identified and analysed by Dixon. He notes that the operation of common law and statutory interventions in the enforcement of demand guarantees is reflective of the judicial balancing of risk between the parties concerned. However, Dixon is of the view that the uncertain, and potentially broadening, operation of both the common law and statutory grounds may significantly curtail the use of bank guarantees and unconditional performance bonds as cash equivalents. He argues that bank guarantees are not necessarily as good as

32 See Hemas Marketing (1994) 2 SLR 181, 186; See also Nestle Lanka [2002] CA 461 (22 January 2004) wherein the Court of Appeal justified the limited court intervention on the ground of commercial utility of the guarantee.


35 [2003] NSWSC 713 (‘Boral’).

36 Dixon, above n 34.

37 Ibid 406; Note that his discussion is based on the Australian Trade Practices Act 1974 (Cth) ss 51AA, 51AC which was superseded as the Australian Consumer Law (Competition and Consumer Act 2010 (Cth) sch 2) ss 20, 22.

38 Ibid.

39 Ibid.
cash due to the common law and statutory interventions in the enforcement of such instruments.\textsuperscript{40} This thesis argues that Dixon’s emphasis on the function of the demand guarantee ‘as good as cash’ and his suggestions to maximise the protection available for the beneficiary, reflects a failure to appreciate the commercial reality that there could be circumstances under which beneficiary attempts to take unconscientious advantage of the unique commercial value of the instrument and that judicial intervention in those circumstances is not necessarily a threat to the security instrument operating ‘as good as cash’.

Another commentator, Agasha Mugasha in his article entitled ‘Enjoining the beneficiary’s claim on a letter of credit or bank guarantee’,\textsuperscript{41} observes that the grounds for enjoining payment on a bank guarantee, are slowly increasing in number and that this trend seems inevitable. With reference to unconscionability, which falls short of fraud as a ground for issuing an injunction restraining a demand under a bank guarantee, Mugasha argues that both Australian and Singaporean courts did not appreciate that the recognition of equitable intervention in cases of unconscionability was eroding the practical force of the demand guarantees.\textsuperscript{42} He goes on to state that some courts, in order to dispense justice have applied the law in a way that would in the long run weaken the commercial utility of these security instruments.\textsuperscript{43} In his conclusion, Mugasha states that:

The law and practice of letters of credit and bank guarantees is rule oriented and there is limited scope for ideals such as fairness, justice or conscience as we understand them in everyday life. Instead, the instruments are based on commercial policy and efficiency considerations that demand their prompt honour...These instruments are mercantile specialities that require the courts and all the users to appreciate that deviations from the special rules that govern them destroys the instruments themselves and may lead to the industry shunning them.\textsuperscript{44}

These remarks not only over-emphasise the commercial policy and efficiency considerations of demand guarantees in favour of the beneficiary, but also offer strong opposition to any argument to extend judicial intervention in the enforcement of

\begin{itemize}
\item \textsuperscript{40} Ibid 395.
\item \textsuperscript{41} Agasha Mugasha, ‘Enjoining the Beneficiary’s Claim on a Letter of Credit or Bank Guarantee’ [2004] Journal of Business Law 515.
\item \textsuperscript{42} Ibid 520.
\item \textsuperscript{43} Ibid 532.
\item \textsuperscript{44} Ibid 537.
\end{itemize}
demand guarantees. However, it is argued that Mugasha has failed to appreciate that law has a limited role to play in commercial considerations and that limited judicial intervention to prevent misuse of the commercial value of the guarantee may equally destroy the popularity of the instrument among applicants who procure them as security for their contractual performance.

Similarly, Adrian Wong argues that the recognition of equity’s intervention in the enforcement of demand guarantees in Singapore (e.g. in *GHL Pte Ltd v Unitrack Building Construction Pte Ltd*, *Raymond Construction Pte Ltd v Low Ya Tong* and *Min Thai Holdings Pte Ltd v Sunlabel Pte Ltd*), is insupportable on principle because it conflicts with the cardinal principles of the law of performance bonds; the cash in hand principle and the sole exception of fraud as a ground for injunctive relief. Wong states that these cardinal principles are inextricably linked to one another and must be upheld concurrently in order for the performance bond to be functional as well as useful to mercantile practice. With reference to the commercial utility of bank guarantees, Wong argues that if the courts take a liberal approach in restricting the payment or receipt of moneys under a performance bond, as long as the circumstances demand it, the commercial purpose of the performance bond, particularly, the cash in hand principle, will be totally frustrated. Wong’s commentary provides strong support for the school of thought that opposes an expansion of judicial intervention in the enforcement of demand guarantees, based on the commercial utility and commercial considerations of demand guarantees.

There is, however, some support for the expansion of judicial intervention in the enforcement of demand guarantees. For example, Mathew Bisley and James Mok analyse the recognition of equitable intervention in restraining the beneficiary calling under a demand guarantee. In particular, these two authors examine the development in Australia of unconscionable conduct under the *Trade Practices Act 1974* (Cth) which was recently superseded as the *Australian Consumer Law (Competition and Consumer Act 2010)* (Cth) which provides a ground for

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48 Ibid 193.
equitable intervention. They explain that the courts’ intervention has previously been available only in limited circumstances, which are mainly where a demand under the payment instrument involves fraud or forgery.\(^{50}\) However, they point out that the two Australian cases, *Olex Focas Pty Ltd v Skodaexport Co Ltd*,\(^{51}\) and *Boral* have determined that statutory unconscionability is another ground for judicial intervention in the enforcement of guarantees. Bisley and Mok argue that this development of the law should not be a cause for concern about the reliability or usefulness of payment instruments because the development of this area of law in other jurisdictions (for example, the United States of America, which considers fraud to include equitable fraud) has not undermined the commercial value of such instruments.\(^{52}\) They conclude that, ‘the introduction of a new exception to the autonomy of payment instruments in Australia is not unprecedented...Just as the development of the fraud exception has proved not to significantly undermine the commercial value of payment instruments,\(^{53}\) the new development of law in Australia that recognises equitable intervention will not significantly undermine the commercial value of demand guarantees.

Alexei Fedotov\(^{54}\) argues that the abuse of demand guarantees by beneficiaries can pose a serious risk to the effectiveness of these instruments in international trade and that the traditional rules relating to the fraud exception have demonstrated their inability to combat this problem.\(^{55}\) The alternative he suggests is an ‘exception encompassing equitable fraud or more specifically unconscionability.’\(^{56}\) He justifies the expansion of the interpretation of fraud in common law:

> Introduction of the unconscionability exception is justified from a doctrinal point of view by the analysis of the developments in the fraud rule in various jurisdictions around the world. Concepts similar to unconscionability have not always been excluded from the ambit of fraud exception. Since demand guarantees are international instruments, it is logical to develop national laws uniformly with international principles.\(^{57}\)

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50 Ibid.
51 (1998) 3 VR 380 (‘*Olex Focas*’).
52 Bisley and Mok, above n 49, 212.
53 Ibid.
55 Ibid 50.
56 Ibid.
57 Ibid.
It appears that on this view, the analyses that justify the recognition of fraud as a ground for judicial intervention – such as public policy considerations, can be extended to analyses supporting unconscionability. With respect to the functions of demand guarantees, Fedotov states that the appropriateness of grounds upon which courts intervene must be viewed in terms of the functions of demand guarantees and how they balance the interests of the parties involved.58 He argues that ‘for demand guarantees to remain commercially popular, it must be essential to protect the parties against abuse.’59 The essence of Fedotov’s argument is that the commercial popularity of demand guarantees is based on the faith of its users and that if the abuse of these security instruments is not curtailed and unconscionable demands are allowed to flourish in the guarantee market, their commercial popularity among applicants will fade.

In a recent commentary, Kelry Loi argues that intervention to prevent payment under performance guarantees in circumstances where the demand under the performance guarantee was abusive, will not adversely affect international trade.60 By reference to commercial utility of performance guarantees he states that ‘confidence in, and utility of, commercial instruments such as performance guarantees cannot possibly be promoted by habitual judicial enforcement of unconscionable payment demands made under oppressive circumstances.’61 In other words, by allowing unfair and opportunistic advantage taking in the enforcement of demand guarantees, and hence allowing unconscionable demands, the courts can not be said to promote the commercial utility of, or the confidence placed in, the security instrument. By way of further reasoning in favour of the recognition of unconscionability as an additional ground for relief (apart from fraud) Loi states that ‘just as the courts will not countenance the law and the court’s own offices being perverted into instruments of fraud the courts will likewise not allow the law or its offices to become instruments of unconscionable conduct.’62

This thesis contends that the scholarly writings that argue for a narrow scope for exceptions to the enforcement of demand guarantees in accordance with the

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58 Ibid 77.
59 Ibid.
61 Ibid 509.
62 Ibid 511.
English common law provide the justification for the ‘commercial utility’ argument enshrined under Sri Lankan law. However, it is argued that by doing so, the Sri Lankan law has failed to appreciate the problems with which the applicants of demand guarantees are faced. I will examine these problems below and will further illustrate them through my qualitative research.

This thesis argues that the commercial objectives of a demand guarantee will not be defeated if the courts are to restrain unfair and opportunistic advantage taking in the enforcement of on-demand guarantees. As regards the on-demand guarantee operating as a security device and ‘as good as cash’, it seems appropriate that a court might even restrain an unfair and opportunistic advantage taking in the enforcement of on-demand guarantees which amounts to an unconscionable demand for cash payment. It is argued that the beneficiary will merely lose the immediate opportunity to turn the demand guarantee into cash-in-hand, which could hardly be viewed as a catastrophic occurrence. If the court decides to lift the preliminary injunction the damage will simply be the loss of use of the guarantee ‘as good as cash’ for a short period and could be compensated for under an undertaking as to damages. If the injunction is maintained and in effect its issue is justified, the beneficiary has no ground to complain. Therefore, it is argued that the Sri Lankan courts as well as some commentators have wrongly assumed that an expansion of the scope of judicial intervention will pose a threat to the commercial value of on-demand guarantees, and in effect have discouraged an expansion of the grounds upon which a demand for payment can be restrained, on an illusory basis. The proponents of the commercial utility of demand guarantees have failed to appreciate that unfair and opportunistic advantage taking in the enforcement of on-demand guarantees and hence unconscionable demands do indeed exist in commercial practice and in such cases equity should prevail over the commercial utility of the instrument that the parties bargained for in their contract.

**Financier’s reputation**

Ordinarily, on-demand guarantees are drafted in a manner that requires the financial institutions that issue them to make payment when demanded, without requiring the beneficiary to prove the default under the underlying contract. The judicial response to demands under these guarantees in Sri Lanka, which follows an approach similar to that of the United Kingdom, is that the issuer should be allowed to honour its financial
commitments to the beneficiary so as to ensure that there will be no effect on the issuer’s ‘reputation for financial and contractual probity.’

However, when the beneficiary’s demand is fraudulent and the bank has knowledge of the fraudulent demand, the law in those jurisdictions requires that the issuer avoids payment. If the issuer wishes to dishonour the payment obligation they need strong evidence of the fraud committed by the beneficiary. As noted by the English Court of Appeal in Montrod Ltd v Grundkotter Fleischvertriebs GmbH, it is not for a financial institution to make its own inquiries about allegations of fraud. Given that the financial institutions have no duty of inquiry and generally wish to safeguard their reputations, it is very unlikely that they, on their own investigations, would refuse to honour the demand of a beneficiary.

As mentioned earlier, the judgements of the English courts that have been consistently followed in the Sri Lankan courts emphasise the need to safeguard the international reputation of financial institutions that issue demand guarantees. This assumption that restraining a financial institution from paying on the guarantee might risk the financial and contractual probity of the institution has become enshrined in judicial thinking. The classic statement of Donaldson MR, in which the English

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63 See Bolivinter Oil [1984] 1 Lloyd’s Rep 251.
See also Dixon above n 34 for a view that an action of this type would generally have extremely limited prospects of success.
65 [2002] 3 All ER 696 [58].
66 Note that my qualitative research (discussed in chapter four) amply demonstrates the attitude of the financial institutions that issue on-demand guarantees in Sri Lanka. The financiers participated in my research stressed that they do not have an obligation to investigate the nature of the beneficiary’s demand and that their obligation is to pay upon a simple written demand; See finding (1) discussed in chapter four.
67 Note that in Tukan Timber Ltd v Barclays Bank PLC [1987] 1 Lloyd’s Rep 171, 214 the House of Lords said that:

The reputation of Barclays depends on strict compliance with its obligations...the machinery of irrevocable obligations assumed by banks is essential to international commerce. Unless such commitments by banks can be honoured, trust in international commerce could be irreparably damaged;

Similarly, Kerr J said in Harbottle v National Westminster Bank Ltd [1977] 2 All ER 862, 864-66 (‘Harbottle’):‘The bank had given its own guarantee and in effect pledged its own credit to the Egyptian bank to pay on demand. Its reputation depends on strict compliance with its obligations. This has always been an essential feature of banking practice’; See also Howe Richardson Scale Co Ltd v Polimec-Cekop and National Westminster Bank [1978] 1 Lloyd’s Rep 161(‘Howe Richardson’); Edward Owen (1978) 1 All ER 976.
68 See Bolivinter Oil [1984] 1 Lloyd’s Rep 251.
courts reiterated the need to protect the reputation of financial institutions that issue demand guarantees, has often been cited in the Sri Lankan Judgments.69

The unique value of such a letter, bond or guarantee is that the beneficiary can be completely satisfied that, whatever disputes may thereafter arise between him and the bank’s customer in relation to the performance or indeed existence of the underlying contract, the bank is personally undertaking to pay him provided that the specified conditions are met. In requesting his bank to issue such a letter, bond or guarantee the customer is seeking to take advantage of this unique characteristic. If save in the most exceptional cases, he is to be allowed to derogate from the bank’s personal and irrevocable undertaking, given be it again noted at his request, by obtaining an injunction restraining the bank from honouring that undertaking, he will undermine what is the bank’s greatest asset, however large and rich it may be, namely its reputation for financial and contractual probity. Furthermore, if this happens at all frequently, the value of all irrevocable letters of credit and performance bonds and guarantees will be undermined…The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which may thereafter be made will clearly be fraudulent. But the evidence must be clear both as to the fact of fraud and as to the bank’s knowledge. It would certainly not normally be sufficient that this rests on the uncorroborated statement of the customer, for irreparable damage can be done to a bank’s credit in the relatively brief time which must elapse between the granting of such an injunction and an application by the bank to have it discharged.70

It is argued that this judicial pronouncement is too extreme. It overstates the importance of protecting the reputation of financial institutions which issue demand guarantees. It focuses on one dimension of reputation – reputation for honouring the beneficiary’s demand. Hence, it fails to appreciate the financier’s reputation with the applicant of the guarantee. According to Donaldson MR, and under English law, any injunction restraining the issuer, however motivated, undermines the reputation for ‘financial and contractual probity’. The only challenge that is substantial, Donaldson MR said, is where the ‘bank knows that any demand for payment already made or which may thereafter be made will clearly be fraudulent’. Arguably, this statement is an exaggeration of the danger to reputation of financial institutions for paying out on

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69 See generally the Sri Lankan Court of Appeal judgments discussed above.
70 Bolivinter Oil [1984] 1 Lloyd’s Rep 251, 352.
demand guarantees and a critical re-examination of the current Sri Lankan law that follows this legal position is overdue.

Again this position was evident in *United Trading Corp SA v Allied Arab Bank*. Ackner LJ made similar observations but went on to state the likelihood of exaggeration of the policy considerations in favour of the banking community:

While accepting that letters of credit and performance bonds are part of the essential machinery of international commerce (and to delay payment under such documents strikes not only at the proper working of international commerce but also at the reputation and standing of the international banking community), the strength of this proposition can be over-emphasised. It can not be in the interests of international commerce or of the banking community as a whole that this important machinery that is provided for traders should be misused for the purpose of fraud.

Thus, in the above statement, Ackner LJ expressed concern over the over-emphasis of the importance of international commerce and reputation and standing of the international banking community. He went on to support this statement by drawing comparison between the narrow scope for intervention under English law with that of the liberal interventionist approach under American law. By reference to American cases that recognise the grant of temporary injunctions on the ground of strong suspicion of fraud not just in clear cases of fraud, Ackner concluded that ‘this more liberal approach...had not resulted in commercial dislocation.’

As at present, in Sri Lanka, all that the financial institutions will have to show is that unless they honour their contractual obligations their reputation as issuers of such instruments will be at risk. The only circumstance in which the financial institutions are not entitled to defend their interests on the basis of damage to reputation is where the beneficiary’s call is fraudulent and they had knowledge of the fraudulent demand.

Financial institutions in Sri Lanka are no doubt in favour of the present position, which makes their role in honouring demand guarantees clear and simple, although it does so possibly at the expense of some of their clients in the export and

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71 [1985] 2 Lloyd’s Rep 554 (‘United Trading’).
72 Ibid 561.
73 Ibid.
the construction industries. Therefore it is argued that the present policy of the courts to safeguard the reputation and international standing of financial institutions does not safeguard the reputation of the financial institutions with those in the export and construction industries who request the issue of these demand guarantees. To illustrate my point, could any one seriously argue that if the Sri Lankan Court of Appeal in any of the cases discussed above had allowed the grant of an injunction restraining the beneficiary calling under the guarantee (rather than restraining the issuer from honouring such demands), this would have resulted in an adverse effect on the reputation of the issuer concerned or of the Sri Lankan issuers of demand guarantees in general?

There is no empirical data which suggests that the expansion of judicial intervention in the payment obligation of financial institutions that issue demand guarantees in Singapore or Australia has damaged the reputation of those financial institutions.\textsuperscript{74} It is therefore unnecessary and undesirable to attempt to extract a particular principle for general application of ‘the damage to issuer’s reputation’ as a possible defence. If the courts are to take serious notice of such arguments it will result in judicial approval of a general presumption that bankers and other financial institutions that issue such guarantees deserve \textit{prima facie} protection against any damage to reputation with the beneficiaries. Again, this is unsupported by any legal theory or common law authority. Thus, it is argued that the reputation argument should fail in circumstances where equitable intervention of the courts becomes necessary to prevent unfair advantage taking in the enforcement of on-demand guarantees.

Overall, the analysis of the literature above demonstrated the differences in approach or emphasis regarding the tension between the following two considerations: the importance of maintaining the commercial utility of demand guarantees and financier’s reputation; and the importance of discouraging or suppressing unconscionable demands. Of course, the Sri Lankan courts’ decision to intervene in the enforcement of demand guarantees in any particular case turns upon the facts of that case. If the facts do not establish a clear case of fraud, the courts will refuse to intervene. Nevertheless, this thesis argues that due to non-legal

\textsuperscript{74} Note that the literature indicates that the experience in Germany also confirms that the international reputation of a bank is less easily subverted by limited judicial interference than has been assumed by English courts and commentators; See generally R. H. Kendall, ‘Autonomy – Performance Bonds’ [1995] \textit{Journal of Business Law} 311-14.
considerations such as financier’s reputation and commercial utility which have played a significant role in the decision making coupled with the narrow interpretation of fraud in common law, in almost all of the reported cases the applicants have failed to establish the existence of fraud in the beneficiary’s claim. In fact, up to the date of the submission of this thesis, the Sri Lankan Court of Appeal has not deviated from the established English orthodoxy. It therefore seems likely that successful applications in the Sri Lankan courts to restrain payment under demand guarantees will remain very small in number.

Problems for the applicants

This thesis argues that the Sri Lankan common law position with regard to interventions in the enforcement of demand guarantees is problematic for the applicants, at least in two respects: firstly, the courts require the applicants to satisfy a heavy burden of proof of fraud on the part of the beneficiary in calling the guarantee; secondly, applicants cannot request the intervention of courts in cases where the beneficiary’s call on the guarantee falls short of fraud, but is clearly an unfair advantage taking which amounts to unconscionable conduct. This second problem has in turn created a protection gap for the applicants of demand guarantees in Sri Lanka. Each of these problems will be considered in the light of the available literature.

The burden of proof and the problem of evidence

Sri Lankan procedural laws outline certain requirements that must be met prior to the court granting an injunction. These requirements apply equally in the case of interlocutory relief founded on fraudulent demands under demand guarantees. The common law in Sri Lanka recognises the following criteria as the burden upon the applicant, if he seeks an injunction to restrain the beneficiary calling on the guarantee:

(i) Show the probability of irreparable injury to the applicant.
(ii) Establish a clear case that the demand for payment is fraudulent and that the issuer knew of the beneficiary’s fraud, and

75 For ingredients necessary for the issue of an interim injunction see Judicature Act (Sri Lanka) s 54; See generally Mahinda Ralapanawa, Sri Lankan Cases and Materials on Injunctions (Saman and Madara Publishers, 1st ed, 1991).
(iii) Establish that the balance of convenience is in favour of the grant of an injunction (i.e. tip the balance in favour of granting an injunction). 

In relation to this criteria, it is argued that the applicant of a demand guarantee faced with an unfair call on the guarantee will have little difficulty in showing the first criterion of ‘irreparable injury’ if an injunction is not granted. For example he may argue that an unfair call will result in immediate cash flow problems for his business and that the injury to his business would be irreparable. Arguably, the biggest hurdle in relation to the second criterion is the standard required by courts in order to establish fraud on the part of the beneficiary. To succeed in his claim to stop payment on the demand guarantee, the applicant must adduce strong corroborative evidence that the beneficiary has committed an act of fraud by calling the guarantee, and that the issuer knew that the beneficiary’s demand under the guarantee was fraudulent. As argued above, the Sri Lankan courts have recognised and followed English common law principles in restraining demands under demand guarantees. This has been done by direct reference to and adoption of the decisions of the English courts. Therefore, case examples and literature that analyse the standard of proof of fraudulent demands under English law will prove useful for my analysis of the standard of proof of fraudulent demands under Sri Lankan law. I will illustrate the key judicial pronouncements in order to demonstrate the onerous task of seeking interlocutory relief based on a fraudulent demand of the beneficiary.

It appears impossible to examine the judicial pronouncements of the English courts on the standard of proof of fraudulent demands, without an initial reference to the seminal English case of Edward Owen, which has been accepted and followed in

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77 The balance of convenience has no relevance until a clear case of fraud is established; See, eg, Felix Dias Bandaranayake v The State Film Corporation (1981) 2 SLR 287, 302 (Soza J); See also Mark Hapgood, Paget’s Law of Banking (13th ed, 2007), 875; Assuming that the applicant succeeds in establishing a clear case of a fraudulent demand, an injunction will not be granted unless he satisfies the balance of convenience test, which is a part of the general requirement for an application for injunctive relief under Sri Lankan law; English courts have stated that in injunctions restraining the enforcement of demand guarantees, the balance of convenience is hopelessly weighted against the plaintiffs; See, eg, Harbottle [1977] 2 All ER 862.

78 My qualitative research identified the cash flow problem that may result from the beneficiary’s call on a demand guarantee, see finding (4) in chapter four.

79 See also Mohamed Abdel, ‘The Regulation of International First Demand Bond; A Comparative Approach’ (1989) 4 Arab Law Quarterly 95.

80 Edward Owen (1978) 1 All ER 976.
the English courts to date. By reference to the standard of proof of fraud on the part of the beneficiary calling the guarantee, the English Court of Appeal in that case stated that ‘it is certainly not enough to allege fraud; it must be “established”, and in such circumstances I should say very clearly established.’ After an examination of the evidence before them, the Court of Appeal went on to state that, ‘it may be suspicious, it may indicate the possibility of sharp practice, but there is nothing in those facts remotely approaching true evidence of fraud or anything which makes fraud obvious or clear to the bank.’ On the basis of this judgement, fraudulent conduct on the part of the beneficiary calling under the guarantee must be very clearly established at the interlocutory stage.

This approach towards the application of the fraud exception has been at the heart of several subsequent decisions in the United Kingdom, for example the statement of the English Court of Appeal in *Bolivinter Oil,* which reiterated the standard of proof set out in *Edward Owen* case:

The plaintiff has to show that his legal rights are threatened by the fraud of the beneficiary...The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which may thereafter be made will clearly be fraudulent. But the evidence must be clear, both as to the fact of fraud and as to the bank’s knowledge.

The above statement reinforces the *Edward Owen* criteria that the court would intervene to grant an injunction only in cases of fraud; and further that the applicant must bear the burden of proof, establishing a clear case of fraud on the part of both the beneficiary calling under the guarantee and the bank on the basis of its knowledge as to the beneficiary’s fraudulent demand. Similarly, the classic statement of Ackner LJ in *United Trading,* which followed the *Edward Owen* criteria states thus:

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81 See also the discussion of English cases under the section entitled ‘Defining fraudulent demands’ in chapter two.
82 *Edward Owen* (1978) 1 All ER 976 (Browne LJ).
83 Ibid (Lane LJ).
84 *Bolivinter Oil* [1984] 1 Lloyd’s Rep 251.
85 Ibid 257.
86 *United Trading* [1985] 2 Lloyd’s Rep 554; See also *Hemas Marketing* (1994) 2 SLR 181, wherein S.N. Silva J applied the test of ‘clear case of fraud’ that payment should not be paid on the letter of guarantee and bond put in suit.
The corroborated evidence of a plaintiff and the unexplained failure of a beneficiary to respond to the attack, although given a fair and proper opportunity, may well make the only realistic inference that of fraud.

We would expect the court to require strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyers…if the court considers that on the material before it the only realistic inference to be drawn is that of fraud, then the seller would have made out a sufficient case of fraud.87

This statement indicates that the applicant must provide strong corroborative evidence of the allegations of fraud and give the beneficiary an opportunity to answer the allegations made. Upon an extensive examination of the Edward Owen case, Ackner LJ reiterated that ‘the evidence must be clear, both as to the fact of fraud and as to the bank’s knowledge.’88 In light of this standard of proof the Court of Appeal came to the conclusion that the plaintiff had failed to establish this criteria.89 Ackner LJ applying this test to the facts of the case went on to state:

Have the plaintiffs established that it is seriously arguable that, on the materials available, the only realistic inference is that Agromark could not honestly have believed in the validity of its demands on the performance bonds?...We therefore conclude that, although the plaintiffs have provided, on the available material, a seriously arguable case that there is good reason to suspect, certainly in regard to some of these contracts, that the demands on the performance bonds have not been honestly made, they have not established a good arguable case that the only realistic inference is that the demands were fraudulent and that the respondents to this appeal should now be acting on this footing.90

Arguably, the general formula to be drawn from this statement is that the fraud must be very clearly established or it must be clear and obvious fraud in circumstances where there may not be another explanation which excludes fraud. In effect, this approach means that the applicant must provide corroborated evidence that the beneficiary lacks honest belief in the default under the underlying contract. At the end of the day the applicant must still show that the only realistic inference is fraud. The question also arises as to how strong that corroborative evidence needs to be.

87 Ibid 561.
88 Ibid.
89 Ibid 565.
90 Ibid 565.
However, Ackner LJ expressed his dissatisfaction with the practice of the courts that adopt ‘so restrictive an approach to the evidence required as to prevent themselves from intervening. Were this to be the case, impressive and high-sounding phrases such as “fraud unravels all” would become meaningless.’\(^{91}\) While this statement appears to open the door to a somewhat less stringent test, it has been stated in the case of *Turkiye Is Bankasi AS v Bank of China*,\(^{92}\) that ‘Ackner LJ was in no way diluting the Owen test, which I consider to be firmly established as the proper criterion in a case of this kind.’\(^{93}\)

Upon a detail consideration of the tests in *Edward Owen* and *United Trading* cases, the Court of Appeal in *Balfour Beatty Civil Engineering v Technical and General Guarantee Company Ltd*,\(^{94}\) through Waller LJ, restated the burden of proof of fraud: ‘as it seems to me, whatever the context in which Edward Owen was decided, it is authority for the proposition that the bank or surety is only entitled to refuse to pay on a bond where it has clear evidence of fraud.’\(^{95}\)

It is perhaps because of this continuous reiteration of the strict legal position that the English Court of Appeal in *Solo Industries UK Ltd v Canara Bank*,\(^{96}\) once again cautioned against over-emphasising the burden of establishing fraud. Their Lordships have observed that:

> As Neil J observed in the judgement under appeal it cannot be in the interests of international commerce or of the banking community as a whole that this important machinery that is provided for traders should be misused for the purposes of fraud…. Moreover, we would find it an unsatisfactory position if, having established an important exception to what had previously been thought an absolute rule, the Courts in practice were to adopt *so restrictive an approach* (emphasis added) to the evidence required as to prevent themselves from intervening. Were this to be the case, impressive and high-sounding phrases such as “fraud unravels all”’ would become meaningless.\(^{97}\)

\(^{91}\) Ibid.


\(^{93}\) Ibid 186 (Hirst LJ).

\(^{94}\) [2000] CLC 252.

\(^{95}\) Ibid 258.

\(^{96}\) [2001] 1 WLR 1800 (‘*Solo Industries*’).

\(^{97}\) Ibid1807.
This statement indicates dissatisfaction on the part of the Court of Appeal, with the burden of establishing fraudulent demands under performance bonds. With regard to the standard of proof of fraud, the Court of Appeal followed the guidance given in the *United Trading* case and stated that the question that needs to be answered is ‘whether it is seriously arguable that, on the material available, that the only realistic inference is that the beneficiary could not honestly have believed in the validity of its demands on the performance bonds’.98

The burden of proof of fraud set out in the *United Trading* case was more recently considered in the English Court of Appeal in *Banque Saudi Fransi v Lear Siegler*,99 (decided nearly five years ago):

In the United Trading case, this court had to consider the standard of proof required where the bank’s customer sought to obtain an injunction against the bank against making payment under a performance bond where the customer sought to invoke the fraud exception. This court held that the evidence of both the fraud and the bank’s knowledge must be clear and that the appropriate test (in relation to fraud) was whether it was seriously arguable that on the material available the only realistic inference was that the beneficiary could not honestly have believed in the validity of its demand on the performance bond.100

Pill LJ agreeing with Arden LJ reiterated that the heavy burden of proof of fraud rests on the applicant in restraining demands under on-demand guarantees:

What has to be established in the present situation at the first stage is a real prospect that fraud by the beneficiary can be proved. That means that there must be a real prospect of proving that the beneficiary could not honestly have believed in the validity of its demands on the performance bond… the contents fall well short of what would be required to demonstrate a real prospect of establishing fraud.101

On this view, the burden rests on the applicant to establish that the beneficiary lacked honest belief of the validity of his demand under the guarantee. Despite the candid dissatisfaction with the restrictive approach to the evidence required to

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98 Ibid 1812.
99 2006 WL 3910199 (‘Banque Saudi Fransi’).
100 Ibid.
101 Ibid.
establish a fraudulent demand in Solo Industries, the outcome of the more recent decision of the English Court of Appeal in Banque Saudi Fransi indicates that the English courts have not lowered the standard of proof required for fraud in demand guarantee cases and that they will continue to adhere to the burden of proof set out in United Trading case, over 25 years ago. Consequently, the Sri Lankan law that follows the English common law on this subject continues to adopt the test of ‘clear case of fraud’ or ‘only realistic inference to be drawn is that of fraud’ or ‘real prospect of proving fraud at the trial.’ The difficulty of meeting this standard of proof in the Sri Lankan courts is well demonstrated by the cases that I discussed above, where allegations of beneficiaries’ fraud was made, but as the court noted in those cases, the applicants failed in satisfying the burden of proof of fraud. Thus, it is argued that from an applicant’s point of view fraud as a ground for interlocutory relief is practically unavailable due to this heavy burden of proof of fraud.

Overall, these English cases that set out the standard of proof of fraud have been consistently and continuously followed by the Sri Lankan courts in restraining the beneficiary calling under a demand guarantee. Hence, the criteria to establish fraud under Sri Lankan law is that the evidence of fraud must be clear, both as to the fact of fraud and as to the bank’s knowledge. In other words, the applicant seeking an injunction to restrain the beneficiary must establish a clear case that the beneficiary’s demand is fraudulent. The difficulty for the applicant who seeks to prevent the payment lies in establishing the lack of honest belief on the part of the beneficiary calling the guarantee and the knowledge on the part of the bank of the beneficiary’s conduct in calling the guarantee. Arguably, it is this criterion that adds to the onerous task of pleading fraud. The judicial pronouncements cited above illustrate the unsuccessful attempts to have this mental element established.

The protection gap

The examination of case law indicated that by recognising fraud as the sole ground for injunctive relief in demand guarantee cases, the law in Sri Lanka favours commercial utility of such guarantees and the protection of the reputation of the financial institutions that issue such guarantees. On the other hand, by so doing, the law has failed to provide for situations where a demand made on the guarantee falls short of actual fraud but is clearly an unfair advantage taking that amounts to unconscionable

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102 See above the discussion of the Sri Lankan Court of Appeal decisions.
conduct. Should the Sri Lankan courts allow such unfair advantage taking in the enforcement of demand guarantees, powerless to intervene because the courts should protect the commercial utility of demand guarantees and provide protection for the reputation of the financial institutions? The Sri Lankan law is completely silent on the appropriate judicial approach to a demand made in circumstances where the conduct of the beneficiary is an unfair advantage taking that amounts to unconscionable conduct on his part.

This thesis argues that if the Sri Lankan law continues to permit unfair and opportunistic advantage taking in the enforcement of guarantees there will be a misuse of demand guarantees to the detriment of the applicants who procure them. The consequence of this gap in the law is the limited protection available for the applicant. Their interests as an important stakeholder of a demand guarantee, is placed at risk due to this inability of the law to address this situation in the guarantee market. Hence, it is argued that Sri Lankan law has created a protection gap for applicants who procure demand guarantees issued subject to this law. This gap in the law facilitates unfair demands for payment. Arguably, the only way to fill this protection gap and thereby combat unfair and opportunistic advantage taking in the enforcement of on-demand guarantees is for courts to allow a further ground for injunctive relief, namely, unconscionability on the part of the beneficiary calling the guarantee.

However, the question arises as to whether the limited protection afforded to the applicants can be justified. One could argue that the applicants of demand guarantees should have been aware of the limited protection available to them if the beneficiary decides to call on the guarantee. This appears to be a view both the Sri Lankan courts and the English courts have taken in their reluctance to intervene in the enforcement of demand guarantees unless the applicant establishes a clear case of fraud on the part of the beneficiary calling under the guarantee. Arguably, this approach has ignored the commercial reality that beneficiaries do not wish to contract unless the guarantees are payable ‘on-demand’ and that if the applicants build the risk of unfair calling into the underlying contract price it will not be commercially sound because the high price of the underlying contract will drive them out of the bidding on the underlying contract. Thus, applicants are compelled to procure on-demand

103 For an analysis of the scope of unfair demands, see chapter two.
guarantees due to the intense competition in the respective industries to secure the underlying contract. Also, it can not be said that the applicants intended to assume the risk of unconscionable behaviour because such conduct is outside the scope of their agreement. Therefore, this thesis argues that applicants of demand guarantees are not less worthy of legal protection. While accepting that applicants who procure demand guarantees should have been aware of the on-demand character of the guarantee and the accompanying risk of unfair calling on the guarantee, it cannot be accepted that the law offers the applicants a limited scope to invoke judicial intervention in those circumstances. In sum, neither the on-demand character of the guarantee, nor the commercial utility of the demand guarantee, and the damage to issuer’s reputation should be allowed to be used to justify the applicants having to accept unfair demands under these guarantees. For these reasons, it is argued that the Sri Lankan law that adopts an approach similar to that of English law remains unsatisfactory and a serious question arises as to its adequacy to protect the interests of applicants of demand guarantees.

My literature review indicates that a parallel can be drawn between the issues that I have raised under Sri Lankan law and the issues that led the courts in Singapore to adopt unconscionability as a separate ground from that of fraud restraining calls under demand guarantees.

Out of all the Singaporean decisions which speak of unconscionability as a separate ground from that of fraud, the most substantial indication of the causes behind the recognition of equitable intervention in the enforcement of demand guarantees is to be found in the landmark GHL, wherein the Justice of Appeal, LP Thean stated as follows:

We agree that performance bonds are used frequently in the construction industry; that they are provided by and to parties who deal at arm’s length; that the use of performance bonds has resulted in substantial benefits to the parties and also in savings; that the court should give effect to the intention of the parties; and that the law in relation to performance bonds should be placed on a clear and unambiguous footing so that they could be accepted by parties whether in Singapore or abroad…It should not be forgotten that a performance bond can operate as an oppressive

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104 See above discussion under ‘Commercial utility’.
105 See above discussion under ‘Financier’s reputation’.
instrument, and in the event that a beneficiary calls on the bond in circumstances, where there is *prima facie* evidence of fraud or unconscionability, the court should step in to intervene at the interlocutory stage until the whole of the circumstances of the case has been investigated. It should also not be forgotten that a performance bond is basically a security for the performance of the main contract, and as such we see no reason, in principle why it should be so sacrosanct and inviolate as not to be the subject to the courts intervention except on the ground of fraud. We agree that a beneficiary under a performance bond should be protected as to the integrity of the security he has in case of non performance by the party on whose account the performance bond was issued, but a temporary restraining order does not prejudice or adversely affect the security; it merely postpones the realisation of the security until the party concerned is given an opportunity to prove his case.  

It is argued that this statement indicates in ample measure, that in the view of Thean JA, the reasons for courts to allow unconscionable conduct as a further ground for judicial intervention in the enforcement of performance bonds are: (I) the need to stop the performance bond operating as an oppressive instrument in the guarantee market; (II) in principle there is no reason to treat performance bonds as sacrosanct and inviolate as not to be an instrument subject to court’s intervention unless there is proof of a fraudulent demand; (III) a preliminary injunction or order does not prejudice or adversely affect the commercial objectives of the guarantee, but rather, it postpones the availability of cash under the guarantee for a short period of time.

In this context it is worth noting my discussion in the previous chapter which highlighted the manner in which the Singaporean decisions suggest that fraud by itself may not be an adequate basis to grant an injunction restraining the beneficiary of a demand guarantee. As I argued in that chapter, the Singaporean courts may have been influenced by the early decision of the English courts in *Potton Homes Ltd v Coleman Contractors Ltd*, that there could be some circumstances apart from fraud when a beneficiary would be restrained from making a demand on the guarantee.  

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107 Ibid 615.
108 (1984) 28 BLR 19 (‘Potton Homes’).
109 See chapter two; Note that May LJ in his judgment in *Potton Homes* concurred with Eveleigh LJ that the defendants were entitled to demand payment of the bond and that the bank must pay. However, he did so, not on the grounds of discussion by Eveleigh LJ, of the conduct of the parties, but on the more orthodox grounds of the *Harbottle* [1977] 2 All ER 862; *Howe Richardson* [1978] 1 Lloyd’s Rep 161; *The Bhoja Trader* (1981) 2 Lloyd’s Rep 256. Therefore, as far as the English law on this matter is concerned, *Potton Homes* is merely obitur dicta.
Quentin Loh and Tang Wu in a commentary entitled ‘Injunctions Restraining Calls on Performance Bonds-Is Fraud the Only Ground in Singapore?’, have fully endorsed and supported the reasons for the recognition of unconscionability as stated by Thean JA in the GHL case. The relevant portion from the commentary reads as follows:

As any practitioner can attest to, achieving a sufficient level of proof of fraud at an interlocutory stage is very difficult except in an exceptional minority of cases. The acknowledged danger of abusive calls is the very reason why the courts should intervene even if the conduct of the beneficiary falls short of fraud but achieves such a level of unconscionability that would offend the notions of justice for a court to stand by and do nothing, fearful of a thrombosis in the market place or interrupting the life blood of commerce…The Singapore Court of Appeals recognition of the fallacy of the symmetry argument and rejection of the argument that the underlying contract is irrelevant to the performance bond under all circumstances should be welcomed. The law cannot be so straitjacketed that it is constrained to standby and watch, powerless to intervene, while an unconscionable call on a bond or a call that represents conduct which is so reprehensible or lacking in good faith that it offends all notions of justice is made.

It is argued that, Loh and Wu’s commentary expresses dissatisfaction with the inadequacy of fraud as the sole ground for courts’ intervention in the enforcement of demand guarantees. Their apparent concern was the courts’ inability to consider the circumstances that ‘fall short of fraud but achieves such a level of unconscionability that would offend the notions of justice’ as a ground for restraining the beneficiary making an ‘abusive call’ on the guarantee. These commentators have supported the recognition of unconscionability by calling the attention for the need to invoke equity in commercial transactions to restrain abusive calling of demand guarantees which in essence is to restrain the beneficiary’s exercise of bad faith or engage in opportunistic advantage taking in calling under demand guarantees.

In a recent judicial pronouncement, Chief Justice of Singapore, explained the rationale for the Singapore courts’ departure from the English position:


111 Ibid 354-58.

The Singapore courts’ rationale in applying unconscionability as a separate and independent ground for restraining a call on a performance bond (especially one given by the contractor-obligor in a building contract) is that a performance bond serves a different function from a letter of credit. The latter performs the role of payment by the obligor for goods shipped to it by the beneficiary (typically via sea or air from another country), and has been the lifeblood of commerce in international trade for hundreds of years. Interfering with payment under a letter of credit is tantamount to interfering with the primary obligation of the obligor...In contrast, a performance bond is not the lifeblood of commerce, whether generally or in the context of the construction industry specifically...yet another relevant consideration is that an excessive or abusive call can cause unwarranted economic harm to the obligor. This is particularly relevant in the construction industry, where liquidity is frequently of the essence to contractors.113

On this view, the functional and commercial reasons behind the Singapore courts’ recognition of unconscionability as a separate and independent ground from that of fraud for restraining the beneficiary calling under a performance guarantee are two fold: First, when a distinction is drawn between the functions of letters of credit and performance bonds, it can be said that, whilst letters of credit are a primary obligation of the applicant of the credit and hence ‘has been the lifeblood of international trade,’ the performance bonds are a secondary obligation of the applicant which arises in the event he defaults in the performance of the underlying contract and hence those guarantees do not serve the function of ‘the lifeblood of commerce’. Secondly, if the beneficiary is allowed to make a demand under the performance bond for a sum in excess of his loss or a demand that amounts to an abuse of the security instrument, he will gain more than what he bargained for. Moreover, if such demands are allowed it would result in economic harm to the

113 Ibid 52, 53 (Chang Sek Keong); See also Mount Sophia [2012] SGCA 28 [18] wherein the Court of Appeal quoted this statement in verbatim and went on to observe that ‘calls made in bad faith on a performance bond would result in the beneficiary receiving something that he was not entitled to, and would, instead, damage the liquidity of the obligor who would have to compensate the issuer of the bond. It was in part this concern that a performance bond could be used as an instrument of oppression that prompted the development of unconscionability, as distinct from fraud, as a ground justifying the grant of injunctions restraining a beneficiary of a performance bond from calling on that bond.’; Ibid [27].

114 Note that Chang Sek Keong CJ by reference to the English position on on-demand performance bonds first laid down by the English Court of Appeal in Edward Owen [1978] QB 159, stated that ‘Lord Denning MR, delivering the leading Judgment, held that an on-demand performance bond stood on a similar footing to a letter of credit (at 171)...In setting out the above principles, Lord Denning was obviously influenced by the well-established autonomy principle applicable to letters of credit, which he acknowledged to be the lifeblood of international trade’: Ibid 52.
applicants – especially to those in the construction industry if they are deprived of their liquidity.

It is argued that the dissatisfaction with the adherence to fraud as the sole ground for restraining the enforcement of demand guarantees, coupled with the objective of discouraging ‘abusive calls’ on demand guarantees have paved the way for the introduction of unconscionability as a ground for restraining demands under demand guarantees in Singapore. In other words, the reasons for the departure from the strict adherence to the fraud exception were the inadequacy of the fraud exception and the need to provide redress to the parties affected by a call on a demand guarantee under circumstances that fell short of fraud. Therefore, a parallel can be drawn between these problems that were sought to be redressed by the courts in Singapore and the problems encountered by the applicants under the current Sri Lankan law. The Sri Lankan cases that I discussed above amply demonstrate that the scope of the fraud as a ground for courts’ intervention is very narrow and that the beneficiaries are left free to demand under the guarantee in circumstances which fall short of fraud – such as in circumstances where the beneficiaries’ conduct in calling under the guarantee is an unfair advantage taking of situational disadvantage of applicants in the guarantee market. It is argued that these are similar if not identical issues confronted by the applicants under Singapore law that has now adopted unconscionability as a new approach to solving these problems.

**Regulating ‘unfairness’**

The preceding analysis in this chapter leads to an important question: what is the economic significance of providing relief against unfair and opportunistic advantage taking in the Sri Lankan guarantee market? This thesis argues that protection against unfair and opportunistic advantage taking that amounts to unconscionable conduct in the guarantee market is a significant step towards regulation of unfair trade activities which might promote lower volume, lead to trading declines and depress activity in the guarantee market. This argument receives support through an analogy to insider
trading activity,\textsuperscript{115} in so far as both insider trading and unconscionable behaviour in the guarantee market can be considered forms of unfair advantage taking.

Both insider trading and unconscionable conduct in the guarantee market can be seen as an unfair advantage taking of a situational disadvantage or vulnerability of a party,\textsuperscript{116} and hence an unfair trade practice, that calls for regulatory responses.\textsuperscript{117} Researchers and law-and-economic writers have argued that there exist numerous economic rationales supporting the regulation of unfair advantage taking:\textsuperscript{118} They argue that where a party expects their potential partner to take unfair advantage of

\textsuperscript{115} Insider trading occurs when an individual (‘insider’) buys or sells securities and other financial instruments on the basis of non-public information. Because the information is not publicly available the individual using such information is trying to gain an unfair advantage over the other investors in the market; see generally Colin Read et al, \textit{Insider Trading: Global Developments and Analysis} in Paul Ali and Greg Gregoriou (eds) (CRC Press, 2009); One of the key justifications for regulatory responses to insider trading is that it is unfair for the better informed investor to gain an unfair advantage over less-well informed investors; See Victor Brudney, ‘Insiders, Outsiders and Informational Advantages under the Federal Securities Laws’ (1979) 93 \textit{Harvard Law Review} 322 in which Brudney argues that the \textit{Securities Exchange Act 1934} (United States of America) justifies the regulation of insider trading because such activity is unfair to outside investors; See also Kim Sheppele, ‘It’s Just Not Right: The Ethics of Insider Trading’ (1993) 56 \textit{Law and Contemporary Problems} 123;\textsuperscript{119} Sheppele refers to the well-known book on insider trading, Henry Manne, \textit{Insider Trading and the Stock Market} (1966) 233, in which Henry Manne reported the outraged reaction of an anonymous lady law student who in a classroom discussion of this subject, stamped her foot and angrily declaimed, “I don’t care; it’s just not right.” Sheppele suggests ethics and equitable rules of disclosure as rationale for forbidding insider trading; Similarly, Schotland argues that of all participants in the stock markets, long-term investor is likely to have a sense of unfairness and thus feel less willing to continue in that stock market; See Roy Schotland, ‘Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market’ (1967) 53(7) \textit{Virginia Law Review} 1425;\textsuperscript{120} Note that more recent research concludes that regulation of insider trading has much to do with fairness considerations and with fostering public confidence and that ‘the public can justifiably be jealous if a party tries to appropriate and exploit for his own personal benefit such information that is rightfully public’; See Jeanne Schroeder, ‘Envy and Outsider Trading: The Case of Martha Stewart’ (2005) 26 \textit{Cardozo Law Review} 2023, 2051;\textsuperscript{121} Note that there exists contrary viewpoints that insider trading can be benign ; See, eg, Dennis Carlton and Daniel Fischel, ‘The Regulation of Insider Trading’ (1983) 35 \textit{Stanford Law Review} 857 in which the authors argue that insider trading contributes to informative stock prices; However, more recent literature indicates that insider trading is not desirable in that the presence of insider trading discourages outsiders (for example stock analysts) from independently generating information, leading to less informative stock prices; See, eg, Michael Fishman and Kathleen Hagerty, ‘Insider Trading and the Efficiency of Stock Prices’ (1992) 23(1) \textit{Rand Journal of Economics} 106; See also Nuno Fernandes and Miguel Ferreira, ‘Insider Trading Laws and Stock Price Informativeness’ (2009) 22(5) \textit{Review of Financial Studies} 1845 in which the authors investigate the relation between a country’s first-time enforcement of insider trading laws and stock price informativeness. Note that their findings indicate that the enforcement of insider trading laws turns some private information into public information, thereby reducing the cost of equity in emerging markets.
them the party will reduce their investment in the exchange relationship. The loss from this diminished investor confidence to the unfair advantage taking party may more than offset their trading gains.\(^{119}\) This argument suggests that taking unfair advantage can discourage investment and hence regulation might be necessary to foster confidence in markets. Other discussions that favour regulation of unfair advantage taking argue that such advantage taking can depress participation and liquidity,\(^{120}\) and that such advantage taking tends to discourage corporate investment and reduce the efficiency of corporate behaviour,\(^{121}\) and so forth.

It might be noted that there is a moral, as well as an economic, dimension to these arguments, in that the literature suggests that fairness and equity considerations coupled with economic rationales have played a significant role in the recent regulatory responses to insider trading. For example, The Insider Dealing Directive (1989/592) which was replaced by the Market Abuse Directive (2003/6) is a legislative response to safeguard the integrity of the European stock market and enhance the investor confidence in those markets. These are based primarily on the perception of insider trading as unfair in that it gives an unfair advantage over the other market participants.\(^ {122}\) Similarly, Australian Corporations and Markets Advisory Committee in its Insider Trading Report (CAMAC 2003) have lent support to the market fairness theory on the regulation of insider trading.\(^ {123}\)

In the demand guarantee context, it can be argued that by giving beneficiaries an unfair advantage in the guarantee market applicants’ participation in that market will be discouraged.\(^ {124}\) My qualitative research that explored unfair demands under demand guarantees in commercial practice suggests the need to restrict beneficiaries taking unfair and opportunistic advantage in the Sri Lankan guarantee market, thus regulating unfair trade practices that depress market activity: ‘Whilst some applicants (50%) indicated that on-demand bank guarantees as security for performance in the export and construction industries is likely to decline in the market in view of their


\(^{123}\) See generally Robert Baxt et all, Securities and Financial Services Law (6\textsuperscript{th} ed, LexisNexis, 2003).

\(^{124}\) Ibid 825.
tendency to procure insurance guarantees and guarantees issued by Sri Lanka Construction Guarantee Fund established by the Government, the others (50%) indicated their dissatisfaction with these guarantees as alternatives to on-demand bank guarantees. ¹²⁵

As I have elaborated in chapter four, this finding offers some empirical support that as a result of inadequate protection against unfair and opportunistic advantage taking of demand guarantees, applicants are moving away from demand guarantees and that there is a trend towards procuring alternatives to demand guarantees (insurance guarantees and guarantees issued by Sri Lanka Construction Guarantee Fund) that provide some protection against opportunistic advantage taking in the guarantee market. Based on this empirical finding it can be argued that at least 50% of the applicants in the on-demand guarantee market have reduced their investment and participation. In other words, beneficiaries’ unfair advantage taking discourages applicants’ confidence to procure on-demand guarantees and hence impairs participation and investment in the on-demand guarantee market.

Thus, my qualitative research results would indicate that unfairness in the guarantee market (the lack of adequate protection against beneficiaries taking opportunistic advantage of the applicants’ vulnerability in the guarantee market) has created a negative impact on the market activity: 50% of the applicants are already forced out of the demand guarantee market.¹²⁶ Thus, the unfairness in the guarantee market has a significant influence over the applicants’ decision to decline their participation in the guarantee market and their tendency to place their confidence elsewhere. Hence, this thesis argues that legislative or regulatory intervention to protect the applicants against beneficiaries’ unfair, opportunistic advantage taking and thereby foster confidence in the guarantee market seems appropriate.

¹²⁵ See finding (5) in chapter four.
¹²⁶ Ibid; George Akerlof’s ‘The Market for Lemons’ which concludes that the ‘bad driving out the good’ in the market is another useful analogy to the argument that unfairness (opportunistic advantage taking ) in the guarantee market drives the applicants out of the guarantee market (although Akerlof’s conclusions apply to a different situation); See George Akerlof, ‘The Market for Lemons: Quality Uncertainty and the Market Mechanism’ (1970) 84(3) Quarterly Journal of Economics 488; In this paper Akerlof describes how the bad cars (lemons) drive out the market for good cars because they sell at the same price as good cars. He argues that this represents the major costs of dishonesty – for dishonest dealings tend to drive honest dealings out of the market; ‘The costs of dishonesty, therefore, lies not only in the amount by which the puracher is cheated; the costs also must include the loss incurred from driving legitimate business out of existence’; Ibid 495.
Conclusion

The review of the relevant case law drew some essential principles applicable to restraining demands under on-demand guarantees in Sri Lanka. The current legal position is a strict adherence to the English common law principles. There are no significant conceptual differences between the case law in the United Kingdom and Sri Lanka on the matter. The judicial pronouncements in Sri Lanka have been consistent and admit of no debate or doubt that intentional fraud committed by the beneficiary in calling under the guarantee provides the justification for refusing performance of the guarantee to the beneficiary. In fact, to date, the Sri Lankan Court of Appeal has not deviated from that established English orthodoxy.

The review of the relevant case law also indicated that when the Sri Lankan courts have been called upon to intervene in the enforcement of demand guarantees a narrow approach has been adopted. Fraud on the part of the beneficiary known to the financial institution is the only substantial ground to block payment under the guarantee. The courts have shown much reluctance to give a broad definition of fraud in such situations and have not considered any ground that falls short of fraud in restraining the enforcement of demand guarantees – in particular, has not considered unfair and opportunistic advantage taking on the part of the beneficiary calling under the guarantee which amounts to an unconscionable conduct on his part, as a further ground for intervention.

The rationale for the narrow scope for judicial intervention has been the commercial considerations and policy in favour of beneficiaries and financial institutions. The Sri Lankan courts have emphasised the need to give effect to the commercial utility of demand guarantees and safeguard the reputation of the financial institutions that issue demand guarantees. In view of the long term interest of the trade and construction industry which form a vital part of the Sri Lankan economy, the approach taken by the Sri Lankan courts in strict compliance with the English law may not be the appropriate one. It is timely to take a more critical look at the current judicial view and particularly at the hallowed assumption based on commercial objectives and financier’s reputation. More attention should be given to the serious injustice to the applicants which can arise and has arisen as a result of unfair and opportunistic advantage taking on the part of the beneficiaries calling under demand
The courts should be more ready to do justice to applicants of demand guarantees by restraining all forms of unfair demands for payment, not just in cases of established fraud. In order to address the issues posed by the narrow application of fraud and to discourage any other form of unfair demands for payment – particularly those unfair and opportunistic advantage taking on the part of the beneficiary calling under the guarantee, it is advisable to adopt a further ground namely, equitable concept of unconscionability for restraining demands under demand guarantees in Sri Lanka.

During the course of my analysis, I argued that from the perspective of applicants of demand guarantees, there are two key preliminary matters that revolve around in seeking judicial intervention to stop the beneficiary demanding payment under the guarantee: the degree of difficulty of establishing a fraudulent demand; and the limited scope for judicial intervention in the enforcement of demand guarantees.

In relation to the first matter mentioned above, this chapter pointed out that at the interlocutory stage an applicant in Sri Lanka must establish a clear case of a fraudulent demand; that the beneficiary’s conduct calling under the guarantee was fraudulent and that the issuer had knowledge of the beneficiary’s fraud. The proof of dishonest intention on the part of the beneficiary coupled with the proof of knowledge on the part of the issuer have proven it impossible to meet the criteria for establishing fraudulent demands.

In relation to the second matter mentioned above, this chapter argued that the scope for judicial intervention in the enforcement of demand guarantees under the Sri Lankan law, is so narrow in scope that it leaves a protection gap for the applicants of demand guarantees. The problem from the Sri Lankan applicants’ viewpoint is that the present ground of fraud is so narrowly interpreted that it is difficult to conceive of circumstances where a Sri Lankan court would intervene: Any thing less clear cut than established fraud on the part of the beneficiary would seem unlikely to succeed as the most recent decisions of the Court of Appeal in Nestle Lanka and Colombo Municipal Council cases confirm only too clearly. As I argued the Sri Lankan common law position does not assist the cause of the innocent victims facing a call on a demand guarantee that falls short of fraud – particularly such calls made in

127 Note that the applicant’s position in relation to unfair and opportunistic advantage taking in the enforcement of demand guarantees in the Sri Lankan guarantee market is discussed in chapter four.
circumstances where the beneficiary’s conduct though not fraudulent, was clearly an unfair and opportunistic advantage taking. Therefore, in practice successful applications in the Sri Lankan courts to restrain payment are likely to remain very small in number, leaving applicants of demand guarantees practically without interlocutory relief against unfair and opportunistic advantage taking in the enforcement of such guarantees.

Thus, I identified a protection gap in the Sri Lankan law that needs to be addressed. I then argued that this gap in the law facilitates unfair demands for payment. Drawing support from my literature review I argued that the issues confronted by applicants under the Sri Lankan law is similar if not identical to the issues that led the Singaporean law to adopt unconscionability as a separate ground from that of fraud restraining beneficiaries calling under demand guarantees.

However, in the immediate future, it does not appear that Sri Lankan courts would diverge from the restrictive interpretation of fraud set by the English courts, but with sufficient persuasion the Sri Lankan courts may accept that wider approach that equity dictates. This thesis argues that in line with the Australian and Singaporean jurisdictions a form of unconscionability should be brought in as an additional ground for restraining payment on demand guarantees in Sri Lanka. Such a revision to the current law would discourage beneficiaries’ opportunistic behaviour seeking unfair advantage in the enforcement of demand guarantees that went unnoticed by the narrow application of fraud in common law.

By analogy to the law-and-economics literature on insider trading an argument was made that unconscionable conduct and hence unfairness in the guarantee market might discourage activity in the demand guarantee market. This argument is not merely philosophical. It derives some empirical support from my qualitative research in the Sri Lankan guarantee market which indicates the trend toward decreasing participation and investments in the demand guarantee market due to the lack of protection against beneficiaries’ unfair and opportunistic advantage taking in calling under demand guarantees.
Chapter Four- Unfair Demands in Commercial Practice: Qualitative Research Results

Introduction

In my introductory chapter I have briefly outlined the methodology adopted in this thesis, namely literature reviews, theoretical analyses and qualitative interviews. This chapter explains the qualitative research undertaken, in detail. The purpose of adopting this methodology was to explore with a sample of representatives from exports, building construction (as applicants of on-demand guarantees) and financial institutions (as issuers of on-demand guarantees) in Sri Lanka, their perceptions of beneficiaries calling under on-demand guarantees. Through the interviews I sought a better understanding of the use and nature of on-demand guarantees in practice, to allow me to proceed from a more informed perspective in terms of designing a legal strategy to combat the problem of unfair advantage taking on the part of the beneficiaries calling under on-demand guarantees in Sri Lanka.

In seeking to understand the use and nature of beneficiaries’ demands under on-demand guarantees in practice, the interview questions sought to elicit the following information:

(a) Is beneficiaries calling under on-demand guarantees a prevalent problem encountered in the export and construction industries in Sri Lanka? Do financial institutions also complain and/or acknowledge the problem?

(b) What is an ‘unfair call’ or ‘unfair demand’ from the perspective of exporters and builders (applicants) and financial institutions (issuers) of on-demand guarantees in Sri Lanka?

(c) What costs do beneficiaries unfair advantage taking accrue to the participants of on-demand guarantees in Sri Lanka? Which participants bear these costs?

(d) Will applicants continue to use on-demand guarantees despite unfair and opportunistic behaviour of the beneficiaries in calling under on-

1 For a brief description of the research methods used in this thesis, see chapter one.
demand guarantees? Are there any alternative security instruments (in lieu of on-demand guarantees) in Sri Lanka?

(e) How do the applicants and issuers look at the current legal position relating to injunctions restraining beneficiaries calling under on-demand guarantees in Sri Lanka?

Thus this chapter describes an important aspect of the study’s research methodology and includes discussions around the following areas: (a) the rationale for a qualitative research approach; (b) description of the participants, location and interview process; (c) ethical considerations; (d) issues of trustworthiness; (e) limitations of the study; (f) the recording and analysis of data; and (g) findings. The chapter culminates with a discussion of the conclusions that can be drawn from the findings of this study.

**Rationale for qualitative research design**

The key idea behind qualitative research is to learn about the problem or issue from participants. The objectives of this methodology are generally focussed on extracting and interpreting the meaning of experience.

Without interviews with participants, an analysis of the limited legal literature on on-demand guarantees in Sri Lanka was unlikely to elicit the rich data necessary to address the research questions. Within the framework of a qualitative approach, the study was most suited for in-depth qualitative interviews. As Patton explains:

> We interview people to find out from them those things we can not directly observe…we can not observe feelings, thoughts and intentions. We can not observe behaviours that took place at some previous point in time. We can not observe situations that preclude the presence of an observer. We can not observe how people have organised the world and meanings they attach to what goes on in the world. We

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3 Sharan Merriam, *Qualitative Research and Case Study Applications in Education* (1998) 15.
4 This genre in qualitative study is also referred to as ‘phenomenology’, a study through which the lived experience of a small number of people is investigated; See Gretehen Rossman and Sharon Rallis, *Learning in the Field: A Introduction to Qualitative Research* (2nd ed, 2003) 97; See also Thomas Schram, *Conceptualizing Qualitative Inquiry: Mindwork for Fieldwork in Education and the Social Sciences* (2003) 70-72.
have to ask people questions about those things. The purpose of interviewing, then, is
to allow us to enter into the other person’s perspective.  

Patton also claims that, ‘qualitative interviewing begins with the assumption
that the perspective of others is meaningful, knowable, and able to be made explicit.’ As Kvale describes it, this is an ‘attempt to understand the world from the subject’s point of view, to unfold the meaning of people’s experiences, to uncover their lived world prior to scientific explanations.’ Similarly, Denzin and Lincoln state that a major benefit of collecting data through individual, in-depth interviews is that they offer the potential to capture a person’s perspective of an event or experience.

The present research fits well with the above criteria because it sought to understand the nature of beneficiaries’ demands under on-demand guarantees in commercial practice from the viewpoint of the relevant industry representatives and thereby capture the meaning of their experiences in their own words. This methodology enabled me to obtain in-depth information around the research topic, to clarify statements and to probe for additional information.

Research participants

As Creswell explains, ‘the idea behind qualitative research is to purposefully select participants or sites that will best help to understand the problem and the research questions.’ Similarly, Patton states that ‘qualitative inquiry typically focusses on relatively small samples, even single cases selected purposefully to permit inquiry into and understanding of a phenomenon in depth.’ Patton also argues that ‘the logic and power of purposeful sampling lies in selecting information-rich cases for study in depth. Information rich cases are those from which one can learn a great deal about issues of central importance to the purpose of the research, thus the term purposeful sampling.’ Therefore, the strategy that was chosen in the selection of participants of this study was to identify the institutions or individuals from which I could learn a great

5 Michael Patton, Qualitative Evaluation Methods (1990) 196.
7 Kvale Steinar, Interviews: An Introduction to Qualitative Research (1996) 1.
8 Norman Denzin and Yvonna Lincoln, Collecting and Interpreting Qualitative Materials (3rd ed. 2008).
9 Creswell, above n 2, 178.
10 Patton, above n 6, 46.
11 Patton, above n 5, 61.
deal about the phenomenon of unfair advantage taking in the enforcement of on-demand guarantees in Sri Lanka. Consequently, the qualitative interviews were conducted across two categories of participants: applicants and issuers of on-demand guarantees in Sri Lanka. These participants are in the best position to relay first-hand experience of the nature of beneficiaries’ demands under on-demand guarantees that their industries are faced with and share their thoughts on the problems associated with such demands for payment. Because the study sought to identify the nature of the problem of unfair and opportunistic advantage taking in the enforcement of on-demand guarantees in commercial practice and offer optimal legal strategies to combat such demands, their direct participation provided an effective way of collecting information of this nature.

The only criterion for the selection of participants was that they represented either the export and/or the construction industry in Sri Lanka that procure on-demand guarantees in the course of their business, or that they represented financial institutions that issue on-demand guarantees in Sri Lanka. This way, I used a typical purposeful sampling which Merriam describes as ‘one that is selected because it reflects the average person, situation or instance of the phenomenon of interest.’12

The research participants included eight commercial banks that issue on-demand guarantees, seven applicants of on-demand guarantees and a leading Insurance Company that issues on-demand guarantee policies (16 individuals in total). Although participants were all representatives from exports, construction and financial institutions in Sri Lanka and had been with the same industry for at least ten years, there were differences among them in the following parameters: length of experience in the relevant industry, level of education, gender and age.

**Location and interview process**

The qualitative interviews were conducted in Colombo in 2011. With guidance from my supervisors, I used the research questions as the framework to develop the interview questions. Then I sent individual emails to prospective participants describing the purpose of the study, inviting their participation and requesting a convenient date and time for an interview to be held in Colombo, Sri Lanka. A confirmation email was sent

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12 Merriam, above n 3, 62.
to the individuals who agreed to be interviewed. Before the interview commenced, the interviewee was handed an information sheet and consent form and was asked to review and sign the consent form required for participation in this study.\(^{13}\) All interviews were conducted face to face with the interviewees and 12 out of 16 were tape recorded in their entirety.

Two interview guides were used for asking questions during the interviews; one interview guide set out the questions for financial institutions that issue on-demand guarantees while the other interview guide set out the questions for applicants of on-demand guarantees. Whilst the semi-structured questions in the interview guides were intended to elicit in-depth information relating to beneficiaries’ demands under on-demand guarantees and views and opinions from the participants, they also ensured that the same basic lines of inquiry were pursued with each issuer and applicant. Thus, the largest part of the interview was guided by a set of questions that I intended to explore. However, neither the exact wording nor the order of the questions was determined ahead of time. This method allowed me to respond to the situation at hand, to the views of the participants and to new ideas on the topic. Interviews were recorded by making handwritten notes and by audio taping. On completion of each interview the audio tape was transcribed verbatim.

I also conducted an informal group interview with the Manager Marketing, Assistant General Manager and Marketing Executive of Sri Lanka Export Credit Insurance Corporation (SLECIC),\(^{14}\) and informal interviews with the Chief Executive Officer of the Construction Guarantee Fund (CGF),\(^ {15}\) and the Executive Director of National Construction Association of Sri Lanka (NCASL),\(^ {16}\) while in Colombo in 2011.

During the process of interviews I was able to collect public documents such as standard forms of on-demand guarantees, publications and annual reports issued by the issuers who participated in the study, and private documents such as copies of actual

\(^{13}\) See Appendix 3- Consent Form; Appendix 4- Information Sheet.
\(^{14}\) Sri Lanka Export Credit Insurance Corporation (SLECIC) facilitates the issue of on-demand export performance guarantees through financial institutions and International Chamber of Commerce (Sri Lanka) &lt;http://www.slecic.lk&gt.;
\(^{15}\) Construction Guarantee Fund (CGF) is a Fund established by the government of Sri Lanka for the purpose of providing guarantees to small and medium scale construction contractors enabling them to undertake construction projects &lt;http://www.cgf.gov.lk&gt;.
\(^{16}\) National Construction Association of Sri Lanka (NCA) is the apex body of building contractors in Sri Lanka that take collective actions to safeguard and promote the interests of the construction Industry and that of the construction contractors in Sri Lanka &lt;http://www.ncasl.lk&gt.;
demands on the guarantees which participants described as unfair claims. These documents, as Merriam states, ‘can help to uncover meaning, develop understanding and discover insights relevant to the research problem.’\(^{17}\)

**Ethical considerations**

In any research study, ethical issues relating to protection of the participants are of vital concern.\(^ {18}\) Although, it was anticipated that no serious ethical threats were posed to any of the participants or the industry they represented, this study employed various safeguards to ensure the protection and rights of the participants.

Informed consent remained a priority throughout the study. At the interview, an information sheet and consent forms were handed over to the participants. The consent forms sought the participant’s consent to participate in the interview and also a willingness to take part in an interview (telephone or via email) for further clarification of matters or concerns raised in the completed interviews.\(^ {19}\) Consent was also confirmed verbally at the time of the interview.

Participants’ rights and interests were considered of primary importance in the dissemination and reporting of data. The collection and storage of data was in identified form up until the stage of writing of the thesis. This was considered preferable to enable the ease of communication with participants throughout the study. The name and contact details of each participant together with a hard copy of the signed consent form were enclosed in a file made for each participant. These files together with the information collected were retained in a secure filing cabinet, and were then de-identified prior to being referred to in this thesis.

**Qualitative validity and reliability**

Qualitative validity means that the researcher checks for the accuracy of the findings by employing certain procedures while qualitative reliability indicates that the researcher’s

\(^{17}\) Merriam, above n 3, 133.
\(^{18}\) Rossman and Rallis, above n 4, 70-79.
\(^{19}\) See also Appendix 4-Information Sheet.
approach is consistent across different researchers and different projects. This study adopted the following strategies to check the validity of the findings and ensure the consistency and reliability of the study:

(a) **Use of triangulation of data:** Data was collected through multiple sources to include interviews and documents collected during the interviews. The interview transcripts were checked against the qualitative documents that could corroborate participants’ versions. For instance, the issuers’ description of the criteria for issue of on-demand guarantees were compared and checked for consistency with the standard forms of on-demand guarantees collected during the interviews. The nature of unfair demands under on-demand guarantees described by the participants was also compared with the actual copies of beneficiaries’ demands for payment, collected during the interviews. This yielded a fuller and richer picture of the phenomenon of unfair demands under on-demand guarantees described by the interviewees.

(b) **Use of member checking:** To enhance the interpretative validity of this study, participants were contacted regarding the information provided during the interview process. Participant quotes taken from the interview transcripts were sent to the participants for their comments.

(c) **Use of rich, thick description to convey the findings:** The primary strategy utilized in this study to ensure external validity was the use of rich, thick descriptions, that is, descriptions with Issuer 1, Issuer 2, Applicant 1, Applicant 2 etc, so that any one interested in ‘transferability’ would have a solid framework for comparison.

(d) **Inclusion of negative or discrepant information in the findings:** This entailed looking for variation in the understanding of the phenomenon and seeking instances that might challenge my expectations or emergent findings. For example, the qualitative research indicated that every applicant of on-demand guarantees is not inevitably a victim of unfair

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20 Creswell, above n 2, 190; Rossman and Rallis argue that validity, reliability and ethics can not be separated, For a study to be trustworthy it must be more than reliable and valid, it must be ethical, see Rossman and Rallis, above n 4, 63; See also Kvale, above n 7, 231 - 241.
21 Triangulation of data means comparing and cross-checking the consistency of information derived at different times and by different means within qualitative methods; See Patton, above n 6, 559.
22 Creswell, above n 2, 200; See also ‘transferability’ discussed below.
23 See below finding (1).
advantage taking on the part of the beneficiaries calling under these guarantees.24

(e) Use of peer briefing to enhance the accuracy and reliability of the account: A doctoral colleague at the University of Cape Town, South Africa, served as a peer examiner. Thus, a review of the codes assigned to interview transcripts and a discussion of the findings with that colleague further ensured that the reality of the participants was adequately reflected in the findings.

Limitations of the study

Although interviews have certain strengths there are various limitations associated with interviewing, some of which are related to the common critiques of qualitative research methodology in general,25 and some of which are inherent in this study’s research design. Recognising these limitations, I have taken the following measures.

It needs to be acknowledged that I came to this research with an initial intuition that the expansion of judicial intervention in the enforcement of on-demand guarantees would benefit the applicants of such guarantees. Having said that, I had no involvement with any of the industries that participated in the study and none of the participants knew me. Therefore, I believe ‘researcher bias’ was not a concern in conducting the interviews. However, to reduce any potential bias during data analysis, I took steps to remove all participant names and coded all interview transcripts (as issuers and applicants with a number for each participant) so as not to associate any material or data with any particular individual.

It should also be acknowledged that not all participants of this study were equally cooperative, articulate and perceptive. Some participants might have been guarded and therefore less candid in their responses. To address this problem, I made a conscious attempt to create an environment that was conducive to honest and open dialogue by seeking permission to record the interviews, and by only recording those participants who were comfortable with having their responses recorded.

24 Ibid.
25 See generally Herbert Rubin and Irene Rubin, Qualitative Interviewing: The Art of Hearing Data (2nd ed, 2005).
Aside from these matters pertaining to participant reactions, a further limitation of this study was that the research sample was restricted. The study focussed on eight banks that issue on-demand guarantees, an insurance company that issues on-demand guarantee policies and seven applicants (exporters and contractors) who procure them. Therefore, a critique of this study might be the limited possibility of transferring the study’s findings to issuers and applicants in general and to other industries that procure on-demand guarantees (such as local suppliers of goods to supermarkets, agents for re-distribution contracts etc.). Although transferability – the ways in which the reader determines whether and to what extent the phenomenon of unfair calls in the export and construction industries can be transferred to another context – is not intended to be addressed in this study the findings may be applied to other contexts. With regard to transferability, Patton promotes thinking of ‘context bound extrapolations’ which he defines as ‘modest speculations on the likely applicability of findings to other situations under similar, but not identical conditions.’26 This is essentially what Merriam refers to as ‘reader or user generalizability which involves leaving the extent to which a study’s findings apply to other situations up to the people in those situations…it is the reader who has to ask, what is there in this study that I can apply to my own situation, and what clearly does not apply.’27 Toward this end I have attempted to provide a detailed description of the participants’ experiences and views to enable the reader to determine how closely their situations match the research situations and whether findings can be transferred.28 Hence, I believe these experiences can be assessed for their applicability and applied appropriately in similar contexts.29 For instance, the findings in relation to the phenomenon of unfair advantage taking in the enforcement of on-demand guarantees in the export and construction industries and the commercial banks’ criteria for the issue of on-demand guarantees can be assessed for their applicability in a particular local re-distribution agreement, supply contract or agency agreement which requires the supplier or the agent to procure an on-demand guarantee as security for due performance.

26 Patton, above n 6, 584.
27 Merriam, above n 3, 211.
28 See below the presentation of findings.
29 Schram states that depth, richness and detail provide the basis for qualitative account’s relevance in some broader context; See Schram, above n 4, 9.
**Data analysis procedure**

The data analysis procedure is shaped by the phenomenological genre that framed this study.\(^{30}\) Phenomenological studies are primarily open-ended, searching for the themes of meaning in participant’s lives and typically rely on interview data.\(^{31}\) Therefore the first step in my analytical process was to consider the themes. Those recorded interviews (12 of 16) that were transcribed verbatim, were each assigned identification codes.\(^{32}\) The hand-written transcripts of those un-recorded interviews were also assigned identification codes. To make the data more accessible and understandable the transcripts were then reduced to what was of most importance and interest and then transformed to draw out themes and patterns. In this way, I undertook an analysis process called ‘open coding’, a grounded theory concept where the descriptors emerge from the data, which is essentially same as what Patton refers to as an ‘inductive analysis.’\(^{33}\)

The second step was to classify the data and place sections of material into categories. Codes were assigned to important segments of the data. In the course of this process, new descriptors had to be created to accommodate some interesting revelations.

It also became necessary for me to prepare summary tables for each research question. These tables were useful in identifying what interviewees have said about each of the research questions and how many times a particular response occurs. Based on this analysis I was able to move forward and think about the broader implications of this research. Toward this end I formulated several conclusions and developed various practical and research related recommendations.\(^{34}\)

\(^{30}\) See text accompanying n 4.

\(^{31}\) Rossman and Rallis, above n 4, 276.

\(^{32}\) Coding is the process of organising the material into chunks or segments of text before bringing meaning to information; See Creswell, above n 2, 186.

\(^{33}\) Inductive analysis involves discovering patterns, themes and categories in one’s data; See Patton, above n 6, 453.

\(^{34}\) See also chapter six.
Findings

In the process of reporting the findings of this study, I explored some of the literature on writing qualitative research reports. Merriam in *Qualitative Research and Case Study Applications in Education* explains this stage as follows:

Since qualitative research focusses on process, meaning and understanding, the product of a qualitative study is richly descriptive. Words and pictures rather than numbers are used to convey what the researcher has learned about a phenomenon. There are likely to be researcher descriptions of the context, players involved and the activities of interest. In addition, data in the form of participants’ own words, direct citation from documents, excerpts of videotapes, and so on, are likely to be included to support the findings of the study. 35

Similarly, Denzin notes that ‘an event or process can be neither interpreted nor understood until it has been well described.’ 36 By way of ‘thick-description,’ 37 I have endeavoured to set out a broad range of experiences. Therefore, the emphasis throughout reporting the findings was on letting participants speak for themselves. Illustrative quotations taken from interview transcripts attempt to portray participant perspectives and capture some of the richness and complexity of the subject matter. Following is a discussion of the findings that emerged from this study with details that support and explain each finding.

Finding (1): The overwhelming majority of the participants (95%) indicated that beneficiaries demanding payment under on-demand bank guarantees were/are a problem encountered by them in the course of their business

The central finding of this study is that beneficiaries calling under on-demand guarantees are a prevalent problem encountered by exporters and builders in Sri Lanka. The data obtained from the financial institutions in consultation with their guarantees departments amply demonstrates the significant proportion of demand guarantees that

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35 Merriam, above n 3, 8.  
36 Denzin and Lincoln, above n 8, 323; Similarly Rossman and Rallis states that ‘thick description makes analysis and interpretation possible’; Rossman and Rallis, above n 4, 275.  
37 Denzin and Lincoln, above n 8, 324; Creswell similarly states that when qualitative researchers provide detailed descriptions of perspectives about a theme, the results become more realistic and richer. This procedure can add to the validity of the findings; Creswell, above n 2, 192; See also Patton, above n 6, 437-440.
have been issued to those applicants in the export and construction industries over the last three years and the increased number of demands that have been received under those guarantees which they identified as unfair claims. This finding is highly significant in terms of the over-whelming number of participants (95%) who found that the inherent nature of the on-demand guarantees and the reluctance on the part of the beneficiaries to accept conditional guarantees is the initial cause of this problem. Financial institutions that issue on-demand guarantees acknowledged this problem in the following ways:

We do not issue conditional guarantees because the beneficiaries insist that the contractor procures an on-demand guarantee. The requirements for on-demand performance bonds and guarantees themselves are bad. Any requirement or term in the contract for construction should be agreed upon a fair-playing ground. When the contractor procures a demand guarantee through us, he undertakes to perform the project. But he has no similar security like “Payment Bond” from the beneficiary. If Payment Bonds are introduced, will those also be “on-demand”? (laughs)...Our total issue of guarantees (100%) is for the construction industry. During the past three years, 60% of the total issue of the guarantees have been called and we believe those claims were unfair. (Issuer 1)

For the last three years we have issued 13500 demand guarantees to exporters (for example to those companies that export agricultural products, textile, garments etc) and to building contractors. This is 90% of the total issue of our demand guarantees. The beneficiaries do not accept conditional bank guarantees. They insist that payment should be “on-demand”. So we have always issued on-demand guarantees. 30% of the total issue (90%) was claimed by the beneficiaries. We believed that the 30% of the claims we received were unfair. (Issuer 2)

We issue only on-demand guarantees. Beneficiaries do not agree to conditional bank guarantees because they do not want to get involve in commercial disputes. During the past three years, we have issued 18105 demand guarantees (that is 75% of the total issue of our demand guarantees) on behalf of our customers in the industrial and agricultural exports and building construction. That’s a significant proportion of our total issue of demand guarantees. 40% of those guarantees have been claimed. We believe that those demands we received for payment were unfair. (Issuer 3)
Over the last three years we have issued 70% of the total issue of demand guarantees to our customers in building construction and in various exports…rubber, garments, food and beverages, petroleum products, tea, coconut. 60% of the total issue of those on-demand guarantees has been called by the beneficiaries. In 99% of those claims we have received the beneficiary was at fault (in our opinion). Beneficiaries attempt to take advantage of the on-demand nature of these guarantees. That’s why we request the beneficiaries to be transparent in the presentation of their claims. (Issuer 6)

Whilst financial institutions that issue on-demand guarantees acknowledged that they receive demands that they believe to be unfair, applicants who procure them through the financial institutions bitterly complained of these demands.

80% of the total number of our customers per year has asked for on-demand guarantees, particularly when the value of the underlying contract is over Rupees Five Million. Our customers have never agreed to accept conditional guarantees…We have received quite a number of claims that were unfair. (Applicant 2)

95% of the total number of our customers has requested demand guarantees. Only 5% has agreed to have conditions in the guarantee…I can tell you several incidents of unfair claims we received under those on-demand guarantees. (Applicant 3)

Only two participants of the 16, while acknowledging the problem of beneficiaries calling under on-demand guarantees in the industries they represent, described why their businesses have not faced unfair call situations. These two participants conveyed their views when they said:

We are a State sponsored body. The beneficiaries of the demand guarantees we procure are always State Agencies. The underlying contract is therefore between two Government Agencies. As a result, these beneficiaries have never called on the demand guarantees we provide them as security for our performance. To the best of my recollection, in a construction project we undertook in 1980, a sub-contractor called on the guarantee. We do not have records of that incident to comment on the validity of that claim…Moreover, since 2008, a Cabinet approval passed in Parliament, exempts our Corporation procuring bank guarantees for 75% of the negotiated jobs under the underlying contract. So we are required to provide demand bank guarantees only for the remaining 25% of the non-negotiated jobs. We always go through State Banks to
procure these guarantees. Given this background, we have not experienced unfair calls on demand guarantees. (Applicant 1)

When it comes to on-demand guarantees we have three choices; guarantees issued by commercial banks (bank guarantees), guarantees issued by the Construction Guarantee Fund (construction guarantees) and guarantees issued by insurance companies (insurance guarantees). The last two types of guarantees, I mentioned, operate quite different to those guarantees issued by commercial banks...both types of guarantees are payable on-demand, though. While the Construction Guarantee Fund monitors the project performance for the guarantees they issue and evaluate the beneficiary’s claim (if any), the insurance companies through “loss-adjusters” evaluate the beneficiary’s claim under the guarantee. So for the last three years, our company has not received any payment demands from our clients. I think the policy of the Construction Guarantee Fund and insurance companies in handling demands under on-demand guarantees results in a fair outcome for us. (Applicant 4)

However, all participants (100%) that issue on-demand bank guarantees stated that when the guarantee is payable on-demand, they do not question the validity of the demand, but rather honour them on-demand:

There is no way to test whether the beneficiary’s demand for payment is unfair or not. We do not monitor the project performance and have no obligation to do so. But, in rare instances we offer to monitor the project on behalf of our customers (applicants of demand guarantees) who maintain a very good banking relationship with us. Only in those situations, if the beneficiary makes a demand on the guarantee we are in a position to comment on the nature of the demand. We as bankers do not go into an inquiry as to the fairness of a claim. That is not our job. I must also mention that we do not have the technical knowledge to assess each claim even if it appears to be unfair. (Issuer 4)

We don’t look into the question whether the claim is fair or unfair. When we receive a claim through our Relationship Manager, we inform the applicant and if we do not hear from him within the next working day, we honour the claim. We the bank won’t involve in issues such as the quality of material used in the construction, cracks in the building, quality of the exported items etc. If there is a claim we honour it. It is for the applicant to go to court and sort the matter out, if he thinks it is unfair. (Issuer 7)
There were cases where the overseas buyers have made claims on the demand guarantees we issued to exporters of tea. In those cases the claims were based on the premise that the quality of the tea was not up to the standards. We, bankers are not in a position to comment whether those claims were genuine or not. (Issuer 5)

Finding (2): All participants (100%) described ‘unfair demands’ in similar terms – indiscriminate demands for payment or demands made in circumstances where the beneficiary engages in opportunistic advantage taking in calling under the guarantee were described as unfair.

The central finding that unfair demands or unfair claims (as majority of participants described it), under on-demand guarantees is a recurring problem for the applicants was further reflected by the nature of the examples and actual incidents through which these participants described their perceptions of unfair claims.

An unfair demand is a claim for payment made by the beneficiary indiscriminately without giving due consideration to the full or partial performance of the underlying contract. For example when 90% of the work under the project is complete the beneficiary calls on the guarantee for the full amount alleging that performance under the contract is not satisfactory or the beneficiary terminates the contract without a proper evaluation of the performance and subsequently claim for the full amount on the guarantee which I think is an unfair demand. (Issuer 1)

We have no objection to encashment of demand guarantees, if there is a genuine default on our part. There could be situations where non-performance was due to factors beyond our control…such as adverse weather conditions, unavailability of a particular material that we have undertaken to use in the supply of items to the overseas buyer. But, on-demand guarantees do not consider these factors. Guarantee is payable on-demand. If the beneficiary calls on the guarantee to take an unfair advantage of these circumstances, such a call is unfair. ( Applicant 5)

I think a demand is unfair in situations where the beneficiary makes an indiscriminate claim on the guarantee. If the project is 99% complete but the beneficiary lodges a claim for the full amount on the guarantee alleging minor differences in the drawings/plans, I would consider such a claim as “unfair”. No beneficiary should be allowed to take an unfair advantage of the position of the applicant who procures a guarantee payable on-demand. (Issuer 4)
I can explain to you the meaning of “unfair” by reference to an example in the export industry our company is in… Overseas buyer may find 5% of the total aluminium supplied by us not in accordance with the specifications in the contract. If the buyer (beneficiary) makes a claim for the full amount on the guarantee alleging defective performance, I would think that the claim for the full amount is unfair…The “on-demand” character of the guarantee is itself, not a fair situation. (Applicant 4)

It was significant to note that two participants explaining unfair claims specifically said that for a call to be ‘unfair’ it need not necessarily be a fraudulent call. These two participants described their perspective of unfair calls in this way:

What happens in construction projects is that beneficiaries allege defective performance or minor non-performance when the project is almost complete (say 95% of the work is complete). Then the beneficiary attempts to exert pressure on the applicant to agree to his terms in completing the project. If the applicant does not agree with the beneficiary, the latter calls on the bank guarantee. So this is an opportunistic advantage taking of the applicant’s position in relation to the guarantee. I think such wrongful behaviour of a beneficiary in trying to encash the guarantee can be identified as an “unfair call”…from a banker’s point of view beneficiary’s conduct need not be fraudulent for it to be “unfair”. (Issuer 2)

Let’s put this concept in perspective. Beneficiaries call on the guarantee when there is a minor dispute under the underlying contract for supply or construction. From a banker’s perspective such a call is unfair…for a banker the claim need not be fraudulent for it to be unfair. For example if a beneficiary knowing well that the delay on the part of the supplier in sending the shipment of the goods is due to bad weather conditions, demands the full amount on the guarantee alleging delay in performance, I would think that such a demand is “unfair”, not “fraudulent” though. (Issuer 3)

A few participants (15%) explained the term ‘unfair’ with reference to various instances in which beneficiaries demanded payment on the guarantees. Among these participants were the Applicant 3, Applicant 6 and Issuers 5 and 8 who shared the following incidents as illustrations of unfair claims:
I procured an on-demand advance payment guarantee for a particular construction project. A government Department was the beneficiary of the on-demand guarantee. One year later, when the work was nearly completed the beneficiary decided to change the design of the project. I could not agree to their new design. So they terminated the contract and claimed the full amount on the advance payment guarantee. That was clearly an unfair claim.

I obtained an on-demand performance guarantee for another project that involved five jobs. So I employed sub-contractors for two of the five jobs. The sub-contractors laid the foundation and thereafter abandoned the site. I could not find another sub-contractor who could complete the work. As I was then faced with financial difficulties and was unable to find a competent sub-contractor to complete the abandoned projects, I requested the beneficiary to grant me further time. Despite my appeal to the beneficiary to enter into negotiations they terminated the contract for the abandoned projects and claimed the full amount on the performance guarantee. That was also another unfair claim I have experienced in the course of my business. (Applicant 3)

Consequent to a successful tender I entered into a contract to develop rural roads in the Southern Province. I furnished an advance payment guarantee and a performance guarantee (both payable on demand) in favour of the beneficiary (a government department). However, due to matters not within my control, (adverse weather conditions, undue influence by the politicians, abrupt changes made to the scope of the project by the beneficiary etc), I could not complete the work on the agreed date. I wrote to the beneficiary explaining my position and requesting further time to complete the work. Immediately after that letter, the beneficiary decided to terminate the contract and claimed for the full amount on both advance payment guarantee and the performance guarantee. (Applicant 6)

Our bank issued a counter-guarantee (payable on-demand) to a Pakistani buyer who has entered into a contract with a Sri Lankan Government Body (applicant) whereby the applicant had to deliver a ship to the buyer (beneficiary of the guarantee) on or before 28th December 2004. However, just two days before this due date of delivery of the ship, the coastal belt was hit by a Tsunami (I am referring to the Indian Ocean earthquake and Tsunami in 2004). Consequent to this natural disaster our customer could not deliver the ship. The overseas buyer made a claim on the performance guarantee, which we believe was an unfair claim…That’s why we advice our customers to know their buyers…we advice them to obtain a “status report” through the Chamber of Commerce in the country the buyer resides… Chamber of Commerce maintains a
data base of exporters and importers who are “black-listed” for various mal-practices committed by them. (Issuer 5)

This happened to a customer (applicant for the guarantee) who was running a condominium business in Colombo. As security for performance of a construction project worth Rupees fifty million, the applicant obtained from us an on-demand performance guarantee favouring an international company (the beneficiary). The applicant completed the project but the beneficiary refused to accept the project completion letter alleging defective performance. Subsequently, the beneficiary called for the full amount on the performance guarantee. In that incident I believe the claim on the guarantee was one sided. The on-demand guarantees by their nature do not provide the applicant an opportunity to put his case across...

In another incident, a road construction company (applicant) undertook infrastructure development in Southern Province in the country. We issued a performance bond payable on-demand of the beneficiary. The entire project was affected by the Tsunami. The construction work was totally destroyed. In order to rebuild the roads, the applicant had to employ workmen once again. As a result of the rising costs of material and workmanship, he was faced with severe financial difficulties. Applicant tried to negotiate the matter with the beneficiary with a view to request a concession and further time to complete the project. The beneficiary first lodged a claim with us for the full amount on the performance guarantee alleging that the applicant failed to perform the contract by due date. We encouraged negotiations between the parties. Ultimately, the applicant had to agree to do some additional work (not specified in the contract) in order to prevent the beneficiary demanding payment on the guarantee. (Issuer 8)

Finding (3): All financial institutions (100%) that participated in this study acknowledged that they are adequately protected against beneficiaries’ calls under the demand guarantees they issue

In view of the criteria adopted in the issue of on-demand guarantees, it is not surprising to note that the financial institutions are adequately protected against demands on the guarantees they issue. These institutions revealed that there had been incidents where the applicants had to turn away business as they were unable to satisfy these criteria to secure a demand guarantee.
As a financial institution we require our customers to provide security for the issue of on-demand guarantees. If the applicant is an individual we require a cash deposit equivalent to 100% of the total value of the guarantee. If the applicant is a cooperate client we require collateral as well as a counter-guarantee which is equivalent to 100% of the total value of the guarantee. (Issuer 2)

We do not issue an on-demand guarantee to any one who requests its issue. We evaluate the applicant’s ability to perform the contract of supply or the contract of construction, as the case may be. We also evaluate the financial strength of the applicant. We would not differentiate the criteria for demand bank guarantee and a loan facility. As a result, we had quite a number of customers who could not procure demand guarantees from us. (Issuer 3)

We do not issue demand guarantees to every applicant. Our customers enjoy what is called a “guarantee facility” from our bank. In other cases we require the applicant to provide mortgage of property or cash deposit as security for the full amount of the guarantee. If the applicant can not satisfy the criteria we can not issue the guarantee…There were a number of instances the customers who came to us were unable to accept business because of the need to provide an on-demand guarantee issued by a commercial bank. (Issuer 4)

There have been several instances where customers were unable to procure demand guarantees from our bank. The applicants must have a banking relationship with us. The issue of the guarantee also depends on the nature of the business the applicant is involved. We won’t give a guarantee securing performance of a construction project on behalf of someone in the garment industry. That’s why we say “know your customer”…when a banking relationship is established through our Relationship Manager we provide a “banking facility” for our customers which includes guarantee facility, loan facility, over-draft facility and letters of credit facility etc.). That means should the applicant want a guarantee being issued, he should have a guarantee facility with us. It is only then we will issue the guarantee. We do not issue guarantees to non-customers of our bank, even if they offer 100% cash security. No body can just walk-in and ask for the issue of a demand guarantee. We are not people who take business-type decisions…we are at the receiving end…if any thing goes wrong it affects our reputation as bankers. (Issuer 7)
As any other bank that issues demand guarantees we too insist on very tangible assets. We don’t issue demand guarantees to every customer. We have rules for the issue of these guarantees…we insist on tangible security. Applicant must provide security to the value of 75% of the total guarantee. We bankers want to make sure of the nature of the job the applicant is undertaking that is, we require proof of sound performance in previous contractual undertakings. (Issuer 8)

Finding (4): All participants (100%) acknowledged that beneficiaries’ calls under on-demand guarantees result in financial difficulties for the applicants

There was unanimity among all participants when they said that unfair advantage taking on the part of the beneficiaries calling under on-demand guarantees results in various financial issues for the applicants. Following are some of the ways the participants expressed their concerns over this issue.

We have encountered financial difficulties as a result of unfair claims on a number of on-demand guarantees secured through banks. In one incident I mentioned to you, the beneficiary called on the retention guarantee which was payable on-demand. As a result, we lost Rupees two million on the retention guarantee which we could have invested in a different project or for a similar guarantee for another project. (Applicant 2)

For the purpose of this project I had to hire sub-contractors and enter into various contracts for supply of material. When the beneficiary terminated the contract and claimed on the guarantee the project came to a complete halt. Sub-contractors of the project demanded money from me for the work completed. The contracts with the suppliers of material also had to be terminated resulting in huge loss of income to our company. (Applicant 3)

When the bonds are encashed we, the applicants face severe financial difficulties. If we have to go to court to obtain an injunction to stop the beneficiary, that process involves money. Obtaining an injunction could be very costly. Small scale traders may find the legal procedure very costly, specially when they have already lost a substantial amount of money and property as security for the issue of the demand guarantees. (Applicant 5)

Medium and small scale contractors in our country are not money-rich. They face various financial difficulties when they go through the banking procedure to obtain
demand guarantees...they risk their credit and property if they have to mortgage their property to procure these guarantees. So, if these guarantees are subsequently encashed by the beneficiary that could be the end of the project or perhaps the future of the contractors. So in my view the encashment of demand guarantees can have “crippling actions” – not only the contractor is financially crippled but also his ability to complete any other projects will be at risk, particularly if he has obtained a bank loan to purchase the equipment, machinery etc. If the contractor is unable to pay back the loan he is once again faced with the risk of losing property mortgaged for the purpose of obtaining the loan. (Issuer 1)

Whilst explaining the nature of ‘crippling actions’ as the possible result of beneficiaries’ demands for the applicants of such guarantees, Issuer 1 and Issuer 2 went further to explain the nature of costs that might accrue to them if a demand for payment is not honoured.

Say we honour the beneficiary’s demand for payment and then ask the applicant to reimburse that amount to us these applicants will refer the matter to arbitration or litigation. If the applicant proves that the claim was fraudulent and that we should not have honoured the beneficiary’s claim, we will face serious consequences. Our reputation will be at risk...moreover we have no way of recovering the money paid to the beneficiary under the guarantee. (Issuer 1)

We, as issuers must honour even an unfair claim for two reasons – First, the guarantee is payable on-demand. So, it is a business call. Secondly, if we do not honour the guarantee our bank’s reputation is at risk. If we do not honour the guarantee, the beneficiaries will not accept our guarantees in the future. If the beneficiary is a government Ministry we are compelled to honour the demand to avoid any complaints that our bank does not honour demand guarantees. (Issuer 2)
Finding (5): Whilst some applicants (50%) indicated that the use of on-demand bank guarantees, as security for performance in the export and construction industries, is likely to decline in the market in view of their tendency to procure insurance guarantees and guarantees issued by Sri Lanka Construction Guarantee Fund established by the Government, the others (50%) indicated their dissatisfaction with these guarantees as alternatives to on-demand bank guarantees.

This finding is significant because it reveals a trend in the Sri Lankan guarantee market: 50% of the applicants has decreased their participation in the on-demand guarantee market and are using insurance guarantees, that is, guarantee policies issued by insurance companies in Sri Lanka, and construction guarantees which are demand guarantees issued by the Construction Guarantee Fund. The reasons behind this trend can be explained by reference to participants' views and other material collected during the interviews.

The reasons for some applicants’ tendency to purchase these on-demand guarantee policies issued by insurance companies and/or construction guarantees rather than demand guarantees issued by commercial banks were, firstly, due to the flexible criterion adopted in the issue of such guarantees, and secondly, due to the reduced potential for unfair advantage taking on the part of the beneficiaries calling for payment. In the context of insurance guarantees, the insurance companies not only require the beneficiary to give reasons for the demand, but also evaluate any demand through their ‘loss adjuster’ before honouring the beneficiary’s demand under the guarantee. This policy of the insurance companies can be seen as an important step toward protecting the applicant against the unscrupulous beneficiary calling for the full amount under the guarantee in circumstances where that demand is a sum in excess of the quantum of the beneficiary’s actual or potential loss, and hence the beneficiary’s call under the guarantee is an amount more than what he has bargained for. If the beneficiary is paid the full amount under the guarantee which is subsequently proved to be a sum in excess of his actual loss, the applicant may run the risk of being unable to recover that excess amount should the beneficiary become insolvent. In the context of construction guarantees, similar protection is available against unfair and opportunistic.

38 See Sri Lanka Insurance Corp Ltd v Shaken Engineering Ltd [2007] Comm HC 135/2004 (06 March 2007). The High Court in this case has decided that the guarantees issued by insurance companies are not guarantees in the strict sense, but can be identified as ‘guarantee policies’.
advantage taking on the part of the beneficiaries calling under them. Applicant 4 described his reasons for declining investments in the on-demand guarantees when he said:

When it comes to on-demand guarantees we now have three options- we can obtain a guarantee issued by a commercial bank, a guarantee policy issued by an Insurance Company or a construction guarantee issued by the Construction Guarantee Fund. The commercial banks issue on-demand guarantees only to their customers who have a “guarantee facility” or “reserve facility”. So the insurance guarantees came into being specially to provide financial support for small scale traders and contractors who are asked to provide on-demand guarantees. Whilst insurance companies require collateral only up to 50% of the total value of the guarantee, the Construction Guarantee Fund issues these guarantees without any collateral. The monitoring procedures involved in these guarantees provide protection against opportunistic advantage taking on the part of the beneficiaries calling under them. For these reasons our company has not obtained on-demand guarantees from commercial banks. For the last year alone our company has procured 85 guarantees from insurance companies and Construction Guarantee Fund for the following businesses; water supply projects (10 guarantees), furniture and aluminium supply (30 guarantees) and building and construction (45). (Applicant 4)

In order to examine the criteria that insurance companies adopt in the issue of guarantee policies and their policy of handling demands on these guarantees (payable on-demand), I conducted an interview with a leading insurance company in Sri Lanka. This company explained their criteria for the issue of on-demand guarantee policies as follows:

We have standard criteria for the issue of on-demand guarantees. (These criteria are set out in a document entitled “Facility for Guarantee Bonds in 2011”)… these criteria help us to review the performance of the company (applicant) for the purpose of approving a guarantee limit. We have a Guarantee Consultant who evaluates the suitability of the issue of the guarantee facility to the applicant. Based on his decision we issue the guarantee...For our regular customers with a good track-record we issue on-demand guarantees up to Rupees one million, without security. However, the “manual” does not permit us to issue these guarantees to new customers unless they provide security up to 50% of the total value of the guarantee. Yet, we are open to negotiation for suitable security between 10% and 50%. As collateral we accept cash, motor vehicle, property etc. (Insurance Company)
This participant also described the nature of the beneficiaries’ demands on guarantee policies that their company has experienced and how their approach to these demands differs from that of the commercial banks that issue on-demand guarantees. The participant described incidents of beneficiaries attempting to take unfair advantage in calling under guarantee policies to illustrate this point:

We issued on-demand performance guarantees to a number of builders who undertook a massive infrastructure development project funded by an International Organisation. The beneficiary claimed on the guarantee alleging non-performance. When we contacted the applicants, that is, the builders, their position was that when they went to the construction sites, either the sites were not cleared or the property has not been identified for them to commence work. It appeared to us that the non-performance was due to the beneficiary’s failure to give instructions. Therefore, we believe that the claims on the guarantees were “unfair” and that the overseas beneficiary was trying to take advantage of the guarantee policy which we had termed as “payable on-demand”…when we receive a claim we try to negotiate with both parties. But in this instance it was not easy for us to negotiate in relation to all the claims with each and every individual. So as usual we sent our loss-adjuster to prepare a report whether we are liable to pay under the guarantees, if so, the extent of our liability…In another incident our customer (the applicant) was a supplier of doors who undertook to supply 6 doors to a government department. We issued a performance guarantee (payable on-demand) for this supply contract. The supplier installed the six doors but with minor defects in two doors. He agreed to rectify the defects. Despite this assurance the beneficiary claimed full amount on the performance guarantee. We sent our loss-adjuster who reported that there are minor defects in two doors and that we honour only 15% of the full amount of the guarantee. The claim for the full amount on the guarantee was therefore “unfair”…we do not honour unfair claims, even if the guarantee policy is payable on-demand. But in the event we receive a court order to honour a claim which we believe is unfair, we inform our Insurance Association and take steps to black list the beneficiary. (Insurance Company)

As a result of the commercial banks’ approach to on-demand guarantees some participants, especially those in the construction industry, are now inclined to procure not only insurance guarantee policies but also on-demand guarantees issued by the Construction Guarantee Fund (Sri Lanka) – a Trust established in 1999, for the purpose of providing guarantees and other securities to construction contractors to
enable them to undertake construction contracts. The fund provides guarantees in the form of bid, performance, advance payment and retention which are payable on-demand. Significantly, these guarantees are given without any collateral, by evaluating the contractors’ capabilities against the project requirements. Thus, the fund provides a service to small and medium scale contractors who find it difficult to have access to commercial banks. The majority of projects are monitored regularly to ensure the project performance. In the event of non-performance, defective or late performance the Construction Guarantee Fund has the authority to take all necessary actions to minimize claims on the guarantees by ensuring the total project performance. With the philosophy of ‘total performance guarantees’, the Construction Guarantee Fund has control over the operations of construction projects alleviating the possibilities of failure on the part of the contractor. Consequently, during the period between 2000 and 2007 the Construction Guarantee Fund has received only claims up to 0.09% of the total value of the guarantees issued. Applicant 3 described the benefits of these guarantees in this way:

During the last year alone we have obtained 50 on-demand guarantees issued by the Construction Guarantee Fund. This is about 95% of the total guarantees we procured during that period. The Construction Guarantee Fund charges only 1% of the total value of the guarantee as their commission for the issue of the guarantee, compared to the 2.5% charged by the commercial banks. The commercial banks require us to provide collateral which is usually 100% of the value of the guarantee. Some banks issue these guarantees only to their customers who are entitled to a “guarantee facility”. Therefore, the small scale contractors in this country find it difficult to obtain an on-demand bank guarantee. Contrary to this strict procedure, the Construction Guarantee Fund issues on-demand guarantees to builders without collateral and above all their well planned out technical and monitoring procedures of the whole project ensures that beneficiaries do not simply call under these guarantees to gain an unfair and opportunistic advantage. (Applicant 3)

39 See Trust Ordinance s 114; See also The Gazette of the Democratic Socialist Republic of Sri Lanka-Extraordinary, No 1685/21 (23 December 2010).
40 See text accompanying n 15.
41 The statistics reveals that of the total 6078 guarantees issued up to 2007 only 26% were to contractors in grades C1, C2 and C3. The balance 74% was to the Medium and Small scale construction contractors. The grading is done by the Institute of Construction Training and Development (ICTAD); See Handbook, Construction Guarantee Fund, 2008 Publication.
However, some participants explained the procedure of the *Construction Guarantee Fund* in handling demands for payment and indicated that some beneficiaries are reluctant to accept guarantees issued by the Fund. As such, whatever the policy adopted by the banks in relation to on-demand guarantees, the builders are compelled to procure their guarantees issued through commercial banks.

Despite the strict monitoring procedures, the guarantees issued through the *Construction Guarantee Fund* have also been called by the beneficiaries – I think the reason behind this is that some beneficiaries tend to take advantage of the guarantee when it is termed as “payable on demand”. But, when the beneficiary lodges a claim on the guarantee, what happens is the money so demanded is kept in an escrow account until the matter is first resolved through arbitration or litigation. Despite this escrow arrangement, some beneficiaries continue to call on the guarantees. Naturally, the *Construction Guarantee Fund*, having control over the performance of the project contests such claims as “unfair” or “indiscriminate”. We know that in similar situations, the commercial banks that issue on-demand guarantees do not contest the claim. They honour the beneficiary’s claim on-demand. Consequently, some beneficiaries are now reluctant to accept guarantees issued by the *Construction Guarantee Fund*. (Applicant 5)

Applicant 2 also expressed a similar view when he stated that their company will continue to procure on-demand guarantees issued through commercial banks despite the fact that these issuers require 100% collateral for the issue of the guarantee and then honour beneficiaries’ claims upon simple demands. This participant described the problems associated with insurance guarantee policies and guarantees issued by the *Construction Guarantee Fund* as follows:

We will continue to use on-demand bank guarantees as security for our contractual performance, because it is the only instrument popular in our industry. If we do not procure them, our clients will retain other companies (our competitors) who are willing to provide such guarantees issued by commercial banks. It is difficult to negotiate with clients to agree to accept on-demand guarantees issued by insurance companies and the *Construction Guarantee Fund*. Our clients insist that payment under the guarantee should be on-demand. That’s why they favour the policy of the commercial banks. (Applicant 2)
None of the applicants that participated in this study were aware of standby credits that can be used in lieu of demand guarantees. Only a few issuers could comment on the unpopularity of standby credits in the local market.

Standby credit is a milder version of a demand bank guarantee. During the past three years we have issued 150 standby credits. From the viewpoint of the applicants (as well as bankers) I think standby credits may provide protection against unfair calls for payment. Under a standby credit the applicant is given a time to establish that the beneficiary’s claim is unfair. We bankers are also entitled to a time period to consider whether the credit should be honoured or not. Issue of an on-demand guarantee involves considerable risk factor. So our commission for the issue of on-demand guarantees is higher than for the issue of standby credits...Unfortunately, in our market, on-demand bank guarantees are the most popular method of providing security for performance in the export and construction sectors. The very nature of on-demand guarantees requires us to honour claims “on-demand” without any proof of default. So, the beneficiaries prefer on-demand guarantees to standby credits. (Issuer 2)

We issue one standby credit for every 300 on-demand guarantees. One bright fellow will want this substitute! (laughs)...Standby credit is actually the solution to the problem of unfair claims under on-demand guarantees. These instruments set out conditions upon which a claim can be made to us. Standbys actually take care of the applicants. Applicants derive all the benefits denied through on-demand guarantees...But, local customers have never requested the issue of this instrument in lieu of on-demand guarantees. (Issuer 8)

**Finding (6): Majority (75%) of the participants were aware of the law restraining demands under on-demand guarantees in Sri Lanka and as such were in a position to comment on the current legal position**

Applicants as well as financial institutions that participated in this research were of the view that the Sri Lankan courts are reluctant to restrain the enforcement of demand guarantees and further that the courts intervene only in circumstances where the beneficiary’s conduct in calling under the guarantee is fraudulent.

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43 Standby letter of credit is a financing instrument which represents an obligation to the beneficiary on the part of the issuer to make payment against a written demand for payment that the applicant has defaulted in the performance of an obligation; See generally, Roeland Bertrams, *Bank Guarantees in International Trade: The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* (Kluwer Law, 3rd revised ed, 2003).
I am aware of the law restraining payment demands under on-demand guarantees. Sri Lankan courts are reluctant to issue injunctions restraining issuers of demand guarantees. So we are adequately protected. In this country, obtaining an injunction restraining the issuer or the beneficiary is a problem. We have experienced indiscriminate calls on the guarantee. But our customers have never been successful in obtaining injunctions restraining the beneficiary…the courts adopt a strict approach to these matters. (Issuer 1)

I am aware of the legal position in Sri Lanka. I have now spoken with our Legal Department and I am confident to answer your questions…Most probably the law is on our side. The courts do not issue injunctions restraining banks honouring on-demand guarantees. In my banking career I have heard of just one instance where the Sri Lankan courts have issued an injunction restraining a banker paying on the guarantee. But I must mention that the law does not provide adequate protection for our clients (applicants) against unfair calls. (Issuer 2)

If the beneficiary could prove that he or she submitted to us a statement to the effect that the applicant has defaulted the contractual undertakings, that itself is sufficient to obtain relief from a court of first instance. All that the beneficiary has to establish is that the guarantee is payable on his demand. But that means our clients find it difficult to establish that the beneficiary is not entitled to payment unless there is proof of fraud on the part of the beneficiary. Though it is a difficult standard of proof, in the courts of first instance our clients have obtained *ex-parte* preliminary injunctions restraining the beneficiaries’ calling under these guarantees. (Issuer 3)

There was a case where we issued an on-demand performance guarantee to a construction company in Sri Lanka. A foreign embassy was the beneficiary of the guarantee. Beneficiary claimed on the guarantee alleging non-performance. We received the claim on a Thursday. As usual we informed our Relationship Manager and through him, the applicant. On the following day we were informed that the parties wish to negotiate the matter. But on the following Monday we received a copy of an injunction order – our client has gone to court and obtained an *ex parte* preliminary injunction restraining the beneficiary demanding payment. (Issuer 7)

Our law has not developed on this subject. Our experience is that in most of these exports and construction contracts the parties incorporate an arbitration clause. This is because the parties know the difficulty of obtaining court injunctions in the event of a
claim or dispute as to the validity of a claim on the guarantee. As a result the parties can not bypass arbitration and go to court. (Issuer 6)

Commenting on the legal position, applicants stated that in certain circumstances they have succeeded in obtaining *ex parte* preliminary injunctions restraining beneficiaries calling under demand guarantees but a majority of them have been discharged upon *inter partes* hearing or on appeal:

The problem with demand guarantees is that the moment the beneficiary decides to encash the guarantee we have to go to court to get an injunction to stop him. But obtaining an injunction from our courts is very difficult. (Applicant 4)

Yes, I am aware of the law relating to injunctions restraining bank guarantee claims … Obtaining an *ex-parte* preliminary injunction restraining the beneficiary may not be very difficult. But to maintain the injunction at the *inter-partes* hearing is very difficult. The courts in this country look at the wording of the guarantee. If the guarantee is an on-demand guarantee the court orders the issuers to honour the claim unless it is obvious that it is a fraudulent claim. So, in circumstances where the beneficiary has done something purposely to gain advantage of the demand guarantee, we can not ask the courts to restrain him claiming on the guarantee…I think that’s why parties incorporate arbitration clauses in the underlying contract, so that other than on a question of law, they can refer any dispute (including such opportunistic advantage taking on the part of the beneficiaries in making claims) to arbitration. (Applicant 5)

Participants who admitted that they are not familiar with the legal position were either the financial institutions who rely on their legal department to handle these matters in court or the applicants who usually retain a law firm or legal practitioners for advice.

I am not familiar with the law restraining bank guarantee demands. It is not really necessary for me to know the law, because every legal matter is done through the legal department in our bank. All I know is that a demand under a bank guarantee is payable on beneficiary’s demand…But recently through a news paper report I came to know that the beneficiary can be restrained from demanding payment even if the guarantee is payable “on-demand”. This article reported an incident where a client of a State Bank has obtained an injunction restraining the beneficiary claiming on the demand guarantee. I also read that in our country obtaining an injunction restraining the
beneficiary is very difficult. Other than this information I have no special knowledge of the law relating to injunctions in Sri Lanka. (Issuer 4)

Banks (including our bank) generally pay on-demand and take steps to recover that money from the applicant. We will thereafter support our client (applicant) to get an injunction. This legal procedure for obtaining injunctions restraining beneficiaries claiming on the guarantee is outside the “guarantee process”. As far as I know, only if our client establishes fraud on the part of the beneficiary calling under the guarantee, the court grants him an injunction. (Issuer 5)

No, I am not familiar with the legal position…When we receive a claim which we believe is unfair we consult our legal team. In the incidents I mentioned to you, our lawyers advised us that it is very difficult to obtain a restraining order unless we prove that the beneficiary has committed fraud in claiming on the guarantee. So we decided not to file action in court. (Applicant 3)

A few participants suggested ways in which the law should develop to mitigate unfair advantage taking on the part of the beneficiaries calling under on-demand guarantees. Some of these comments are quoted below.

I suggest that the beneficiaries should be required to give reasons for the demand. The applicant should be given a grace period to honour the demand. As to the grounds upon which a beneficiary can be restrained from demanding payment, the law should not confine the call situations to “fraudulent calls”. Some times the beneficiaries do not cooperate with the contractors – they fail to provide drawings, plans, make payments and then expect the contractor to perform within the stipulated time period. If the contractor fails to perform the beneficiary demands payment under the guarantee. In those circumstances, the beneficiary does not commit fraud by claiming on the guarantee…but the applicant can not stop him calling on the guarantee. Whilst our law should be a bit more willing to intervene in the enforcement of demand guarantees, there should be a strict regulatory system for the construction industry in our country. (Issuer 1)

The procedure for obtaining an injunction restraining a claim on the guarantee is cumbersome. The procedure should be simplified, so that our clients can obtain injunctions restraining beneficiaries trying to take unfair advantage in claiming payment under these guarantees. It is very difficult to prove a fraudulent demand. Therefore, the beneficiaries take advantage of this position by making indiscriminate
calls on the guarantee. We need a law reform to simplify the procedure and thereby prevent beneficiaries exploiting the law that favours them. The law reform should therefore create a fair-playing ground for both applicant and the beneficiary. (Issuer 2)

When the applicant asks for an injunction the dispute is basically between him and the beneficiary (a commercial dispute). I suggest that irrespective of the nature of the guarantee the court should give consideration to the nature of the commercial dispute between the applicant and the beneficiary. What we would like to see is some kind of investigation into the nature of the beneficiary’s demand, before allowing his claim for payment. Our courts look at the on-demand nature of the guarantee rather than the true nature of the beneficiary’s demand. Therefore when issuing injunctions the courts should adopt some kind of investigation into the nature of the demand on the guarantee, even in cases where there is no evidence of a fraudulent claim – because as I said before from the perspective of a banker, a claim could be “unfair” even if it can not be called “fraudulent”. (Issuer 3)

I think in order to resolve this issue we should try to formulate a framework under which the applicant is given a time frame (3/4 weeks) to answer the claim on the guarantee. It is not fair to give the beneficiary the option to claim payment upon a simple demand. (Applicant 4)

We have experienced mal-practices on the part of the beneficiaries calling on the guarantees. We can not restrain the beneficiary committing a mal-practice in calling under the guarantee... because our law says that the payment can be restrained in cases where the beneficiary commits a fraud in calling the guarantee. Our law needs to develop on this issue. (Issuer 6)

There should be a justification for the beneficiary’s claim on the guarantee. If the claim is unjustified, the beneficiary should be restrained by looking at the extraneous matters that has led to the applicant’s non-performance or late performance of the contract. If the court finds that these factors were beyond the control of the applicant, then the beneficiary’s claim should be restrained as an unfair claim. (Applicant 5)

A few participants believed that the International Chamber of Commerce’s Uniform Rules for Demand Guarantees (URDG 758),\footnote{ICC Uniform Rules for Demand Guarantees (entered into force 1 July 2010). URDG apply to any demand guarantee or counter guarantee that expressly indicates it is subject to them; See URDG art 1; See also chapter six.} can be used as a deterrent to
unfair calls under on-demand guarantees. These participants emphasised the importance of Article 15 (a) of the rules which require the beneficiary demanding payment under the guarantee to provide a statement indicating in what respects the applicant has breached the underlying contract.\(^{45}\)

International Chamber of Commerce is promoting the uniformity of the law that governs demand guarantees. When the beneficiary of the guarantee is an International Company we always suggest that the guarantee be issued subject to URDG. Article 15(a) now requires the beneficiary to provide a supporting statement with his claim for payment under the guarantee. We believe that these rules are the solution to the unfair calling on demand guarantees by the international beneficiaries. (Issuer 7)

We encourage the incorporation of URDG which requires the beneficiary to give reasons for the demand. Article 15 of the rules has set out this requirement. These rules provide directions to the demander. But in reality the beneficiaries prefer not to incorporate URDG. (Issuer 1)

We advise our customers of the advantages of incorporating URDG- Revision 758 as the law governing the demand guarantee. In the event the beneficiary wishes to make a claim under Article 15(a) of the URDG he has to give reasons for the demand. (Issuer 5)

**Conclusions from the qualitative research**

Findings of the qualitative research portray a realistic picture of the phenomenon of beneficiaries’ demands under on-demand guarantees in Sri Lanka. The conclusions from this study follow the research questions and the findings and therefore address five areas: (a) the question whether unfair advantage taking in the enforcement of on-demand guarantees is a problem encountered by participants of on-demand guarantees in Sri Lanka; (b) the characteristics of unfair demands from the perspective of issuers and applicants of such guarantees; (c) the costs of beneficiaries calling under on-demand guarantees; (d) the availability of alternative instruments in lieu of on-demand

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\(^{45}\) See URDG apps which provides sample terms for art 15 (a)’s supporting statement to be provided by the beneficiary; In the case of performance guarantee, the supporting statement could state: The applicant is in breach of its obligations with respect to the underlying relationship because [of late delivery] [the contract’s performance was completed by the due date] [there was a shortfall in the quantity of the goods supplied under the contract] [the delivered works are defective].
guarantees; and (e) issuers’ and applicants’ perceptions of the current legal position restraining demands under on-demand guarantees. This discussion will be linked to a proposal for law reform in Sri Lanka and a final reflection of this research, in chapter six of the thesis.

**Conclusion (1): Beneficiaries demanding payment under on-demand guarantees were/are a phenomenon encountered in practice**

The conclusion to be reached from findings 1 and 3 are that in practice, both financial institutions and their customers (applicants in the export and construction industries) encounter unscrupulous beneficiaries calling under on-demand guarantees. Whilst applicants of on-demand guarantees acknowledge these demands as a problem, financial institutions that issue on-demand guarantees, do not complain of such demands as a problem for two reasons: firstly, when the guarantee is payable on demand the issuer’s obligation under the guarantee is to honour the demand and as such it is not required to investigate the nature of the demand; and secondly, financial institutions protect themselves against beneficiaries’ calls by obtaining an appropriate form of security from the applicant. It can also be concluded that financial institutions that issue on-demand guarantees are adequately protected against unscrupulous beneficiaries demanding payment under these guarantees and as such applicants are the ultimate victims of such demands.

A related conclusion that can be drawn from finding 1 is that a significant percentage of the total number of demand guarantees issued by the commercial banks, particularly over the last three years, was either in connection with exports (agricultural exports such as tea, coconut or industrial exports such as rubber products, garments, food and beverages) or in connection with local and international construction projects. However, a significant number of those guarantees have been called by the beneficiaries. For example, 100% of the total issue of demand guarantees by Issuer 1 was for the construction industry out of which 60% of those guarantees have been called by the beneficiaries; 90% of the total issue of Issuer 2 related to exports and construction projects and 30% of those guarantees have been called by the beneficiaries; similarly 75% of the total issue of Issuer 3 and 70% of the total issue of Issuer 6 were for the applicants in the export and construction industries. 40% and 60%, respectively, of those demand guarantees have been called by the beneficiaries.
A further and related conclusion that can be drawn is that whilst beneficiaries calling under on-demand guarantees is a prevalent phenomenon in on-demand guarantees issued by commercial banks, it is less prevalent in the similar instruments issued by insurance companies and the Construction Guarantee Fund. In this regard, it can also be concluded that the policy that commercial banks adopt in honouring the guarantee (which is, pay upon a simple demand of the beneficiary) is different to the strict regulatory and monitoring policies that insurance companies and the Construction Guarantee Fund adopt in the issue and honour of demands under guarantee policies and construction guarantees, respectively.

**Conclusion (2): The characteristics of ‘unfair’ demands**

The second major finding – finding 2 of the qualitative study – was that all participants who indicated that unfair demands under on-demand bank guarantees is a prevalent phenomenon in their industries, explained this phenomenon as indiscriminate demands for payment or demands in circumstances where the beneficiaries attempt to take opportunistic and unfair advantage of the applicant’s disadvantageous situation in relation to the demand guarantee.

A conclusion that can be drawn from this finding is that from the viewpoint of issuers and applicants of demand guarantees, a beneficiary’s demand under the guarantee is ‘unfair’ if in the circumstances he makes an indiscriminate demand for payment or his conduct in calling under the guarantee is an unfair advantage taking of a peculiar situational disadvantage of the applicants of demand guarantees. The recurring instances of such demands in the participants’ experiences were where the beneficiary called on the guarantee to:

(a) take an unfair advantage by calling for the full amount of the guarantee whether there is full or merely partial performance of the underlying contractual obligations; or
(b) take an unfair advantage in circumstances where non-performance or delay in performance of the underlying contract was due to factors beyond the control of the applicant, such as natural disasters, unavailability of a particular material that caused the delay in construction or supply of the export items.

A related and significant conclusion is that from the perspective of participants of this research, for a demand to be unfair it need not necessarily be a fraudulent
demand. Incidents through which some participants attempt to describe unfair demands illustrate this conclusion. A further conclusion that can be drawn from this finding is that participants’ perception of ‘unfair’ captures the essence of the concept of unconscionable conduct in the context of on-demand guarantees, analysed in chapter two.46

Conclusion (3): Costs of beneficiaries calling under on-demand guarantees

Finding 4 of this study draws the conclusion that unfair advantage taking on the part of the beneficiaries calling under on-demand guarantees is a significant problem which has led to financial difficulties for the applicants of such guarantees (exporters and building contractors) in Sri Lanka. Costs accruing to the applicants include the following:

(a) Costs of litigation. The only way to stop the beneficiary demanding payment under the guarantee is to obtain an injunction restraining him from calling under the guarantee. Small and medium scale exporters and builders in Sri Lanka find this legal process not only cumbersome but also very costly.

(b) Cash flow problems in relation to future investments. A demand on the guarantee has serious implications for the availability of a guarantee facility for future business transactions that require the applicant to provide on-demand guarantees. If the issuer refuses to extend the credit facility to the applicant, the applicant will be compelled to provide cash or property as security for the issue of demand guarantees. This means a serious cash flow problem for the applicant in managing his future business, especially if he is a small or medium scale exporter or constructor.

(c) Loss of income through the sub-contracts entered for the purpose of completing performance under the underlying contract with the beneficiary. If the supplier of goods overseas or the builder had entered into sub-contracts for the supply and performance of the main contract, a call on the guarantee affects the chain of supply and sub-contracts with local suppliers and sub-contractors, respectively. This is so because, in the event of a call for payment, the

46 See conceptual analysis of unconscionable demands in chapter two.
underlying contractual performance comes to a halt which in turn results in the termination of sub contracts for materials (in the case of building contracts) and termination of supply contracts with local suppliers (in the case of export contracts) resulting in a loss of income for the applicants. This could also mean that these applicants’ reputation with their sub-contractors is at a risk.

(d) ‘Crippling actions’ due to the bank’s reimbursement of the demand under the indemnity agreement with the applicant for the demand guarantee. First, the bank honours the beneficiary’s demand for payment and then seeks reimbursement on the collateral or the indemnity agreement with the applicant. This results in crippling actions for the applicant in three respects:

- It affects the credit facility available to the applicant through his bank. The on-demand guarantees are normally considered by banks as simply another credit granted to their clients. The banks generally charge all or some proportion of the amount outstanding on the guarantee against the applicants’ borrowing potential. This may affect the applicants’ ability to accept or perform various other contracts at the same time.
- Loss of property if property was mortgaged for the purpose of securing the guarantee.
- If for the purpose of performing the contract, the builder or supplier had obtained a bank loan to purchase the machinery and/or technology for packaging, these parties usually rely on profits from those contracts to repay the bank loan/s. If the overseas buyer alleging poor standard of goods or packaging refuses to accept goods and subsequently calls for payment on the performance guarantee, the exporter faces serious problems of repaying the loan/credit. A similar chain of events will occur for the builders who obtain bank loans to buy machinery for construction projects.

A related conclusion to be drawn, from the perspective of financial institutions, is that if the beneficiary’s claim is not honoured, there will be costs that accrue to the financial institutions that issue demand guarantees:
(a) **Damage to reputation and loss of future business:** If the issuers do not readily and promptly honour claims under on-demand guarantees, the beneficiaries in future transactions will be reluctant to accept on-demand guarantees issued by them.

(b) **Costs of litigation:** In applications for injunctions restraining the beneficiary demanding payment, the applicant will name the beneficiary as the respondent. However, if the applicant decides to name the issuer as a respondent, in those cases the issuer also will have to bear the cost of litigation.

**Conclusion (4): Instruments in lieu of on-demand bank guarantees**

In view of finding 5 of this study, it can be concluded that 50% of the applicants in the export and construction sectors in Sri Lanka have reduced their investments in on-demand guarantees and are using insurance guarantee policies and construction guarantees (both are payable on-demand) issued by insurance companies and the *Construction Guarantee Fund*, respectively. The reasons for this reduced participation and investment in on-demand guarantees are two fold:

(a) **Flexible criteria for the issue of insurance guarantee policies and construction guarantees of the Construction Guarantee Fund.** Whilst commercial banks require 100% collateral or cash deposit or a guarantee facility for the issue of on-demand guarantees, the insurance companies require only 50% or less of the total value of the guarantee as collateral for the issue of on-demand guarantee policies. Significantly, the Sri Lanka *Construction Guarantee Fund* does not require any collateral for the issue of construction guarantees to small and medium scale contractors.

(b) **The policy of insurance companies and the Construction Guarantee Fund in handling demands under on-demand guarantees differs from the policy of the commercial banks in relation to handling of demands under on-demand bank guarantees.** Not only do the banks not monitor the underlying contractual performance, they honour the beneficiary’s claim upon a simple demand. The banks that issue on-demand guarantees do not investigate the ‘fairness’ of the beneficiary’s demand under the guarantee – this leaves the opportunity for some unscrupulous
beneficiaries to take unfair advantage by calling under the guarantee. By way of contrast, the *Construction Guarantee Fund* not only monitors the project for which the guarantee was issued, but also in the event of a beneficiary’s call for payment, deposits the guarantee claim in an escrow account until the parties resolve the matter by arbitration or litigation. Similarly, insurance companies through their loss-adjuster, evaluate the demand on the guarantee policy. Thus, neither the *Construction Guarantee Fund* nor the insurance companies honour beneficiaries upon a simple demand, particularly in circumstances where they believe the beneficiary is attempting to take an opportunistic advantage by calling under the guarantee.

However, it is likely that (despite the problems associated with the criteria for the issue and honour of claims) some applicants will continue to procure on-demand bank guarantees as a security instrument in Sri Lanka, due to:

(a) The intense competition in their respective industries to secure the underlying contract;

(b) The fact that the beneficiaries prefer to secure a guarantee which can be called without the issuer determining the amount to be paid under the contract. Consequently, they will enter into contracts with applicants who are willing to provide guarantees which are strictly payable ‘on-demand’; and

(c) The beneficiary’s ability or market power to impose terms on the intensely competitive applicant side of the market.

Overall, it can be concluded that the ability of the insurance guarantees and construction guarantees to mitigate the risk of beneficiaries taking unfair and opportunistic advantage in the enforcement of the guarantees could make such guarantees more appealing than on-demand guarantees issued by commercial banks, not only to the applicants but also to the beneficiaries, who ultimately assume the cost of the demand guarantee passed onto them as part of the underlying contract price. However, neither insurance guarantees nor construction guarantees are likely to replace on-demand bank guarantees because their payment, in the case of insurance guarantees, is subject to approval of the loss-adjuster, and their payment in the case of construction
guarantees is done through an escrow account monitored by the *Construction Guarantee Fund*. Thus, it can be concluded that whilst the competition in the market compels the applicants to procure on-demand guarantees issued by commercial banks, the opportunistic and unfair advantage taking in the on-demand guarantee market has discouraged the applicants from using such guarantees as security for underlying contractual performance.

A related conclusion that can be drawn from this finding is that standby credits that can be used in lieu of on-demand guarantees is not a popular security instrument in Sri Lanka. The reason is that beneficiaries do not wish to satisfy conditions if a demand for payment has to be made. The beneficiaries prefer the benefits of the on-demand guarantees, and are (apparently) in a position to enforce this demand. This also supports another related conclusion that in the Sri Lankan guarantee market beneficiaries most likely have significant market power and hence are in a position to be able to force on-demand guarantees onto their contracting parties.

**Conclusion (5): Current law from the participants’ perspective**

The overall conclusion that can be drawn from finding 6 of this study is that, under Sri Lankan law, it may not be difficult to obtain *ex parte* preliminary injunctions restraining the beneficiaries calling under demand guarantees. But it is very difficult for the applicants to maintain the preliminary injunction at the *inter-partes* hearing, for two reasons: (a) firstly, the courts only allow the grant of such injunctions in cases where the applicant proves that the beneficiary is guilty of fraud in calling under the guarantee, which is difficult to prove; and (b) secondly, the courts do not recognise any conduct that falls short of fraud on the part of the beneficiary calling under the guarantee as a ground for injunctive relief. That is to say the courts have not recognised indiscriminate calls or calls in circumstances where the beneficiary’s conduct was an unfair advantage taking of the applicant’s disadvantageous situation, as a ground for restraining the beneficiary calling under the demand guarantee.

A related conclusion that can be drawn is that there is a need to introduce changes to the current law in Sri Lanka in relation to the grounds upon which the law should intervene to restrain beneficiaries calling under on-demand guarantees.

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47 See also discussion under ‘Problems for the applicants’ in chapter three.
A further conclusion that can be drawn is that financial institutions could use their substantial influence to incorporate the International Chamber of Commerce’s *Uniform Rules for Demand Guarantees (URDG 758)* as a term into the guarantee, so as to reduce the risk of unscrupulous beneficiaries taking unfair advantage in calling under on-demand guarantees.\textsuperscript{48}

\textsuperscript{48} See the section entitled ‘The issue of the guarantee subject to URDG 758’ in chapter six
Chapter Five-Theoretical Justifications for Restraining Unconscionable Demands

Introduction

It has been argued in chapters two and three that in order to mitigate the risk of unfair advantage taking in the enforcement of on-demand guarantees, the Sri Lankan law needs to recognise the equitable concept of unconscionable conduct as a ground for restraining the beneficiary calling under the guarantee. The aim of this chapter is to provide theoretical justifications for this legal solution to unfair advantage taking – the adoption of unconscionability as a ground for restraining the beneficiary calling under on-demand guarantees.\(^1\) The analysis draws upon the legal doctrine of freedom of contract and the economic principle of cost-benefit. The question sought to be analysed in the chapter is how far these legal and economic principles support the restraint of demands under on-demand guarantees based on unconscionable conduct on the part of the beneficiary.

I will begin with a section that analyses the limitations recognised under the doctrine of freedom of contract with reference to principles of fairness and their application to on-demand guarantee contracts. This section will briefly survey the rich philosophical literature on the classical doctrine of freedom of contract and certain claims about changes in the amount of freedom of contract over time. In the course of this analysis, it will be argued that whilst the classical doctrine of freedom of contract is no longer influential, there are aspects of that doctrine that still bind many contractual relations, and that any limitations on freedom of contract should properly be justified. Applying this legal doctrine to on-demand guarantees, I will first examine standard forms of on-demand guarantees and their impact on freedom of contract. On this point I will argue that the standardisation of on-demand guarantees reflects the relatively weak bargaining position or the relatively weak bargaining potential of the applicants vis-à-vis the issuers and beneficiaries rather than the lack of free expression of their will in negotiating the terms upon which the guarantee is payable. Second, I will examine unconscionability as a ground for rescission or non-enforcement of contracts and its conflict with freedom of contract in the enforcement of on-demand guarantees. In relation

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to this apparent conflict between unconscionability and freedom of contract, I will
endeavour to answer whether freedom of contract in the enforcement of on-demand
guarantees should be permitted in any absolute form. Thus, my intention in this section is
to examine the way in which unconscionability on the part of the beneficiary calling on
the guarantee restricts and regulates freedom of contract and to examine the desirability
of control over such freedom. In short, this section of the chapter will consider a
theoretical justification for diverging from freedom of contract in the enforcement of on-
demand guarantees, with a view to combating the problem of beneficiaries’ unfair and
opportunistic advantage taking in the enforcement of such guarantees.

Then I will consider two possible arguments against adopting unconscionability
as a limitation upon the enforceability of demand guarantees. These arguments are
concerned with the fact that unconscionability as a separate ground from that of fraud
will expand the judicial discretion to step into the free bargain between the issuer and the
beneficiary and thereby conflicts with the fundamental doctrine of freedom of contract.
Firstly, if the court restrains the issuer, its obligation to honour the beneficiary ‘on-
demand’ is affected. Secondly, if the beneficiary’s demand is restrained the beneficiary’s
right to demand (without having to prove the default) under the guarantee is affected.

The final section of this chapter will outline the economic theory of cost-benefit
with its relevance to on-demand guarantees. The objective of this section is to analyse the
economic advantages and disadvantages (benefits and costs) of restraining
unconscionable demands under on-demand guarantees. Clearly it would not be desirable
to choose unconscionability as a model for reforms (in Sri Lanka) if it appears to have
harmful net effects. In relation to the costs of unconscionable demands under on-demand
guarantees, I will examine the least-cost risk avoider principle. The least-cost risk avoider
is the party whose actions can reduce the harm at the lowest cost. This, combined with
the economic imperative of efficiency, leads to the conclusion that whichever party is the
least-cost risk avoider should take measures to avoid the risk of harm.
**Doctrine of freedom of contract**

The concept of freedom of contract presents a convenient framework within which to examine questions surrounding the formation and enforcement of on-demand guarantees. The doctrine of freedom of contract serves two purposes in this chapter. First, it allows consideration of whether the freedom to bargain for the terms upon which the guarantee is payable should exist in the context of standard forms of on-demand guarantees. It will be argued that the present market mechanisms have made the traditional concepts of freedom of contract somewhat illusory in standard forms of on-demand guarantees. Second, it allows consideration of the idea of freedom from law’s intervention with the enforcement of the on-demand guarantee and its conflict with unconscionability as a ground for courts’ intervention in the enforcement of on-demand guarantees. As a background to my approach, I will first outline the classical form of the doctrine of freedom of contract and its gradual transformation which recognised certain qualifications to it based on principles of justice and fairness. In the course of this analysis I will attempt to encapsulate the prominent jurisprudential and economic arguments in favour of the doctrine, and also those advanced against it. Lending support to the latter arguments that question the classical doctrine of freedom of contract I will argue that courts’ intervention in the enforcement of on-demand guarantees is not necessarily restrictive of individual autonomy because such intervention can be justified on grounds of equity and/or principles of fairness.

**(a) Classical doctrine of freedom of contract**

In the 19th century the concept of freedom of contract was founded on the philosophical justification in the ‘will theory’ of contract and found its economic justification in laissez-faire liberalism. The will theory asserted that contractual obligations are by definition self imposed and therefore the task of a court was to discover what the parties have agreed and give effect to that agreement. The philosophy of laissez-faire was understood to mean that the State, and thus the law, should intervene with people’s activities as little as possible.

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The classical doctrine of freedom of contract recognised the choices available to the contracting parties as to whom they contracted with, what they contracted for and on what terms. The prevalent view in the 19th century was that:

Freedom of contract meant that you could choose whom you wanted to contract with, and you could arrive at the terms you wanted by mutual agreement… [T]he law assumed that each man could fend for himself, and if he entered into a harsh or burdensome contract he had only himself to blame because there was freedom of contract and he could have gone elsewhere.

Under this classical model, the contracting parties were seen as the best judges of their rights and obligations, and if they voluntarily entered into a contract the only function of the law was to enforce it. The courts were reluctant to consider any exceptions to freedom of contract. Atiyah’s work further explains this classical doctrine of freedom of contract:

They simply thought that, in nearly all cases, it was in the public interest to enforce private contracts. Indeed, it was widely thought that this was proved by fundamental economic principles. As late as 1875 one of the greatest Judges of the nineteenth century, Sir George Jessel, declared that, “if there is one thing more than another which public policy requires, it is that men of full age and competent understanding shall have the utmost liberty of contracting and that their contract when entered into freely and voluntarily, shall be held sacred and shall be enforced by Courts of Justice.”

On this view, the enforcement of private contracts was based on the public policy that the courts should respect and enforce voluntary contracts between competent persons and thereby give effect to the individual freedom and sanctity of the doctrine of freedom of contract. Similarly, Kessler describes the 19th century concept of freedom of contract as follows:

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4 Freedom of contract as we know today has stemmed from the enlightenment ideals of John Locke. Locke reasoned that society functioned best when freely determined social contracts governed human behaviour. Similarly, Modern Libertarianism such as that advanced by Robert Nozick sees freedom of contract as the expression of the independent decisions of separate individuals pursuing their own interests in a ‘minimal state’; See Harry N Scheiber, The State and Freedom of Contract (Stanford University Press, 1998).


Since the contract is the result of free bargaining of parties who are brought together by
the play of the market and who meet each other on a footing of social and approximate
economic equality, there is no danger that freedom of contract will be a threat to the
social order as a whole.\(^7\)

The freedom of contract school of thought believed that freedom of contract
presupposes approximate social and economic equality of the parties to the contract and
that the freedom of contract is not a threat to the social order. Thus, dominant thought in
the 19\(^{th}\) century was that individuals should be free to enter into whatever bargains they
considered would benefit them and the courts should facilitate that freedom by enforcing
whatever bargains individuals chose to make.\(^8\) Therefore the courts were extremely
reluctant to intervene in the enforcement of contracts.

(b) Regulation of freedom of contract

The literature shows that in the closing years of the 19\(^{th}\) century freedom of contract
was severely diminished.\(^9\) In the first instance, the freedom to choose the persons with
whom one sought contractual relationships was diminished, for example, the suppliers
of gas, water and other indispensable amenities were monopolised by service providers
and consumers had no choice in the selection of their service providers.\(^10\) Freedom of
contract in the second sense, namely, the freedom to determine the terms of the contract
and the freedom to enforce such terms, was also diminished by judicial and legislative
intervention. For example, in 1983, two judges of the High Court of Australia remarked
that ‘in the early part of this century, overriding importance attached to the concept of
freedom of contract and to the need to hold the parties to their bargains. These
considerations, though still important, should not be allowed to override competing
claims based on long standing heads of justice and equity.’\(^11\) In this regard Atiyah notes
that the classical doctrine of freedom of contract has lost judicial support and

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\(^7\) Friedrich Kessler, ‘Contracts of Adhesion – Some Thoughts about Freedom of Contract’ (1943) 43
_Columbia Law Review_ 629, 630.


argues that freedom of contract has now been visibly affected and largely superseded by a different set
of values which seeks among other things to remedy the injustices of the free market; See also Mark
Betty Mensch, ‘Freedom of Contract as Ideology (Book Review of The Rise and Fall of Freedom of

\(^10\) See Atiyah, above n 5, 8.

\(^11\) _Legione v Hateley_ (1983) 57 ALJR 292, 309 (Mason and Deane JJ)
recognition and is now subject to certain limitations in the law. Similarly, Allan and Hiscock state that, ‘today, contract is more than the regulation of the rights of the parties by the exercise of their private will; it now has a regulatory scheme which has been built on the base of agreement by both statute and judicial decision in order to give expression to an increasingly perceived public interest.’

This regulation of freedom of contract was especially true in later years when the law of contracts included rules that parties either expressly or impliedly had not discussed in their contract. Additionally, as the rules governing particular types of contract developed (for example in relation to sale of goods) it became possible to codify the obligations of the parties to such contracts. With such developments it became unnecessary and, in fact, hopeless to support the legal fiction that contractual obligations were determined solely by the mutual agreement of the parties to the contract notwithstanding the fact that in many instances parties did enjoy the freedom to exclude any statutorily imposed obligation by mutual agreement.

As the literature reveals, there is an increasing trend under which the courts and Parliaments now impose certain restrictions on freedom of contract as a means of redressing unfair, oppressive, opportunistic, unconscionable conduct and so on.

The courts’ refusal to enforce certain agreements is arguably an acknowledgment that the law must protect certain classes of contractors from the harmful effects of their own agreements. It is probably also an acknowledgement that

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12 For a comprehensive account of these limitations, see Patrick S. Atiyah, *The Rise and Fall of Freedom of Contract* (Clarendon Press, 1979). Atiyah contends that there has been continuous weakening of belief in the values involved in the individual freedom of choice and this weakening has been reflected in the law. This view has been endorsed by Francisco Cabrillo, who opines that ‘we live in a world in which contracts are nowhere close to being completely free and restrictions are created by every legal system’; See Francisco Cabrillo, *The Rise and Fall of Contract in Western Economies: A Common Experience* (Gabler, 2008); Grant Gilmore, *The Death of Contract* (Ohio University Press, 1974).

13 David Allan and Mary Hiscock, *Law of Contract in Australia* (CCH Australia Ltd, 2nd ed, 1992) 5-6. These authors argue that freedom of contract was not a principle of law so much as a declaration of policy of non intervention by the State in commercial affairs; See also Michael Trebilcock, ‘Critiques of the Limits of Freedom of Contract: A Rejoinder’ (1995) 33(2) Osgoode Hall Law Journal 353.

14 See Atiyah, above n 5, 8.

15 According to Richard A Epstein one of the major conceptual tools used by courts in their assault upon private agreements has been the doctrine of unconscionability; See Richard A Epstein, ‘Unconscionability: A Critical Reappraisal’ (1975) 18(2) Journal of Law and Economics 293, 294; See also Sir Gerard Brennan, ‘Opening Address’ (1990) 3 Journal of Contract Law 85, 88; ‘the law of contract, unqualified and unsupplemented, would reflect the laissez-faire values of a bygone age. Nowadays…the law seeks to uphold the values of equality, fair dealing and good faith’ <http://www.lexisnexis.com/libraryproxy.griffith.edu.au/au/legal/results/pubTreeViewDoc.do?nodeId=TACTAABAAB&pubTreeWidth=23%25>.
the central presupposition of the freedom of contract school of thought – approximate social and economic equality of the parties to a contract – was in fact false.

This thesis argues that this development is similarly manifest in the law applicable to on-demand guarantees. The unconscionable conduct recognised under the common law in Singapore and statutory unconscionability in ss 20(1), 21 and 22 of the Australian Consumer Law (Competition and Consumer Act 2010 (Cth) sch) can be viewed as one such example where freedom of contract is regulated by courts and parliament. However, in the absence of special regulation, it is argued that the classical doctrine of freedom of contract still survives and is evident in many commercial transactions. It is particularly relevant where it can be reasonably argued that rough equality of economic power exists between the parties, and is probably well suited to such situations.

This thesis argues that non-compliance with fairness and equity-based principles – conduct such as taking unfair advantage of vulnerability, conduct lacking in good faith, fair dealing and fair play – and hence ‘unconscionability’ on the part of the beneficiary calling under the guarantee provides justification for judicial or regulatory intervention in the freedom of contract relating to the enforcement of demand guarantees.

In assessing whether the beneficiary has complied with fairness and equity-based principles, it will be relevant to examine the standards of behaviour or industry codes applicable in the demand guarantee context. Alternatively, it will be relevant to examine whether the beneficiary’s conduct in calling under the guarantee is consistent with the intentions of the parties at the time the applicant procured the security instrument in favour of the beneficiary. It would certainly not be fair dealing or fair play for the beneficiary of the guarantee to demand payment in circumstances in which it is unconscionable for him to do so and obviously was unlikely to have been intended by the applicant at the time the guarantee was procured. Hence, there should be a recognition of the implied duties of the applicant to exercise good faith and fairness in the performance of the underlying contractual duties for which the demand guarantee was procured, and also the corresponding duties of the beneficiary to exercise good faith and fairness in seeking to enforce the demand guarantee (though the very nature of such guarantees gives him the right to demand payment under the guarantee without having to prove the default under the underlying contract). The beneficiary insisting upon his right to
payment under the guarantee in accordance with the bargain that has been struck in circumstances where it is unconscionable to do so, is a violation of the fair standards of conduct that he should have adhered to in the guarantee market. Hence, an argument can be made that in those circumstances, the intentions of the parties that the guarantee is payable on-demand, should not be narrowly interpreted, absent the background context of fair play. In other words, freedom of contract in the enforcement of demand guarantees should be treated as though it is in a symbiotic relationship with other values that restrict their operation, so as to ensure that freedom of contract is not misused.

Thus, it is argued that in the context of on-demand guarantees the beneficiary’s right to payment should not be exercised dishonestly, improperly or capriciously. Arguably, this is the whole underlying justification for the law’s intervention with on-demand guarantees, in circumstances where the beneficiary insists on his right to payment whilst being guilty of unconscionable conduct as recognised under Singaporean and Australian Laws. Thus, the law today intervenes at numerous points with freedom of contract, directed at principles of fairness or in the name of equity, which arguably is not an indication of a complete loss of freedom of contract. Atiyah’s book *Rise and Fall of Freedom of Contract* contains many striking illustrations of that fact.16

**Freedom of contract in standard forms of on-demand guarantees**

A standard form contract, once its contents have been formulated by a business firm, will be used by that firm in every bargain dealing with the same product or service. These standard form contracts do not necessarily conform to the patterns of interaction, negotiation and other bargaining anticipated by traditional contract law.17 Some commentators have argued that due to this lack of negotiation and other bargaining, the individuality of the parties which gave colour to the old type of contract has now disappeared.18 Others have endeavoured to draw a distinction between standard forms in consumer contracts and commercial contracts and justify the existence of these standard forms in the context of commercial transactions. In this regard it is argued that standard form commercial contracts are the result of extensive prior negotiations between parties whose bargaining powers are fairly matched, and that they are adopted because ‘they

16 For example, Atiyah identifies duress, undue influence, unconscionability, legislative restrictions as examples of doctrinal constraints on the classical doctrine of freedom of contract; Atiyah, above n 12.
18 See Kessler, above n 7, 631.
facilitate the conduct of trade’ or – in economic terms – they reduce transaction costs.\textsuperscript{19} For example, Karl Llewellyn argues that the benefits of standard forms of commercial contracts are as follows:

\begin{quote}
The “general law” is much too general. It needs tailoring to trades and to lines of trading. Nothing can approach in speed and sanity of readaptation the machinery of standard forms of a trade and for a line of trade, built to meet the particular needs of that trade. They save trouble in bargaining. They save time in bargaining. They infinitely simplify the task of internal administration of a business unit, of keeping tabs on transactions, of knowing where one is at, of arranging orderly expectation, orderly fulfilment, orderly planning. They ease administration by concentrating the need for discretion and decision in such personnel as can be trusted to be discreet. This reduces human wear and tear, it cheapens administration, it serves the ultimate consumer.\textsuperscript{20}
\end{quote}

On this view, standard form contracts save the trouble and time in bargaining and simplify the internal administration of a business including keeping tabs on transactions, arranging orderly expectation, orderly fulfilment and orderly planning. Similarly, commenting on the admitted virtues of standardised contracts, Nicholas Wilson states that:

\begin{quote}
By saving time and trouble in bargaining, simplifying internal administration and facilitating planning they reduce administrative costs to an extent which must benefit both parties. They have, it is said, a lulling effect induced by the knowledge that one is signing “what everyone else has signed”. They also reduce risk to a calculable quantity and, perhaps most important of all, have the potential, if drawn up in an enlightened manner, of becoming “a wise code governing intra- or extra-trade relations of a business group”.\textsuperscript{21}
\end{quote}

Hence, a further benefit of standard form contracts would be that if drafted in a comprehensive manner, they will have the potential to become a code of trade relations

\textsuperscript{19} See Michael Trebilcock, ‘The Doctrine of Inequality of Bargaining Power: Post-Benthamite Economic in the House of Lords’ (1976) 26 University of Toronto Law Journal 359. This distinction between consumer standard form contracts and commercial standard form contracts is drawn from the House of Lords decision in Macaulay v Schroeder Publishing Co Ltd [1974] 1 WLR 1308 (House of Lords); See also Wickrema Weerasooria, Bank Lending and Securities in Australia (Butterworths, 1998) 563 in which it is stated that an argument in favour of standard form contracts is that they have been drawn up for the health and expansion of the trade or business that uses them.


\textsuperscript{21} Nicholas Wilson, ‘Freedom of Contract and Adhesion Contracts’ (1965) 14 International and Comparative Law Quarterly 172, 175.
of a particular group of business. David Slawson points out the virtues of standard forms of contracts as factors that led to an increased use of standard forms for contractual purposes:

The first of these, which I have already mentioned, is that business began to find it profitable to use standard forms. The critical factor was size. A business that is large enough to engage in numerous transactions can substantially reduce its costs of transacting by using just one kind of standard form for all its transactions of a kind. Standard forms also enable a business to make its risks of transacting more manageable by making them uniform for all its transactions of a kind.22

Large businesses would benefit from the use of standardised contracts because they can substantially reduce the transaction costs and serve as a tool that helps to manage the risks of transacting by applying a uniform set of clauses to similar transactions.

Based on the virtues of standard forms of contracts in general, an argument can be made that standard forms of on-demand guarantees should be regarded as a result of extensive prior negotiations, and should be welcomed on the basis that they reduce the costs of negotiating an on-demand guarantee and facilitate trade by providing security for performance under the underlying contract. Whilst acknowledging these virtues of standard forms of on-demand guarantees, this thesis argues that their existence is a departure from the principles underpinning the classical doctrine of freedom of contract including the recognition of explicit bargaining as the core of genuine freedom of contract.23 Arguably, as in the case of consumer standard form contracts, these standard forms of on-demand guarantees in the Sri Lankan market reflect the relatively weak bargaining position of the applicants on one hand and the relatively superior bargaining positions of the issuers and beneficiaries on the other and thus amount to a departure from classical freedom of contract principles.

23 See Kessler, above n 7, 631: Note that some commentators have argued that the standard forms of contracts undermine the voluntariness of the contractual obligations; See Andrew Robertson, ‘The Limits of Voluntariness in Contract’ (2005) 29 Melbourne University Law Review 179; However, in the demand guarantee context, it cannot be argued that the applicants do not voluntarily enter into such agreements – rather it is a matter of the relatively weak bargaining position of the applicants in the Sri Lankan guarantee market and hence the lack of true bargaining that makes such standard form guarantees contrary to the classical freedom of contract principles; As one commentator said ‘because of the obvious difference in size and strength of one of the parties, it is difficult to deny an inequality of bargaining power in most transactions where such [standard form] contracts are used. This has been judicially acknowledged’; Weerasooria, above n 19, 562.
According to one commentator the genus ‘standard form contracts’ is said to have three species. First is the compulsory contract which arises when one has no option but to enter into the contract with the offeror, because the services offered are so essential as to be in the nature of public utility. Second, the contract falls within a state of affairs in which certain terms are prescribed and others are proscribed by legislation. Third, there are those standardised contracts not falling within either of the first two species which are generally termed ‘adhesion contracts’: the form of the contract is drawn up by one party and the other party has merely to adhere to it, having no say with respect to the terms. It is possible that the standard forms of on-demand guarantees fall within the realm of this third species of standard form contracts as the applicant by procuring an on-demand guarantee issued by a financial institution, has to ‘adhere’ to the terms of payment prescribed by them. The courts have generally enforced such agreements by typically asking ‘Did the parties agree that payment under the guarantee should be made on-demand?’ However, it is argued that this approach of the courts fails to appreciate that the very existence of on-demand forms does not reflect the notion of contract as a bargaining process.

The empirical research outlined in chapter four amply demonstrated that commercial banks (in Sri Lanka) that issue on-demand guarantees use standard forms for the issue of such guarantees and the applicants have no choice but to agree to the terms of payment (usually, the beneficiary’s entitlement to payment upon a simple written demand) contained in those standard forms. An argument can be made that the nature of these standard forms of on-demand guarantees departs from classical freedom of contract principles because the payment terms are not the result of explicit bargaining. Highlighting the dangers inherent in the rising trend in favour of standard form contracts Lord Diplock once observed:

It is the result of the concentration of particular kinds of business in relatively few hands. The ticket cases in the nineteenth century provide what are probably the first examples. The terms of this kind of standard form of contract have not been the subject of negotiation between the parties to it or approved by any organisation representing the

24 Wilson, above n 21.
26 See generally Grant Gilmore, The Death of Contract (Ohio University Press, 1974).
27 See Kessler, above n 7.
interests of the weaker party. They have been dictated by that party whose bargaining power either exercised alone or in conjunction with others providing similar goods or services enable him to say: *If you want these goods or services at all, these are the only terms on which they are obtainable. Take it or leave it* (emphasis added).\(^{28}\)

The acceptance of these terms by the applicants of on-demand guarantees, arguably, is the result of the relatively weaker bargaining position (rather than no bargaining power) that they occupy in the market, or an indication that they have assented to such terms because of necessity. Over 60 years ago, in a consumer setting, Friedrich Kessler correctly observed that:

> Standard form contracts are typically used by enterprises with strong bargaining power. The buyer can not select because there is a monopoly or the industry offers only one standard clause. Thus the standard form indicates the decline of free enterprise and the concomitant rise of monopoly power.\(^{29}\)

The empirical research which has informed this thesis provides support for this statement in the context of the standard forms of on-demand guarantees in the Sri Lankan market: the medium and small scale contractors and exporters in Sri Lanka can not avoid these standard forms of on-demand guarantees because they are dependent on the financial institutions that provide the guarantee facility to them.\(^{30}\) These applicants also depend on the overseas beneficiaries to secure the underlying contract – under any payment terms preferable to the beneficiary. Therefore, whilst the applicants’ dependency increases, their ability to negotiate terms steadily decreases. Thus, this thesis argues, as in the case of consumer standard forms of contract, the standard forms of on-demand guarantees in the Sri Lankan market arise in circumstances where the bargaining positions of the applicants, beneficiaries and issuers is not fairly matched.


\(^{29}\) Kessler, above n 7, 631.

\(^{30}\) See also chapter four; Note that in a different context English courts in *Alec Lobb (Garages) Ltd v Total Oil GB Ltd* [1985] 1 All ER 303, 313 observed that ‘it is seldom in any negotiation that the bargaining powers of the parties are absolutely equal. Any individual wanting to borrow money from a bank, building society or other financial institution in order to pay his liabilities or buy some property he urgently wants to acquire will have virtually no bargaining power. He will have to take or leave the terms offered to him’; See Weerasooria, above n 19, 567.
Following are some examples of payment conditions in standard forms of on-demand bank guarantees, which not only indicate that financial institutions that issue on-demand bank guarantees in Sri Lanka use similar or identical forms but also the fact that the payment terms themselves are one-sided, meaning that they are intended to benefit the beneficiary or protect the financial institution at the expense of the applicant:

We…do hereby undertake to pay you on demand a sum of money not exceeding [Guarantee Currency]. [Guarantee Amount] (Sri Lankan Rupees [amount in words]) should [Applicant Name] fail to perform their contract with you in respect of [Project Name]. (Standard form of On-demand Guarantee-Issuer 3)

We hereby affirm that we are guarantor and responsible to you, on behalf of the contractor, up to a total of…(amount in figures) such sum being payable in the type and proportions of currencies in which the contract price is payable, and we undertake to pay you, upon your first written demand (and without cavil or argument) any sum or sums within the limits of …(amount in figures) as aforesaid (without your needing to prove or to show grounds or reasons for your demand for the sum specified therein). (Standard form of On-demand Guarantee-Issuer 4)

We hereby affirm that we are guarantor and responsible to you, on behalf of the contractor, up to a total of…(amount in figures) such sum being payable in the type and proportions of currencies in which the contract price is payable, and we undertake to pay you, upon your first written demand (and without cavil or argument) any sum or sums within the limits of …(amount in figures) as aforesaid (without your needing to prove or to show grounds or reasons for your demand for the sum specified therein). (Standard form of On-demand Guarantee-Issuer 7)

We …., a banking corporation incorporated in the United Kingdom having its Head Office in London and carrying on business at No…., in the Democratic Socialist Republic of Sri Lanka do hereby undertake to pay on demand at Colombo all charges that may be claimed by you in respect of default.

(Standard form of On-demand Guarantee-Issuer 2)

These terms are usually to the effect that the issuer undertakes to make payment to the beneficiary on his demand and thus secure to the beneficiary a right to payment. The fact that commercial banks that issue on-demand guarantees use similar wording in the payment clauses and that they have been accepted as non-negotiable terms also
indicates that applicants have no choice in the market when it comes to on-demand bank guarantee clauses. The applicants in need of on-demand guarantees are frequently not in a position to shop around for better terms because all competitors (that is all commercial banks in Sri Lanka) use the same or similar clauses. There the relatively superior bargaining position of the commercial banks that issue on-demand guarantees has stemmed from the monopoly position they occupy in the market. Then, it becomes relevant to ask whether it is feasible for the applicants to investigate the alternatives available in the guarantee market; for example this would involve the costs of comparing the on-demand guarantee forms of the commercial banks with payment clauses in the insurance guarantees, construction guarantees and standby letters of credit.  

Assuming that the latter forms of guarantees (that is the standard forms used for instruments that can be used in lieu of demand guarantees) offer better terms of payment that are beneficial to the applicants (for example in the case of insurance guarantees the guarantee is payable on-demand upon the loss-adjuster’s recommendations to the insurance company that the beneficiary’s claim for a particular amount should be honoured), the question then arises whether the applicants are in a position to entirely avoid the on-demand guarantees of the commercial banks? My empirical research in the Sri Lankan guarantee market indicates that at least 50% of the applicants are compelled to procure those guarantees issued by commercial banks (that are strictly payable on-demand) due to the fact that overseas beneficiaries would not agree to contract unless the guarantee is payable on-demand and hence the competition in the market to procure the underlying contract, particularly for those in international trade and the construction industry are compelled to agree to the beneficiaries’ requirements.

Thus my empirical research demonstrates that these payment terms are non-negotiable and even if the alternatives are available (on different terms), due to the competition in the market the applicants can not completely avoid guarantees payable on-demand of the beneficiaries. This supports the argument advanced in this thesis that the standard forms of on-demand guarantees in the market arise out of the relatively superior bargaining positions of the issuers and beneficiaries, because both the issuer and the beneficiary can say to the applicant that ‘these are my terms-take it or leave it.’ Arguably, in such a ‘take it or leave it’ transaction, there is absence of actual freedom of contract – freedom to negotiate and bargain the terms of the guarantee. Yet, their existence in the guarantee market is proof that they are by no means unusual and are guided by the ‘usual-

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31 See also discussion under ‘Instruments in lieu of on-demand bank guarantees’ in chapter four.
32 Ibid.
and are generally accepted by applicants, issuers and beneficiaries as instruments that ‘facilitate the conduct of trade.’

**Freedom of contract – enforcement**

Contract law facilitates individual autonomy or freedom. Therefore, there is a strong presumption of enforceability of freely bargained agreements. The on-demand guarantee like any other contract is presumed to be based on the genuine consent and open-meeting of minds of parties to the contract. Even in circumstances where the parties have used standard forms of on-demand guarantees, the law presumes the implied consent of the parties to the term that the guarantee is payable on-demand. Therefore, in circumstances where the parties have clearly agreed (in a standard form or otherwise) that the beneficiary is entitled to payment on demand without proof of default the classical doctrine of freedom of contract recognises the issuer’s obligation to pay upon a simple demand by the beneficiary. Therefore, the function of the law is to facilitate the enforcement of such agreements.

However, the ‘freedom’ to enforce the payment terms in the demand guarantee should only be allowed to be exercised as long as there is bona fides on the part of the beneficiary calling under it. Arguably, any factor which vitiates the virtues that underpin the enforcement of contractual obligations can be utilised to justify the law’s intervention with the enforcement of that contractual undertaking.

When the beneficiary presents a demand for payment under the demand guarantee, the fraud exception is often used to justify non payment. The Sri Lankan courts have demonstrated that they are willing to intervene in the bargain of the parties to on-demand guarantees, on the ground of fraud on the part of the beneficiary calling under the guarantee. Thus an exception to freedom of contract in the enforcement of demand guarantees exists in Sri Lanka when the beneficiary asserts his right to payment.

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33 See Lenhoff, above n 25, 484.
34 See Trebilcock, above n 19.
37 See discussion under ‘The Sri Lankan common law position’ in chapter three.
fraudulently. It is argued that under those circumstances the interventionist role of the law is essential to the smooth enforcement of contractual undertakings.

It is significant that in recent years, the courts in Singapore and Australia have been willing to expand this intervention by giving recognition to unconscionability as a separate ground from that of fraud for restraining payment under on-demand guarantees. Arguably, this represents an expansionist attitude on the part of the Singaporean and Australian courts towards intervention in the commercial bargain of the parties. Advocates of this more inclusive approach have drawn their support from a classic statement of Ackner LJ in the United Trading Corporation S.A. and Murray Clayton Ltd v Allied Arab Bank Ltd. Ackner LJ in that case noted that in America the concept of fraud is far wider than that under English law and hence interlocutory relief appears to be more easily obtainable and supported that view with the observation that ‘there is no suggestion that this more liberal approach has resulted in commercial dislocation.’ To the best of my knowledge, there is no empirical evidence to suggest that the Singaporean or Australian courts’ recognition of a further ground for intervention in the enforcement of demand guarantees (namely, unconscionability as a separate ground from that of fraud for restraining the beneficiary calling under the guarantee) has resulted in the commercial dislocation of on-demand guarantees. I argue that when there are allegations of unconscionability on the part of the beneficiary it is not wrong for the court or the legislature to step in to serve justice. Whilst this suggested approach expands judicial intervention from fraudulent demands to unconscionable demands, it also recognises a justifiable limitation on freedom of contract. Arguably, the idea behind this intervention is that unconscionable conduct should not be permitted on the part of the beneficiary against the applicant even where the applicant has earlier agreed that the guarantee is payable upon a simple demand of the beneficiary.

The conflict between freedom of contract and unconscionability

The recognition of unconscionable conduct as a ground for restraining payment under demand guarantees is undoubtedly a challenge to the doctrine of freedom of contract, in

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38 See generally chapter two.
its classical form. There is scope for argument that courts’ intervention in the enforcement of demand guarantees will do no justice to the beneficiary if it amounts to a reckless disregard of his bargain in the on-demand guarantee. In other words, the courts’ intervention in the enforcement of demand guarantees could result in certain ramifications: namely conflict with the issuer’s autonomous undertaking to honour the beneficiary upon a simple demand and conflict with the beneficiary’s right to payment upon a simple demand. These ramifications of the law’s intervention with the rights and obligations of the parties to an on-demand guarantee and its conflict with freedom of contract as applied in modern times are examined below.

(a) The conflict with issuer’s undertaking to pay

An on-demand guarantee is normally an absolute undertaking of the issuer to pay upon a simple demand of the beneficiary. However, if an injunction is sought against the issuer, the law intervenes in that autonomous undertaking in at least two circumstances. Firstly, where the demand under the guarantee is fraudulent — this is the recognised ground upon which the law in the United Kingdom and Sri Lanka intervenes with the issuer’s contractual undertaking to pay upon demand. Secondly, as analysed in chapter two, Singaporean and Australian jurisdictions recognise that where the demand so made is unconscionable the law is permitted to step in and protect the applicant by restraining the issuer from honouring his contractual obligations towards the beneficiary.

One might argue that enforcement of on-demand guarantees respects freedom of contract and that if guarantees are not enforced they will not be entered into in the first place. Issuers and beneficiaries would lose the choice to bind themselves in the future. On this point this thesis argues that there is very little to suggest that the concept of unconscionability poses a direct threat to the perceived freedom of contract between the issuer and beneficiary. This argument finds support in the fact that freedom of contract is not an absolute ideal but operates under certain limitations based on principles of fairness that were discussed earlier in this chapter.

41 See Atiyah, above n 12, 729. Atiyah explains the instances which have caused a gradual decline of the importance of free choice.
42 See chapter three; It pointed out that the Sri Lankan courts are extremely reluctant to intervene with the issuer’s undertaking to honour the demand based on the assumption that injunctions against the issuer could damage its reputation.
(b) The conflict with beneficiary’s right to demand

On-demand guarantees stipulate that the beneficiary is entitled to payment on demand, without proof of default under the underlying contract. However, there is nothing which prevents a guarantee being issued subject to certain conditions, in which case the beneficiary can not simply make a demand for payment unless those conditions are satisfied. However, as noted in the introductory chapter, the scope of this thesis is limited to on-demand guarantees which entitle the beneficiary to payment upon a simple demand without having to prove the default of the applicant.

In the context of on-demand guarantees, one could argue that the emergence of the concept of unconscionability might create far reaching consequences with regard to a beneficiary’s entitlement to payment on-demand. On this point, it is argued that the classical doctrine of freedom of contract no longer protects a beneficiary who has acted against his conscience in calling under the demand guarantee. As outlined above, over time courts have tempered the application of the classical doctrine of freedom of contract by reference to what is fair, reasonable, just, equitable, in good faith or good conscience in a particular case. As some commentators observe, of these concepts conscience has so far played the leading role in modern Australian contract law and the principle to be derived from this concept is that a party may not assert a contractual right if it would be unconscionable to do so.43

The implication of such a general principle for contracting parties is clear. A modern court will resolve rights and obligations of parties not merely by reference to the letter of the on-demand guarantee, but will consider whether the application of the letter accords with conscience in a particular case. In this sense, the attitude of the Singaporean and Australian courts may be understood as amounting to a rejection of the rigid application of the classical doctrine of freedom of contract, which would allow a beneficiary to enforce his right to payment on-demand.

It is argued that while these jurisdictions will continue to apply the established rules of contract law, originally derived from the concept of freedom of contract as necessary starting off points in the resolution of rights of a beneficiary of an on-demand

guarantee, they will not hesitate to depart from those rules where on the facts of the case their invocation is clearly unconscionable.

**A cost-benefit analysis**

There is ample legal literature in both Singapore and Australia which emphasises the importance of restraining unconscionable demands under on-demand guarantees. However, there is a dearth of literature that has investigated the economic efficiency of this phenomenon using a cost-benefit analysis. Since on-demand guarantees are intimately linked with the commercial world, it is argued that these instruments and the law applicable to on-demand guarantees can be analysed in terms of cost-benefit. In the analysis that follows, I will consider the costs and benefits of applying unconscionability as a legal restriction on the enforcement of on-demand guarantees. The cost-benefit analysis which I have undertaken for the purpose of this thesis does not encompass a detailed economic investigation. My approach to this inquiry is to ask the basic question: What costs and benefits would accrue if the beneficiary of the guarantee is restrained from making an unconscionable demand for payment? During the course of this inquiry various legal arguments will be presented that are apt for evaluation through a typical economic investigation.

In economic terms, this is a hypothesis which can be proved positive only if the ‘benefits’ of unconscionability exceed the ‘costs’ accrued to the parties to the demand

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44 See generally chapter three which examines the reasoning behind the recognition of unconscionability as a further ground for restraining the enforcement of demand guarantees.


46 Cost-benefit is a generic term embracing a wide range of evaluative procedures which lead to a statement assessing (costs and benefits) advantages and disadvantages of a particular activity; See generally Ajit Dasgupta and David Pearce, *Cost-Benefit Analysis: Theory and Practice* (Macmillan Press, 1972); This is the most commonly used approach in normative or welfare economics. For a discussion of Positive v Normative economics, see Cento Veljanovski, *The Economics of Law* (Institute of Economic Affairs, 2nd ed, 2006) 56; The techniques used in identifying and comparing costs and benefits are numerous. Some economists believe that if a law, when applied, would result in an overall gain even if there are some people who will be worse off, in which case that new law should still be enacted. Legislators must then determine whether remedial measures should be put in place to help those adversely affected. This approach in economics is called the Kaldor-Hicks criterion of efficiency (it is also known as a potential Pareto improvement). It is based in the measure of overall gains exceeding overall losses to whomsoever they accrue. For a comprehensive explanation of this criterion, see Peter Sassone and William Schaffer, *Cost-Benefit Analysis: A Handbook* (Academic Press, 1978) 9-12.
guarantee. In solving this issue economists might adopt various criteria to test the net benefits. Then, if the benefits exceed costs, another, distinct, cost-benefit analysis might be undertaken to see the cost-benefits balance of the remedies proposed.

Economists typically use quantitative statistics to prepare the final report in a cost-benefit analysis. However, the analysis of costs and benefits of restraining unconscionable demands in this chapter will be somewhat different to the typical cost-benefit evaluation in economics in that the analysis is not supported by quantitative statistics. No doubt such a quantitative approach will be an avenue for future economic research as suggested in the final chapter of this thesis.

Hence, this thesis argues that from an economic viewpoint unconscionability as a legal restriction will result in benefits as well as costs to the parties involved in the operation of on-demand guarantees (the financial institution, the beneficiary and the applicant). The discussion below examines unconscionability as a ground for restraining the beneficiary calling under the guarantee and hence has a focus on the potential costs and benefits of legal intervention on the applicants and beneficiaries in particular.

**Law’s intervention and potential costs**

(i) **Costs of providing additional form of security**

As was noted in the introductory chapter, on-demand guarantees are issued to cover performance contingencies in a wide variety of business settings, particularly in the export and construction industries. However, these security instruments are intended to provide not only security but also ‘prompt relief’ to the beneficiary in the event of default under the underlying contract. If the law recognises unconscionability as an additional restriction on beneficiaries’ demands, it is very likely that these beneficiaries would demand additional security in the event that their demand under the guarantee is not readily and promptly available to them. Arguably, this is an additional cost on the applicant who has to enter into an indemnity agreement with the issuer to procure the issue of the guarantee. For example, my empirical research shows that commercial banks in Sri Lanka require the applicants to provide 100% collateral (mortgage of property) or cash deposit or a guarantee facility as security for the full amount of the guarantee. This means that applicants either tie up their credit facility and/or tangible securities for the issue of the guarantee. Arguably, these applicants will suffer additional costs and
financial difficulties if beneficiaries demand a security in addition to an on-demand guarantee that can be readily and promptly convertible to cash.

(ii) Costs of procuring counter-guarantees from foreign banks

Unconscionability as a ground that expands judicial scrutiny of the circumstances under which the beneficiary can be restrained from demanding payment under the guarantee might raise new concerns for the applicants, issuers and guarantor-banks. By issuing a counter-guarantee payable on-demand, the issuing bank is under an obligation to honour a demand under the counter-guarantee. For example, in circumstances where a foreign bank (guarantor-bank) issues a counter-guarantee to an issuer in Sri Lanka subject to the law of Sri Lanka, it is only in very exceptional circumstances, such as fraud on the part of the beneficiary, that the guarantor-bank will opt to dishonour the demand for payment. With the recognition of unconscionability as a further ground for restraining the beneficiary calling under the guarantee, these financial institutions might encounter situations where their reputation with the issuing banks for paying out on the guarantees can be damaged.47 These financial institutions will be compelled to take costly precautionary measures to safeguard their reputation as banks providing counter-guarantees. Consequently, procuring a counter-guarantee will be costly from the point of view of both the issuing bank and the applicant.

(iii) Costs of litigation and costs pending litigation

Ordinarily in an application for injunction restraining the beneficiary calling under the guarantee both the applicant and the beneficiary will be required to bear certain costs which accrue to them as a result of the pending litigation between the parties in relation to a disputed demand of a beneficiary under the guarantee. As outlined in chapter three, both under Sri Lankan and English laws the applicant would be successful in litigation only in exceptional cases such as fraud on the part of the beneficiary calling under the guarantee. The empirical research undertaken for this thesis indicated that small and medium scale exporters and builders in Sri Lanka find this legal process not only cumbersome but also very costly. An argument can be made that unconscionability as a further legal restriction on beneficiaries’ demands would expose the parties to litigation which would result in costs of litigation and other costs pending litigation.

47 See also the discussion under ‘Financier’s reputation’ in chapter three.
It is argued that from the point of view of the applicant who seeks to prevent the beneficiary calling under the guarantee, the costs pending litigation would include any expenditure associated with the underlying contract. For example, the empirical research shows that in the Sri Lankan context, building contractors and exporters of goods overseas (applicants of on-demand guarantees) may suffer loss arising from any subcontracts of the works they have already delegated. This is so because, in the event of litigation of a disputed demand under the guarantee, the underlying contractual performance comes to a halt which in turn results in the termination of subcontracts for materials (in the case of building contracts) and termination of supply contracts with local suppliers (in the case of export contracts) resulting in a loss of income for the applicants.

If the issuers and guarantor-banks are also parties to the litigation (in cases where the injunction is sought against both the beneficiary and the financier) they too will suffer costs pending litigation. In chapter three, I have analysed the issuer’s damage to reputation argument, in some detail. Bankers and other financial institutions that issue and regulate on-demand guarantee instruments provide a vital function in any economy. If these financial institutions are restrained from honouring their financial commitments, their ability to attract local and international business contracts that seek on-demand guarantees will be at risk. Consequently, these financial institutions will face the risk of losing profit that could have been earned through the issue of on-demand guarantees and counter-guarantees. Therefore, from a financial institution’s point of view it can be argued that the costs associated with damage to financial reputation could go up if they are not allowed to honour the payment obligation under an on-demand guarantee.

Hence, an argument can be made that if unconscionability is recognised as a ground for restraining the beneficiary calling under the guarantee (that is, if the equitable intervention aims at restraining the beneficiary rather than the financier), the costs of legal intervention would fall on the applicants and beneficiaries to the exclusion of the financier.

Notably, the relevant literature in Singaporean and Australian jurisdictions that recognise unconscionability suggest no evidence that their banking system has experienced a threat to the issuer’s reputation as a financing institution as a result of the expansion of judicial discretion to issue injunctions restraining the beneficiary calling
under the guarantee unconscionably. I have examined this aspect in detail elsewhere in this thesis.48

Law’s intervention and potential benefits

(i) Reduce transaction costs

Transaction costs were defined by one economist as the physical cost of search, negotiation and contract formation and monitoring and policing costs: ‘In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed and so on.’49 With reference to these transaction costs, Veljanovski and Harris state that:

In the hypothetical, ideal world in which each party was fully informed about all the circumstances and could accurately predict the future, and the costs of negotiating were negligible, the parties would draw up a “complete contingent contract”, that is one which exhaustively specified all the parties’ rights and obligations in every possible situation, and which provided a set of procedures and penalties to deal with every conceivable aspect of non performance…In practice such a contract would be very costly (in both time and expense) to draw up and enforce.50

In practice, it is difficult to imagine a situation where parties to a contract are fully informed and hence would be in a position to draw up a ‘complete contingent contract’. It is argued that unconscionability either as a statutory provision or a common law provision can be construed as a default rule which saves the parties to a demand guarantee the expense of having to negotiate and draft provisions dealing with demands for payment under the guarantee.

The reason for the use of standard forms of on-demand guarantees in the market is that it is too costly for parties to negotiate on-demand guarantees with a comprehensive set of rules that cover a variety of contingent situations. It can be argued that even standard forms of on-demand guarantees are not complete contingent contracts, in that

48 Ibid.
they do not exhaustively provide for many contingencies upon which the beneficiary may seek to enforce the demand guarantee and what set of procedures and penalties should apply to every conceivable aspect of the enforcement of the guarantee. By failing to negotiate for these contingent situations, the applicant and the beneficiary tacitly agree to rely on the law to resolve any dispute between them as to payment on the demand guarantee. Arguably, both the applicant and the beneficiary would consequently benefit from the low transaction costs if the law provides for contingencies such as unconscionable demands on the part of the beneficiary.

(ii) Economise on information costs

Information costs are another facet of transaction costs. There is a general tendency among lawyers and legislators to assume that information is costless, but economists understand that it is very costly to acquire information (new facts) and minimise mistakes. When parties negotiate an on-demand guarantee they will incur the monetary costs of acquiring information in relation to the guarantee they intend to procure and about the nature of liability in the event of a call under the guarantee. Therefore, it is argued that with the recognition of unconscionability as a ground for restraining payments under on-demand guarantees, the law becomes a source of new information for the participants of on-demand guarantee contracts. This reduces the cost of obtaining correct information as to the situations under which a call on the guarantee can be stopped, and also reduces the corresponding costs of relying on incorrect information.

(iii) Mitigate financial difficulties

The value of the on-demand guarantee that the beneficiary requires is a significant percentage of the contract value. To issue the guarantee, the applicant’s bank requires security for its full amount, which means tying up the applicant’s working capital and preventing him from pursuing other opportunities. This situation for the applicant is even more disadvantageous in jurisdictions where there is limited scope for restraining unfair and opportunistic advantage taking in the enforcement of these on-demand guarantees. Arguably, this is true in the context of Sri Lankan exporters and builders who are entitled to restrain the beneficiary only in limited cases of actual fraud on the part of the beneficiary and not otherwise.

51 Ibid 112.
When the beneficiary makes a demand to the issuer, the latter’s obligation is to honour the beneficiary and then reimburse the amount from the security provided for the issue of the guarantee. Consequently, the applicant who procured the demand guarantee is exposed to financial difficulties. The empirical research discussed in chapter four identified this situation for the small and medium scale builders and exporters in Sri Lanka. Arguably, judicial intervention in the enforcement of demand guarantees in circumstances not only fraudulent but also unconscionable would be a useful strategy for mitigating financial difficulties for applicants. Currently, due to the lack of legal protection against unfair advantage taking on the part of the beneficiaries calling under the guarantees, these applicants encounter certain costs. It is argued that, based on the empirical research results, prevention of unfair advantage taking which amounts to unconscionable conduct on the part of the beneficiary could result in a substantial elimination of the ‘cash flow problems in relation to future investments,’52 ‘loss of income through the sub-contracts entered for the purpose of completing performance under the underlying contract with the beneficiary,’53 and ‘crippling actions due to the bank’s reimbursement of the claim under the indemnity agreement with the applicant for the demand guarantee.’54

(iv) The protection against opportunistic and unfair advantage taking

Unconscionability as a restriction on the beneficiary demanding payment under a demand guarantee can be treated as an important protection for the applicants against beneficiaries’ opportunistic advantage taking. The empirical research discussed in the previous chapter illustrates that beneficiaries tend to call for payment on the guarantee to exert pressure on the exporter or the builder to agree to new terms or extend the term of the guarantee.55 Unless the applicant is successful in showing that this conduct amounts to fraud, the beneficiary is allowed to take an unfair advantage in the enforcement of the demand guarantee. Therefore, it can be argued that the laws that recognise unconscionability as a legal restriction on the encashment of on-demand guarantees would operate as a vital protection against advantage taking of the situational disadvantage or the vulnerability of the applicants in the guarantee market.

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52 See discussion under ‘Costs of beneficiaries calling under on-demand guarantees’ in chapter four.
53 Ibid.
54 Ibid.
55 See qualitative research participants’ comments under finding (2) in chapter four.
Thus, an argument can be made that restrictions on unconscionable conduct in the guarantee market would discourage the beneficiaries’ opportunistic advantage taking in seeking the enforcement of demand guarantees. As I argued in chapter three, restrictions on unconscionable conduct and hence restrictions on unfair trade activity in the guarantee market are an important step toward ensuring that the applicants are not forced out of the guarantee market.56

Who will be the least-cost risk avoider?

The examination of costs and benefits of restraining unconscionable demands under on-demand guarantees leads to an important question for consideration: in relation to the costs of unconscionable conduct on the part of the beneficiary calling under the guarantee, which party to the on-demand guarantee will be the least-cost risk avoider? This question will essentially address Ronald Coase’s least-cost avoider principle (also known as the cheapest-cost risk avoider), which states that when parties A and B can both take actions to avoid the harm, efficiency dictates that whoever who can reduce the harm at the lowest cost should do so.57 Hence, in relation to unconscionable demands under on-demand guarantees, this least-cost risk avoider is understood to mean the party who could avoid the cost risk of an unconscionable demand at the lowest cost. In other words, it is a question of whose actions can reduce harm at the lowest cost, so that whichever party is the least-cost risk avoider should take measures to avoid the risk of harm.

This principle assumes that there is agreement over what counts as harm. However, in relation to demand guarantees one could argue that there are multiple, competing, types of harm that may result from an unconscionable demand. For example from the perspective of beneficiaries one may see their inability to demand cash, (even in circumstances where their conduct in calling under the guarantee was unconscionable) as a type of harm. However, the increases in the beneficiary’s liquidity in those circumstances come about at the expense of the applicant’s liquidity, and financial certainty. Which type of harm should be avoided here? In chapter three I have argued that an interim injunction restraining an unconscionable demand under the guarantee will not defeat the liquidity of the guarantee. The beneficiary will merely lose his ability to turn the demand guarantee into cash for a short period of time. After all, unconscionable conduct of a beneficiary can be treated as a form of harmful activity and therefore should

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56 See discussion under ‘Regulating unfairness’ in chapter three.
the person who creates the harm (in this case, the beneficiary) be able to complain of any costs accruing to him if the law intervenes to restrain his own opportunistic behaviour? An argument can be made that any conduct that defeats the very purpose for which the demand guarantee was procured would be harmful to the applicant as most would agree that the beneficiaries’ unfair advantage taking is harmful to the applicants as well as to trading activity in the guarantee market. This argument derives some empirical support from my qualitative research in the Sri Lankan guarantee market.58

Similarly, from the perspective of financial institutions one may see their inability to honour demands under the guarantee as likely to damage their reputations, and that this is a harm that should be avoided. But is there an agreement as to this particular type of harm? I have argued in chapter three that a reputation for ‘always’ paying is earned, to some extent, at the expense of fairness to the applicant. In other words, in seeking to avoid harm to their reputation (to beneficiaries), financial institutions create harm for the applicants. Hence, it is possible to argue that the financial institutions could avoid the harm to the applicants.

Assuming that the financial institutions could avoid such harm at a lower cost, and if efficiency is a primary consideration, then a ‘bigger pie’ can be created by allocating the responsibility for avoiding this form of harm to them. But is efficiency the only consideration that is relevant? Clearly not to private parties: who receives how much of the pie also matters very much, particularly to financial institutions, and it is in their interests to avoid the assumption of costs, even if to do so would, in terms of overall efficiency, be an improvement to the system in general. The problem with costs is that they are borne by specific parties, not in general. This problem is in the nature of a social dilemma, a strategic situation in which all players could, in principle, be better off by cooperating, and yet, when acting independently, they generate a different, worse-off, situation.

However, governments can help to overcome this. An argument can be made that governments, in contrast to individual parties, are (or should be – a crucial difference) less concerned with the interests of specific parties, and more concerned about general efficiency. They are less worried about who gets how much of the pie, and more about making the pie as big as possible. Hence, governments should focus on the degree to

58 See qualitative research finding (5) in chapter four.
which allowing for protection against unconscionability will increase the overall efficiency of the guarantee market. For example it would be relevant to investigate the manner in which protection against the opportunistic advantage taking in the guarantee market will bring about an overall increase in efficiency in the guarantee market.

The general idea behind the Coase reasoning is that efficiency matters, that the goal is to make the overall pie as large as possible. In the scenario at hand, if banks are lower cost avoiders, then assuming the introduction of a more efficient legal regime, it should be possible and profitable in principle for compensation to be paid to compensate the losers under such regime. In other words, given the pie is bigger, it should be possible, in principle, to compensate the losers under the regime for the harm they suffer, and still retain gains after such a payment.⁵⁹

In this context, it should also be noted that none of the financial institutions that participated in my qualitative research acknowledged that they have an obligation to investigate the ‘fairness’ of the beneficiary’s demand and that they ought to be responsible for the harm that the lack of investigation may cause to the applicants’ liquidity. Thus there is empirical evidence (and in fact it stands to reason) that financial institutions should not bear the costs of avoiding the harm of an unconscionable demand on the part of the beneficiary – their obligation is essentially to pay on-demand. But they unanimously agreed that unfair advantage taking on the part of the beneficiaries calling under on-demand guarantees results in significant harm to their clients’ liquidity (referring to liquidity of the applicants of demand guarantees).⁶⁰

Based on the arguments advanced thus far, this thesis argues that there is an objective form of harm flowing from the unconscionable conduct of the beneficiary calling under the guarantee – harm to the applicant’s liquidity. The issue, given this form of harm, is who should bear the cost of such harm (including the costs of preventing it). In other words, the question is how to allocate responsibility for it. As between the applicant and the beneficiary who should be responsible for avoiding the harm at a lower cost?

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⁵⁹ Note that efficiency, as defined under a Kaldor-Hicks criterion (a potential Pareto improvement) does not require such compensation to be paid; rather, it must exist only in principle. It is precisely this notion of hypothetical efficiency gains that is relevant to governments who are intent on increasing the size of the pie (rather than the gains to any one party); See text accompanying above n 46.

⁶⁰ See qualitative research finding (4) in chapter four.
To gain some insight into this question, consider a hypothetical example. In this example, the beneficiary should be held liable for the harm resulting from his unconscionable conduct in calling under the guarantee, because the beneficiary alone could have avoided the costs of an unconscionable demand at a lower cost (say for example $250; the cost of initiating negotiations prior to making the demand) than the applicant alone (say for example $400; the cost of insurance against unconscionable demands). In this example, as between the beneficiary and the applicant, the beneficiary is the least-cost risk avoider, regardless of whether the potential costs of an unconscionable demand is greater than $250 or not. In other words, the principle of least-cost avoidance dictates that the beneficiary should take remedial measures such as initiating negotiations between the parties (prior to a demand for payment) if that is cheaper than the applicant taking out insurance against such demands under the guarantee. Thus, in this example, it can be argued that the beneficiary alone should be held liable for his conduct because he alone could have avoided the harm of an unconscionable demand at a lower cost.

This example’s resolution hinges on the relative costs to each of parties. What would be the position regarding the likely relative costs to each of the parties? Consider the risk avoidance measures available for both the applicant and the beneficiary of an on-demand guarantee – they are both in a position to avoid the cost of an unconscionable demand. In the above example the applicant could have taken out insurance against unconscionable calling (if such insurance is available in the insurance market) under the guarantee. However, insurance as a cost risk avoidance measure will result in an increase of the underlying contract price and in an increase of transaction cost. Thus, if the applicant is to take a high level of precautions against an unconscionable demand these precautions will result in an increase of costs to both himself and to the beneficiary of the guarantee. Therefore, this criterion does not require the applicant to take measures, the costs of which would exceed the expected costs of an unconscionable demand. It is also to be noted that insurance against unconscionable calling under on-demand guarantees as a risk avoidance measure is not available even in jurisdictions that have recognised unconscionability as a ground for restraining the enforcement of on-demand guarantees.61

61 To the best of author’s knowledge no such insurance is available in Singapore or in Australia. However, the Australian Finance and Insurance Corporation offers ‘Bond Insurance’ against wrongful calling under on-demand guarantees which provides indemnity upto 95% of the loss resulting from a wrongful demand. Note, however, that this cover does not refer to unconscionable demands; See Australian Finance and Insurance Corporation <http://www.efic.gov.au/insurance/Pages/bondinsurance.aspx>; See also chapter six.
Then the question arises whether the beneficiary could have avoided the harm at lesser costs and what measures would simply be available for him? Thus, the question as to whether the applicant or the beneficiary should have avoided the cost risk of an unconscionable demand is quite specific to the availability and cost of those measures.

Based on this point, an argument can be made that the beneficiary who makes an unconscionable demand under the guarantee is the party who can readily be identified as the least-cost risk avoider. The least-cost risk avoider provisionally identified with strict liability, in unilateral accident cases provides conceptual support for this argument. Hence, the literature that supports economic strict liability will provide a starting point for this analysis. Guido Calabresi and Jon Hirschoff in ‘Toward a Test for Strict Liability in Torts’, propose the least-cost risk avoider principle to explain the basis of strict liability: ‘The strict liability test should simply require a decision as to whether the injurer or the victim was in a better position both to judge whether avoidance costs would exceed foreseeable accident costs and to act on that judgment.’

Thus, Calabresi and Hirschoff suggest that in a least cost avoider test the question to be determined is which of the parties is relatively more likely to find out whether avoidance is worth it and to act upon that judgment. In this inquiry they suggest that strict liability should be determined by reference to questions such as who had the greater knowledge of the risk involved and who was better able to avoid that risk by altering behaviour. William Landes and Richard Posner argue that causation in tort law can be understood to mean that the injurer causes the injury when he is the least cost avoider of it but not otherwise. Similarly, Richard Epstein argues that the person who creates the

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62 Strict (injurer) liability is the rule that injurers are strictly liable for the losses of their conduct, regardless of whether or not they are at fault. Thus, strict liability assigns costs to activities based on causation, independent of a finding of fault. Strict liability ensures that the injurer always to takes into account the costs his conduct imposes on others; See generally Jules Coleman, Risks and Wrongs (Oxford University Press, 2002) <http://www.oxfordscholarship.com.libraryproxy.griffith.edu.au/view/10.1093/acprof:oso/9780199253616.001.0001/acprof-9780199253616>.

63 See generally Guido Calabresi, The Costs of Accidents: A Legal and Economic Analysis (Yale University Press, 1970) which is unquestionably the most important academic writing in liability in tort. As Calabresi argues, the person who should be held liable is the person who could have prevented the accident with the least cost of taking care (cheapest cost avoider); See also Guido Calabresi and Jon Hirschoff, ‘Toward a Test for Strict Liability in Torts’(1972) 81 Yale Law Journal 1055.

64 Calabresi and Hirschoff, Ibid 1060.

65 Ibid 1066.

risk is the least cost avoider because he has control over the circumstances that create the risk.67 Stephen Gilles commenting on Epstein’s system of strict liability states that:

In effect we have a rule of thumb: the person who chooses to set in motion means within his or her control is usually in the best position to avoid the harms associated with those actions - whether the harm is viewed as intentional or unintentional. Conversely potential victims have, again in general, far less control over their exposure to risks from the myriad of possible risk creating activities in which others may engage...The person who can most easily avoid harm and the person who creates the risk are, in general, one and the same. That person, the cheapest cost avoider, is the person who “causes” harm in the sense that he or she is responsible for the harm.68

On this view, the person who is in control of his conduct is usually in a better position, vis-a-vis his potential victims to avoid the harm that that conduct causes. If this is so, then an equation can be made: the person who creates the harm is the person who is in a better position to avoid the harm. In the demand guarantee context, an argument can be made that the beneficiary (usually, the active person in making demands under the guarantee) is the person who is in a better position to avoid the harmful consequences of his unconscionable behaviour in calling under the guarantee. The applicants who procure such guarantees have far less control over the beneficiaries’ behaviour in calling under the guarantee. Yet, the beneficiaries themselves are in a better position to easily avoid the harmful consequences of unconscionable conduct by simply modifying their behaviour – for example, compliance with principles of good faith and fair dealing in seeking the enforcement of the guarantee. In a subsequent commentary Gilles proposes a conception of causation as risk-creation and a conception of responsibility as risk-avoidability.69

My tentative view is that risk-creation, like ownership, is in large measure a proxy for risk-avoidability. A person whose activities involve the creation of risk (to self or others) is ordinarily by that very fact in a position to reduce or avoid those risks, either by taking additional care or by refraining from engaging in the activity. Risk-creators and risk-takers are thus prima facie good risk-avoiders.70

70 Ibid 275.
Thus, when deciding who should be held liable for avoiding the risk at a lower cost, these authors suggest that the party who creates the risk and is capable of controlling the risk is usually in the best position to avoid the harm. In relation to unconscionable demands under on-demand guarantees, an argument can be made that the beneficiary who creates the risk of unconscionable demands is in the best position to control his conduct and thereby reduce the significant harm that that conduct may cause to the applicant. The beneficiary being the risk creator is prima facie a good risk avoider of an unconscionable demand under the guarantee and hence will be the least-cost risk avoider.

Epstein, in his analysis, elaborates upon an argument for the ‘assumption of risk’ as a defence that limits the application of least-cost risk avoider principle; this is the idea that the defendant ought not to be responsible for the harm that he inflicted upon the plaintiff because the plaintiff took upon himself the risk of that harm.71 He explains the rationale for this defence: ‘Whenever the plaintiff assumes the risk of harm inflicted by the defendant, the case presumptively should be treated as thought the plaintiff inflicted harm upon himself.’72

Then, in relation to the cheapest-cost risk avoider of unconscionable demands under on-demand guarantees, can it be said that the applicant of an on-demand guarantee has agreed that he would take the risk of an unconscionable demand or that he did know of the high probability and the accompanying costs of an unconscionable demand? To Epstein, the applicant of an on-demand guarantee is more likely to be the cheapest-cost risk avoider if he had knowledge of the high risk of an unconscionable demand and therefore had opportunity to avoid the potential costs of unconscionable demands. This thesis argues that an on-demand guarantee is an instrument of security and trust and that a reasonable person in the position of the applicant would not have expected that the guarantee would be called unconscionably (though there is a probability that the guarantee may be called without proof of default of the underlying contract) and that he should have taken precautions to avoid the costs of unconscionable demands at the time the guarantee was negotiated. Again it is logical to assume that no applicant would agree to procure an on-demand guarantee if he expected a very high risk of unconscionable demands.


72 Epstein, Ibid 185.
conduct on the part of the beneficiary demanding under the guarantee. Thus, it is argued that Epstein’s least-cost risk avoider ‘defence’ should have limited applicability in deciding who should be treated as the least-cost risk avoider of an unconscionable demand.

**Conclusion**

The arguments presented in this chapter served two purposes: first, to provide an analysis of unconscionability (as a legal restriction) in a *theoretical sense* looking at justifications for diverging from freedom of contract with a view to combating the problem of unfair advantage taking in the enforcement of on-demand guarantees; and second, to provide an analysis of unconscionability (as a legal restriction) from a *practical sense* looking at the economic impact of the legal restrictions on enforcement of on-demand guarantees, including a cost-benefit analysis of restraining unconscionable demands.

The starting point for my theoretical analysis was that the on-demand guarantee is a contract which falls within the ambit of the law of contract. Therefore, an interesting avenue for the exploration of the essence of enforcement of on-demand guarantees is the doctrine of freedom of contract. It would not be wrong to say that the jurisdictions I have referred to in this thesis (Sri Lanka, United Kingdom, Singapore and Australia) are unanimous in their recognition of freedom of contract, as a fundamental doctrine in the law of contract. The doctrine of freedom of contract in the enforcement of on-demand guarantees requires that the courts would respect and maintain the fundamental character of the guarantee that it is payable ‘on-demand’. Undoubtedly the courts in these jurisdictions have understood this very well. This is evident from the response of the courts to the enforcement of the beneficiaries’ demands under on-demand guarantees. It is only in exceptional circumstances that the courts intervene to restrain the beneficiaries calling under these demand guarantees. Yet, these jurisdictions differ on whether and to what extent the law is permitted to intervene in the enforcement of on-demand guarantees. For example, the examination of case law in chapter three showed that under Sri Lankan law, the beneficiary is barred from asserting his right to payment in only limited circumstances such as when the demand is tainted by fraud. In contrast, the Singaporean and the Australian courts have adopted an expansionist approach with regard to intervention in the enforcement of on-demand guarantees. I argued that with the
recognition of unconscionability as a separate ground from that of fraud for restraining payment on the guarantees, these two jurisdictions have put more weight on the value of fairness than the doctrine of freedom of contract.

I argued that in many areas of contract, freedom of contract in the classical sense is lacking and this trend is manifest in the law applicable to on-demand guarantees as well. Therefore, my endeavour was to argue that the classical doctrine of freedom of contract has lost its value in certain areas of on-demand guarantees. Firstly, I argued that the bargaining positions of the applicants, issuers and beneficiaries of on-demand guarantees are not fairly matched, most notably in the case of standard form contracts of on-demand guarantees. Therefore, in such ‘take it or leave it’ transactions, there is absence of actual freedom of contract. Drawing from my empirical research results, I argued that the acceptance of standard forms of on-demand guarantees reflects the relatively weak bargaining position occupied by applicants in the Sri Lankan guarantee market, rather than lack of free expression of their will in negotiating an on-demand guarantee. Secondly, I argued that the law’s intervention with freedom of contract in the enforcement of on-demand guarantees has evolved as a mechanism to safeguard the interests of applicants, most notably in cases where the beneficiary’s demand for payment is unconscionable.

Then I considered the conflict between freedom of contract and unconscionability. The conflict arises when the courts trade the doctrine of freedom of contract for that of fairness when called upon to adjudicate allegedly unconscionable calls under on-demand guarantees. To be sure, it is not wrong for the courts to apply the principles of fairness and justice in determining whether the beneficiary should be allowed to encash the guarantee. Thus, I argued that the doctrine of freedom of contract in its classical form is incomplete and in the enforcement of on-demand guarantees the doctrine should operate under certain limitations based on the principles of fairness and justice.

During the course of this analysis I pointed out that judicial intervention with fraudulent demands has not been construed as a threat to freedom of contract in the enforcement of on-demand guarantees. Therefore, courts should have the power to intervene in the enforcement of the demand guarantee not only in the event that the beneficiary’s conduct calling the guarantee is fraudulent but also in the event that the
beneficiary’s conduct is unconscionable. The beneficiary should equally be disentitled to assert his right to payment when the demand is tainted by unconscionability as when it is tainted by fraud. Judicial intervention under such circumstances, as I argued, cannot be construed as a threat to freedom of contract or a sacrifice of individual liberty in the enforcement of on-demand guarantees.

In fairness to issuers and beneficiaries of on-demand guarantees, I examined two possible ramifications of unconscionability as a legal restriction; the impact on the issuer’s undertaking to honour the beneficiary upon a simple demand and the beneficiary’s right to payment upon a simple demand. On these two points it was argued that the issuer’s undertaking to pay on-demand and the beneficiary’s right to demand without adducing proof of default should not be taken in isolation. If the beneficiary’s demand is tainted by unconscionability it is perfectly justified for the law to step in to serve justice.

Thus, the arguments presented in this chapter supported the interventionist approach of the Singaporean and Australian courts in relation to demand guarantees when there are allegations of unconscionable conduct on the part of the beneficiary calling under the guarantee. One could argue that the courts should not be vested with unlimited discretionary power to decide whether a particular call is unconscionable, as this would result in an imbalance between freedom of contract and the principles of fairness and justice. In order to counter this argument, chapters two and six of the thesis recommend an appropriate scope for the application of unconscionability in restraining calls under on-demand guarantees.

The final section of this chapter identified the basic economic logic of restraining unconscionable demands under on-demand guarantees — its underlying costs and benefits. In summary, from an applicant’s viewpoint it was argued that restraining unconscionable demands would result in a reduction of transaction costs, a reduction of information costs, would provide relief against cash flow problems in relation to future investments, would mitigate ‘crippling actions’ due to the bank’s reimbursement of the claim under the indemnity agreement and would provide protection against opportunistic advantage taking. The beneficiary too will benefit from the low transactions and information costs. As regards costs of legal intervention, both the beneficiary and the applicant will be exposed to litigation which would result in increases in costs of
litigation and costs pending litigation. Finally, some of the potential costs that were identified will fall exclusively on the applicants, namely costs of providing additional forms of security, and increased costs of procuring counter-guarantees. I drew support from my empirical research through qualitative interviews to illustrate some of these potential costs and potential benefits. As I argued, from an economic viewpoint a typical cost-benefit analysis using quantitative data would be needed to investigate the balance of cost-benefit. Only if and when the Sri Lankan courts adopt unconscionability as a legal restriction on the enforcement of on-demand guarantees will the economists be able to undertake a typical cost-benefit analysis which would test the veracity of these claims through quantitative data and analysis. Therefore, in the Sri Lankan context it will inevitably be necessary to go into a detailed economic analysis of these issues. This approach is essentially what my concluding chapter refers to as an evidence-based law reform in Sri Lanka.

However, in the absence of such empirical support, the literature that analyses economic strict liability provided the conceptual support for my argument that a beneficiary who is responsible for creating the risk of an unconscionable demand is the person who is in a better position to avoid the harm of his unconscionable behaviour and that therefore he can be identified as the least-cost risk avoider of unconscionable demands.
Chapter Six- A Proposal for Legal and Structural Reform

Chapters 1-5 in retrospect

The objective of this thesis has been to explore the phenomenon of the beneficiaries calling under on-demand guarantees in the export and construction industries in which on-demand guarantees are frequently used, though they are a special feature in a wide variety of commercial industries in Sri Lanka. I argued that with the increased use and significance of on-demand guarantees the guarantee market is accompanied by an increase in the incidence of unfair and opportunistic advantage taking on the part of the beneficiaries calling for payment. My research question/s revolved around an analysis of such unfair and opportunistic advantage taking in the enforcement of on-demand guarantees in Sri Lanka, drawing on legal developments in this area in Singapore and Australia.

Based on the conceptual framework that I developed in chapter two, it was argued that ‘unfairness’ in the enforcement of on-demand guarantees can appropriately be identified when it encapsulates not only the beneficiary’s fraudulent conduct but also unfair advantage taking of vulnerability of the applicant, and hence unconscionable conduct towards the applicant calling under the guarantee. I argued that the ‘fraud’ contemplated under the Sri Lankan law does not embrace situations where the beneficiary’s conduct in calling under the guarantee amounts to an unfair advantage taking of vulnerability or situational disadvantage of the applicant which would be recognised as ‘unconscionable’ in Singapore and Australia. I then surveyed the literature through case examples to illustrate the genesis and development of unconscionability as a ground for restraining the beneficiary calling under a demand guarantee in Singapore and Australia. My examination of the case law revealed that unconscionability is well recognised in Singapore as a ground for restraining the beneficiary calling under a demand guarantee. Similarly, Australian courts have recognised the possibility of restraining the beneficiary calling under a demand guarantee unconscionably. While Singaporean courts have recognised unconscionability as a conduct lacking in good faith, Australian courts have made reference to its meaning in equity. It should be noted that the Australian Consumer Law (Competition and Consumer Act 2010 (Cth) sch 2) does not provide a specific definition of unconscionable conduct that can be applied in the on-
demand guarantee context. There are, however, some general principles that can be ascertained: s 20 of the *Australian Consumer Law* refers to unconscionable conduct within the meaning of unwritten law, while s 22 provides for a set of principles that may be relevant in the context of statutory unconscionable conduct. There is also work being done by courts in exploring the scope and meaning of this provision in other contexts, which has flow-back relevance to on-demand guarantees. Therefore, to explore the equitable criteria for defining unconscionability in the context of on-demand guarantees, and to add detail, it remains necessary to turn to the equitable concept of unconscionability.

In chapter two, I argued that not all forms of unconscionable conduct in equity are appropriate to describe unconscionable demands under on-demand guarantees and that two strands of unconscionable conduct in equity, that is, exploitation of a situational disadvantage or harsh or oppressive insistence on strict legal rights to take unfair advantage of vulnerability or situational disadvantage provide useful bases for conceptual analysis of unconscionable demands under on-demand guarantees. I also argued that some of the listed indicators of statutory unconscionability – principles of good faith and fair dealing – come under these two strands of unconscionable conduct. In order to provide a theoretical foundation for my conceptual analysis of unconscionable demands I then examined the relevance of unconscionability to the broader concern with the theory of exploitation. Drawing on the essential elements of the theory of exploitation I argued that unconscionable demands under on-demand guarantees are a case of wrongful exploitation, and that therefore unconscionability provides a strong *prima facie* case for judicial intervention in the enforcement of on-demand guarantees.

Chapter three which focussed on an analysis of the current legal position relating to restraining demands under on-demand guarantees in Sri Lanka revealed that the courts’ primary concern in the enforcement of these guarantees is whether the guarantee is payable on-demand without proof of default. The courts have also shown reluctance to intervene in the issuers’ obligations to honour the guarantee when demanded. Thus, the judicial approach in Sri Lanka is weighted heavily in favour of the beneficiaries and the issuers. The applicants who procure demand guarantees have limited protection available to them – it is not easy for them to get the courts to intervene if a demand under the guarantee is made unfairly. To achieve this, fraud will have to be shown and even if there is fraud, to present a convincing case may prove to be impossible due to the nature of
evidence required to establish a case of fraud at Sri Lankan common law. Any thing that falls short of fraud is insufficient to invoke judicial intervention. Hence, Sri Lankan law takes an essentially ‘hands off’ approach to the beneficiaries’ unfair and opportunistic advantage taking in the enforcement of demand guarantees. As a result, the applicants of demand guarantees have become the ultimate victims of the beneficiaries’ unfair and opportunistic advantage taking in calling under these guarantees.

Upon a critical analysis of the Sri Lankan common law position on the matter, in chapter three I argued that by adopting a narrow scope for legal intervention in the enforcement of on-demand guarantees the Sri Lankan law has created a protection gap for the applicants of such guarantees in the market. Focussing on the recent development of the Singaporean and Australian laws it was argued that unconscionability on the part of the beneficiaries calling under demand guarantees will provide a useful strategy to mitigate unfair and opportunistic advantage taking in the enforcement of on-demand guarantees in the Sri Lankan market. Drawing on two conflicting schools of thought on this development in Singapore and Australia, I examined the arguments for and against unconscionability as a ground for restraining the enforcement of on-demand guarantees. Following the school of thought that supports unconscionability as a ground I argued that the commercial utility of demand guarantees will not be served by honouring unconscionable demands. I also claimed that the financier’s reputation argument should fail in circumstances where the equitable intervention of the courts becomes necessary to prevent beneficiaries’ unfair and opportunistic advantage taking which amounts to unconscionable conduct in calling under these guarantees. Finally, I argued that protection against unconscionable conduct in the enforcement of demand guarantees is a significant step towards regulation of unfair trade practices that reduce investment, participation and liquidity in the guarantee market. I supported this argument by an analogy to insider trading in so far as both insider trading and unconscionable behaviour in the guarantee market can be considered forms of unfair advantage taking.

A qualitative research methodology enabled me to explore the phenomenon of unscrupulous beneficiaries calling under on-demand guarantees in the Sri Lankan market, in some detail. The qualitative research also provided me with the opportunity to identify the costs and benefits of restraining such calls in the Sri Lankan market. Findings and conclusions that were drawn from this research (discussed at chapter four) enabled me to proceed from a more informed perspective in terms of designing a legal strategy to
combat the problem of beneficiaries’ unfair and opportunistic advantage taking in calling under on-demand guarantees in Sri Lanka. These findings and conclusions have also enabled me to propose practical, as opposed to legal, strategies that can be adopted for mitigating this problem in Sri Lanka. This proposal is essentially what I have referred to below as a ‘package of strategies’ for mitigating the risk of unfair and opportunistic advantage taking in the enforcement of on-demand guarantees.

Having identified the nature of the beneficiaries’ unfair and opportunistic advantage taking in the enforcement of on-demand guarantees in commercial practice, my endeavour in chapter five was to provide theoretical justifications for the adoption of unconscionability, the legal solution to this problem. First, drawing on the doctrine of freedom of contract in the enforcement of on-demand guarantees, I argued that this legal doctrine in its classical form is incomplete and in the enforcement of on-demand guarantees it should operate under certain limitations based on the principles of fairness and justice. Therefore, judicial intervention with unconscionable demands cannot be construed as a threat to freedom of contract or a sacrifice of individual liberty in the enforcement of on-demand guarantees. Second, drawing on the economic theory of cost-benefit, I identified the basic economic logic of restraining unconscionable demands under on-demand guarantees by focussing on its underlying costs and benefits. To illustrate some of the potential costs and potential benefits of restraining unconscionable demands, I drew support from my qualitative research results.

Then in relation to the costs of unconscionable conduct on the part of the beneficiary calling under the guarantee, I examined the question: who will be the least-cost risk avoider of unconscionable demands. In response to this question I argued that the beneficiary who creates the risk of unconscionable demands is in the best position to control his conduct and/or avoid that conduct which can result in significant harm to the applicant. Hence, an argument was made that, in general, the beneficiary will be the least-cost risk avoider of unconscionable demands under demand guarantees.

This concluding chapter confines the discussion to these areas; (i) practical mechanisms for achieving law reform that introduces unconscionability as a separate and independent ground from that of fraud for restraining the enforcement of demand guarantees in Sri Lanka; (ii) a proposal impacting upon the activities of the applicants of
on-demand guarantees (iii) a proposal impacting upon the activities of the financial institutions; and (iv) suggestions for future research.

These proposals are targeted to address the protection gap in Sri Lankan law and to propose a package of strategies that aim to ensure that beneficiaries do not unfairly call on the guarantees in a manner that amounts to an unfair advantage taking of the situational disadvantage of the applicants in the Sri Lankan guarantee market.

Reforming the current law

The comparative analysis that has been adopted as part of the methodology of my thesis played a significant role in enabling me to propose changes to the law restraining demands under on-demand guarantees in Sri Lanka. One of the significant works of comparative law literature identifies the significance of this research methodology in the field of law reform:

The society is like a train with law as the engine…The comparatist is a mechanic, who has the job of finding the parts which will make the engine run more smoothly. Accordingly, proposals for reform either operate purely on the technical level - offering a simpler or more elegant way of achieving the same practical solution to a problem - or involve only tinkering with relatively minor points of detail.¹

Hence, my objective in proposing legal reform is to offer a solution to a social phenomenon, that is, unfair and opportunistic advantage taking in the enforcement of on-demand guarantees that my qualitative research has examined in detail. Any proposal to introduce the concept of unconscionability into the domestic law in Sri Lanka must presuppose a particular kind of problem to be addressed, that can be satisfactorily addressed through the introduction of unconscionability as a ground for restraining demands under on-demand guarantees. In chapter three I have argued that the current Sri Lankan law is inadequate to combat beneficiaries’ unfair and opportunistic advantage taking in calling under on-demand guarantees and that there is a protection gap for applicants of such guarantees. Then in chapter four I elaborated on the nature of this phenomenon in the export and construction industries in Sri Lanka. The participants of the qualitative research, whilst sharing their experiences of this phenomenon in

commercial practice, expressed concern that the current legal position does provide protection against unfair calls that fall short of fraud – calls made in circumstances where beneficiaries’ conduct amount to an unfair and opportunistic advantage taking of vulnerability of applicants in the guarantee market. Therefore, I argued that the introduction of unconscionability as a separate ground from that of fraud would be the best way to provide a legal solution to this problem.

The question of whether Sri Lanka should favour the Singaporean or Australian common law approach to unconscionability as a separate ground from that of fraud for restraining beneficiaries calling under on-demand guarantees, or the Australian statutory unconscionability regime, ultimately depends upon the structure and scope of the model on offer. As a first step to this process of reform the appellate courts need to take the initiative by adopting an approach similar to the Singaporean model, that is, judicial recognition of unconscionability as a separate ground from that of fraud restraining demands under on-demand guarantees. This would allow the appellate courts to apply and interpret unconscionability as a ground for restraining beneficiaries calling under demand guarantees in a selected range of appropriate judicial test cases. In order to facilitate this move, there should also be enhanced funding commitment for the relevant governmental regulators to bring suitable test cases, so that applicants under these guarantees have the benefit of the new law as soon as possible. It is only when and if the common law approach proves successful in mitigating unfair and opportunistic advantage taking in the enforcement of on-demand guarantees that the legislature should consider statutory unconscionability in developing this area of law. In doing so, the drafters may consider s 20(1) and s 22 of the \textit{Australian Consumer Law} as model provisions.\footnote{For the purpose of drawing up statutory unconscionability the legislature may look into the possibility of incorporating the concept of unconscionable conduct by way of an amendment to the \textit{Fair Trading Commission Act 1987} (Sri Lanka), read with \textit{Fair Trading Commission Act No. 57 of 1993} (Sri Lanka), which is regarded as the key competition law in Sri Lanka.}

Understanding the scope and the terms of the concept of unconscionability will be useful in interpreting the circumstances that fall within the ambit of unconscionable conduct in the demand guarantee context. In order to ensure that the expansion of judicial or legislative intervention does not erode the negotiability of on-demand guarantees in the market, this concept needs to be structured carefully. Notably, the \textit{Australian Consumer Law} does not provide a specific definition or any illustrations of unconscionable conduct.
in business transactions. I argued in chapter two that there is no single or defining meaning of the concept of unconscionable conduct that has universal application. Rather, its meaning is derived through a range of equitable criteria. On the basis of the case law, I have argued that exploitation of a situational disadvantage or harsh or oppressive insistence on strict legal rights to take unfair advantage of vulnerability provide useful bases for the conceptual analysis of unconscionable demands under on-demand guarantees.

Therefore, it is important for the purpose of adopting either model, Singaporean or Australian, that Sri Lankan courts, policy makers and the legislature develop a clear set of defining elements of unconscionability that can be used to adjudicate commercial disputes. If Sri Lanka is to adopt the Australian model of statutory unconscionability then it would be useful not only to bring the equitable principle of unconscionable conduct into a statute but also to provide a brief explanation of the constituent elements and some indicators of unconscionable conduct that can be applied in the context of commercial contracts.

The conceptual analysis of unconscionability that I developed in chapter two will be a useful starting point for a proposal of a definition of unconscionable conduct specially suited for restraining the beneficiaries calling under on-demand guarantees. Based on my conceptual analysis of unconscionability and drawing upon some factors listed in s 22 of the Australian Consumer Law, the following wording is proposed as sample criteria for defining unconscionable conduct that can be applied in the demand guarantee context:

(1) Unconscionable conduct which relates to the terms or performance of a commercial contract includes conduct which:

(a) involves taking unfair and opportunistic advantage of a vulnerability of a person or a situation of that person in relation to the contract where to do so is contrary to equity; or

3 Note that in Australia there had been several attempts in the past to define statutory unconscionability in trade transactions. Several of these attempts of various interested parties which came by way of proposed amendment to the previous Trade Practices Act 1974 (Cth) but have not been brought into effect under the Australian Consumer Law due to a number of factors; See Senate Standing Committee on Economics Report, The Need, Scope and Content of a Definition of Unconscionable Conduct for the Purposes of Part IV A of the Trade Practices Act 1974 (December 2008) <http://www.aph.gov.au/SENATE/committee/economics_ctte/tpa_unconscionable_08/>; See also The Treasury, Department of Innovation, Industry, Science and Research Report, Strengthening Statutory Unconscionable Conduct and the Franchising Code of Conduct (February 2010) <http://azcz.paocool.com/documents/1744/PDF/unconscionable_conduct_report.pdf>.

4 See analysis of unconscionable demands in chapter two. 
(b) amounts to harsh or oppressive insistence on strict legal rights to take an unfair advantage under the contract.

(2) In determining whether a party to a commercial contract has engaged in unconscionable conduct, the court may have regard to:

(a) the terms and conditions of the contract;\(^5\)

(b) the relative strengths of the bargaining positions of the parties to the contract;\(^6\)

(c) the nature of the conduct of the party alleged to have engaged in unconscionable conduct in connection with the commercial relationship, after the parties entered into the contract and the extent to which the contract is performed;\(^7\)

(d) whether as a result of the unconscionable conduct engaged in by one party to the contract has resulted in detriment (financial or otherwise) to the other party;

(e) the extent to which the parties have complied with concepts of fair-play, fair-dealing and with any industry codes of conduct;\(^8\) and

(f) the extent to which the parties have acted in good faith.\(^9\)

Explanation: The list of indicators of unconscionable conduct provided in the definition is inclusive not exhaustive.

The wording I have proposed above will serve two purposes: first, it would make clear that the concept of unconscionable conduct would apply not only to the formation of commercial contracts but also to the conduct of the parties pursuant to the contract. Hence, unconscionable conduct on the part of the beneficiary calling under the guarantee falls within the realm of the application of this concept in the demand guarantee context. Second, it incorporates the themes of unconscionable conduct in equity that I argued in chapter two are appropriate to describe unconscionable conduct in the context of demand guarantees: exploitation of a situational disadvantage or harsh or oppressive insistence on strict legal rights to take unfair advantage of vulnerability. However, the suggested definition is not limited to these equitable principles or to a set of illustrations that can be drawn from the Singaporean and Australian case law. As I have suggested in the list of indicators, the terms and conditions of the contract, the nature and the extent to which the

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\(^5\) See also *Australian Consumer Law* s 22(2)(j)(ii).

\(^6\) Ibid s 22(2)(a).

\(^7\) Ibid s 22(2)(j)(iv).

\(^8\) Ibid ss 22(2)(g), (h).

\(^9\) Ibid s 22(2)(l).
contract has been performed are relevant to a finding of unconscionable conduct in commercial contracts. The defining indicators also suggest that an evaluation of the detriment resulting from the unconscionable conduct and policy documents related to industry codes of conduct are also relevant to a finding of unconscionable conduct in commercial contracts. Thus, my objective was to propose a set of defining elements of unconscionable conduct in commercial contracts that would develop this concept both collaboratively and independently from the equitable and common law principles.

It is reiterated that by proposing a definition, it is solely intended to provide a sample criteria in determining what constitutes unconscionability in a commercial bargain. Arguably, the proposed structure will provide a tool that will overcome much of the complexity of the doctrine of unconscionability, as evidenced in the vast literature available both in Singapore and Australia.10

The proposed structure of the concept of unconscionability would give the beneficiaries of on-demand guarantees a clear indication as to what types of conduct might be deemed unconscionable. At the same time, it will give a clear indication to the beneficiaries of on-demand guarantees as to what the actual boundaries of acceptable behaviour in calling under the guarantee are, and would cause them to adjust their practices of calling under on-demand guarantees accordingly. If and when the Sri Lankan courts and legislature develop the defining elements of unconscionability then in the application of this concept as a ground for restraining beneficiaries the courts will always limit the application of unconscionability with reference to previous judgments which have set out the scope of its application. Therefore, the recognition of unconscionability as a separate ground for issuing injunctions restraining beneficiaries calling under demand guarantees should not cause a significant increase in the number of cases in which injunctions are granted and should not be significant enough to reduce the commercial utility of demand guarantees or affect the financial institutions’ reputation for paying out on these instruments. To the best of my knowledge, as at the date of submission of this thesis both in Singapore and Australia there is no empirical evidence to suggest that unconscionability as a ground for intervention in the enforcement of on-demand guarantees has resulted in commercial disutility of demand guarantees, or that their financial institutions are continuously exposed to the risk of damage to reputation for paying out on these instruments.

10 See generally chapter two.
The Singaporean case law discussed in chapter two illustrates that unconscionability has been adopted mainly in construction contracts that provide for on-demand guarantees. In Australia, the application has been in both construction and international trade contracts that provide for on-demand guarantees. My empirical research amply demonstrated that unfair advantage taking on the part of the beneficiaries calling under demand guarantees is a phenomenon in both construction and international trade in Sri Lanka. Therefore, I am of the opinion that in the Sri Lankan context the expansion of the law’s intervention with on-demand guarantees needs to be applied to both international trade and construction contracts. However, this should not mean that unconscionability should not be adopted as a ground for law’s intervention with other commercial contracts (such as distribution agreements, agency contracts, supply of materials for exports or construction) that provide for on-demand guarantees. This approach is essentially what I have referred to as ‘transferability’ of my qualitative research results.11 Again, this transferability will only be possible if the courts’ approach to test cases in selected areas, preferably in contracts for construction and exports, make a real and beneficial difference in practice. Thus, the real question is whether or not the reform in this area of law will achieve the necessary result in practice. Obviously, it is impossible to predict this in advance. Inevitably there will be a ‘settling-in’ period in which applicants and financial institutions will need to await a sufficient number of judicial test cases to know the impact of unconscionability in mitigating unfair and opportunistic advantage taking in the enforcement of on-demand guarantees in the Sri Lankan market. These test cases will also provide valuable material for empirical and analytical research, to augment understanding of the effect of unconscionability in commercial contracts that provide for demand guarantees and inform evidence-based review. The pro bono services of the Legal Aid Foundation of the Bar Association of Sri Lanka could usefully be encouraged in this direction.

Thus, to mitigate the risk of unfair and opportunistic advantage taking in the enforcement of on-demand guarantees and thereby build up a better legal system in a complex area like demand guarantees, the judiciary and legislature need to exercise their expertise and discretion, make the hard decisions and draw up detailed rules. A legal framework that helps to protect applicants will ensure that applicants who risk their credit or guarantee facility in procuring on-demand guarantees are not left without a remedy.

11 See discussion relating to transferability of qualitative research results discussed under ‘Limitations of the study’ in chapter four.
against beneficiaries who attempt to exploit the vulnerable applicants in the Sri Lankan guarantee market.

However, in the end, any decision to reform the current legal position in Sri Lanka is a matter of legal policy and political judgment that would take into consideration several factors including: (a) whether law reform would be the only and best strategy to mitigate unfair and opportunistic advantage taking in the enforcement of on-demand guarantees in Sri Lanka?; (b) the availability of other strategies or policies that can be introduced or developed for mitigating the adverse consequences of this phenomenon in Sri Lanka; and (c) a typical cost-benefit analysis of the proposed law reform. These factors are all intertwined and a careful examination of them would be the first step towards a new legal or regulatory framework for mitigating unfair and opportunistic advantage taking in the enforcement of on-demand guarantees in Sri Lanka.

The major impetus behind reform of this area of law in Sri Lanka would be a public acknowledgment that the current legal position is not adequate to mitigate the risk of unfair and opportunistic advantage taking and those applicants’ interests in the guarantee market are not adequately protected. This would be need to be followed by an acknowledgment that this can best be addressed through judicial or legislative mechanisms expanding the grounds upon which demands under on-demand guarantees can be restrained. Therefore, it is important that not only the applicants (such as exporters and builders) but also financial institutions in the country agree that the current Sri Lankan law is inadequate to mitigate unfair advantage taking in the guarantee market and that expansion of judicial intervention in the enforcement of such guarantees might be possible and best. It might be possible for these stakeholders to inform their concerns and recommendations through the institutions that represent them such as Sri Lanka Export Credit Insurance Corporation (SLECIC), Sri Lanka Construction Guarantee Fund (CGF), National Construction Association of Sri Lanka (NCASL), The Ceylon Chamber of Commerce and The Institute of Bankers of Sri Lanka (IBSL). It is also important that the Law Commission of Sri Lanka together with the Ministry of Justice and Law Reforms initiate dialogue between the judicial and legislative arms of the government to work towards a new legal regime that helps to mitigate the risk of unfair and opportunistic advantage taking in the enforcement of demand guarantees in Sri Lanka.
Practical solutions for implementation by applicants

The applicants who procure demand guarantees should be aware of the on-demand character of the guarantee, the accompanying risk of unfair and opportunistic advantage taking on the part of the beneficiaries calling under the guarantees and the limited legal protection available to them in the event of such calls under the guarantees. Thus, under Sri Lankan common law where courts uphold the on-demand character of the guarantee and the issuer’s irrevocable obligation to honour the beneficiary on-demand, applicants have to consider themselves how best to mitigate the risk of unfair and opportunistic advantage taking on the part of unscrupulous beneficiaries calling under these guarantees.

So far, I have placed emphasis on a legal solution for mitigating adverse consequences of unfair and opportunistic advantage taking in the enforcement of on-demand guarantees in Sri Lanka. The focus of this section will be to suggest some strategies by which applicants could reduce the subjective power of on-demand guarantees in the beneficiaries’ hands and try to ensure that those guarantees are not called in a manner that amounts to an opportunistic advantage taking. First, based on my empirical research results I will examine whether the use of instruments in lieu of on-demand guarantees in the Sri Lankan market should be encouraged as a strategy for mitigating the risk of unfair and opportunistic advantage taking in the enforcement of demand guarantees. Second, based on my conclusions in chapter four, I will argue that issuance of demand guarantees subject to the latest revision of the International Chamber of Commerce’s Uniform Rules for Demand Guarantees (commonly referred to as URDG, Revision 758) may provide a useful strategy to mitigate the risk of unfair and opportunistic advantage taking on the part of the beneficiaries calling under demand guarantees. Third, I will argue that a fast-track adjudication clause be incorporated in the demand guarantee itself, which requires the beneficiary to submit his claim to an adjudicator prior to making the demand for payment. This may provide a useful strategy to mitigate the risk of unfair and opportunistic advantage taking on the part of the beneficiaries calling under demand guarantees. It is possible that the best solution to unfair and opportunistic advantage taking in the enforcement of on-demand guarantees will come from a package of strategies that extend beyond law reform and that could be adopted at the drafting stage of a demand guarantee.
(i) The choice between on-demand guarantee and its alternatives

The applicants of on-demand guarantees who participated in my empirical research acknowledged that for a considerable time it has been evident in international trade (exports) and the construction industry that beneficiaries have resorted to unfair and opportunistic advantage taking in the enforcement of on-demand guarantees, and as a result of this situation the applicants have encountered financial difficulties. My empirical research revealed that insurance guarantee policies, construction guarantees and standby credits are the three main security instruments that can be used in lieu of on-demand guarantees in the Sri Lankan market. It may be possible that some applicants are not aware of these alternative security instruments that can be purchased in lieu of on-demand guarantees issued by commercial banks. It may also be possible that the majority of applicants are fully aware of their options in the guarantee market but are unable to make use of them as a result of overseas beneficiaries insisting that applicants procure an on-demand guarantee that can be promptly realised in the event of default. In this regard my empirical research revealed that in order to survive in a competitive market to secure overseas contracts some of these applicants are compelled to procure on-demand guarantees of the commercial banks. The examination below will be instructive in understanding the need to better inform the applicants to consider their alternatives to the on-demand guarantees in the Sri Lankan market and thereby mitigate the risk of unfair and opportunistic advantage taking.

I propose that the applicants – before procuring an on-demand guarantee – be educated to give proper consideration to the policy of the commercial banks, insurance companies and the Construction Guarantee Fund in handling demands under the guarantees issued by these issuers. In the case of on-demand insurance guarantee policies, the beneficiary is entitled to payment on-demand but the amount claimed is subject to approval of a loss-adjuster, and in the case of on-demand construction guarantees, the beneficiary is entitled to payment on-demand but his demand will be honoured through an escrow account monitored by the Construction Guarantee Fund. In contrast, in the case of on-demand guarantees issued by commercial banks the beneficiary’s demand is honoured promptly without any investigation into the demand or monitoring procedures of the performance of the underlying contract. Based on this empirical finding it can be proposed that if the applicant is dealing with a domestic trade contract or construction

12 See conclusion (4) of the qualitative research discussed in chapter four.
13 Ibid.
project it will be worthwhile for him to enter some negotiations with his local beneficiaries to agree on an insurance guarantee policy or in the case of a construction contract to agree on a construction guarantee of the Construction Guarantee Fund as security for performance under the underlying contract. It is of course impossible to predict with any precision whether the majority of beneficiaries would agree to accept an on-demand guarantee from the insurance market or from the Construction Guarantee Fund. It is equally impossible to predict whether these two types of guarantees will overtake the on-demand guarantees of the commercial banks because the beneficiaries either local or international would prefer to secure an on-demand guarantee, one that is truly payable upon a simple demand, as security for the underlying contract.

From the applicants’ point of view (especially in the case of small and medium scale traders and builders), it would be easier for them to approach the local insurance market and the Construction Guarantee Fund for the issue of on-demand guarantees. As my qualitative research indicated, this is because these institutions adopt a flexible criterion for the issue of demand guarantees. It is only in the event that the applicants have no choice or have failed in negotiations with beneficiaries that they agree to procure an on-demand guarantee that will be honoured without any monitoring procedures of the underlying contract performance or any investigation into the validity of the claim. It is also proposed that the applicants consider the possibility of including a clause in the demand guarantee whereby the amount available for the beneficiary is reduced pro rata to the performance of the underlying contract by the applicant so that the beneficiaries will not be able to take an unfair advantage by calling for the full amount under the guarantee in circumstances where there had been partial or complete performance of the underlying contract. However, it is impossible to predict whether the banking community would agree to alter their standard forms of on-demand guarantees to insert such clauses.

As I concluded in my empirical research, standby credits are another alternative to on-demand guarantees in the guarantee market, however they are not a popular security instrument in Sri Lanka. It would, however, still be possible to persuade overseas beneficiaries to agree to accept a standby credit in lieu of an on-demand guarantee. In this context it is worth noting the comments of Issuers 2 and 8 in my empirical research who believed that standby credit is actually the solution to the problem of unfair and opportunistic advantage taking in the enforcement of on-demand guarantees and that

14 See finding (5) and conclusion (4) of the qualitative research discussed in chapter four.
15 Ibid.
applicants derive all of the benefits denied through on-demand guarantees. A further suggestion for the applicants is that they examine these benefits or negotiate with commercial banks the benefits they could derive from obtaining a standby credit in lieu of on-demand guarantees: the low costs/interest rates of purchasing standby credit in the Sri Lankan market; the policy of honouring payment under standby credits, that is, in the event of a call under the standby credit the beneficiary is required to submit a statement of default; and that the applicant is entitled to a time period to respond to the beneficiary if the need arises.

Overall, what I have proposed in this section is that if applicants are able to convince beneficiaries to accept the alternatives to the on-demand guarantees, they will derive the benefits denied through on-demand guarantees and at the same time minimise the risk of unfair and opportunistic advantage taking by the beneficiaries.

(ii) The issue of the guarantee subject to URDG 758

I argue that the issue of on-demand guarantees subject to the International Chamber of Commerce’s Uniform Rules for Demand Guarantees which came into effect on 1st July 2010 (commonly referred to as URDG 758) will be another useful strategy for mitigating the risk of unfair and opportunistic advantage taking in the enforcement of on-demand guarantees in Sri Lanka.

This latest revision of URDG which replaced URDG 458 brought a new set of rules for demand guarantees into the 21st century. The URDG is primarily intended for transnational use, for example in transactions with parties from different countries or cross-border transactions. However, the rules can also apply in domestic transactions. By virtue of Article 1 of URDG 758, the rules apply to any demand guarantee or counter guarantee where incorporated by reference in the text. The provisions of Article 15(a) should be read with Article 17 (e) – formalities for a valid demand, Article 20 – time for examination of demand, Article 23 – extend or pay demands and Article 24 – non-

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16 Ibid.
18 See URDG 758 Introduction.
20 See URDG 758 art 1.
complying demand, are useful in achieving this objective. I will now turn to a brief examination of these provisions in order to illustrate their significance and role in mitigating the risk of unfair and opportunistic advantage taking on the part of the beneficiaries calling under demand guarantees.

The recognition of the autonomy of the demand guarantee in Article 5 of URDG 758 which states that ‘a guarantee is by its nature independent of the underlying relationship and the application, and the guarantor is in no way concerned with or bound by such relationship,’ insulates the financial institutions that issue demand guarantees from the performance contingencies of the underlying contract. Article 6 of URDG 758 which states that ‘guarantors deal with documents and not with goods, services or performance to which the documents may relate’ further strengthens the financial institutions’ independent role in demand guarantees. This means that the issuers are not required to investigate the breaches of the underlying contract and that the issuer is under an obligation to honour the beneficiary upon a simple written demand. This principle has also been the emphasis in several judicial decisions, both in the United Kingdom and Sri Lanka, discussed in chapter three.21 Thus, the URDG 758 recognises that a demand under a demand guarantee cannot be reviewed by reference to any extraneous circumstances, and the beneficiary is entitled to be paid on demand. Therefore the issue of the guarantee subject to URDG 758 should not be a concern for the issuers – because the rules do not require the issuer to take into account anything beyond the four corners of the beneficiary’s written demand.

However, by issuing a demand guarantee subject to the rules in URDG the issuer is obliged to honour only demands which satisfy the criteria set out in Article 15 of the rules. The beneficiary is expected to present with his demand a statement that the applicant is in breach of the underlying contractual obligations for which the guarantee was provided. This contrasts with the position under Sri Lankan law – a demand for payment need not accompany a statement that the applicant is in breach of the underlying contractual obligations. Article 15 (a) of URDG 758 which sets out the formalities for a valid demand states that:

A demand under the guarantee shall be supported by such other documents as the guarantee specifies, and in any event by a statement, by the beneficiary, indicating in

21 See generally the cases discussed under ‘The Sri Lankan common law position’ in chapter three.
what respect the applicant is in breach of its obligations under the underlying relationship. This statement may be in the demand or in a separate signed document accompanying or identifying the demand.22

By virtue of this provision, the beneficiary is required to support his demand for payment by a statement indicating in what manner the applicant is in breach of his contractual obligations for which the demand guarantee was issued. The model forms that accompany URDG 758 set out the following sample terms for Article 15 (a)’s supporting statement to be provided by the beneficiary:

In the case of a tender guarantee, the supporting statement could state:

The Applicant:
- has withdrawn its offer during the tender period, or
- while it was declared the successful bidder, the Applicant did not sign the contract corresponding to its offer and/or failed to provide the guarantee(s) requested in the call for tenders

In the case of a performance guarantee, the supporting statement could state:

The Applicant is in breach of its obligations with respect to the underlying relationship because [of late delivery] [the contract’s performance was not completed by the due date] [there was a shortfall in the quantity of the goods supplied under the contract] [the delivered works are defective] etc.

In the case of a payment guarantee, the supporting statement could state:

The Applicant has not fulfilled its contractual payment obligations.

Supporting statements required under other types of guarantees (advance payment, retention money, delivery, warrantee maintenance, etc.) are likewise expected to be general in their drafting without the need for the beneficiary to substantiate its claim or to provide meticulous technical detail of the breach absent an express requirement in the guarantee itself.23

The requirement to present a statement of breach, but not to justify, establish or prove the breach, imposes constraints on beneficiaries who attempt to take unfair and opportunistic advantage by calling under the guarantees. The beneficiary’s demand that accompanies a statement of breach will be useful evidence that the beneficiary’s conduct was an unfair, and opportunistic advantage taking of a disadvantaged position of the applicant in the guarantee market. The beneficiary would be reluctant to make a written

22 See URDG 758 art 15.
23 See URDG 758 Apps.
statement alleging non-performance, delay or defective performance, if that statement
indicates an opportunistic behaviour or a conduct lacking in bona fides. Therefore this
provision can be construed as a significant constraint on unfair advantage taking in the
enforcement of demand guarantees.

This requirement is further strengthened by the provisions of URDG 758 art 17 (e) which requires the beneficiary to make an honest demand which complies with his statement of breach. If the beneficiary makes a dishonest demand the statement of breach will be useful evidence that the beneficiary’s call was fraudulent.

The URDG 758 in Article 20 allows five business days following the day of presentation for the issuer to determine if a complying demand has been made. If the issuer determines that the demand is compliant, the demand must be honoured. Unlike the position under Sri Lankan common law, these rules emphasise that the issuer can not simply honour the demand – it must examine whether the demand is compliant. However, this examination of the demand is independent of the underlying contract. For example, the issuer will compare the beneficiary’s statement of breach with that of the documents specifying the nature of the contractual performance, whether the beneficiary himself or his agent could make a demand under the guarantee and so forth. The beneficiary’s demand and the supporting statement should not conflict with the terms and conditions set out in the demand guarantee. If the issuer determines that the demand under the guarantee is a compliant demand it must honour the demand. If the issuer determines that the demand under the guarantee is not a compliant demand it must reject the demand or approach the applicant for a waiver of the discrepancies.

It is well known in the guarantee market that some beneficiaries tend to make ‘extend or pay’ demands compelling the applicants and financial institutions to extend the expiration date of the guarantee or pay the full amount of the guarantee on-demand. Extending the validity of the demand guarantee is usually the natural response to these

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24 See URDG 758 art 2 which defines a complying demand as a demand that meets the requirements of a complying presentation; It defines a complying presentation as a presentation that is in accordance with, first the terms and conditions of that guarantee, second these rules so far as consistent with those terms and conditions and third, in the absence of a relevant provision in the guarantee or these rules, international standard demand guarantee practice.
25 See also URDG 758 art 19.
26 See URDG 758 art 20 (b).
27 See URDG 758 art 24.
28 Note that the actual copies of demands under on-demand guarantees collected during my qualitative research amply demonstrate this feature in the Sri Lankan guarantee market. For reasons of confidentiality these documents have not been referred to in this thesis.
demands. Under the _URDG 758_ the issuer is allowed to suspend payment for a period not exceeding 30 calendar days following its receipt of the demand.\(^{29}\) It should not be forgotten that some beneficiaries make ‘extend or pay’ demands in circumstances where they are not satisfied with the performance of the contract but where the guarantee is to expire before any compromise can be reached. Therefore, such ‘extend or pay’ demands could mean that these beneficiaries believe there is some chance of negotiation before the guarantee is called. Therefore, it would be in the interests of all stakeholders to extend the guarantee by a period (not exceeding 30 calendar days) and allow time for corrective action or meaningful negotiations to take place.

Arguably, the provisions in the _URDG 758_, as examined above, will not only help to achieve a fair procedure for handling demands under demand guarantees but will also reduce the scope for fraudulent or opportunistic advantage taking in the enforcement of the guarantees. However, the process of getting the beneficiaries to agree and then to apply the rules in the _URDG 758_ will be a challenge to be overcome by the applicants of demand guarantees who compete in the market to secure the underlying contracts with overseas beneficiaries. A greater responsibility lies with issuers of demand guarantees to educate and encourage the parties to incorporate _International Chamber of Commerce’s Uniform Rules for Demand Guarantees (URDG 758)_ as the governing law of the guarantee. Specifically, in the Sri Lankan context, the domestic applicants should be made aware of the advantages of incorporating _URDG 758_ into the guarantee.

Overall, what I have proposed in this section is that if the demand guarantee is issued subject to the _URDG 758_, the rules will require the beneficiary to provide a supporting statement of the breach of the underlying contractual relationship along with a demand for payment and this strategy will constrain not only fraudulent but also unfair and opportunistic advantage taking on the part of the beneficiaries calling under these guarantees.

\(^{29}\) See _URDG 758_ art 23; Note that the financial institutions participated in my qualitative research were of the view that unless they had received instructions from the applicant to extend the validity of the demand, they would honour the beneficiary upon a simple demand; Note that complying art 23 satisfies the ‘information duty’ under art 16 which set out the issuers’ duty to inform the applicant (where applicable the Correspondent Bank) of any demand under the guarantee; See also _URDG 758_ art 16.
(iii) Incorporation of fast-track ‘adjudication clauses’

The third strategy that I propose for mitigating the risk of unfair and opportunistic advantage taking on the part of the beneficiaries calling under demand guarantees is the incorporation of a fast-track adjudication clause in the guarantee itself.\(^{30}\) In theory such a process of adjudication is ‘inquisitorial’ meaning that the process is usually an informal hearing through which a binding decision is made by a competent person appointed by the parties. This method of dispute resolution is increasingly used in international construction projects and is frequently used as a trigger for the call of demand guarantees.\(^{31}\) It is argued that a clause in the demand guarantee that it may be called only on production to the correspondent bank (if a counter-guarantee has been issued) or the issuing bank (if there is no correspondent bank involved) of an adjudicator’s decision that the call is justified, provides a useful strategy for mitigating unfair and opportunistic advantage taking whilst retaining the on-demand character of the guarantee. Drawing upon adjudication models in the United Kingdom and Australia I will now examine this argument in some detail.

Arguably, in the Sri Lankan context it will be useful to adopt an adjudication scheme in commercial contracts (particularly in contracts that provide for demand guarantees) which would enable the commercial parties to see the court door as the last door, not the front door in resolving demands under on-demand guarantees. The United Kingdom’s Housing Grants Construction and Regeneration Act 1996, which has been operating successfully over fifteen years,\(^{32}\) could provide a suitable model for such a scheme which could also develop instruments similar to the United Kingdom’s ‘adjudication bonds’.\(^{33}\) However, the United Kingdom legislation applies only to construction contracts and it follows that its application in the demand guarantee context is limited to claims arising from construction contracts.\(^{34}\) Section 108(1) which confers the right to adjudication states that: ‘A party to a construction contract has the right to

\(^{30}\) See Rodrigo, above n 17, 238.


\(^{32}\) See generally Adjudicator Nominating Body < http://www.adjudication.co.uk>; See also Local Democracy, Economic Development and Construction Act 2009 (UK).

\(^{33}\) Adjudication bonds follow the on-demand guarantee format but are subject to a condition that any demand would have to be accompanied by a certificate of entitlement from an individual recognised as an adjudicator; See generally Adjudicator Nominating Body, ibid.

\(^{34}\) See Housing Grants Construction and Regeneration Act 1996 (UK) ss 104,105.
refer a dispute arising under the contract for adjudication under a procedure complying with this section.\textsuperscript{35}

In Australia, States have successfully adopted adjudication schemes based on this U.K. model.\textsuperscript{36} However, this thesis does not suggest that in the Sri Lankan context, the statutory adjudication be made compulsory or be limited to construction contracts. Instead, the parties to any commercial transaction (particularly the contracts that provide for demand guarantees) should be given the right to adjudication. Thus, it would be appropriate to introduce an Adjudication Act rather than an Act of Parliament which facilitates adjudication only for the construction industry in Sri Lanka. However, it is important to note that it would still be possible for the parties to a commercial contract to have an adjudication clause in the contract even without an Act of Parliament that gives them the right to adjudication, which would be called contractual adjudication. Whilst statutory adjudication can be conferred as a right to the parties that right will not necessarily be available under contractual adjudication.\textsuperscript{37}

It is argued that adjudication of demands under demand guarantees will provide a swift and effective mechanism of resolving the validity of the beneficiary’s demand for payment. Under the U.K. adjudication model, which has been recognised as a speedy mechanism of resolving disputes,\textsuperscript{38} the demand for payment if challenged by the applicant (the builder) will be delayed only for a short period of time, that is, 28 days from the date of the referral.\textsuperscript{39} This thesis suggests that in the context of demand guarantees, determination of claims within 28 days of the referral would be appropriate to maintain the commercial efficacy of the demand guarantee. This speed will ensure that the overriding objective of providing immediate payment to the beneficiary is not defeated. Thus, a process that involves the referring party (applicant or beneficiary)

\textsuperscript{35} Ibid s 108(1); Note that for the purpose of adjudication the term ‘dispute’ includes any difference.


\textsuperscript{39} See Housing Grants Construction and Regeneration Act 1996 (UK) s 108(2)c.
getting an adjudicator appointed within a day or so, and sending the documents or a submission in reply, and the adjudicator deciding the validity of the beneficiary’s demand under the guarantee within the 28 day period from the date of referral, will not defeat the commercial efficacy of demand guarantees. It is argued that the beneficiary will merely lose the immediate right to turn the demand guarantee into cash. If the adjudicator decides that the beneficiary is entitled to payment the damage will simply be the loss of use of the cash for a period of 28 days and could even be compensated for under an undertaking as to damages. If the adjudicator decides that the demand under the guarantee is an unfair and opportunistic advantage taking on the part of the beneficiary and in effect cannot be justified, the beneficiary can hardly complain. Hence it can be argued that fast-track adjudication can be a useful strategy to limit the beneficiaries’ ability to take unfair and opportunistic advantage in calling under on-demand guarantees in the market.

Under an adjudication system, it is also appropriate to disallow the ‘cooling-off period’ before adjudication can commence. If the paying bank (that is the correspondent bank /issuing bank) encourages negotiation between the applicant and the beneficiary, this time period will further delay the payment under the guarantee and frustrate the whole process of adjudication. Therefore, the obligation of the paying bank under an adjudication scheme would be to require the beneficiary to immediately comply with the adjudication clause in the contract. If in the opinion of the adjudicator, the beneficiary is entitled to payment, the paying bank should honour the beneficiary upon a simple demand. Therefore, it is argued that the inclusion of an adjudication clause in the contract will not destroy the on-demand character of the guarantee.

For any dispute resolution system to be effective it must be cost effective and economical.40 It is argued that in resolving disputed demands under demand guarantees, adjudication fulfils this criterion. Due to the strict time limit, that is, determination of the beneficiary’s claim under the guarantee within 28 days of the referral, the cost of adjudication will be comparatively cheaper than that of obtaining an injunction through litigation.41 The adjudication process does not necessarily require the issuer to be a party to the proceedings. This will save financial institutions from legal costs and time in

relation to disputed demands under demand guarantees. Hence, not only the applicant but also the financial institutions will benefit from adjudication of disputed demands under on-demand guarantees.

Unlike the case with applications for injunctions restraining the beneficiary demanding payment under the guarantee, in applications for adjudication of demands under the guarantee, the adjudicator could assess the demand on its merits. Arguably, the scope of the demands that can be referred to adjudication is not confined to fraudulent demands under the guarantee. Therefore, the incorporation of adjudication clauses will help the applicants of demand guarantees to curb the risk of unfair calling which falls short of fraud. Arguably, the scope of matters that can be referred to adjudication will include not only alleged fraudulent demands but also unfair and opportunistic advantage taking on the part of the beneficiaries calling under demand guarantees.

Overall, what I have proposed in this section is that the parties to commercial contracts that provide for demand guarantees should incorporate an adjudication clause in the contract which will require the beneficiary to obtain an order of an adjudicator if he wishes to be paid under the guarantee, and that this strategy will constrain the unfair and opportunistic advantage taking on the part of the beneficiaries calling under demand guarantees. The beneficiary’s right to payment on-demand does not deprive the parties from the right to have their conflicting claims adjudicated by an independent person according to their merits. Therefore, the introduction of a fast-track adjudication scheme for commercial contracts that provide for demand guarantees seems appropriate. In drafting such a scheme, it is advisable that Sri Lanka follows the United Kingdom model for adjudication with appropriate amendments. The adjudication scheme proposed in this thesis, whilst maintaining the on-demand character of the guarantee, will operate as a strategy that mitigates the risk of unfair and opportunistic advantage taking in the enforcement of demand guarantees.

**Policy changes to be implemented by commercial banks**

I concluded in my empirical research that although there is a trend toward decreasing investments in on-demand guarantees in the Sri Lankan market neither the insurance

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42 See also ‘the powers of the Adjudicator’ under the *Housing Grants Construction and Regeneration Act 1996* (UK) ss12-19.
43 See discussion under ‘The protection gap’ in chapter three.
guarantees nor the construction guarantees are likely to replace those on-demand guarantees of the commercial banks.\textsuperscript{44} This is because some beneficiaries (particularly overseas beneficiaries) prefer to secure a guarantee which can be called without the issuer determining the amount to be paid under the contract. Whilst this thesis does not suggest that commercial banks establish some mechanism which enables them to investigate the validity of the beneficiary’s demand under the guarantee, these institutions might adopt a somewhat more balanced approach when a demand for payment is received. Some ways to achieve this balance would be:

- When a demand under the guarantee is received, the applicant should not only be promptly informed of the demand but also be granted a reasonable time (3-4 working days) to contact the beneficiary and enter into prompt negotiations with him. The financial institutions which participated in my qualitative research were unanimous when they said that their obligation is to honour the beneficiary promptly without any questions being asked. However, if both the applicant and the beneficiary agree to enter negotiations, then it would save many of the potential costs that may fall on the parties to this arrangement.\textsuperscript{45} Hence, I propose that there should be a mechanism in place for immediate dialogue between the parties before the beneficiary is allowed to receive payment under the guarantee.

- In certain instances some beneficiaries tend to make ‘extend or pay’ demands compelling the applicants and financial institutions to extend the expiration date of the guarantee or pay the full amount of the guarantee on-demand. The copies of actual demands under on-demand guarantees that I have collected during my empirical research (for reasons of confidentiality, I have not disclosed and/or discussed these documents in chapter four or anywhere else in my thesis) and the participants’ experiences illustrate that some beneficiaries require the applicants to keep extending the validity of the guarantee by simply threatening to demand the full value of the guarantee each time it approaches its expiry date. This situation can lead to unforeseen and increased costs for the applicants. Extending the validity of the demand guarantee would be possible only if the issuer has received instructions from the applicant to extend the guarantee. In the absence of instructions the issuer is entitled to honour the beneficiary upon a simple demand.

\textsuperscript{44} See conclusion (4) of the qualitative research discussed in chapter four.
\textsuperscript{45} See, eg, the potential costs of judicial intervention in the enforcement of on-demand guarantees discussed in chapter five.
It is proposed that in such ‘extend or pay demands’ the issuer as a responsible financial institution should take immediate steps to inform its customer – the applicant – before the demand is honoured. This approach may open up not only an opportunity for negotiations between the beneficiary and the applicant but also save any potential damage to the applicant’s guarantee facility.

If the beneficiary’s demand is honoured, the next immediate step for the banker is to reimburse that amount from the applicant’s account or recover under the indemnity agreement. My empirical research revealed that in the Sri Lankan context, the reimbursement of the demand under the guarantee exposes the applicants (particularly the small and medium scale exporters and builders) to a range of financial difficulties. With a view to providing some relief to these applicants, until the matter is litigated or settled, I propose that the issuer reimburses the amount of the call in stages. For example if the applicant is a customer with a good track-record, the issuer may reimburse 60% of the call in stage 1, pending litigation. During this period they can charge their usual fee for the balance amount or convert this amount to a loan wherein the applicant is required to pay interest for the loan. If the issuers are in possession of significant collateral or a letter of comfort from a parent company of the applicant, the mechanism I proposed above should not be a great concern for the banker.

I propose that the financial institutions encourage the parties to incorporate International Chamber of Commerce’s Uniform Rules for Demand Guarantees (URDG 758) as a contractual term into the contract of the guarantee. Specifically, the domestic applicants should be made aware of the advantages of incorporating URDG 758 into the guarantee. The banks’ legal departments may consider the inclusion of URDG 758 in the standard forms of on-demand guarantees whilst allowing the parties the liberty to negotiate the choice of law in the event the beneficiary opposes to the adoption of URDG 758.

In the Sri Lankan context there is a need to educate the applicants of the availability of standby credits that can be used in lieu of on-demand guarantees. It may be possible to convince overseas beneficiaries to agree to a standby credit in lieu of on-demand guarantees. Those beneficiaries from the United States who are
accustomed to standby credits in the U.S. market will probably have no objection to this arrangement as security for underlying contracts.

**Establishment of insurance against unfair calling**

When the demand guarantees are called unfairly – called in circumstances where the conduct of the beneficiary was either fraudulent or amounts to an opportunist advantage taking – the impact on the applicant is both immediate and severe. In the United Kingdom the typical solution for this problem involves procuring insurance against the risk of unfair calling which provides cover against demands made in circumstances where the applicant is not in default under the underlying contract or where the applicant’s default under the contract has arisen due to a political event such as export licence cancellation or war preventing the performance of the contract. 46 It appears that whilst the English law provides adequate protection against fraudulent demands, the exporters are left themselves to decide upon suitable insurance against beneficiaries taking unfair advantage in circumstances where the exporters are not in default of the contractual obligations or in circumstances where the non-performance of the contract was due to certain factors beyond the control of the exporter. However, my qualitative research informs that such insurance support is currently not available in Sri Lanka. Neither the Sri Lanka insurance market nor the Sri Lanka Export Credit Insurance Corporation has so far offered similar protection for the applicants of on-demand guarantees. Therefore, it may be useful for both the applicants of on-demand guarantees and the insurance companies together with the Sri Lanka Export Credit Insurance Corporation to establish a type of insurance covering unfair and opportunistic advantage taking of unscrupulous beneficiaries in calling under on-demand guarantees in Sri Lanka. Whilst Sri Lanka Export Credit Insurance Corporation might be able to establish such cover specially for the exporters, insurance companies should explore the possibility of introducing such cover at least for the construction industry that uses on-demand guarantees in both local and international construction projects.

46 In the United Kingdom ‘unfair calling insurance’ can be purchased from the London insurance market. It may also be possible for exporters to obtain such cover from the Exports Credits Guarantee Department; See United Kingdom Export Credits Guarantee Department <http://www.ecgd.gov.uk/products-and-services/bond-insurance-policy>; Similarly the Australian Finance and Insurance Corporation offers ‘Bond Insurance’ against wrongful calling under on-demand guarantees which provides indemnity up to 95% of the loss resulting from the demand. Note, however, that this cover does not refer to unconscionable demands; See Australian Finance and Insurance Corporation <http://www.efic.gov.au/insurance/Pages/bondinsurance.aspx>.
However, it would appear that financial institutions that issue on-demand guarantees will not require the applicants to procure this type of insurance as a precondition to the issue of on-demand guarantees. This is because the insurer will only pay out after the issuer has reimbursed the applicant’s account following the beneficiary’s call. The issuers who participated in my research have acknowledged that currently they are adequately protected through indemnity agreements with the applicants of on-demand guarantees. Therefore, the establishment of insurance against beneficiaries’ opportunistic and unfair advantage taking in calling under demand guarantees will provide a direct benefit to the applicants by providing cover against financial difficulties and losses arising from such calling.

**Future research directions**

I propose that further research be conducted in the Sri Lankan guarantee market to identify the prevalence of the phenomenon of unfair and opportunistic advantage taking on the part of the beneficiaries calling under on-demand guarantees in industries other than exports and construction that use on-demand guarantees as security for contractual performance. Whilst it is not impossible to extend the qualitative research results of my thesis to these other industries, it would still be useful to conduct further empirical research into this phenomenon in areas such as redistribution, agency and supply of material for domestic production.

In the Sri Lankan context, the introduction of unconscionability as a separate ground from that of fraud cannot be considered as a reform in isolation. From an economic point of view it might or might not be a suitable step or even the best first step. As I have discussed in chapter five, economic cost-benefit analysis typically uses quantitative data to determine the economic efficiency of laws and regulations. From a legal point of view, I have argued that law reform to introduce unconscionability and thereby expand the judicial discretion to intervene in the enforcement of on-demand guarantees would result in both costs and benefits to all stakeholders in the guarantee market. However, it will be beneficial in the future to conduct an economic investigation into the economic efficiency of unconscionability as a ground for restraining calls under on-demand guarantees in a jurisdiction where this concept is well recognised and developed. There currently appears to be a lack of empirical evidence in the form of typical cost-benefit analyses in the Singaporean or Australian guarantee markets which
would have provided some indications as to the market behaviours or responses to an expansion of legal intervention in the enforcement of on-demand guarantees in those economies.

Such a detailed economic investigation both in Singapore and Australia would prove useful not only for further legal and economic development in those jurisdictions but also for other jurisdictions that look to Singaporean or Australian models for law reform. A typical economic analysis investigating the expansion of judicial or statutory intervention in the enforcement of on-demand guarantees will be useful in identifying whether law reform will encourage or deter the use of such guarantees in the market.

In the Sri Lankan context such an economic investigation would only be possible when the judicial test cases are brought before courts. Upon a range of domestic and international test cases being brought before court, the Sri Lankan government may commission economic research and evidence-based law reform analysis in this area. This proposed economic research would provide an evidence-based assessment for the judicial and legislative arms of government as to whether a law reform will work or not.

Overall, this thesis has explored the problem of unfair and opportunistic advantage taking in the enforcement of on-demand guarantees in Sri Lanka and has argued that the solutions are to be found in the following: (1) recognition of unconscionability as a ground for restraining the beneficiary calling under the guarantee; (2) implementation of practical measures targeted at reducing the potential for unfair and opportunistic advantage taking in the enforcement of on-demand guarantees; and (3) implementation of policy changes impacting upon the activities of commercial banks in the issue and handling of demands under on-demand guarantees.
‘The underlying values of equity centred on good conscience will almost certainly continue to be a driving force in the shaping of the law unless the underlying values and expectations of society undergo a fairly radical alteration…’

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The nature and operation of demand guarantees in practice

Demand guarantee is a written declaration from an issuer, which guarantees to satisfy a beneficiary’s claim for a certain financial amount if the applicant does not meet certain obligations (default in delivery or performance of the goods or work executed). However, these guarantees do not require the beneficiary to produce any proof of default. The beneficiary will generally receive payment of the full amount upon a simple demand to the issuer: The term demand guarantees in this thesis encompass both direct and indirect demand guarantees in domestic and international use: The objective of this note is to explain the nature and operation of direct and indirect demand guarantees in practice.

Direct demand guarantees

Direct demand guarantees are those issued by the applicant’s financier directly to the beneficiary without involving a correspondent bank. The issue of such guarantees establish an immediate legal relationship between the issuer and the beneficiary. I have created the following diagram that explains the parties and procedure involved in a typical direct demand guarantee transaction.

The operation of a direct demand guarantee can be explained through a hypothetical example of a construction contract: Dimo, a Sri Lankan construction company (Applicant) agrees to build an office complex for the Municipal Council of Colombo (Beneficiary). Under the contract, the builder is required to provide a demand guarantee as security for his due performance. The builder procures this guarantee from his bank (Issuing Bank), say Bank of Ceylon. Bank of Ceylon then issues the guarantee directly to the Municipal Council of Colombo. If the builder does not fulfil its end of the agreement, the Municipal Council is entitled to make a demand on the guarantee, but without having to prove the default under the construction contract. Bank of Ceylon will then honour the Municipal Council with the predefined amount of money specified

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in the guarantee and then will seek reimbursement of that amount under the indemnity agreement with the builder.

**Indirect demand guarantees**

In the case of an indirect demand guarantee, another bank (Correspondent Bank) is involved. The applicant’s financier will issue an indirect guarantee (a counter guarantee) made on behalf of the correspondent bank, based upon which the latter will issue its guarantee on behalf of the beneficiary. I have created the following diagram that explains the procedure involved in a typical indirect demand guarantee transaction.

The operation of an indirect guarantee can be explained through a hypothetical example of an export contract. For example a Sri Lankan exporter of tea (Applicant) is required to provide a demand bank guarantee to his foreign buyer (Beneficiary) located in Singapore as security for his performance under the contract. The exporter procures this guarantee from his bank (Issuing Bank), say Bank of Ceylon. Bank of Ceylon requests a Singaporean bank (Correspondent Bank) to issue the demand guarantee to the buyer located in Singapore. As security for the issuance of this guarantee Bank of Ceylon (Issuing Bank) gives a counter-guarantee to the Singaporean bank (Correspondent Bank). If, the exporter (Applicant) does not fulfil its end of the agreement, the buyer (Beneficiary) is entitled to payment upon a simple demand without having to prove that the exporter (Applicant) has failed to supply the required quantity or quality of the tea or that he delayed the supply of tea. In case the Singaporean bank’s (Correspondent Bank’s) guarantee is eventually used by the buyer (Beneficiary), the counter-guarantee serves to provide security to them. Bank of Ceylon (Issuing Bank) is bound to pay a defined amount upon the demand of the Singaporean bank (Correspondent Bank) in case the buyer’s (Beneficiary’s) demand has been honoured. Thereafter, Bank of Ceylon (Issuing Bank) will seek reimbursement of that amount under the indemnity agreement with the exporter (Applicant).

It should be noted that the bank has no duty of inquiry and generally wishes to safeguard its reputation, and hence it is very unlikely that a bank on its own investigations would refuse to honour the demand of a beneficiary. Therefore, even in

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The issuer does not and can not ‘look behind’ the allegation of its customer’s non-performance or delay payment in order to investigate the validity of the allegation; See Henry D. Gabriel ‘Standby Letters of Credit: Does the Risk Outweigh the Benefits?’ [1988] Columbia Business Law Review 705, 713.
circumstances where the issuer has failed to make a proper assessment of the beneficiary’s claim, the applicant is obliged to reimburse the issuer under the indemnity agreement. It follows that in the hypothetical examples discussed above even if the beneficiary’s demand under the guarantee was unfair neither the Bank of Ceylon (in the case of direct guarantee) nor the Singaporean Bank (in the case of the indirect guarantee) has no duty to investigate the nature of the demand or require the buyer to prove the default under the underlying contract.
Demand guarantees in the export industry

Guaranteeing exporter performance

The objective of this note is to explain the basic function of demand guarantees in the permanent export and temporary export in Sri Lanka. At the initial stage of my research, I conducted a data collection at the Sri Lanka Export Credit Insurance Corporation (SLECIC) – the government body that facilitates the issue of demand guarantees to exporters in Sri Lanka. SLECIC facilitates the issue of export performance guarantees through financial institutions and International Chamber of Commerce (Sri Lanka). The general information derived through this initial study proved useful to identify the basic function of demand guarantees in the permanent export and demand guarantees (known as ATA carnet) in the temporary export. The relevant information is summarised below.

Export performance guarantees

In the permanent export category, exporters are often called upon to execute performance bonds duly guaranteed by Sri Lankan banks covering due performance of export contracts. These security instruments are commonly known as ‘export performance guarantees’. To issue guarantees on account of these exporters SLECIC offers counter-guarantees to commercial banks on liberal terms, to the extent of cover up to 75% of the loss in connection with bid bonds, performance bonds, advance payment bonds and guarantees in lieu of retention of money. These guarantees in essence operate as securities for the issue of performance guarantees. Thus, SLECIC do not involve in the actual issue of guarantees, rather provides a support service to the Sri Lankan exporters by facilitating the procurement of demand guarantees. I have created the following diagram that explains the function of SLECIC in facilitating the issue of export performance guarantees.
Direct export performance guarantee covering the ATA carnets system

As regards, international temporary exports that provide for demand guarantees there is a system in place in Sri Lanka, specifically catered for the purpose of providing on-demand guarantees, which is called ATA carnets system.* Export Performance guarantees covering ATA carnets system are issued to the Chamber of Commerce (ICC), Sri Lanka. Exporters who procure a carnets document are exempt from the customs duty. These documents guarantee that the exporters bring back the temporary exports to Sri Lanka. The exporter is required to deposit the value of the guarantee determined by the ICC, Sri Lanka. Those exporters who can not finance the full amount of the guarantee may request SLECIC to issue a counter-guarantee to ICC. As a support service provider, SLECIC issues a counter-guarantee to ICC upon a 10% cash deposit of the total value of the guarantee. This procedure can be depicted through a diagram as follows:

![Diagram showing the process of issuing and handling ATA carnets](image)

In view of this mechanism in place that addresses the guarantee needs of temporary exporters, demand guarantees issued by financial institutions does not play a significant role in the temporary export in Sri Lanka. However, demand guarantees issued by commercial banks and other financial institutions still play an important role in the permanent export in the areas such as tea, rubber and garments.

This initial study revealed that over the past three years SLECIC has facilitated a very small number of export performance guarantees issued through commercial banks which is about 9% out of their total issue of export guarantees. These guarantees are collateral to banks that issue export performance guarantees to the beneficiary. Therefore, SLECIC does not handle demands for payment on these guarantees. This initial study was therefore useful in identifying participants for my qualitative research. Consequently, my qualitative interviews were designed to probe information from the Financial Institutions that issue these guarantees in Sri Lanka and therefore are in a better position to relay their experiences in handling demands for payment under export performance guarantees payable on-demand of the beneficiary.

* ATA stands for Admission-Temporari-Admission. ATA Carnet is a custom document which enables the exporters to participate in trade fairs and exhibitions abroad and win export contracts.
CONSENT FORM

(GU Ref No: Law/05/10/HREC)

MITIGATING THE RISK OF UNFAIR DEMANDS UNDER ON-DEMAND GUARANTEES IN THE EXPORT AND CONSTRUCTION INDUSTRIES IN SRI LANKA: A PROPOSAL FOR LEGAL AND STRUCTURAL REFORM

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By participating in this interview, I confirm that I have read and understood the information about this research project and have specifically noted that:

• I understand that my involvement in this research is voluntary and anonymous and the duration of this interview would be approximately 45 minutes.

• I understand that my involvement in this research will include answering questions on the nature of unfair demands under on-demand guarantees with which the industry that I represent has had to deal.

• I understand that I will receive no direct benefits by participating in this research.

• I understand that I am able to withdraw at any time without comment or penalty.

• I understand that the information concerning me will be maintained in a locked filing cabinet at the Griffith University, Socio Legal Research Centre and that my personal details will be treated as strictly confidential and the information I provide will be coded and securely stored and will be used for the publication of a thesis and subsequent educational publications.

• I have read the information titled ‘Information Sheet’ and understand that if I have any questions at any time I can contact the PhD researcher or the chief investigators.
• I understand that this research will hopefully contribute to a law reform in Sri Lanka with a view to combat the problem of unfair demands under on-demand bank guarantees and therefore the potential benefits will hopefully be accrued to the industry I represent. Participation in this research will not result in any risk to me or the industry I represent.

• I understand that if requested, the results of this study will be communicated to me.

• I have read the section in the information sheet titled ‘Protecting your confidentiality’ and have had any questions answered to my satisfaction.

• I understand that I can contact the Manager, Research Ethics at Griffith University Human Research Ethics Committee on (07) 3735 5585 or research-ethics@griffith.edu.au if I have any concerns about the ethical conduct of the project.

• My signature means that I agree to participate in this research.

Participant’s Signature……………………… Date……/……/……

Name………………………………..
INFORMATION SHEET

(GU Ref No: Law/05/10/HREC)

MITIGATING THE RISK OF UNFAIR DEMANDS UNDER ON-DEMAND GUARANTEES IN THE EXPORT AND CONSTRUCTION INDUSTRIES IN SRI LANKA: A PROPOSAL FOR LEGAL AND STRUCTURAL REFORM

WHO IS DOING THIS RESEARCH?

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This study is being conducted by the PhD researcher as part of her Doctor of Philosophy Degree at the Griffith University Socio-Legal Research Centre. The chief investigators are supervising her PhD program.
WHY IS THIS RESEARCH IMPORTANT?

On-demand guarantees arguably operate as the only reliable instrument that provides security against non-performance, late performance or defective performance of a number of export and construction contracts in Sri Lanka. With their increased use comes an increase in the incidence of unfair demands for payment. The exporters and builders who procure these guarantees have become the ultimate victims of unfair demands and are facing difficulties associated with such claims by the beneficiaries.

Some of the difficult and timely questions that this research will answer are: how prevalence is the problem of unfair demands under on-demand guarantees in Sri Lanka, what costs do exporters and builders suffer as a result of unfair calling by the beneficiaries and are there any alternative security instruments similar to on-demand guarantees that can be used in the export and construction industries in Sri Lanka.

PROTECTING YOUR CONFIDENTIALITY

You have been identified as an exporter /a construction company/ a building contractor/ an issuer of demand guarantees in Sri Lanka whose experiences and views we are interested in.

You will take part in this interview anonymously.

The conduct of this research involves the collection, access and / or use of your identified personal information. The information collected is confidential and will not be disclosed to third parties without your consent, except to meet government, legal or other regulatory authority requirements. A de-identified copy of this data may be used for other research purposes. However, your anonymity will at all times be safeguarded. For further information consult the University’s Privacy Plan at http://www.griffith.edu.au/about-griffith/plans-publications/griffith-university-privacy-plan or telephone +61 7 3735 5585.

If you are happy for us to contact you for further discussions (via telephone or email), the contact details you voluntarily provide will be stored in a locked filing cabinet at the Griffith University Socio Legal Research Centre and destroyed after a 5 year period.

The PhD researcher’s thesis and any publication of the study’s findings will not identify participants either directly or by inference. The interview does not ask you for information which identifies you or your business clients.

DO YOU HAVE ANY QUESTIONS?

We are happy to answer any questions you may have. Please do not hesitate to contact the PhD researcher, Thanuja Rodrigo at Griffith University’s Socio Legal Research Centre on Tele: +61 7 3735 6631 or t.rodrigo@griffith.edu.au You may also contact the chief investigators listed at the top of this information sheet.
IF YOU HAVE A COMPLAINT

Griffith University carries out research in line with the National Statement on Ethical Conduct in Human Research. If you have any concerns or complaints about the ethical conduct of this study you should contact the Manager, Research Ethics on +61 7 3735 5585 or research-ethics@griffith.edu.au