MITIGATING THE RISK OF UNFAIR CALLING ON DEMAND GUARANTEES IN THE SRI LANKAN MARKET

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This paper argues that the inherent characteristic of demand guarantees coupled with the issuer’s obligation to honour the beneficiary when demanded, creates the potential for unfair calls under demand guarantees which is a rather important risk for the applicant. An examination of the Sri Lankan common law position reveals the limited scope for judicial intervention in restraining unfair calls under demand guarantees. The objective of this paper is to present two strategies for mitigating the risk of unfair calling whilst retaining the on-demand character of the guarantee: (I) The issue of the guarantee subject to the latest Revision of the International Chamber of Commerce’s Uniform Rules for Demand Guarantees (commonly referred to as URDG, Revision 758) which requires the beneficiary to submit a statement of breach along with the demand for payment. (II) The incorporation of a fast-track ‘Adjudication’ clause within the guarantee itself, which requires the beneficiary to submit his claim to an adjudicator prior to making the demand for payment.

I INTRODUCTION

In Europe, throughout Africa, Asia and the Middle East, demand bank guarantees have become critically important in a wide variety of commercial transactions.  

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1 A 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). Demand guarantees do not require the beneficiary to produce any proof of default. The beneficiary will generally receive payment of the full amount upon the presentation of a written statement to the issuer stating that the applicant has failed to perform; For a brief description of demand guarantees, see, Howard N Bennett, ‘The Formal Validity of Demands Under Performance Bonds’ (1991) 6 (5) Journal of International Banking Law 207-211.

These demand guarantees in the strict sense, with no frills and no qualifying conditions, have represented 90 percent or more of all of the guarantees issued internationally so far.3 In the Sri Lankan context demand guarantees predominantly feature in the export and construction industries. These demand guarantees provide security for due performance in major export contracts such as apparel garments, tea, rubber and gem.4 With the reconstruction of buildings and infra-structure in Tsunami-devastated areas and 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 and are frequently given as security for due performance of the contract.5 These guarantees ensure against any risk of non performance, delayed performance and defective performance of the contractor’s obligations; such as failure to do the work which the builder has contracted to carry out and failure to supply materials to another contractor working on the same project and so forth. If the beneficiary is unhappy with the performance of the contract, justifiably or not, the on-demand character of the demand guarantee gives the beneficiary the ability to demand payment on it.

With the increased use of demand guarantees comes an increase in the incidence of demands for payment. The very nature of demand guarantees gives the beneficiary the right to call for payment regardless of any reasons or proof as to whether the exporter or builder has failed in any of its contractual obligations for which the guarantee was provided. The beneficiary will generally receive payment of the full amount upon the presentation of a written statement to the issuer stating that the applicant has failed to perform.6 Such demand guarantees are therefore, properly

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4 Note Commercial banks and Sri Lanka Export Credit Insurance Corporation (SLECIC) provide guarantees (payable on demand) to these major exports in the country. Sometimes the SLECIC guarantee acts as a counter guarantee on which the exporter’s bank can issue the required guarantee to the foreign buyer; See, Sri Lanka Export Credit Insurance Corporation <http://www.slecic.lk>.

5 Note in the construction industry in Sri Lanka, many building contracts are awarded by the Government after seeking bids for tender from various contractors. Since these contracts are awarded out of public funds, the government is concerned to ensure that the successful tenderer upon a contract being signed, performs in conformity with the said contract. So they are required to provide a guarantee from a bank, an insurance company or any other financial institution that issue these guarantees. To facilitate this move, the Construction Guarantee Fund provides guarantees to construction contractors for them to provide in place of Bid Bonds, Performance Bonds and such other securities when they are called upon to provide same when undertaking construction contracts.

6 Note that the term ‘issuer’ in this paper denotes a bank or other financial institution such as an insurance company, for example, Construction Guarantee Fund (Sri Lanka) that issues demand guarantees.
described as being ‘virtually promissory notes payable on demand’ and they obviously leave the door wide open to unfair calling by the beneficiaries.

It is hardly surprising that many financial institutions refer to such guarantees as ‘suicide bonds’, meaning that their obligation to pay the beneficiary arises on first demand without proof of default. 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 written call alone would be sufficient to trigger the payment under the guarantee. ‘Guarantees in such unqualified terms seem astonishing, but I am told that they are by no means unusual’ commented Justice Kerr in a leading English case, *RD Harbottle (Mercantile) Limited v National Westminster Bank Limited*, ‘such guarantees are sometimes drawn upon without any or any apparent justification’. This position may encourage the beneficiaries to see the guarantee as a means of putting pressure on the applicant, because the very nature of the guarantee ensures that he receives payment even if the applicant objects to it.

Thus, the terms of this security arrangement allow the beneficiary to call on the guarantee simply if he wishes to be paid. Whether there is a reasonable basis in fact for the beneficiary’s demand is irrelevant. Whilst the on-demand character of the guarantee is aligned strongly with the beneficiary’s interests it leads to one of the problems of issuing a demand guarantee, that of unfair calling. When referring to ‘unfair calls’ or ‘unfair demands’ in this paper, it is argued that from the viewpoint of applicants of demand guarantees a demand is ‘unfair’ if in the circumstances, the beneficiary makes a fraudulent demand, makes an indiscriminate demand for payment or he can not justify his conduct in calling on the guarantee. Some instances of such demands would be where the beneficiary calls on the guarantee to:

(a) take advantage of the on-demand nature of the guarantee by calling for the full amount of the guarantee irrespective of the full or partial performance of the underlying contractual obligations; or

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10 Ibid.

11 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.
(b) take advantage of the on-demand nature of the guarantee 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.

It is argued that not only fraudulent demands but also demands that fall short of fraud (such as circumstances (a) and (b)) fall within the meaning of ‘unfair calling’ as it is used in this paper. Risk of Unfair Calling on Demand Guarantees in the Sri Lankan Market

Hence, section II of this paper examines the nature and operation of demand guarantees in practice. During the course of this examination it will be emphasised that an important risk associated with the issue of demand guarantees is the risk of unfair calling by the beneficiaries. Section III revisits a line of judicial decisions of the Sri Lankan courts which reiterate the principles that the courts must apply while considering the question of unfair calls under demand guarantees. Whilst these cases represent business conflicts in which applicants sincerely believed that the beneficiary’s call on the demand guarantee was unfair they fairly represent the full range of demand guarantee cases decided in the Sri Lankan appellate courts over the last two decades. It will be shown that the judicial pronouncements in these cases draws upon the built-up experience of English common law principles in matters relating to demand guarantees which are now well entrenched in the Sri Lankan common law. The objective of the case law analysis in section III is to illustrate the limited protection available to an applicant if the beneficiary decides to call on the guarantee ‘unfairly’. Section IV argues that the issue of the guarantee subject to the International Chamber of Commerce’s Uniform Rules for Demand Guarantees (Revision 758) which requires the beneficiary to give reasons for the demand and the incorporation of a fast-track ‘Adjudication’ clause in the guarantee itself which requires the beneficiary to submit his claim to adjudication provide useful strategies to curb the risk of unfair calling on demand guarantees in Sri Lanka.

II THE OPERATION OF DEMAND GUARANTEES IN PRACTICE

The diagram below serves the purpose of explaining the parties and procedure involved in a typical demand bank guarantee transaction.

Diagram 1 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
Diagram 1: The parties involved in a typical demand bank guarantee transaction

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 first written 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).

In banking practice, it is not unusual for an issuer to require the applicant to provide security and enter an indemnity agreement with them in order to procure the guarantee. By requesting the issuer to enter a demand guarantee contract with the beneficiary, the applicant runs the risk of the issuer taking advantage of the security provided by him in the event that the beneficiary calls on the guarantee. The applicant will therefore be concerned to ensure that the issuer is only obliged to pay to the beneficiary in ‘fair’ cases. Given that the bank has no duty of inquiry and generally wishes to safeguard its reputation, it is very unlikely that a bank on its own investigations would refuse to honour the demand of a beneficiary. Therefore, even in 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 example (discussed above) even if the overseas buyer’s demand under the guarantee was

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12 The issuer does not and cannot ‘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; As noted by the Court of Appeal in Montrod Ltd v Grundkotter Fleischvertriebs GmbH [2002] 3 All ER 696 at [58] it is not for a bank to make its own inquiries about allegations of fraud.
unfair the Singaporean Bank has no duty to investigate the nature of the demand or require the buyer to prove the default under the underlying contract.

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. This gives rise to a fundamental principle upon which demand guarantees operate in the market- ‘principle of autonomy’ which in essence denotes that the demand guarantee is independent of the performance of the underlying contract.13 The issuer thus undertakes an absolute obligation to pay the beneficiary according to the terms of the guarantee. This paper argues that this inherent characteristic of demand guarantees coupled with the Sri Lankan common law approach that emphasises the principle of autonomy and the issuers’ absolute obligation to honour the beneficiary under the guarantee places the applicants of such guarantees at a disadvantageous position in the guarantee market.

III UNFAIR CALLS IN SRI LANKAN LITIGATION

The Sri Lankan courts have recognised that they should not intervene with the on-demand nature of the guarantee except in cases of established ‘fraud’ on the part of the beneficiary calling on the guarantee. Arguably, the Sri Lankan approach upholding the ‘on-demand’ character of the guarantee creates undesirable consequences for the applicants of such guarantees. Examination of demand guarantee cases that have come before the appellate courts over a period of two decades illustrate this argument. They represent the full range of on-demand guarantee cases that have come before the appellate courts thus far. They are not in any way biased toward the more controversial cases; they are not one sided. This case law analysis also serve to emphasise that the appellate courts in Sri Lanka have now firmly established that ‘fraud’ of the beneficiary known to the bank is the sole ground for injunctive relief to block payment under demand guarantees.14

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14 Note ‘illegality’ of the underlying contract may constitute a ground for restraining a demand under the guarantee; See, generally, Roger J Johns and Mark S Blodgett, ‘Fairness at the Expense of Commercial Certainty: The International Emergence of Unconscionability and Illegality as Exceptions to the Independence Principle of Letters of Credit and Bank Guarantees’ (2011) 31 Northern Illinois University Law Review 297-337.
In *Indica Traders Pte Ltd v Seoul Lanka Construction Pte Ltd* \(^{15}\) and *Hemas Marketing Pte Ltd v Chandrasiri* \(^{16}\) the Court of Appeal comprehensively discussed the principles governing when a call on a demand bank 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 \(^{17}\) and a performance bond, payable on-demand. The facts relevant to this application are briefly as follows. Seoul Lanka (Applicant) was a construction company which entered into a contract with Indica Traders (Beneficiary) 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 (Issuer) and a performance bond issued by Ceylinco Insurance Co. (Issuer) as security for the due performance of all terms and conditions under the contract.

A dispute arose between the parties which resulted in termination of the underlying contract and Indica Traders (Beneficiary) making a claim on the guarantees. The two primary matters that came up for consideration in this appeal were:

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

(b) whether the claim on the guarantee had been made without any basis.

In deciding the first issue the Court of Appeal was not prepared to go into the issue of breach of the underlying contract, which would have disturbed the long respected principle that the demand guarantee is independent of the performance of the underlying contract. This is the autonomy principle referred to above. \(^{18}\) Therefore, the payment undertaking given by the issuer was considered as independent of the performance of the underlying contract between the applicant and the beneficiary. The Court of Appeal reiterated the principles enunciated in the famous English case of *Edward Owen Ltd v Barclays Bank* \(^{19}\) and the subsequent decision in *Bolivinter Oil SA v Chase Manhattan Bank* \(^{20}\) that adopted a similar approach. The Court of Appeal quoted in verbatim what Lord Denning had said in the *Edward Owen* case:

\(^{15}\) (1994) 3 Sri Lanka Reports 387.

\(^{16}\) (1994) 2 Sri Lanka Reports 181.

\(^{17}\) The 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.

\(^{18}\) See above n 13.

\(^{19}\) [1978] 1 QB 159.

So, as one takes instance after instance, these performance guarantees are virtually promissory notes payable on demand. So long as the Libyan customers make 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... 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 or conditions. The only exception is when there is a clear fraud of which the bank has notice.21

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 Bolivinter Oil. The Court of Appeal then quoted passages from the judgment of Donaldson MR:

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 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.22

This statement has been judicially recognised in subsequent cases and remains the leading statement of the autonomy principle in Sri Lankan Law. The judicial approach in Indica Traders was unanimously adopted by Justices Ranaraja and S.N. Silva in the subsequent case of Hemas Marketing Pte Ltd v Chandrasiri.23 The Court of Appeal reiterated the English law principles relating to restraining claims under demand bank guarantees. The issue in Hemas Marketing arose in relation to an agreement that Hemas Marketing (Beneficiary) had entered into with Chandrasiri, wherein the latter’s company “Erandis” (Applicant) was nominated as the agent for the re-distribution of some of the products of Hemas. Erandis (Applicant) had procured two bank guarantees as security for their performance under the re-distribution contract.

Erandis (Applicant) on its part was unable to pay for the goods supplied by Hemas (Beneficiary) on time. Erandis (Applicant) entered into a settlement agreement with

22 Ibid.
Hemas (Beneficiary) to pay the sums due on the goods delivered. A few days later, Hemas Marketing (Beneficiary) terminated the re-distribution contract, requested Erandis (Applicant) 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 (Beneficiary) in demanding payment on the bank guarantees could not be reconciled with their having coming to a settlement agreement just days before. The court held that no allegations of actual fraud had been proven against Hemas Marketing (Beneficiary) for demanding payment on the bank guarantees. The Court of Appeal was guided by the principles set out in Edward Owen Engineering v Barclays International, Power Curber International Ltd v National Bank of Kuwait, Siporex Trade v Bank Indo Suez and Harbottle (Mercantile) v National Westminster. The Court of Appeal observed that,

“They (demand bank guarantees) were established as a universally acceptable means of payment equivalent to cash in trade and commerce, on the basis that the promise of the issuing bank to pay was wholly independent of the contract between the buyer and the seller and the issuing bank would honour its obligation to pay regardless of the merits or demerits of the dispute between the buyer and the seller...the Courts will leave the merchants to settle their disputes under the contracts by litigation. The courts are not concerned with the difficulties to enforce such claims. These are risks which merchants take.”

This judicial pronouncement, arguably, provides the rationale for upholding the autonomy of demand guarantees. It is important to note that Lord Justice Roskill spoke to the same effect in the English case of Howe Richardson Scale Co Ltd v Polimex-Cekop & National Westminster Bank Ltd, he said:

“Whether the obligation arises under a letter of credit or under a guarantee, the obligation of the bank is to perform that which it is required to perform by that particular contract, and that obligation does not in the ordinary way depend on the correct resolution of a dispute as to the sufficiency of performance by the seller to the buyer or by the buyer to the seller as the case may be under the sale and purchase contract; the bank here is simply concerned to see whether the event has happened upon which its obligation to pay has arisen.”

In a series of subsequent decisions, the English courts have upheld the autonomy principle in no uncertain terms and these principles followed in the Sri Lankan courts are now well entrenched in the Sri Lankan common law. The decision of the Court of Appeal in Nestle Lanka Ltd v Ribya Teas (Private) Ltd and National

25 Ibid; See also Attock Cement Co Ltd v Romanian Bank for Foreign Trade [1989] 1 Lloyd’s Rep 572.
26 Howe Richardson Scale Co Ltd v Polimex-Cekop [1978] 1 Lloyd’s Rep 161, 165.
Development Bank of Sri Lanka, also illustrates a similar approach to restraining demands on demand bank guarantees. Nestle Lanka (Applicant) the plaintiff in that case, was a distributor of the products of the first defendant, Ribya Teas (Beneficiary). In order to provide security for the performance of Nestle Lanka (Applicant) as a distributor, the Ribya Teas (Beneficiary) had requested that Nestle Lanka (Applicant) furnish a bank guarantee to the value of three million Rupees. At the instance of Nestle Lanka (Applicant), National Development Bank (Issuer) had issued an unconditional bank guarantee, payable on demand, for three million Rupees. Subsequently, disputes arose between Nestle Lanka (Applicant) and Ribya Teas (Beneficiary) with regard to their financial transactions and accounts culminating in the action, initially filed in the District Court of Colombo. The District Court issued the interim injunctions sought by Nestle Lanka (Applicant) in its claim. The first injunction was to prevent Ribya Teas (Beneficiary) from demanding payment upon the bank guarantee and the second injunction was to prevent the National Development Bank (Issuer) from making payment upon the said guarantee.

In emphasising the applicable legal principles, the Court of Appeal followed the rationale in Indica Traders and Hemas Marketing. The court reiterated that demand guarantees are payable on-demand and 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 justification for this strict approach as emphasised by Amaratunga J. was the commercial value of bank guarantees.

Afterwards, there has 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 sought to justify the availability of injunctions restraining calls on bank guarantees to cases of fraud, on the basis of the commercial value of the instrument. The court’s primary concern as explicit in their pronouncements was whether these guarantees were payable on-demand.

KPC Builders (Applicant) entered into a contract with the Municipal Council of Colombo (Beneficiary) for the construction of a housing scheme at Church Street, Colombo 02. The entire contract sum was for 8,028,258 Rupees and according to the terms of the contract dated 30 March 1988, the National Insurance Corporation

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28 In general English and Australian courts require the same standard of proof to be applied in seeking to enjoin the beneficiary from making a demand on the guarantee and the bank from making payment on the guarantee; See Agasha Mugasha ‘Enjoining the Beneficiary’s Claim on a Letter of Credit or Bank Guarantee’ (2004) 5 Journal of Business Law 515-538.
30 (Unreported, Court of Appeal Application No 776/94 (F), 29 April 2008).
(Issuer) issued a performance bond and additionally KPC Builders was to provide a bank guarantee as security for the advance payment made to them. Accordingly, their bankers, Bank of Ceylon (Issuer), issued a bank guarantee. Though works commenced and advance payment was made by the Municipal Council (Beneficiary), works on the site were abruptly terminated and the contractors alleged that they were compelled to terminate the contract due to the fault of the Municipal Council (Beneficiary).

The Municipal Council (Beneficiary) then required the Bank of Ceylon (Issuer), the bankers of KPC Builders (Applicant), 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 (Issuer) from paying any money to the Municipal Council (Beneficiary) on the bank guarantee. The question the Court of Appeal was called upon to determine was whether KPC Builders (Applicant) were entitled to an injunction restraining 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 written demand…the Guarantor must pay the moment the conditions undertaken in the guarantee arises and calls for payment. Whether the principal contract was truly breached for which the guarantee contract was made has no relevance to the guarantor’s obligation to pay. The guarantee contract is an autonomous contract and is similar in that sense to the ‘Autonomy of the Letter of Credit’. Yet another creature of the law of Banking. 31

The Court of Appeal went on to justify its approach on the basis of the commercial objectives of a bank guarantee:

Such a bank guarantee is effectively as valuable as a promissory note and is intended to affect the ‘tempo’ of the party’s obligations in the sense that, when an allegation of breach of contract is made (in good faith) the beneficiary can claim the bank guarantee and receive its value pending resolution of the contractual dispute. He does not have to wait till the final determination of his rights before he receives money. 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.32

As evidenced in the decided cases, the Sri Lankan law recognises the following criteria as the burden upon the applicant, if he seeks an injunction to restrain the beneficiary calling on the guarantee: (a) establish that the demand for payment is fraudulent and (b) the issuer knew of the beneficiary’s fraud.33 Thus Sri Lankan

31 Ibid.
32 Ibid.
courts are reluctant to intervene with the on-demand nature of demand guarantees unless there is established fraud on the part of the beneficiary of which the bank has knowledge. As regards the criteria (a) 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. As regards element (b) the difficulty for the applicant who seeks to prevent the payment lies in proving the knowledge of fraud on the part of the bank. It is argued that due to this heavy burden of proof of fraud in all of the cases that have come before the appellate courts, the applicants have failed to establish the existence of fraud in the beneficiary’s claim.

A Problems for the Applicants

This paper argues that the Sri Lankan common law position in the intervention with 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, the judicial intervention with the enforcement of demand guarantees is limited to cases where the applicant establishes that the beneficiary’s call on the guarantee is clearly

34 See the classic statement of Ackner LJ in United Trading Corp v Allied Arab Bank [1985] 2 Lloyd’s Rep 554, 561: ‘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.’ This statement has been accepted and followed in Sri Lanka as the established standard of proof of fraud; Silva J in Hemas Marketing v Chandrasiri applied the test of strong prima facie sustainable case that payment should not be paid on the letter of guarantee and bond put in suit.


fraudulent. Any circumstance that fall short of fraud is not considered as a ground for injunctive relief against the beneficiary. For example it is unlikely that a Sri Lankan court would intervene to restrain the beneficiary calling on the guarantee in circumstances where the beneficiary attempts to;

(a) take advantage of the on-demand nature of the guarantee calling for the full amount of the guarantee in circumstances there is full or partial performance of the underlying contractual obligations; or

(b) take advantage of the on-demand nature of the guarantee 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. 38

However, the question arises as to whether the courts’ approach can be justified. The approach of the Sri Lankan courts adopting a limited scope for judicial intervention is based on two key grounds; the autonomy principle which gives effect to the commercial utility39 of demand guarantees and the reputation of the financial institutions that issue demand guarantees.40 Accordingly, courts have been extremely reluctant to grant injunctions preventing the payment of a demand guarantee on the application of the applicant. There is therefore an established approach in Sri Lanka to regard as ‘absolute’ the obligation of the issuer to pay the beneficiary. In fact, it is rare that the Sri Lankan Court of Appeal has deviated from this established position. It is likely that the Sri Lankan courts will continue to adopt this approach in the years to come.

Thus, the judgements of the English courts that have been consistently followed in the Sri Lankan courts emphasise the need to give effect to the on-demand character of the guarantee and the need to safeguard the international reputation of financial institutions that issue demand guarantees.41 These principles have become enshrined

38 See Introduction.


41 Tukan Timber Ltd v Barclays Bank PLC[1987] 1 Lloyd’s Rep 171, where 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’; Harbottle
in the judicial thinking. This paper argues that this approach has ignored the commercial reality that beneficiaries do not wish to contract unless the guarantee is payable on-demand and that applicants are compelled to procure demand guarantees due to the intense competition in the respective industries to secure the underlying contract.

IV STRATEGIES

The applicants who procure demand guarantees should be aware of the on-demand character of the guarantee, the accompanying risk of ‘unfair calling’ on the guarantee and the limited legal protection available to them in the event of a call on the guarantee. Thus, in the Sri Lankan common law position with courts upholding 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 calling. The focus of this section is to suggest some strategies in which applicants could reduce the subjective power of on-demand guarantees in the beneficiaries’ hands and try to ensure that it is not called unfairly. Firstly, it is argued that the demand guarantee be issued subject to International Chamber of Commerce’s Uniform Rules for Demand Guarantees (URDG 758). Secondly, it is argued that a fast-track adjudication clause be incorporated in the demand guarantee itself. Arguably, the ultimate solution to unfair calling on demand guarantees is more likely to come from a combination of these two strategies that could be adopted at the drafting stage of a demand guarantee.

A The Issue of the Guarantee Subject to URDG 758

The latest revision of the International Chamber of Commerce’s Uniform Rules for Demand Guarantees came into effect on 1st July 2010 (commonly referred to as URDG 758) replacing URDG 458. This process brings a new set of rules for demand guarantees in to the 21st century.42 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.43 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.44 This paper argues that issuance of demand guarantees subject to this latest revision of the International Chamber of Commerce’s Uniform Rules for Demand Guarantees provides a useful strategy to mitigate the risk of unfair calling under demand guarantees. Arguably the provisions of Article 15(a) read with Article 17 (c) -

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43 Bertrams, above n 37, 33.
44 URDG 758 art 1.
formalities for a valid demand, Article 20 - time for examination of demand, Article 23 - extend or pay demands and Article 24 - non-complying demand are useful in achieving this objective.

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 underlying contract and that even if the demand for payment under the guarantee is unfair the issuer is under an obligation to honour the demand. This principle has also been the emphasis in several judicial decisions, both in the United Kingdom and Sri Lanka, discussed above. Therefore the *URDG 758* recognises that a claim 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 in to account any thing 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 demands which satisfy the criteria set out in Article 15 of the rules. In turn, 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. Article 15 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 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.

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:

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45 See also, cases that emphasize the principle of autonomy in bank guarantees; *Edward Owen Engineering Ltd v Barclays Bank International Ltd*, above n 12, 171, 174; *Burleigh Forest Estate Management Pty Ltd v Cigna Insurance Australia* [1992] 2 Qd R 54.

46 *URDG 758* art 15.
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.

The requirement to present a statement of breach, but not to justify, establish or prove the breach, imposes constrain on beneficiaries who attempt to take advantage of the on-demand nature of the guarantee. This requirement is further strengthened by the provisions of Article 17 (e) which requires the beneficiary to make an honest claim which complies with his statement of breach. If the beneficiary makes a dishonest claim the statement of breach will be useful evidence that beneficiary’ call was fraudulent. Therefore this provision can be construed as a significant constraint on unfair calling under demand guarantees.

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 complying, the demand must be honoured. Unlike the position under Sri Lankan common law, these rules emphasise that the issuer can not simply honour the beneficiary- it must examine whether the demand is complying. 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 etc. The beneficiary’s demand and the supporting

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47 URDG 758 art 2, which defines a ‘complying demand’ as a demand that meets the requirements of a complying presentation; Article 2 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.

48 See also URDG 758 art 19.
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 complying demand it must honour the beneficiary.\(^{49}\) If the issuer determines that the demand under the guarantee is not a complying demand it must reject the demand or approach the applicant for a waiver of the discrepancies.\(^{50}\)

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 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.\(^{51}\) It should not be forgotten that some beneficiaries make ‘extend or pay’ demands in circumstances they are not satisfied with the performance of the contract but that 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 interest 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.

Thus these provisions in the URDG 758 not only will help to simplify procedures of handling claims under demand guarantees but also reduce the scope for ‘unfair’ claims for payment. However, the process of getting the beneficiaries to agree and then to apply the rules in the URDG 758 will be a challenge to overcome by the applicants of demand guarantees who compete in the market to secure the underlying contracts with overseas beneficiaries. Therefore 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. Specially, in the Sri Lankan context, the domestic applicants should be made aware of the advantages of incorporating URDG 758 in to the guarantee. The banks’ legal departments may also 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.

### Incorporation of Fast-Track ‘Adjudication Clauses’

In theory the process of adjudication is ‘inquisitorial’ meaning that the process is usually an informal hearing through which a binding decision is made by a

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\(^{49}\) URDG 758 art 20(b).

\(^{50}\) URDG 758 art 24.

\(^{51}\) URDG 758 art 23; Note, complying with this Article satisfies the ‘information duty’ under Article 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.
competent person appointed by the parties. This method of dispute resolution is increasingly used in international construction projects and is particularly usefully used as a trigger for the call of demand guarantees. This paper argues 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 calling whilst retaining the on-demand character of the guarantee.

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 claims under the guarantee. The Housing Grants Construction and Regeneration Act 1996 (UK), which has been operating successfully over ten years, could provide a suitable model for such a scheme which could also develop instruments similar to the United Kingdom’s ‘adjudication bonds’. However, the United Kingdom legislation applies only to construction contracts and it follows that its application to demand guarantee claims is limited to claims arising from construction contracts. Section 108(1) which confers the right to adjudication states that:

A party to a construction contract has the right to refer a dispute arising under the contract for adjudication under a procedure complying with this section.

In Australia, States have successfully adopted adjudication schemes based on this UK model. However, this paper does not suggest that in the Sri Lankan context, the statutory adjudication be made compulsory or 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

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53 See generally adjudication.co.uk <http://www.adjudication.co.uk>; See also Local Democracy, Economic Development and Construction Act 2009 (UK).
54 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 recognized as an ‘adjudicator’.
56 Ibid s 108(1); for the purposes of adjudication ‘dispute’ includes any difference.
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.\(^{58}\)

It is argued that adjudication of claims under demand guarantees will provide a swift and effective mechanism of resolving the validity of the beneficiary’s claim for payment. Under the U.K. adjudication model, which has been recognised as a speedy mechanism of resolving disputes\(^ {59}\) 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 of the referral.\(^ {60}\) However, this paper suggests that determination of claims within 14 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) getting an adjudicator appointed within a day or so and sending the documents and/or a submission in reply and the adjudicator deciding the validity of the beneficiary’s claim under the guarantee within the 14 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 in to cash, hardly a catastrophic occurrence. 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 14 days and could even be compensated for under an undertaking as to damages. If the adjudicator decides that the claim under the guarantee is unfair and in effect can not be justified, the beneficiary can hardly complain. It is argued that with a ‘fast-track adjudication’ limiting the beneficiaries taking an unfair advantage of the on-demand guarantees in the market, honest users of such guarantees will be comfortable using it. Thus, prevention of unfair calling under demand guarantees will help to maintain the commercial utility of on-demand guarantees in the market.


\(^{60}\) Housing Grants Construction and Regeneration Act 1996 (UK) s 108(2)(c).
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 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’s claim 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. It is argued that in resolving claims under demand guarantees, adjudication fulfils this criterion. Due to the strict time limit proposed in this paper (that is determination of the beneficiary’s claim under the guarantee within 14 days of the referral) the cost of adjudication will be comparatively cheaper than that of obtaining an injunction through litigation. Unlike in applications for injunctions restraining the beneficiary calling the guarantee, the adjudication process does not necessarily require the issuer to be a party to the proceedings. This will save the financial institutions from legal costs and time in relation to disputed claims under demand guarantees. Hence, not only the applicant but also the financial institutions will benefit from adjudication of claims under on-demand guarantees.

Unlike in applications for injunctions restraining the beneficiary demanding payment on the guarantee, in applications for adjudication of claims under the guarantee, the adjudicator could assess the claim on its merits. Arguably, the scope of the claims that can be referred to adjudication is not confined to fraudulent claims 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.

**V CONCLUSION**

The analysis of the current legal position relating to restraining demands under demand guarantees in Sri Lanka reveals that the courts’ primary concern in the enforcement of demand guarantees is whether the guarantee is payable on-demand without proof of default. The courts have also shown reluctance to intervene with the issuers’ obligations to honour the guarantee when demanded. Thus, the judicial

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63 The definition of ‘unfair’ as used in this paper is under ‘Introduction’.
approach is weighted heavily in favour of the beneficiaries and the issuers. Consequently, the applicants who procure demand guarantees have limited protection when the guarantee is given in on-demand form. It is not easy for them to get the courts to intervene if a call on 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 difficult standard of proof required to establish a case of fraud at Sri Lankan common law. Thus, Sri Lankan law takes an essentially ‘hands off’ approach to the enforcement of demand guarantees. As a result, the applicants of demand guarantees have become the ultimate victims of unfair calling.

This paper suggested that at the drafting stage of a demand guarantee the applicants adopt some strategies for mitigating the risk of unfair calling on demand guarantees. Focussing on the Sri Lankan position, first, it was argued that the demand guarantee if issued subject to the URDG 758 will require the beneficiaries to provide a supporting statement of the breach of the underlying contractual relationship along with a demand for payment and this strategy will constrain the unfair calling on demand guarantees. The banking community could use their substantial influence to incorporate URDG in the standard forms of demand guarantees so as to reduce the risk of unfair calls being made.

Second, it was argued that the parties to commercial contracts that provide for demand guarantees if incorporate an adjudication clause in the contract will require the beneficiary to obtain an order of an adjudicator, if he wishes to be paid under the guarantee and this strategy will constrain the unfair calling on 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 paper whilst maintaining the on-demand character of the guarantee will operate as a strategy that mitigates the risk of unfair calling under demand guarantees.