
Theoretical justifications for restraining “unconscionable” demands under on-demand guarantees

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Whilst English courts have adopted “fraud” on the part of the beneficiary calling under the guarantee as the sole ground upon which the enforcement of on-demand guarantees can be restrained, the Australian courts have adopted “unconscionability” as a separate ground from that of “fraud” for restraining the enforcement of such guarantees. Drawing upon the doctrine of “freedom of contract” and principles of “cost-benefit” in economics this article provides theoretical justifications for the Australian court’s divergence from the English law principles in matters restraining demands under on-demand guarantees.

INTRODUCTION

The English common law approach that fraud on the part of the beneficiary known to the financial institution is the only exception to block payment under on-demand guarantees has long been recognised in the Australian jurisdictions as well as in various other jurisdictions.¹ It appears that these courts have often been guided by the principles set out by Lord Denning in the old English case of *Edward Owen Ltd v Barclays International Bank* (1978) 1 All ER 976. In that case, the nature of “fraud” in on-demand guarantees was established as a lack of honest belief on the part of the beneficiary that the event upon which the 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.²

It follows that 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 English common law. The nature of fraud that applies to on-demand guarantees enunciated by Lord Denning M R has been followed faithfully and with utmost respect by the English Court of Appeal in a number of subsequent decisions.³ It is argued that English approach to restraining the enforcement of on-demand guarantees does not provide a remedy where the beneficiary’s claim under the guarantee amounts to a “fraud” in equity, that is, where the beneficiary’s claim amounts to an “unconscionable” demand.

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¹ For example, in compliance with the English common law principles Sri Lanka continues to adopt fraud as the sole ground for restraining the beneficiary calling under on-demand guarantees. Significantly, the Singaporean courts have deviated from the application of English common law principles in that Singaporean courts now recognise unconscionability as a separate ground from that of fraud restraining the enforcement of on-demand guarantees; For an analysis of the concept of fraud as the only justification for blocking payment on bank guarantees in various jurisdictions, see generally Bertrams RIVF, *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* (3rd revised ed, ICC Publishing Inc, October 2004).

² *Edward Owen Ltd v Barclays International Bank* (1978) 1 All ER 976 at 983.

³ See *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd’s Rep 251; *Potton Homes Ltd v Coleman Contractors Ltd* (CA Feb 24, 1984); *State Trading Corporation of India Ltd v ED & F Man (Sugar) Ltd* (CA, July 17, 1981); *Turkiye IS Bankasi AS v Bank of China* [1998] 1 Lloyd’s Rep 250.

However, Australian courts in reliance of the *Australian Trade Practices Act 1974* (Cth) (TPA) which is now the *Australian Consumer Law* (ACL) (Sch 2 of the *Competition and Consumer Act 2010* (Cth)), have adopted the equitable concept of unconscionability as a separate ground from that of fraud restraining the enforcement of on-demand guarantees.⁴ The material part of the ACL 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.⁵

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.⁶ It is implicit that in the application of this provision the applicant will have to satisfy 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.⁷

It is important to note that neither the previous legislation, the TPA nor the ACL provides a statutory definition of “unconscionable conduct”.⁸ 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 TPA which is the equivalent of s 20(1) of the ACL. These attempts have come from a number of academic writings⁹ and judicial pronouncements.¹⁰ The literature, therefore, suggests that it is hard to find a uniform interpretation of the term “unconscionable conduct”. However, in relation to

⁴ See s 20(1) of the *Australian Consumer Law* (Sch 2 of the *Competition and Consumer Act 2010* (Cth)) which is the equivalent of s 51AA of the *Trade Practices Act 1974* (Cth).

⁵ See text accompanying n 4.

⁶ Standby Letter of Credit is a financing instrument developed by 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 first demand guarantee; see Wheble B S, “Problem Children – Standby Letters of Credit and Simple First Demand Guarantees” (1982) 24 *Arizona L Rev* 301; In *Harbottle v National Westminster Bank Ltd* [1977] 2 All ER 862 Kerr J drew an analogy with cases dealing with confirmed letters of credit, suggesting that such cases applied equally to demand performance guarantees.

⁷ See below the section entitled “Recognition of ‘unconscionability’ in on-demand guarantee cases”.

⁸ In Australia there had been several attempts in the past to define “statutory unconscionability” with the objective of maintaining commercial certainty 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* (Sch 2 of the *Competition and Consumer Act 2010* (Cth)) 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 viewed 28 September 2009; 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 viewed 5 August 2011.

⁹ See Buckley R P, “Unconscionability Amok, or Two Readily Distinguishable Cases?” (1998) 26 *ABLR* 323 at 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 Horrigan B T, “The Expansion of Fairness-based Business Regulation” (2004) 32 *ABLR* 169; See also Baxt B and Archibald E, “Consumer and Business Protection: Its Role in a Pro-competition Statute” in Hanks F and Williams P (eds), *Trade Practices Act – a Twenty-Five Year Stocktake*, (2001, The Federation Press) pp 171 and 174.

¹⁰ In *Commonwealth v Verwayen* (1990) 170 *CLR* 394 at 444, Deane J said that “unconscientious” was a more accurate term than “unconscionable”; In *Hurley v McDonald’s Australia Ltd* [2000] *ATPR* 41-741, the Full Federal Court said: for conduct to be regarded as “unconscionable”, serious misconduct or something clearly unfair or unreasonable, must be demonstrated; In *CG Berbatis Holdings Pty Ltd v Australian Competition and Consumer Commission* (2001) 185 *ALR* 555; [2001] *FCA757*, 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; See also Baxt B and Bennet E, “Unconscionability” (2003) 93 *ACLN* 45;

on-demand guarantees, it is argued that the courts have applied a particular theme of “unconscionability”, that is, “harsh or oppressive insistence on strict legal rights” as a ground for judicial intervention in the enforcement of on-demand guarantees. For instance, referring to this form of “unconscionability”, the Supreme Court of Victoria in *Olex Focas Pty Ltd v Skodaexport Co Ltd* [1998] 3 VR 380 stated at 405 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 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.¹¹

Therefore, in referring to unconscionability in this article, it is argued that a demand is “unconscionable” if in the circumstances the beneficiary’s conduct in calling on the guarantee amounts to a harsh or oppressive insistence on his right to payment. However, it would still be possible for the courts to apply “exploitation of a situational disadvantage” as another equitable theme for judicial intervention with enforcement of on-demand guarantees. It is argued that in relation to on-demand guarantees an applicant is situated in a “situational disadvantage” because the very nature of the on-demand guarantee gives the beneficiary the right to demand payment without having to prove the default under the underlying contract. However, a comprehensive discussion of these equitable themes of “unconscionability” is beyond the scope of this article.

The objective of this article is to provide a theoretical justification for the Australian court’s adoption of unconscionability as a separate ground from that of fraud restraining beneficiaries’ calling on demand guarantees; a legal justification based upon the doctrine of “freedom of contract” and an economic justification based upon a “cost-benefit” analysis.

The doctrine of “freedom of contract” serves two purposes in this article. First, it allows consideration of whether the freedom to bargain 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. Secondly, 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 this approach, this article 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 the author attempts to encapsulate the prominent jurisprudential and economic arguments in favour of the doctrine, and also those against it. Lending support to the latter arguments that question the classical doctrine of “freedom of contract” it will be argued that Australian courts’ intervention in the enforcement of

The full Federal Court examined s 51AA and the concept of “unconscionable” within the meaning of unwritten law in some detail in *Australian Competition and Consumer Commission v Samton Holdings Pty Ltd* (2002) 117 FCR 301, where it was stated that the language of s 51AA requires identification of conduct able to be characterised 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] ATPR 46-265; 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 *Glenariff Holdings Pty Ltd v Tah Land Pty Ltd* [2005] FCA 132 at [7] and [8].

¹¹ See also Parkinson P, “The Notion of Unconscionability”, *Unfair Dealing*, Vol 35 in Clarke P and Parkinson P (eds), *Laws of Australia* (Lawbook Co, Sydney, 1993) p 42, wherein the author states that “harsh or oppressive insistence on strict legal rights” is a form of “unconscionability” recognised in equity; see also Browne J, “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 the case of *Olex Focas Pty Ltd v Skodaexport Co Ltd* [1998] 3 VR 380 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.

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.

Finally, drawing on the economic principles of “cost-benefit” this article will analyse the benefits and costs of restraining “unconscionable” demands under on-demand guarantees. However, the “cost-benefit” approach mentioned in this article is used as a general guide in terms of legal analysis rather than as a detailed economic evaluation or demonstration of that particular theory or test.

RECOGNITION OF “UNCONSCIONABILITY” IN ON-DEMAND GUARANTEE CASES

This section analyses the way in which “unconscionability” has been understood in the Australian cases as a ground for restraining the beneficiary calling on the guarantee. These cases have been chosen because they fairly represent the genesis and development of “unconscionability” in on-demand guarantee cases in the Australian jurisdictions, and they will therefore prove useful to the theoretical analysis of “unconscionable” demands, which is the concentration of this article. It is also important to note that this analysis has not omitted any cases that have been decided the other way; the cases in which the beneficiary’s “unconscionability” was alleged, but in which the courts decided that it was not present. Thus, the case sample below represent the full range of Australian cases to date, that illustrate the Australian court’s approach to “unconscionability” as a ground for restraining demands under on-demand guarantees.

In relation to on-demand guarantees there are some judicial pronouncements that invite the introduction of “unconscionable” conduct in s 20(1) of the ACL as a ground for restraining the beneficiary calling under the guarantee. This was first raised by the Supreme Court of Victoria in *Olex Focas*.¹²

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.¹³

Prior to this case, a finding based on “unconscionability” in the context of commercial transactions had not been made in Australia, although, in *Hortico (Australia) Pty Ltd v Energy Equipment Co (Australia) Pty Ltd* [1985] 1 NSWLR 545, it had been considered. Young J 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”.¹⁴

In *Olex Focas*, Olex, the plaintiff sub contractors, agreed to undertake the supply and installation of telecommunications, tele-supervisory and instrumentation systems work for Skodaexport, the first defendant 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 the Hong Kong 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*.

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 TPA.

¹² See *Olex Focas Pty Ltd v Skodaexport Co Ltd* [1998] 3 VR 380; 134 FLR 331; see also Pugh-Thomas A, “Performance Guarantees and Unconscionable Conduct – an Australian Perspective” (1997) 12(10) *Journal of International Banking Law* 414; Baxt R. “A Bomb Shell on Unconscionable Conduct” (1997) 25 ABLR 227; Baxt R, “Unconscionable Conduct under Trade Practices Act” (1997) 71 ALJ 432; Baxt R, “Unconscionability Taken One Step Too Far?” (1997) 25 ABLR 301; Tyree A, “Performance Bonds and Section 51AA of the Trade Practices Act” (1997) 8 JBFLP 338.

¹³ *Olex Focas Pty Ltd v Skodaexport Co Ltd* [1998] 134 FLR 331; 3 VR 380 at 405.

¹⁴ *Hortico (Australia) Pty Ltd v Energy Equipment Co (Australia) Pty Ltd* [1985] 1 NSWLR 545 at 554.

Applying the rationale of *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443, 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 needs to be established. The plaintiffs 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 TPA 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”.¹⁵

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. Thus, in Australia “statutory unconscionability” has now been recognised as a separate ground from that of “fraud” 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 (in admin and rec)* [2003] NSWSC 713¹⁶ examined the applicability of “unconscionability” to commercial transactions. The issue was raised in the context of a standby letter of credit which, in principle, is similar to a demand guarantee.¹⁷

Boral Formwork and Scaffolding Pty Ltd (Boral) (the plaintiff) and Action Makers Ltd (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 second defendant 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 TPA 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.¹⁸ Thus, the court was satisfied that it would be appropriate to make an order under s 51AA of the TPA as there was evidence of “unconscionable” conduct within the words of s 51AC. As to the principle of autonomy 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.¹⁹

The concluding remarks of Austin J. provide further justification for the application of statutory

¹⁵ *Olex Focas Pty Ltd v Skodaexport Co Ltd* [1998] 134 FLR 331; 3 VR 380.

¹⁶ See also Tyree A, Sheahan J, Rowe M, “Standby Credits” (2007) 18 JBFLP 46; Dixon W, “As Good as Cash? The Diminution of the Autonomy Principle” (2004) 32 ABLR 391.

¹⁷ The term Standby Letter of Credit is explained above. See text accompanying n 6.

¹⁸ *Boral Formwork and Scaffolding Pty Ltd v Action Makers Ltd (in admin and rec)* [2003] NSWSC 713 at [87] (Austin J).

¹⁹ *Boral Formwork and Scaffolding Pty Ltd v Action Makers Ltd (in admin and rec)* [2003] NSWSC 713 at [87] (Austin J).

“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 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.²⁰

In view of this judicial pronouncement it is argued that in circumstances “sufficiently special” judicial intervention with the autonomy principle 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 disturbance of the autonomy.

The decision in *Clough Engineering Ltd v Oil and Natural Gas Corp Ltd* (2008) 249 ALR 458; [2008] FCAFC 136 (*Clough Engineering*) 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 and Natural Gas Corp Ltd (ONGC), an Indian corporation. Clough entered into a lump sum contract with ONGC for US\$215 million to develop oil and gas fields in India. Clough was required to provide an irrevocable bank guarantee in the amount of US\$21 million, 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 TPA preventing payment on the 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 TPA. The court in that case noted that there remain three exceptions where a court may prevent the issuer of the guarantee from making the payment. 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 s 51AA of the TPA; 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 for 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 v Pipeline Authority* (1979) 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.

²⁰ *Boral Formwork and Scaffolding Pty Ltd v Action Makers Ltd (in admin and rec)* [2003] NSWSC 713 at [94].

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.²¹

The court came to the conclusion that ONGC were not acting “fraudulently” or in a manner that constituted “unconscionable” conduct.²² Therefore, the essential question was whether the contract contained any qualification on the right to call on the guarantee. The court found that the performance guarantee in question was an unconditional one. Accordingly, the court allowed the ONGC to call upon the guarantee and allowed the bank to pay on the guaranteed sum. This case thus represents the judicial appraisal of the grounds upon which a claim on a bank guarantee be prevented in Australia. Since the decision was based on the third ground mentioned above, there was no substantial evaluation of the “unconscionability” provisions.

The Supreme Court of Victoria in the most recent decision in *Board Solutions Australia Pty Ltd v Westpac Banking Corp* [2009] VSC 474, 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 *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 they 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.²³

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 their undertaking to the distribution agreement. Therefore, a case had been made out on the basis of a potential breach of s 51AA of the TPA.

Thus, *Olex Focas* to *Board Solutions Australia* fairly represent the way in which unconscionability has been most typically used in the Australian courts in restraining beneficiaries calling under on-demand guarantees. It would be interesting to observe whether and to what extent the Australian courts would continue to apply “unconscionable” conduct in s 20(1) read with s 22(2) which sets out the list of criteria the court may have regard to in determining “unconscionable conduct” in business transactions under the ACL as a ground for restraining demands under on-demand guarantees.

²¹ *Clough Engineering Ltd v Oil and Natural Gas Corporation Ltd* (2008) 249 ALR 458; [2008] FCAFC 136 at [138].

²² Note that in *Australian Competition and Consumer Commission v Samton Holdings Pty Ltd* (2002) 117 FCR 301, 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; See also Riley J, *Employee Protection at Common Law* (The Federation Press, Sydney, 2005) Ch, p 203.

²³ *Board Solutions Australia Pty Ltd v Westpac Banking Corp* [2009] VSC 474 at [44]-[45].

DOCTRINE OF FREEDOM OF CONTRACT

The classical doctrine of “freedom of contract” in the 19th century 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.²⁴ 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.²⁵

Thus, 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.²⁶ 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”. 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.²⁷

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 in to freely and voluntarily, shall be held sacred and shall be enforced by Courts of Justice.²⁸

Similarly, Kessler describes the 19th century concept of freedom of contract as follows:

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.²⁹

Thus, dominant thought in the 19th 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.³⁰ Therefore the courts were extremely reluctant to intervene with the enforcement of contracts.

The literature shows that in the closing years of the 19th century “freedom of contract” was severely diminished.³¹ In the first instance, the freedom to choose the persons with whom one sought contractual relationships was diminished; the supplies of gas, water and other indispensable amenities

²⁴ For a discussion of the philosophy underlying classical contract law, see Paterson J, Robertson A and Duke A, *Principles of Contract Law*, (3rd ed, Thomson Reuters, 2009) pp 5-9; See also Collins H, *The Law of Contract* (4th ed, Butterworths, 2003).

²⁵ See Guest AG, *Anson’s Law of Contract* (26th ed, Clarendon Press, Oxford, 1984) p 4, wherein Guest opines that “freedom of contract” is one of the corner-stones of the 19th century laissez-faire economics.

²⁶ “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. Yet, 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 Scheiber H, *The State and Freedom of Contract*, (Stanford University Press, 1998).

²⁷ See Atiyah P, *An Introduction to the Law of Contract* (Oxford University Press, 1961) pp 9-10.

²⁸ See Smith S, *Atiyah’s Introduction to the Law of Contract* (6th ed, Clarendon Press, Oxford, 2005) pp 9-10.

²⁹ See Kessler F, “Contracts of Adhesion – Some Thoughts About Freedom of Contract” (1943) 43 *Columbia Law Review* 629 at 630.

³⁰ See Atiyah P, *An Introduction to the Law of Contract* (5th ed, Clarendon Press, 1995) p 8.

³¹ See Collins H, *Law in Context – the Law of Contract* (2nd ed, Butterworths, 1993). Collins 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 Pettit Jr M, “Freedom, Freedom of Contract and the Rise and Fall” (1999) 79 *Boston Law*

were monopolised by service providers and consumers had no choice in the selection of their service providers.³² “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. In this regard Atiyah notes that the classical doctrine of “freedom of contract” has lost judicial support and recognition and is now subject to certain limitations in the law.³³ 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.³⁴

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 (eg 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 parties did enjoy the freedom to exclude any statutorily imposed obligation by mutual agreement.³⁵

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 unreasonable, unfair, fraudulent or unconscionable conduct.³⁶ 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 argued that this development is similarly manifest in the law applicable to on-demand guarantee contracts. The “unconscionability” recognised under the Australian common law in reliance of the provisions in s 20(1) of the ACL 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.

Arguably, principles of fairness and/or equity provide a justification for regulatory interference in “freedom of contract” relating to the formation and enforcement of contractual obligations. In this regard one commentator notes:

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

Review 263; Mensch E, “Freedom of Contract as Ideology (Book Review of the Rise and Fall of Freedom of Contract by Atiyah)” (1981)33 *Stanford Law Review*, 753-772; Havighurst H, “Limitations Upon Freedom of Contract” (1979) *Arizona State Law Review* 167.

³² See Atiyah, n 30.

³³ For a comprehensive account of these limitations see Atiyah P, *The Rise and Fall of Freedom of Contract* (Clarendon Press, Oxford, 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 Cabrillo, who opines that “we live in a world in which contracts are no where close to being completely free and restrictions are created by every legal system”; See Cabrillo F, *The Rise and Fall of Freedom of Contract in Western Economies: A Common Experience* (Gabler, 2008); Gilmore G, *The Death of Contract*, (Ohio University Press, 1974).

³⁴ See Allan DE, Hiscock ME, *Law of Contract in Australia* (2nd ed, CCH Australia Ltd, 1992) pp 5-6. The 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 Trebilcock MJ, “Critiques of the limits of Freedom of Contract a Rejoinder” (1995) 33(2) *Osgoode Hall Law Journal* 353.

³⁵ See Atiyah, n 30.

³⁶ According to Epstein one of the major conceptual tools used by courts in their assault upon private agreements has been the doctrine of “unconscionability”; See Epstein RA, “Unconscionability: A Critical Reappraisal” (1975) 18(2) *Journal of Law and Economics* 293 at 294: It has been well established in many jurisdictions that the “abus de droit” entitles the courts to disregard the bargain freely entered into between the parties; See Gutterman E, “Bank Guarantees and Standby Letters of Credit: Moving Towards a Uniform Approach” (1990) 56 *Banking Law Review* 167 at 183.

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.³⁷

Both common law and civil law jurisdictions have now recognised that the principles of good faith, fair dealing and reasonableness should play a pivotal role in the formation and performance of contracts.³⁸ Therefore, 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 “fraudulent” conduct (as under English and Australian Laws) and/or “unconscionable” conduct (as under Australian Law). 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* is a striking illustration of that fact.

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. It is generally accepted that these standard form contracts do not conform to the patterns of interaction, negotiation and other bargaining anticipated by traditional contract law.³⁹ 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.⁴⁰ 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 by arguing that they are result of extensive prior negotiations between parties whose bargaining powers are fairly matched and are adopted because “they facilitate the conduct of trade” or in economic terms they reduce transaction costs.⁴¹ Arguably, standard forms of on-demand guarantees should be interpreted as a result of extensive prior negotiations and should be welcomed on the basis that they facilitate trade by providing security for performance under the underlying contract. Whilst acknowledging these virtues of standard forms of on-demand guarantees, this article argues that as in the case of consumer standard form contracts, they reflect the unequal bargaining positions of the applicants and beneficiaries in the guarantee market and thus, amounts to a departure from the principles underpinning the classical doctrine of “freedom of contract”.

According to Wilson, the genus “standard form contracts” is said to have three species.⁴² 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. Secondly, the contract falls within a state of affairs in which certain terms are prescribed and others are proscribed by legislation. Thirdly, 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

³⁷ *Intefoto Picture Library Ltd v Stillette Visual Programmes Ltd* [1989] 1 QB 433 at 439 (Bingham LJ) in Chitty J, Beale HG, *Chitty on Contracts* (29th ed, Sweet & Maxwell, 2004) p 18.

³⁸ See generally Brownsword R, Hird N, and Howells G, *Good Faith in Contract: Concept and Context* (Dartmouth Pub Co, 1999); Peden E, *Good Faith in the Performance of Contracts*, (LexisNexis Butterworths, Sydney, 2003).

³⁹ See Slawson WD, “Standard Form Contracts and Democratic Control of Lawmaking Power” (1971) 84 *Harvard Law Review* 529.

⁴⁰ See Kessler, n 29 at 631.

⁴¹ See Trebilcock M, “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 (HL).

⁴² Wilson N, “Freedom of Contract and Adhesion Contracts” (1965) 14 *International and Comparative Law Quarterly* 172 at 175.

by one party and the other party has merely to adhere to it, having no say with respect to the terms.⁴³ 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. However, 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.⁴⁴

It is well known that in practice financial institutions that issue on-demand guarantees use standard forms for the issue of such guarantees and that 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. The nature of these standard forms of on-demand guarantees departs from the classical “freedom of contract” principles because the payment terms are not the result of explicit bargaining that is at the core of genuine “freedom of contract”.⁴⁵ 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 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.*⁴⁶ (Emphasis added)

The acceptance of these terms by the applicants of on-demand guarantees, arguably, is the result of the 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.⁴⁷

It is argued that applicants specially those who are in a weaker bargaining position 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. 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.

The payment terms in on-demand guarantees 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 almost every financial institution that issue on-demand guarantees use similar wording in the “payment clauses” also indicates that applicants have no choice in the market when it comes to on-demand 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 use the same or similar clauses. There the inequality of bargaining position has stemmed from the non-competitive position of the financial

⁴³ See generally Lenhoff A, “Contracts of Adhesion and the Freedom of Contract: A Comparative Study in the Light of American and Foreign Law” (1962) 36 *Tulane Law Review* 481.

⁴⁴ See generally Gilmore, n 33.

⁴⁵ See Kessler, n 29.

⁴⁶ *Schroeder v Macaulay* [1974] 3 All ER 616 at 624 as cited in Venkatesa TS, *The Law of Contracts and Tenders* (6th ed, Hyderabad: Gogia and Company, 1994) p 9; However, Trebilcock and Dewees argue that products offered on a take-it-or-leave-it basis is evidence not of market power but of a recognition that they reduces costs involved in negotiating separately every transaction. See Trebilcock MJ and Dewees DN, “Judicial Control of Standard Form Contracts” in Burrows P, Veljanovski CJ (eds), *The Economic Approach to Law* (Butterworths, 1981) pp 93 and 99.

⁴⁷ See Kessler, n 29.

institutions that issue on-demand guarantees. For instance, it is appropriate to ask why an applicant could not get a competitor of the issuer to offer better terms of payment under the guarantee. If competitors are available to do business with the applicant, but they are not willing to offer better terms, arguably, there is some prima facie evidence that applicant genuinely consented to or preferred to the issuer's arrangement that the guarantee is payable without any proof of default.

The fact that these payment terms are non-negotiable also supports the above argument that the standard forms of on-demand guarantees in the market do not arise out of the equal bargaining positions as between the parties, 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". Yet, their existence in the guarantee market is proof that they are by no means unusual and are guided by the "usual-terms-test"⁴⁸ and are generally accepted by applicants and beneficiaries as instruments that "facilitate the conduct of trade".⁴⁹

FREEDOM OF CONTRACT IN THE ENFORCEMENT OF ON-DEMAND GUARANTEES

Contract law facilitates individual autonomy or freedom.⁵⁰ 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 on-demand guarantee should only be allowed to be exercised as long as there is "bona fides" on both sides to the guarantee. Arguably, any factor which vitiates the understanding and openness between the parties can be utilised to justify the law's intervention with that contractual undertaking.⁵¹

When the beneficiary presents a demand for payment under the on-demand guarantee, the "fraud" exception is often used to justify non-payment. The English courts have amply demonstrated that they are least willing to intervene with the bargain of the parties to the on-demand guarantees, by recognising "fraud" as a ground for such intervention although placing the burden of proof of "fraud" at a very high standard.⁵² Thus, an exception to "freedom of contract" exists when the beneficiary asserts his right to payment "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 the recent years, the courts in 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 demand guarantees. Arguably, this represents a liberal attitude on the part

⁴⁸ See Lenhoff, n 43 at 484.

⁴⁹ See Trebilcock, n 41.

⁵⁰ See generally Fried, *Contract as Promise* (Cambridge, Harvard University Press, 1981); see also Trebilcock MJ, *The Limits of Freedom of Contract* (Cambridge, Harvard University Press, 1993).

⁵¹ Epstein R, *Principles for a Free Society: Reconciling Individual Liberty with the Common Good*, (Perseus Books, 1998) p 29. Epstein is probably right when he asserts that most of the law of contract is not about the principle of "freedom of contract". It is also worth noting what Sir George Jessel presented (in 1875) "the laissez –faire idea" of what the limits of regulation in contracts should be. A discussion of this can be found on p 58; See also Greig D W, Davies J L R, *The Law of Contract*, (Law Book Co, 1987), pp 22-23.

⁵² See *Turkiye Is Bankasi AS v Bank of China*, [1998] 1 Lloyd's Rep 250; see also Teng, "Bank Guarantees-Counter Guarantees (Case Comment of *Turkiye Is Bankasi AS v Bank of China*)" (1998) 13(5) *Journal of International Banking Law* 56.; See generally Xiang G, Buckley R, "A Comparative Analysis of the Standard of Fraud Required under the Fraud Rule in Letter of Credit Law" (2003) 13 *Duke Journal of Comparative and International Law* 293, <http://www.law.duke.edu/journals> viewed 1 September 2010.

of the Australian courts towards intervention in the commercial bargain of the parties.⁵³ Advocates of the liberal approach have drawn their support from a classic statement of Ackner LJ in the *United Trading Corp S A and Murray Clayton Ltd v Allied Arab Bank Ltd* [1985] 2 Lloyd’s Rep. 554. Ackner LJ in that case supported that view with the observation that “there is no suggestion that this more liberal approach has resulted in commercial dislocation”.⁵⁴ Certainly, no empirical research appears to suggest that the liberal intervention of the Australian courts has resulted in the commercial dislocation of on-demand guarantees. Therefore, it is argued 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 limitation on “freedom of contract”. Arguably, the idea behind this law’s 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 written demand of the beneficiary.

Yet, there is scope for argument that this liberal approach will do no justice to the beneficiary if the court’s intervention amounts to a reckless disregard of his bargain in the on-demand guarantee, that is, his right to payment *on demand*. The possible 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” are examined below.

THE CONFLICT BETWEEN FREEDOM OF CONTRACT AND UNCONSCIONABILITY

The expansion of the traditional ground of “fraud” for restraining payment under on-demand guarantees is undoubtedly a challenge to the doctrine of “freedom of contract”, in its classical form. With the introduction of “unconscionability” as a separate ground from that of “fraud”, the law’s intervention in on-demand guarantees has been expanded and 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. In this section the author examines and critically analyses those commercial ramifications from the perspective of the doctrine of “freedom of contract” as applied in modern times.⁵⁵

The conflict with issuer’s undertaking to pay

As examined before, an on-demand guarantee is normally an absolute undertaking of the issuer to pay upon a simple written demand of the beneficiary. However, the law intervenes with that autonomous undertaking in at least two circumstances. First, where the demand under the guarantee is “fraudulent” – this is the recognised ground upon which the English law intervenes with the issuer’s contractual undertaking to pay upon demand.⁵⁶ Secondly, 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 article 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 and justice.

⁵³ See analysis of Australian cases under the section entitled “Recognition of ‘unconscionability’ in on-demand guarantee cases”.

⁵⁴ See *United Trading Corp S A and Murray Clayton Ltd v Allied Arab Bank Ltd* [1985] 2 Lloyd’s Rep 554 at 561 (Ackner LJ); Unlimited “freedom of contract”, like unlimited freedom in other directions, does not necessarily lead to public or individual welfare, See Williston S, “Freedom of Contract” (1921) 6 *Cornell Law Quarterly* 365 at 374; see also Hillman R, *The Richness of Contract Law: An Analysis and Critique of Contemporary Theories of Contract Law* (Kluwer Academic Publishers, 1998) p 9.

⁵⁵ See Atiyah, n 33, p 729. Atiyah explains the instances which have caused a gradual decline of the importance in free choice.

⁵⁶ See text accompanying n 3.

The conflict with beneficiary's right to demand

The very nature of the on-demand guarantee stipulates that the beneficiary is entitled to payment "on demand without proof of default under the underlying contract". In the context of such 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, this article argues that the classical doctrine of "freedom of contract" no longer protects a beneficiary who has acted against his conscience in calling on 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 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".⁵⁷ Arguably, 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.

The implication of such a general principle for contracting parties is clear. A modern Australian court will resolve rights and obligations of parties not merely by reference to the letter of the 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 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 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 efficiency⁵⁸ of this phenomenon using a "cost-benefit analysis".⁵⁹ 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". Hence, it is the aim of this article to present a "cost-benefit" analysis of "unconscionability" as a legal restriction on demands under on-demand guarantees. However, the "cost-benefit" analysis which this article has undertaken does not encompass a detailed economic investigation. The author's approach to this inquiry is to ask the basic questions. Why restrain "unconscionable" demands under on-demand guarantees? What costs and benefits would accrue if such demands for payment are restrained?

Thus, in the analysis below the author will consider the costs and benefits of applying "unconscionability" as a legal restriction on the enforcement of on-demand guarantees. How does

⁵⁷ See generally Seddon NC, Ellinghaus MP, *Cheshire and Fifoot's Law of Contract* (8th Australian ed, LexisNexis Butterworths, Australia, 2002).

⁵⁸ The term "economic efficiency" refers to the relationship between the aggregate benefits of a situation and the aggregate costs of the situation. See Polinsky MA, *An Introduction to Law and Economics* (2nd ed, Aspen, 1989) p 7. According to Stone, the economic analysis generally criticises a particular rule in terms of their economic efficiency and consequences. See Stone R, Dobson P, Kidner R, Kenny P, and Gravells N, *Principles of Contract Law* (3rd ed, Routledge-Cavendish, 1997) p 2.

⁵⁹ "Cost-benefit" is a generic term embracing a wide range of evaluative procedures which lead to a statement assessing advantages and disadvantages of a particular activity; See generally Dasgupta A and Pearce D, *Cost-Benefit Analysis: Theory and Practice* (Macmillan Press Ltd, 1972); This is the most commonly used approach in normative or welfare economics. For a discussion of Positive v Normative economics, see Veljanovski C, *The Economics of Law* (2nd ed, The Institute of Economic Affairs, 2006) p 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 also called 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 Sassone P and Schaffer W, *Cost-Benefit Analysis: A Handbook* (Academic Press, 1978) pp 9-12.

“unconscionability” as a common law or statutory provision, promote efficient outcomes in the context of on-demand guarantees? 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 on-demand guarantee. In solving this issue, economists might adopt various criteria to test the net benefits that might accrue to the parties to on-demand guarantee transactions. 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 article is somewhat different to the typical “cost-benefit” evaluation in economics. In that analysis is not supported by quantitative statistics. However, such a quantitative approach will be an avenue for future economic research. The questions that this article will analyse are: what are the costs and benefits of restraining “unconscionable” demands under on-demand guarantees; and will the benefits of restraining “unconscionable” demands outweigh their costs?

Apart from the issuer and beneficiary, the applicant and the guarantor-bank (if a counter-guarantee is issued) have an indirect role to play in an on-demand guarantee. These applicants are usually the sellers who export goods or building contractors who risk their credit in requesting banks and other financial institutions to issue such guarantees and enter indemnity agreements with the latter in order to procure the issue of the guarantee. Therefore, costs and benefits of restraining “unconscionable” demands can be analysed in terms of the costs and benefits that might accrue to the beneficiaries, applicants, guarantor-banks and issuers of on-demand guarantees. This article argues that “unconscionability” as a legal restriction will result in benefits as well as costs to the parties to an on-demand guarantee and that “benefits” appear to outweigh the “costs”.

Law’s intervention and potential costs

Costs of providing additional form of security

On-demand guarantees are issued to cover performance contingencies in a wide variety of business settings, particularly in exports and construction industries. However, these security instruments are intended to provide not only “security” but also “prompt relief” to a beneficiary in the event of default under the underlying contract. The Australian law that recognises “unconscionability” as an additional restriction on beneficiary demands, is very likely to encourage the beneficiaries to demand additional security in the event that their claim on the demand guarantee is not readily and promptly available to them. Arguably, this is an additional “cost” on the applicant who has already entered an indemnity agreement with the issuer to procure the issue of the guarantee. For example, Australian financial institutions 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 a demand guarantee that can be readily and promptly convertible to cash.

Costs of procuring counter-guarantees from foreign banks

One could argue that “unconscionability” as a ground that expands judicial scrutiny of the circumstances under which a beneficiary can be restrained from claiming on the guarantee might raise new concerns for the issuers and guarantor-banks. By issuing a counter-guarantee payable on-demand, the issuing bank is under a contractual obligation to honour demands under the counter-guarantee. For example, in circumstances where a foreign bank (guarantor-bank) issues a counter-guarantee to an issuer in London subject to the law of United Kingdom, 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 beneficiary’s demand for payment. If the guarantor-bank decides to dishonour the beneficiary’s demand, it runs the risk of litigation in the jurisdiction of the issuing bank. Arguably, “unconscionability” has expanded the grounds upon which the Australian law could intervene with the autonomous undertaking of banks that issue counter-guarantees. This could mean that these foreign banks acting as guarantor-banks might frequently be exposed to the risk of litigation. It is argued that

if these financial institutions are frequently exposed to the risk of litigation, they 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.

Costs of litigation and costs pending litigation

The issuer, applicant, beneficiary and the guarantor-bank 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 noted above, under English law the applicants would be successful in litigation only in exceptional cases such as “fraud” on the part of the beneficiary calling the guarantee. Arguably, “unconscionability” as a new legal restriction on beneficiary demands, opens the door for frequent litigation which would result in increase in costs of litigation and other costs pending litigation.

It is argued that from the point of view of the applicant who seeks to prevent the beneficiary calling the guarantee, the costs pending litigation would include any expenditure associated with the underlying contract. For example, building contractors and exporters of goods overseas (applicants of on-demand guarantees) may suffer loss arising from any sub-contracts of the works they have already delegated. This is so because, in the event of litigation of a disputed claim under the guarantee, the 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.

The issuers and guarantor-banks too will suffer costs pending litigation. Bankers and other financial institutions that issue and regulate on-demand guarantee instruments form a vital component of 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. Notably, the relevant literature in Australian jurisdictions that recognise “unconscionability” suggest no evidence that their banking system has experienced a threat to the issuers’ reputation as a financing institution as a result of the expansion of judicial discretion to issue injunctions restraining “unconscionable” demands.

Law’s intervention and potential benefits

Reduce transactions costs

Transactions 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.⁶⁰

With reference to these transactions 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

⁶⁰ Ronald Coase quoted in Veljanovski C, *Economic Principles of Law* (Cambridge University Press, 2007) p 47.

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.⁶¹

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 contracting parties, that is the applicant and the beneficiary of a demand guarantee, the expense of having to negotiate and draft provisions dealing with demands for payment under the guarantee. In practice, standard forms of on-demand guarantee contracts are not complete, in that they do not provide expressly for many contingencies upon which the beneficiary may demand payment. The reason, however, for this use of standard forms of on-demand guarantees in the market is that it is too costly for parties to negotiate on-demand guarantees on a comprehensive set of rules that cover a variety of contingent situations. By failing to negotiate 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 guarantee is issued subject to Australian law which provides for contingencies such as “unconscionable” conduct on the part of the beneficiary calling the guarantee.

Economise on information 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.⁶² 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 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 Australian law becomes a source of new information for the participants of on-demand guarantee contracts and thereby reduces the cost of obtaining correct information and the corresponding costs of relying on incorrect information.

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 further disadvantageous in jurisdictions where there is limited scope for restraining the beneficiary calling on the guarantee. Arguably, this is true in the context of applicants who procure on-demand guarantees subject to English law and are entitled to restrain the beneficiary only in limited cases of actual “fraud” on the part of the beneficiary and not otherwise.

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 may be exposed to financial difficulties. Arguably this situation is true for the small and medium scale traders and builders. Furthermore, judicial intervention with the enforcement of on-demand guarantees in circumstances not only “fraudulent” but also “unconscionable” would be a useful strategy for mitigating financial difficulties for these applicants. It is argued that, prevention of “unconscionable” demands could result in a substantial elimination of the cash flow problems in relation to future investments and cash law problems due to the bank’s reimbursement of the claim under the indemnity agreement with the applicant for the demand guarantee, loss of income through the sub-contracts entered for the purpose of completing performance under the underlying contract with the beneficiary and provide relief for the applicants of such guarantees.

Thus, it is argued that by expanding the grounds upon which the beneficiary can be restrained to incorporate “unconscionability”, the beneficiaries will be reluctant to demand payment under the

⁶¹ See Veljanovski C and Harris D, “The Use of Economics to Elucidate Legal Concepts: The Law of Contract” in Daintith T and Teubner G (eds), *Contract and Organisation: Legal Analysis in the Light of Economic and Social Theory* (Walter de Gruyter, 1989) p 110.

⁶² Veljanovski and Harris, n 61, p 112.

guarantee unless the applicant has in fact defaulted under the underlying contract of sale or construction as the case may be. Arguably, the Australian law that expands the judicial intervention with calls under on-demand guarantees will mitigate financial difficulties for the applicants, arising from such calls.

Protection against opportunistic advantage-taking

“Unconscionability” as a restriction on a beneficiary demanding payment under a demand guarantee can be treated as an important protection for the applicants against beneficiaries’ opportunistic advantage-taking. Arguably, some beneficiaries tend to call for payment on the guarantee to exert pressure on the applicant to agree to new terms or extend the term of the guarantee. Unless the applicant is successful in showing that this conduct amounts to “fraud”, the beneficiary is allowed to take advantage of the “on-demand” nature of the guarantee. Therefore, it is argued that the Australian law that recognises “unconscionability” as a legal restriction on the encashment of on-demand guarantees operates as a vital protection against such advantage-taking of the on-demand nature of the guarantee.

Who will be the least cost-risk avoider?

The cost-benefit analysis of restraining unconscionable demands under on-demand guarantees leads to an important question for consideration; in relation to the costs of “unconscionable demands”, 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 can reduce the harm at the lowest cost should do so.⁶³ In relation to unconscionable demands under on-demand guarantees, this “least cost-risk avoider” is understood to mean the party who could avoid the risk of an unconscionable demand at the lowest cost. If for example, the unconscionable conduct of the beneficiary calling under the guarantee causes significant financial difficulties to the applicant, this principle 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. In other words, it is a question of whose actions can reduce harm at the lowest cost, so that whichever the party is the least cost-risk avoider should take measures to avoid the risk of harm.

If the beneficiary is the least cost-risk avoider he should be held liable and if the victim of an unconscionable demand, that is the applicant is the least cost-risk avoider he should bear the loss resulting from an unconscionable demand. For example, the beneficiary should be held liable for his unconscionable conduct in calling under the guarantee, because the beneficiary alone could have avoided the call at a lower cost (eg \$250) than the applicant alone (eg \$400). In this example, as between the beneficiary and the applicant, beneficiary is the least cost-risk avoider, regardless of whether the potential costs of an unconscionable demand is greater than \$250 or not. Thus, it can be argued that the beneficiary alone should be held liable for his conduct because he alone could have avoided an unconscionable demand at a lower cost.

What would be the most efficient way to avoid the cost of an unconscionable demand? And who should be the least cost-risk avoider of an unconscionable demand under on-demand guarantees?

Both the applicant and the beneficiary of an on-demand guarantee are in a position to avoid the cost of an unconscionable demand. For example, the applicant may take out insurance against unconscionable calling (if such an 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 parties to the guarantee. Therefore, this criterion does not require the applicant to take measures, as the costs of those, would exceed the expected costs of an unconscionable demand. It is also to be

⁶³ See Coase R, “The Problem of Social Cost” (1960) 3 *Journal of Law and Economics* 1, <http://www.jstor.org/stable/724810> viewed 27 September 2011.

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.⁶⁴ Therefore, it is argued, that the question as to whether an applicant should have avoided the cost risk of an unconscionable demand is quite specific to the availability and cost of those measures.

This article argues 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. It is argued that even without a detailed investigation in to the cost avoidance measures available to the beneficiary, it is obvious that he is the only person who could avoid an unconscionable demand under the guarantee and therefore he should be the least cost-risk avoider. The least cost-risk avoider provisionally identified with economic strict liability in cases of tort provides conceptual support for this argument.⁶⁵ Hence, the literature that supports economic strict liability will provide a starting point for this analysis.

Landes and 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.⁶⁶ Similarly Epstein argues that the person who creates the risk is the least risk avoider because he has control over the circumstances that create the risk.⁶⁷ 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

Thus, when deciding “who should be held liable for avoiding the risk at a lower cost”, Landes and Posner 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, it is argued 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.

Epstein, in his analysis goes further to adopt “assumption of risk” as a defence that limits the application of “least cost-risk avoider”.⁶⁹ Then, 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 illustrate Epstein’s thinking further, the applicant 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

⁶⁴ To the best of the author’s knowledge no such insurance is available in Australia. However, it should be noted that 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 <http://www.ecgd.gov.uk/products-and-services/bond-insurance-policy> viewed 20 July 2011.

⁶⁵ See generally Calabresi G, *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; see also Calabresi G and Hirschhoff J, “Toward a Test for Strict Liability in Torts” (1972) 81 *Yale Law Journal* 1055.

⁶⁶ See Landes W and Posner R, *The Economic Structure of Tort Law* (Harvard University Press, 1987) p 229.

⁶⁷ See Epstein R, “A Theory of Strict Liability” (1973) 2 *The Journal of Legal Studies* 151, <http://www.jstor.org/stable/724030> viewed 21 September 2011.

⁶⁸ See Gilles S, “Negligence, Strict Liability and the Cheapest Cost-avoider” (1992) *Virginia Law Review* 1291 at 1325, 1338 <http://www.jstor.org/stable/3654451> viewed 26 September 2011; see also Epstein, n 69.

⁶⁹ See Epstein R, “Defenses and Subsequent Pleas in a System of Strict Liability” (1974) 3 *The Journal of Legal Studies*, 165 at 185, <http://www.jstor.org/stable/724124> viewed 27 September 2011; see also Anderson, “The Missing Theory of Variable Selection in the Economic Analysis of Tort Law” (2007) 2 *Utah Law Review* 255 at 277 <http://law.bepress.com/expresso/eps/1561> viewed 23 September 2011.

costs of unconscionable demands. This article 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 could 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 high risk of unconscionable 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 application in deciding who should be treated as the least cost-risk avoider of an unconscionable demand.

CONCLUSION

The arguments presented in this article 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”; and secondly, 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 demand guarantees, including a “cost-benefit” analysis of restraining “unconscionable” demands.

The starting point of the 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 mainly referred to in this article (United Kingdom 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 contract between the issuer and the beneficiary. 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 with the enforcement of the demand guarantee. Yet, these jurisdictions differ on whether and to what extent the law is permitted to intervene in the enforcement of on-demand guarantee contracts. For example, under English law, the beneficiary is disentitled to assert his right to payment in limited circumstances such as when the demand is tainted by “fraud”. In contrast, the approach of the Australian courts is more liberal with regard to intervention in the enforcement of on-demand guarantees. Therefore, this article argued that with the recognition of “unconscionability” as a separate ground from that of “fraud” for restraining payment on the guarantees, the Australian courts have put more weight on the value of fairness than the doctrine of “freedom of contract”.

This article argued that in many areas of contract, “freedom of contract” in the classical sense is lacking and this trend is manifested in the law applicable to on-demand guarantee contracts as well. Therefore, it was argued that the classical doctrine of “freedom of contract” has lost its value in certain areas of on-demand guarantees. First, it was argued that the bargaining positions of the applicants, issuers and beneficiaries of on-demand guarantees are unequal, 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”. It was also argued that the acceptance of standard forms of on-demand guarantees reflects the bargaining position occupied by applicants in the guarantee market, rather than lack of free expression of their will in negotiating a demand guarantee. Secondly, it was 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 this article examined 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 in determining whether the beneficiary should be allowed to encash the guarantee. Thus, this article 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 it was emphasised that judicial intervention with “fraudulent” demands can not be construed as a threat to “freedom of contract” in the enforcement of on-demand guarantees. Therefore, courts should have the power to intervene with the on-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 argued, can not 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, this article also examined two possible ramifications of “unconscionability” as a legal restriction; the conflict with the issuer’s autonomous undertaking to honour the beneficiary upon a simple demand and the conflict with 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. These arguments should be founded on bona fides of both parties. If the beneficiary’s demand is tainted by “unconscionability” it is perfectly justified for the law to step in to serve justice to all parties concerned. Therefore, the Australian courts’ intervention in the enforcement of on-demand guarantees should not be unwelcome by the contracting parties. Thus, the arguments presented in this article supported the liberal interventionist approach of the Australian courts in relation to on-demand guarantees when there are allegations of “unconscionable conduct” on the part of the beneficiary.

The final section, of the article identified the basic economic logic of restraining “unconscionable” demands under on-demand guarantees – its underlying costs and benefits and its relevance to the principle of “least cost-risk avoider”. From an applicant’s viewpoint it was argued that restraining “unconscionable” demands would result in reduction of transactions costs, reduction of information costs, relief against cash flow problems in relation to future investments, mitigate financial difficulties for the applicants due to the bank’s reimbursement of the claim under the indemnity agreement and provide protection against opportunistic advantage taking, etc. The beneficiary too will benefit from the low transactions and information costs. As regards “costs” of legal intervention, both the beneficiary and the applicant (including the issuer and guarantor-bank) may be exposed to constant litigation which would result in increases in costs of litigation and costs pending litigation. 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. Whilst it appears logical from a legal sense to state that the “benefits” of “unconscionability” exceed the “costs” accrued to the parties to the demand guarantee, from an economic viewpoint a typical cost-benefit analysis using quantitative data would be needed to investigate the balance of “cost-benefit”. However, the literature that analyses economic strict liability provided the conceptual support for the argument that the beneficiary who is responsible for creating the risk of an unconscionable demand is the only person who could avoid such a demand under the guarantee and therefore he will be the least cost-risk avoider.