

The Autonomy Principle and Interdependent Aspects of
Independent Undertakings

Kumiko Koens

Submitted September 2001

A thesis submitted for the degree of Master of Philosophy of
The Australian National University.



Table of Contents

Preface	iv
Table of Cases	v
This thesis is my own work and all sources used have been acknowledged.	
Chapter 1 Background Undertakings and Standby Credits	1
1 Introduction	1
2 Outline of Independent Undertakings and Standby Credits	4
(a) Performance Bond, Performance Guarantees, Bank Guarantees and Standby Credits	4
(b) Nature of Independent Undertaking	5
3 Overview of Independent Undertaking Law	8
(1) Uniform Customs and Practice for Documentary Credits (UCP)	8
(2) Uniform Rules for Contract Guarantees (URCG) and Uniform Rules for Demand Guarantees (URDG)	13
(3) ICG Convention on Independent Guarantees and Standby Letters of Credit	16
(4) International Standby Practices (ISP98)	18
4 Transactional Features of Independent Undertakings from a Comparative Perspective of Standby Credits and Other Independent Undertakings	20
(a) Transactional Structure Parties	20
(b) Conditions for Payment Documentary Nature	22
(c) Types of Independent Undertaking	27
Chapter 2 The Autonomy Principle: Operational and Functional Features of Independent Undertakings	32
1 Theoretical Structure of the Autonomy Principle in Contract with Negotiable Instrument	32
2 Functions of Independent Undertaking	37
(a) Secure Performance: Risk Allocation Policy	38
(b) Secure Payment Obligation in Financial Transactions: Credit Takeover and Debit	40
3 Significance of the Autonomy Principle in Post-Payment Period	47

Kumiko Koens

Kumiko Koens

September 2001

Table of Contents

Preface	iv
Table of Cases	vi
Chapter 1 Independent Undertakings: Introduction	1
1 Introduction	1
2 Outline of Independent Undertaking.....	4
[1] Performance Bond, Performance Guarantee, Bank Guarantee and Standby Credit.....	4
[2] Nature of Independent Undertaking.....	6
3 Overview of Independent Undertaking Law	8
[1] Uniform Customs and Practice for Documentary Credits	9
[2] Uniform Rules for Contract Guarantees (URCG) and Uniform Rules for Demand Guarantees (URDG).....	13
[3] UN Convention on Independent Guarantees and Standby-Letters of Credit	16
[4] International Standby Practice (ISP98).....	18
4 Transactional Features of Independent Undertakings from a Comparative Perspective of Standby Credits and Other Independent Undertakings.....	20
[1] Transactional Structure: Parties	20
[2] Conditions for Payment: Documentary Nature	23
[3] Types of Independent Undertaking.....	27
Chapter 2 The Autonomy Principle: Operational and Functional Features of Independent Undertakings	32
1 Theoretical Structure of the Autonomy Principle in Contrast with Negotiable Instrument.....	32
2 Functions of Independent Undertaking.....	37
[1] Secure Performance: Risk Allocation Device.....	38
[2] Secure Payment Obligation in Financial Transactions: Credit Enhancement Device	43
3 Significance of the Autonomy Principle in Post-Payment Period.....	47

[1] Reimbursement	47
[2] Subrogation	49
a Subrogation and the Autonomy Principle.....	50
b Some Implications for the Application of Subrogation.....	57
Chapter 3 Significance of Independent Undertaking in Underlying Contract....	63
1 Qualification upon the Beneficiary's Right to Demand in the Underlying Contract.....	64
[1] <i>Wood Hall</i> case.....	64
[2] Actual Application of the Dictum.....	66
[3] Different Construction on the Similar Provision	72
[4] Some Implication from English Cases	75
2 Parties' Intention in Furnishing Independent Undertaking	78
3 Integrity of Independent Undertaking	81
[1] Re-consideration of the <i>Wood Hall</i> case.....	81
[2] Standby Credit Cases	83
[3] Independent Undertaking: Bank Guarantee, Performance Bond and Standby Credit.....	88
[4] Proposed Solution	91
Chapter 4 The Exception to the Autonomy Principle and Injunction	94
1 Symmetry and Asymmetry with Commercial Credit	96
[1] Question about Perceived View of Symmetry	96
[2] The Autonomy Principle in Commercial Credit.....	102
[3] The Autonomy Principle in Independent Undertaking.....	105
[4] Impact of <i>Edward Owen</i>	107
2 Notion of the Exception to the Autonomy Principle.....	110
[1] Development of Recent Independent Undertaking Law	110
a Uniform Commercial Code	112
b UN Convention on Independent Guarantees and Stand-by Letters of Credit	115
[2] The Exception to the Autonomy Principle in Specific Factual Situations	123
a Applicant Claims Obligation Completed (or That Under No Obligation) .	125

b Demand Vitiated by Beneficiary's Conduct.....	127
c Demand upon Contingency Not Secured by Independent Undertaking.....	130
2 Unconscionability and the Exception to the Autonomy Principle	132
[1] Unconscionability in Independent Undertaking Cases	132
[2] Unconscionability in <i>Trade Practices Act 1974</i> Section 51AA	135
[3] Unconscionability and the Exception Principle of Independent Undertakings.....	139
3 Integral Application of the Exception Principle and the Role of the Issuer 141	
Chapter 5 Conclusion.....	148
Bibliography.....	154

Preface

Independent undertakings — unconditional bank guarantees, performance bonds, performance guarantees and standby credits — emerged from practice in fulfilling commercial needs of international and domestic transactions in various countries. Despite different names and different origins, these instruments have been used for the same commercial purposes. These instruments have the same legal effect, and therefore they share the fundamental principle — the autonomy principle. This study attempts to clarify the significance of the autonomy principle, focusing on the commercial purposes of independent undertakings or parties' intention of furnishing them.

In this study, research is carried out into common law jurisdictions, mainly Australia, England and the United States. Secondly, some civil law developments are reflected through analysis on the UNCITRAL project. Nonetheless, it is revealed that principles and theories, which are in universal description isolated from particular jurisdictions, are more practical. It is a focal point of this study that, for commercial devices used often international settings, the transnational law is a key factor for success in responding market needs.

Many people have greatly assisted in different ways to this dissertation. I owe the greatest debt to my supervisor, Prof. Mitsumasa Tanabe, an emeritus professor of Nagoya University in Japan. He not only supervised my thesis for the master degree at Nagoya University, also has been greatly supportive of my research in Australia. I would like to thank Dr. Agasha Mugasha, who was my original supervisor, and enabled me to commence research at the National Australian University. I owe a special debt to Prof. Stephen Bottomley, who overtook the position of my official supervisor after Dr. Mugasha left for the University of Essex. I am grateful to Prof. W S Weerasooria at Monash University, who has voluntarily supervised me on technical aspect of thesis production. I also thank Mr. Leith Wintour, Manager of legal section of Westpac Banking Corporation, who provided the outline of a practical operation of independent undertakings in Australia. I owe a significant debt to Ian Temby for his help in proofreading the final product. Without his great patience, this product would

not have materialised. Lastly, I thank my husband, William, who has been supporting and encouraging me to carry on my research work through various aspects of our life.

Author's Note: Online Open Access: National City Bank, 31 NY2d 985

Kumiko Koenis (1997) 14 Ver Jur 362 [32 ER 402]

September 2001

Director and Chairman Companies v OJ Roberts Holdings Pty Ltd

(1992) 104 ALR 134

Lebanese Conference Association Ltd v Mariller Construction Proprietary Ltd

(1990) 14 CLR 385

Alford Shire Pty Ltd v National Australia Bank Ltd (Deceased, Estate of

Alford WA, Tompkins v, 10 February 1997)

Bechtels Pty Ltd v BRB Power New Zealand Ltd (1994) 1 VR 930

Bank of North Carolina NA v Rock Hill Bank, 204 F2d 2034 (7th Cir 1957)

Binder Motion Construction Ltd v Eikon Engineering (Australia) Pty Ltd (1994)

NSWLR 431

Begins v State Bank of New South Wales (1994) 41 ALJ 28

Bi (Australia) Pty Ltd v Cigna Insurance Australia Ltd (1990) 11 BCLR 64

Blainey v Ryan (1956) 79 CLR 382

BoElector Oil PA v Chase Manhattan Bank NA (1981) 1 VLR 392

Burleigh Point Estate Management Pty Ltd v Cigna Insurance Australia Ltd (1992) 2

CLR 54

Cargill International SA v Bangladesh Sugar & Food Processing Corp (1994) 2

CLR 501, 504, 514

Cashden v Proton (1983) 11 QGD 530 (CA)

Centlight Carving Machine Co Inc v American Bank & Trust Co, 865 F2d 1340

(1992)

CKB & Associates v Myrie McCormick Perleberg, 751 SW 2d 626 (Tex 1987)

Commercial Bank of Australia v Amadio (1983) 151 CLR 847

Comau International Ltd v Gary McKee (London) Ltd, Unreported, District Appeal

(Civil Division), Neill LJ, Kitchin LJ, 26 November 1991

Credentia v Evidentia (1997) 14 Ver Jur 369 [33 ER 402]

Deutsche Rückversicherungs AG v Walwyn Insurance Co Ltd (In Liquidation, Comp No

124 of 1991), Swiss as Group Inc v Insurance SA v Walwyn Insurance Co

Ltd as Co-Defendant (1996) 1 ALJ 291

Table of Cases

- Asbury Park & Ocean Grove Bank v National City Bank, 35 NYS2d 985
- Aldrich v Cooper (1803) 8 Ves Jun 382 [32 ER 402]
- Australian Competition and Consumer Commission v C G Berbatis Holding Pty Ltd
(2000) 169 ALR 324
- Australian Conference Association Ltd v Mainline Constructions Proprietary Ltd
(1978) 141 CLR 335
- Austral Ship Pty Ltd v National Australia Bank Ltd (Unreported, Supreme Court of
WA, Templeman J, 13 February 1997)
- Bachmann Pty Ltd v BHP Power New Zealand Ltd [1999] 1 VR 420
- Bank of North Carolina NA v Rock Island Bank, 570 F2d 202 (7th Cir 1978)
- Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd (1991)
NSWLR 451
- Begbie v State Bank of New South Wales [1994] ATPR 41,881
- BI (Australia) Pty Ltd v Cigna Insurance Australia Ltd (1990) 11 BCL 64
- Blomley v Ryan (1956) 99 CLR 362
- Bolivinter Oil SA v Chase Manhattan Bank NA [1984] 1 WLR 392
- Burleigh Forest Estate Management Pty Ltd v Cigna Insurance Australia Ltd (1992) 2
QdR 54
- Cargill International SA v Bangladesh Sugar & Food Industries Corp [1996] 2
Lloyd's Rep 524
- Castellain v Preston (1883) 11 QBD 380 (CA)
- Certifugal Casting Machine Co Inc v American Bank & Trust Co, 966 F2d 1348
(1992)
- CKB & Associates v Moore McCormick Petroleum, 743 SW2d 653(Tex 1987)
- Commercial Bank of Australia v Amadio (1983) 151 CLR 447
- Costain International Ltd v Davy McKee (London) Ltd (Unreported, Court of Appeal
(Civil Division), Neill LJ, Russell LJ, 26 November 1990)
- Craythorne v Swinburne (1807) 14 Ves Jun 160 [33 ER 482]
- Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and others; Group Josi
Re (formerly known as Group Josi Reinsurance SA) v Walbrook Insurance Co
Ltd and others [1996] 1 All ER 791

Discount Records Ltd v Barclays Bank International Ltd [1975] Lloyd's Rep 444
Dixon v Steel [1901] 2 Ch 602
Duncan Fox & Co v North and South Wales Bank (1880) 6 App Cas 1
Dynamic Corporation of America v The Citizens and Southern National Bank, 356
FSupp 991 (1973)
Edward Owen Engineering Ltd v Barclays Bank International Ltd [1978] 1 QB 159
Equuscop Pty Ltd v Perpetual Trustees WA Ltd (Unreported, French, Kiefel, and
Sundberg JJ, 5 December 1997)
Ex p Brett; Re Howe (1871) LR 6 Ch App 838
Ex parte Williamson (1869) 5 Ch App309
Flecher Construction Australia Ltd v Varnsdorf Pty Ltd [1998] 3 VR 812
Garcia v National Australian Bank Ltd (1998) 155 ALR 614
George Collings (Aust) Pty Ltd v HF Stevenson (Aust) Pty Ltd (1997) 73 FLR 91
Hamzeh Malas & Sons v British Imex Industries Ltd [1957] 2 QB 127
Hortico (Aust) Pty Ltd v Energy Equipment Co (Aust) Pty Ltd (1985) 1 NSWLR 545
Howe Richardson Scale Co v Polimex-Cekop [1978] 1 Lloyd's Rep 161
Hughes Bros Pty Ltd v Telede Pty Ltd [1989] 7 BCL 210
Inflatable Toy Pty Ltd v Bank of New South Wales (1994) 34 NSWLR 243
Intraco Ltd v Notis Shipping Corporation [1981] 2 Lloyd's 256
Intraworld Industries, Inc v Girard Trust Bank, 336 A2d 316 (1975)
Itek Corporation v First National Bank of Boston, 730 F2d 19 (1984)
J H Evins Industries (NT) Pty v Diano Nominees Pty Ltd (Unreported, Supreme Court
of NT, Kearney J, 30 January 1989)
John Edwards and Co v Motor Union Insurance Co Ltd [1992] 2 KB 249
Louth v Diprose (1992) 175 CLR 621
Mathew Hall Mechanical Electrical & Engineers Pty Ltd v Baulderstone Pty Ltd
(1994) 10 BCL 148
Maurice O'meara Co v National Park Bank of New York, 146 NE 636 (1925)
M Golodets & Co Inc v Czarnikow-Rionda Co Inc (The Galatia) [1979] 2 All ER 726
Nicholas v Ridley [1904] 1 Ch 192 (CA)
Old Colony Trust Ci v Lawyer's Title & Trust Co, 297 F 152 (1924)
Olex Focas Pty Ltd v Skodaexport Co Ltd [1996] 134 FLR 331
Orakpo v Manson Investments Ltd [1978] AC 95

Pearson Bridge (NSW) Pty Ltd v The State Rail Authority of New South Wales
(1982) 1 ACLR 81

Planned Parenthood League of Massachusetts v Francis X Bellotti, 641 F2d 1006
(1981)

Potton Homes Ltd v Coleman Constructors Ltd [1984] 28 BLR 18

R D Harbottle (Merchantile) Ltd v National Westminster Bank Ltd [1978] QB 146

Reed Construction Services Pty Ltd v Kheng Seng (Australia) Pty Ltd (Unreported,
Supreme Court of NSW, Austin J, 20 November 1998)

Re National Permanent Benefit Building Society; Ex parte Williamson (1869) 5 Ch
App 309

Re Trivan Pty Ltd (1996) 134 FLR 368

Rose Developments Inc v Pearson Properties Inc, 832 SW2d 286 (1992)

Selvas Pty Ltd Hansen & Yuncken (SA) Pty Ltd (1986) 6 ACLR 36

Siporex Trade SA v Banque Indosuez [1982] 2 Lloyd's Rep 146

Société Métallurgique d'Aubrives & Villerupt v British Bank for Foreign Trade
(1992) 11 LI L Rep 168

State Trading Corporation of India Ltd v ED & F Man (Sugar) Ltd (Unreported, Court
of Appeal (Civil Division), Lord Denning MR, Shaw and Griffiths JJ, 17 July
1981)

Stern v McArthur (1988) 165 CLR 489

Sztejin v J Henry Schroder Banking Corporation, 31 NYS2d 631 (SC 1941)

Tenore Pty Ltd v Roleystone Pty Ltd (Unreported, Supreme Court of NSW, Giles J,
14 September 1990)

The Emery-Waterhouse Company v Rhode Island Hospital Trust National Bank, 757
F2d 399

Themehelp Ltd v West [1996] QB 84

Traders Finance Corporation Ltd v Marks [1993] NZLR 1776

Tudor Development Group Inc v United States Fidelity & Guaranty Company, 968
F2d 357 (3rd Cir 1992)

United City Merchants (Investments) Ltd v Royal Bank of Canada [1983] AC 168

United Trading Corp v Allied Arab Bank [1985] 2 Lloyd's Rep 554

Washington Construction Company Pty Ltd v Westpac Banking Corporation [1982] 1
QdR 179

Westpac Banking Corporation v The Duke Group Ltd [1994] 31-237262 Ont C J

Lexis 2937 (Aug 25, 1994)

Wichita Eagle & Bacon Publishing Co v Pacific National Bank, 343 FSupp 332 (ND

Cal 1971)

Wood Hall Ltd v Pipeline Authority (1979) 141 CLR 443

Legal analysis of conditional guarantees. The party is concerned with the flow of performance of the other party and will therefore attempt to obtain security as a safeguard to ensure balance his performance or payment. For example, in construction contracts, the contractor is often required to provide a cash deposit at the time of commencing the contract and retain an amount against progressive payment. These moneys are a certain percentage of the contract price, held back by the proprietor, or kept in a separate account at interest to ensure that the contractor can meet his obligations.

In Australia, unconditional guarantees became a commonplace for the security of providing cash in construction contracts. The proprietor now wishes to obtain the full amount of money for payment by the contractor, payable as unconditional guarantees — being paid by the guarantor — in lieu of a cash deposit and retained money.

As can be seen in this scenario, there are three parties involved: the contractor, the proprietor and the guarantor. The contractor, who enters into a contract with a construction contract, is required to furnish the unconditional guarantee or security. The proprietor is the person in whose favour an unconditional guarantee is issued. The guarantor is the bank or other financial institution which issues the unconditional guarantee upon the contractor's request.

It follows that these three parties are fundamentally related to each other, namely: the unconditional guarantee instrument between the proprietor and the guarantor; the contract or contract — the underlying contract — between the contractor and the proprietor; and the agreement entered between the contractor and the guarantor. This unconditional guarantee is, as with a conditional guarantee, a promise relationship.

Chapter 1 Independent Undertakings: Introduction

1 Introduction

Generally, in any kind of commercial contract, one party is concerned with the due performance of the other party and will therefore attempt to obtain security as a safeguard to counterbalance his performance or payment. For example, in construction contracts, the contractor is often required to provide a cash deposit at the time of concluding the contract and retention money against progressive payment. These moneys are a certain percentage of the contract price, held back by the proprietor, or kept in a separate account as security, to ensure that the contractor carries out his obligation.

In Australia, unconditional guarantees emerged as a replacement for the security of providing cash in construction contracts. The contractor, who wishes to obtain the full amount of money for payment by the proprietor, provides an unconditional guarantee — being paid by the guarantor — in lieu of a cash deposit and retention money.

As can be seen in this scenario, there are three parties involved; the contractor, the proprietor and the guarantor. The contractor, obliged to perform under a construction contract, is required to furnish the unconditional guarantee as security. The proprietor is the person in whose favour an unconditional guarantee is issued. The guarantor is the bank or other financial institution which issues the unconditional guarantee upon the contractor's request.

It follows that three transactions are functionally related to each other, namely: the unconditional guarantee transaction between the proprietor and the guarantor; the construction contract — the underlying contract — between the contractor and the proprietor; and the application contract between the contractor and the guarantor. Thus an unconditional guarantee is, as with a traditional guarantee, a tripartite relationship.

However, there is a clear distinction between traditional guarantees and unconditional guarantees. While traditional guarantees are payable upon proof of a breach of an underlying contract, payment under unconditional guarantees is made without the obligation to prove any default. Usually they are payable upon demand in writing. Though an unconditional guarantee is issued in order to secure the performance of an underlying contract, the obligation assumed by the guarantor is not correlated with it. The operation of such a guarantee is independent from the construction contract. This special feature of unconditional guarantees is known as the “autonomy”, or “independence”, principle.

This study will attempt to clarify the significance of the autonomy principle from the interdependent aspects of the unconditional guarantee. The autonomy principle is the foundation of the unconditional guarantee. It operates to separate the guarantee from other related contracts, and to treat it as a discrete and independent transaction. The issuer of an unconditional guarantee is obliged to pay according to the terms and conditions of the operative undertaking without any reference to the other contracts. However, given that the guarantee is a security for an obligation under other transactions, in a practical sense, the guarantee transaction and the other related transactions are closely interdependent. While the relationships between these transactions are functionally and commercially correlated in some respects, they are, at the same time, independent of each other in other respects. This is because the parties to the underlying relationship agreed to an unconditional guarantee.¹ By analysing the significance of the autonomy principle among these transactions, namely within the framework of a multi-party relationship, the parties’ rights and obligations will be accurately delineated, and the full meaning of the autonomy principle will be illuminated.

In this study, “unconditional guarantees”, “performance bonds”, “performance guarantees”,² “independent guarantees”³ and “standby credits”,⁴ used in various

¹ Roeland Bertrams, *Bank Guarantees in International Trade* (2nd ed, 1996) 162.

² “Performance bonds” and “performance guarantees” are issued in Australia and England.

³ “Independent guarantees” are mainly issued in Europe and used for international transactions.

⁴ “Standby credits” are issued by banks in the United States.

regions, will be analysed and treated as legally the same devices. In light of the commercially universal nature of these instruments, the legal treatment in other regions will give considerable insight, and help to resolve the issues and enhance the legal development in Australia. For convenience, the phrase “independent undertaking” will be used as an umbrella term to denote all of the above instruments.

The following sections of this chapter will provide an outline of independent undertakings, their origin, nature, source of law and transactional features. Chapter 2 will clarify the autonomy principle in more detail. The significance of the autonomy principle will be illuminated through investigating the nature of independent undertakings from the perspective of their operational and functional features.

Chapter 3 will investigate the significance of the autonomy principle in the underlying contract relationship by focussing on some Australian cases which approved the ability of the underlying contract terms to qualify the beneficiary’s right to demand under the unconditional guarantee. This study will critically analyse this issue in light of the integral operation of the independent undertaking.

Chapter 4 will re-examine the fraud exception to the autonomy principle. Although it has been well established that the fraud exception originally developed in conventional commercial credit transactions, it seems that its substance in the context of independent undertakings has remained unexplored in Australia. This analysis will examine the functional difference between commercial credits and independent undertakings, arguing that the different application of the fraud exception is necessary in the independent undertaking context. Furthermore, the unconscionability provision of the *Trade Practices Act 1974*⁵ will be examined as another ground for the exception to the autonomy principle.

In summary, the theme of this study is that the autonomous nature of independent undertakings is a creature of commerce to serve certain purposes based on the parties’

⁵ *Trade Practices Act 1974* s. 51AA: A corporation must not, in trade or commerce, engage in conduct that is unconscionable within the meaning of the unwritten law, from time to time, of the States and Territories.

intentions. It is important to understand properly what the parties are aiming to achieve in the underlying contract through furnishing an independent undertaking. The legal interference with its operation, therefore, should be carefully scrutinised from the perspective of the commercial purpose for the independent undertaking and with regard to the parties' intentions.

2 Outline of Independent Undertaking

[1] Performance Bond, Performance Guarantee, Bank Guarantee and Standby Credit

A performance bond, performance guarantee or bank guarantee is a security device for indemnification when one party defaults on its obligation in the underlying contract. In Australia, a bank guarantee has been typically used in construction contracts as a means of guaranteeing to the proprietor the financial viability of the contractor and the contractor's ability to perform the obligations under the contract,⁶ as well as guaranteeing to the contractor the proprietor's payment obligation.⁷ An "unconditional" type of bank guarantee emerged in practice to replace the cash deposit as security or retention money, which was a common practice in construction contracts to secure the performance of an obligation. The nature of an unconditional guarantee came up for judicial analysis in 1970s.⁸ One of the first cases in which the High Court of Australia had to consider the legal position of an unconditional guarantee was *Australian Conference Association Ltd v Mainline Constructions Proprietary Ltd*.⁹ Aickin J remarked:

The bank guarantee is a somewhat curious instrument, though we were told that the term was not uncommon. Though headed 'Bank Guarantee' it is not in form a guarantee, and its only

⁶ James O'Donovan and John Phillips, *The Modern Contract of Guarantee* (3rd ed, 1996) 769; G A Penn, A M Shea and A Arora, *The Law and Practice of International Banking* (1987) 261.

⁷ *Hortico (Aust) Pty Ltd v Energy Equipment Co (Aust) Pty Ltd* (1985) 1 NSWLR 545.

⁸ See W S Weerasooria, *Bank Lending and Securities in Australia* (1998) [11.28].

⁹ (1978) 141 CLR 335.

operative provision is an unconditional undertaking to pay a sum of money on demand by the proprietor. In that respect it resembles, and perhaps is, a 'promissory note' ...¹⁰

During the same period, in international construction contracts, the origins of "first demand" or "simple demand" guarantees can be traced. The increasing wealth of the oil producing countries of the Middle East enabled these countries to conclude major contracts with western firms for large-scale projects.¹¹ Similarly in international sales contracts, the buyer, who is obliged to pay for unseen goods by commercial credit, requires a bond as security for the seller's performance. The proprietor of the construction contract, or the buyer of the international sales contract, with the bargaining power, sought to avoid the defences which the contractor or the seller could raise against them.¹² The "first demand" or "simple demand" guarantee, which the bank is obliged to honour upon the demand by the beneficiary, namely the proprietor or the buyer, is a typical product of such a superior bargaining power.¹³ At the same time, financial institutions issuing guarantees have traditionally preferred first demand commitments which enable them to avoid being involved with the disputes between the parties to the underlying contract.¹⁴

In the United States, on the other hand, a letter of credit was employed in a place of a guarantee. It has long been the general rule that federally chartered American banks have not been entitled to pledge their credit by acting as sureties.¹⁵ Before undertaking a secondary guarantee, the guarantor must calculate the chances that the principal will default and, after undertaking the guarantee, must determine whether default has

¹⁰ Ibid 370. See also Weerasooria, above n 8, [11.33].

¹¹ These projects concerned infrastructure improvements (roads, airports, harbour facilities), public works (housing, hospitals, communication networks, power station), industrial and agricultural projects, and national defence. See Bertrams, above n 1, 1.

¹² Boris Kozolchyk, 'Bank Guarantees and Letters of Credit: Time for a Return to the Fold' (1989) 11 *University of Pennsylvania Journal of International Business Law*, 1, 8; Bertrams, above n 1, 2.

¹³ Kozolchyk, above n 12, 8.

¹⁴ Penn, Shea and Arora, above n 6, 268.

¹⁵ Section 24 of the National Bank Act authorises banks to carry out the business of banking. 12 USCA §24 (Seventh) (West, Supp. 1995). See John F Dolan, *The Law of Letters of Credit* (rev ed, 1996) [12-4]-[12-5]; E P Ellinger, 'Standby Letters of Credit' (1978) 6 *International Business Lawyer*, 604, 611.

actually occurred.¹⁶ These activities, involving actuarial judgements and factual investigations, have not been a part of the business of banking.¹⁷ This enhanced the wide usage of letters of credit to serve the function of guarantees or of performance bonds, providing for payment against a certificate attesting the main obligor's default.¹⁸ In the 1960s, standby credits became popular in domestic commerce of the United States. Issued to safeguard the position of the beneficiary if another person failed to perform an undertaking, it operates as an extension of the conventional commercial credit concept.

Despite their different origins, a performance bond, performance guarantee, bank guarantee, and standby credit serve the same purpose.¹⁹ They are issued in the same commercial settings and share the same payment mechanism. In all these types of documents the issuer undertakes to pay a certain amount of money to the beneficiary provided a certain event takes place, which is usually the non-performance of an obligation owed by the account party to the beneficiary.²⁰ The payment is due against a demand to be made in a prescribed form, which may be a simple written demand or the presentation of certain documents.²¹ Despite some minor differences, it is well accepted that they are conceptually and legally the same devices.²²

[2] Nature of Independent Undertaking

An independent undertaking is generally defined as an engagement made at the request of the applicant (or principal), where the financial institution (issuer or guarantor) is obliged to pay money to the beneficiary upon compliance of specified

¹⁶ John F Dolan, above n 15, [12-25].

¹⁷ Ibid.

¹⁸ Ellinger, above n 15, 610-611.

¹⁹ E P Ellinger, 'Documentary Credits and Finance by Mercantile Houses' in A G Guest (ed), *Benjamin's Sale of Goods* (5th ed, 1997) [23-217]; Geraldine Andrew and Richard Millett, *Law of Guarantees* (2nd ed, 1995) [16.28]; Weerasooria, above n 8, [11.31]; Bertrams, above n 1, 6.

²⁰ Ellinger, above n 19, [23-217].

²¹ Ibid.

²² Roy Goode, *Commercial Law* (2nd ed, 1995) 1032; Bertrams, above n 1, 6.

conditions in the operative undertaking.²³ In the leading Australian case of *Wood Hall Ltd v The Pipeline Authority*,²⁴ Barwick CJ explained the nature of a bank guarantee:

In my opinion, there is no basis whatever upon which the unconditional nature of the Bank's promise to pay on demand can be qualified by reference to the terms of the contract between the contractor and the owner. Equally, there is no basis on which the owner's unqualified right at any time to demand payment by the Bank can be qualified by reference to the terms or purpose of that contract.²⁵

Lord Denning MR described the issuer's obligation under the performance bond in *Edward Owen Engineering Ltd v Barclays Bank International Ltd*²⁶ as follows:

A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; not with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions.²⁷

Although the purpose of an independent undertaking is to indemnify the beneficiary for losses resulting from the applicant's default, the issuer's obligation, or the beneficiary's right, under an independent undertaking is to be determined solely by reference to terms and conditions specified in the undertaking.²⁸ The issuer is obliged to pay upon demand, or the beneficiary is entitled to payment by demand, where such demand complies with the terms and conditions of the operative undertaking, without proving the applicant's default. Accordingly, the issuer does not investigate the factual status of the underlying contract, and fulfils its duty by paying against a demand which on its face conforms to the operative undertaking. Moreover, it cannot invoke defences derived from the underlying contract and other related contracts to refuse payment. This operational feature is acknowledged as an effect of the "autonomy" or "independence" principle of independent undertakings.

²³ Gordon B. Graham and Benjamin Geva, 'Standby Credit in Canada' (1984) 9 *Canadian Business Law Journal*, 180, 181.

²⁴ (1979) 141 CLR 443.

²⁵ *Ibid* 445.

²⁶ [1978] 1 QB 159.

²⁷ *Ibid* 171.

²⁸ Bertrams, above n 1, 9.

The courts and commentators have often described this peculiar issuer's promise as a "contract". It may be useful to clarify the legal nature of this new phenomenon by analogy to existing legal theory, though this undertaking does not fit well within general contract principles.²⁹ For example, its binding force is not supported by consideration, which was once the most controversial issue from the academic point of view. It does not involve offer and acceptance (being considered binding as from the time of issue unless and until rejected by the beneficiary); it is not governed by any special formal requirements (such as a deed); it fits neither the definition of a bilateral contract nor that of a unilateral contract.³⁰ Consequently, the commercial reality may lead to the conclusion that an independent undertaking is *sui generis*. An independent undertaking of this nature is best regarded as a mercantile speciality, which, by the usage of merchants, has effect by virtue of its issue without any additional requirements.³¹

3 Overview of Independent Undertaking Law

Independent undertakings are scarcely codified in national statutory laws.³² Article 5 of the Uniform Commercial Code (UCC) in the United States, which is applied to both conventional commercial credits and standby credits, is acknowledged as the most comprehensive compilation of letters of credit rules. The fundamental feature of letters of credit, the autonomy principle, is enshrined in Section 5-103(d) as follows:

Rights and obligations of an issuer to a beneficiary or a nominated person under a letter of credit are independent of the existence, performance, or non-performance of a contract or arrangement out of which the letter of credit arises or which underlies it, including contracts or arrangements between the issuer and the applicant and between the applicant and the beneficiary.

²⁹ For discussion of the juridical nature of this undertaking, see Roy Goode, 'Abstract Payment Undertakings' in P Cane (eds), *Essays for Patrick Atiyah* (1991).

³⁰ Roy Goode, 'Abstract payment Undertakings in International Transactions' (1996) 22 *Brooklyn Journal of International Law*, 1, 3.

³¹ Goode, above n 30, 3; Dolan, above n 15, [2-5].

³² Bertrams, above n 1, 27. As to the national registration of letters of credit, see AN Oelofse, *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) 11.

Yet Article 5 of the UCC is skeletal. It resolves a few fundamental questions, but leaves many major issues for the courts and much space for merchants and bankers to fashion the letter of credit product in new ways to serve commercial activity.³³ When it is necessary, the courts supplement the law of contract to the extent that contract principles do not interfere with the unique nature of the independent undertaking.³⁴

In Australia, as well as other common law countries, the courts have regarded business custom and usage as the primary source of the independent undertaking law. The courts have carefully treated independent undertakings as mercantile specialities, and created a special body of case law.

However, rules developed domestically may vary from country to country, which may cause uncertainty in the international context. This is because these transactions often occur internationally. This demands a move to make uniform rules or to harmonise rules internationally. And it motivates national banking associations, official or private international organisations, to formulate formal rules, or even codes, in order to protect parties' interests by enhancing the predicability of transactions and eliminating undesirable practices. Several regimes have been established.

In the following section, the background and the specific feature of independent undertaking rules will be briefly described.

[1] Uniform Customs and Practice for Documentary Credits

The International Chamber of Commerce (ICC) has published the Uniform Customs and Practice for Documentary Credits (UCP), which is viewed as a set of standard rules embodying commercial credit practices used in the international sales of goods

³³ Dolan, above n 15, [4-11].

³⁴ *Ibid* [2-5].

context. The UCP binds the parties where it has been incorporated by reference into the credit agreement.³⁵

No other rules are accepted as universally as the UCP. This is because, first, the UCP is the collected rules of practices that have gained wide acceptance in the letter of credit community. Second, the UCP contains in considerable measure transactional provisions to govern every aspect of common “healthy” transactions.³⁶ The UCP helps to reduce negotiation costs concerned with detailed provisions of the credit, in line with internationally accepted practice. In addition, the ICC has revised the UCP almost every decade to update the provisions so that they are applicable to the current practice.

The UCP cannot be referred to as law.³⁷ The text of the UCP is neither systematic nor comprehensive enough to warrant the legal characterisation of a “code”,³⁸ and there are many facets of the relationships between the various parties which have to be answered by reference to the common law.³⁹ However, it is too narrow to take the view that the UCP should be regarded as a set of model rules which have no significance for the parties unless adopted by their contract.⁴⁰ It should be argued that

³⁵ Article 1 of the UCP provides that “[t]he [UCP] shall apply to all Documentary Credits ... where they are incorporated into the text of the Credit. They are binding on all parties thereto, unless otherwise expressly stipulated in the Credit”. See also *M Golodets & Co Inc v Czarnikow-Rionda Co Inc (The Galatia)* [1979] 2 All ER 726, 737-738.

³⁶ Boris Kozolchyk, ‘Towards New Customs and Practices for Documentary Credits: The Methodology of the Proposed Revision’, [1993] *Commercial Law Annual*, 371, 373.

³⁷ *M Golodets & Co Inc v Czarnikow-Rionda Co Inc (The Galatia)* [1979] 2 All ER 726, 737-738.

³⁸ Boris Kozolchyk, ‘Chapter 5 Letters of Credit’ in Jacob S Ziegel (eds), *Volume 9 Commercial Transactions and Institutions, International Encyclopedia of Comparative Law* (1979) para 23. The UCP does not deal with many areas, for example, the availability of injunction, restraining orders or other summary procedures. For a more exhaustive analysis, see Matti Kurkela, *Letters of Credit under International Trade Law* (1985) 31-39. Although this analysis was made in relation to the previous version of the UCP, it is relevant to the current version as well. The ICC has not changed its policy with regard to these matters. See also Charles Del Busto (ed), *Documentary Credits UCP 500 & 400 Compared* (1993).

³⁹ Goode, above n 22, 984-985.

⁴⁰ *Ibid* 985.

the UCP is directly incorporated, by implication, into the contract on the basis that their adoption is so much a matter of course that the parties must be taken to have intended to contract with reference to them, even if the contract does not state this in terms and even if one of the parties was not aware of the UCP.⁴¹

The ICC has dealt with standby credits in the UCP since the 1983 revision. Article 1 of the 1993 revision (UCP 500), which is presently in force, provides:

The Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No 500, shall apply to all Documentary Credits (including to the extent to which they may be applicable, Standby Letter(s) of Credit) where they are incorporated into the text of the Credit. They are binding on all parties thereto, unless otherwise expressly stipulated in the Credit.

The inclusion of standby credits in the UCP confirms the nature of standby credits as letters of credit. And more significantly it reinforces the autonomous character of standby credits. Article 3 of the UCP states:

- a. Credits, by their nature, are separate transactions from the sales or other contract(s) on which they may be based and banks are in no way concerned with or bound by such contract(s), even if any reference whatsoever to such contract(s) is included in the Credit. Consequently, the undertaking of a bank to pay, accept and pay Draft(s) or negotiate and/or to fulfil any other obligation under the Credit, is not subject to claims or defences by the Applicant resulting from his relationships with the Issuing Bank or the Beneficiary.
- b. A beneficiary can in no case avail himself of the contractual relationships existing between the banks or between the Applicant and the Issuing Bank.

Additionally, the general provisions, such as the construction of credits and the issuer's basic liabilities, clarify the ambiguous terms and conditions in the standby credit.

However, there are transactional and functional differences between commercial credits and standby credits. Whereas commercial credits are a payment device in international sales contracts, standby credits are primarily used as a security device in various transactions. Commercial credits become payable upon the presentation of shipping documents that show that the seller has taken affirmative steps to comply with the sales agreement.⁴² Standby credits, on the other hand, are used in the context

⁴¹ Ibid.

⁴² Dolan, above n 15, [1-16].

of a party's non-performance of an agreement. To put it briefly, the fundamental differences between standby credits and commercial credits are; (1) the documents tendered for payment, and (2) the commercial setting.⁴³

Nonetheless, the ICC has made the most rudimentary accommodation for standby credits in the UCP,⁴⁴ embodied in Article 1. It simply states that the UCP is applied to standby credits "to the extent to which they may be applicable". The ICC has neither added specific provisions nor modified the existing UCP provisions, originally designed to govern the conventional commercial credit transaction, for standby credit practice. Accordingly, difficulties arise, which fall into two categories: problematic provisions of the UCP and omissions in UCP coverage.⁴⁵

The UCP provisions concerning shipping documents (Article 23 to Article 33) are inapplicable for standby credit. Further, the provisions based on the practices of sales of goods and shipment of goods may work contrarily or detrimentally to standby credit practices.⁴⁶ For example, the failure to make one of a series of instalment drawings signals a departure from the intention of the parties in the sales of goods context. Under Article 41 the availability of credit ceases from that time unless otherwise stipulated.⁴⁷ In contrast, the failure to make a drawing will rarely be regarded as a problem by the applicant in the standby credit context.⁴⁸ There are even

⁴³ Ibid [1-16]-[1-17].

⁴⁴ James E. Byrne, 'Standby Rulemaking: A Glimpse at the Elements of standardization and Harmonization of Banking Practice', in Jacob S Ziegel (ed), *New Developments in International Commercial and Consumer Law Proceeding of the 8th Biennial Conference of the International Academy of Commercial and Consumer Law* (1998) 139, 145.

⁴⁵ Ibid.

⁴⁶ For a detailed analysis, Ibid 145-147.

⁴⁷ Article 41 Instalment Shipments/Drawing:

If drawings and/or shipments by instalments within given periods are stipulated in the Credit and any instalment is not drawn and/or shipped within the period allowed for that instalment, the Credit ceases to be available for that and any subsequent instalments, unless otherwise stipulated in the Credit.

⁴⁸ Byrne, above n 44, 146.

situations where the parties may expect that the beneficiary will be able to make drawings in a series without regard to whether it has made a prior drawing.⁴⁹

Furthermore, there are no provisions in the UCP which solely regulate standby practices.⁵⁰ Thus, where the UCP is incorporated into the standby credit, some modification of the UCP is required and individual negotiation to draft further provisions is needed.⁵¹

[2] Uniform Rules for Contract Guarantees (URCG) and Uniform Rules for Demand Guarantees (URDG)

In 1968, the ICC made the first draft of the uniform rules for independent guarantees, or demand guarantees, in close cooperation with UNCITRAL (the United Nations Commission on International Trade Law).⁵² Since this kind of guarantee is a creature of practice, the project aimed to declare its legitimacy and to reduce uncertainty in practice by uniform rules. In 1978 the Uniform Rules for Contract Guarantees (the URCG) were issued.

During the process of formulating the URCG, the most disputed issue concerned the extent to which the payment of a guarantee should be made subject to certain conditions.⁵³ The treatment of “an unfair call” by the beneficiary on the demand guarantee was a prime concern in this project. To strike a balance between the parties’ interests, Article 9 provides that the claim must be supported by a court decision or an arbitral award justifying the claim, or the approval of the principal in writing to the claim and the amount to be paid must be given. It was laudable to aim for curbing unfair calls on demand guarantees, however these requirements, to a large extent, undermined the *raison d’être* of demand guarantees as a substitute for the cash

⁴⁹ Ibid 146.

⁵⁰ Ibid 147-150.

⁵¹ Ibid 145-149.

⁵² Lars A E Hjerner, ‘Contract Guarantees’, in Petar Šarčević and Paul Volken (eds) *International Contracts and Payments* (1991) 69,71.

⁵³ Ibid.

deposit.⁵⁴ In light of the market conditions and bargaining power of the beneficiary, this amounts to ignoring the commercial reality and its needs. Thus the URCG have largely remained unaccepted.

With the experience of the URCG, the ICC decided to produce a new set of rules to provide for commercial demands and practical needs. In effect the ICC approved the validity of simple demand guarantee, even where there is a possibility that the principal may be exposed to the risks of an unfair call from time to time. The URDG provide that they cover all types of demand guarantee which have the documentary character of the payment conditions in Article 2.⁵⁵

- (a) For the purpose of these Rules, a demand guarantee (hereinafter referred to as “Guarantee”) means any guarantee, bond or other payment undertaking, however named or described, by a bank, insurance company or other body or person (hereinafter called “the Guarantor”) given in writing for the payment of money on presentation in conformity with the terms of the undertaking of a written demand for payment and such other document(s) (for example, a certificate by an architect or engineer, a judgement or an arbitral award) as may be specified in the Guarantee, such undertaking being given
 - (i) at the request or on the instructions under the liability of a party (hereinafter called “the Principal”); or
 - (ii) at the request or on the instructions and under the liability of a bank, insurance company or any other body or person (hereinafter “the Instructing Party”) acting on the instructions of principal to another party (hereinafter “the Beneficiary”).
- (b) Guarantees by their nature are separate transactions from the contract(s) or tender conditions on which they may be based, and Guarantors are in no way concerned with or bound by such contract(s), or tender conditions, despite the inclusion of a reference to them in the Guarantee. The duty of a Guarantor under a Guarantee is to pay the sum or sums therein stated on the presentation of a written demand for payment and other documents specified in the Guarantee which appear on their face to be in accordance with the terms of the Guarantee.

With the recognition of market reality and the necessity to balance the parties’ interests, the ICC sought to impose some constraint on the unfair calling of a guarantee without undermining its efficacy as a swift remedy in the event of perceived default.⁵⁶ Article 20 prescribes a statement of the general indication of the nature of a principal’s default as the prerequisite to a beneficiary’s entitlement to payment, in

⁵⁴ Roy Goode, ‘The new I.C.C. Uniform Rules for Demand Guarantees’ [1992] *Lloyd’s Maritime and Commercial Law Quarterly*, 190.

⁵⁵ *Ibid* 196.

⁵⁶ Goode, above n 22, 1043.

addition to the demand being made in writing.⁵⁷ The constraint is somewhat limited in that the statement of breach is required only from the beneficiary himself, not from an independent third party.⁵⁸ Its practical effect as a safeguard against unfair calling is, to say the least, questionable. In the final analysis, the inherent vulnerability of the principal is an inevitable side effect of the demand guarantee as a useful mercantile device.

Originally the ICC attempted to link standby credits to the URDG. There are some recognised differences between demand guarantees and standby credits, although it is generally perceived that such differences lie in business practice and not in law.⁵⁹ The test is whether the issuer's payment obligation is primary.⁶⁰ To the extent that an undertaking is independent of the underlying contract and payable against the submission of documents, they are the same devices.⁶¹ Hence any formal exclusion of standby credits from the URDG would merely cause confusion, since standby credits meet in every particular the definition of "demand guarantee" contained in Article 2(a).⁶²

⁵⁷ Article 20(a):

Any demand for payment under the Guarantee shall be in writing (in addition to such other documents as may be specified in the Guarantee) be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it) stating:

- (i) that the Principal is in breach of his obligation(s) under the underlying contract(s) or, in the case of a tender guarantee, the tender conditions; and
- (ii) the respect in which the Principal is in breach.

⁵⁸ Goode, above n 22, 1043.

⁵⁹ Goode, above n 22, 1032; Goode, above n 54, 193-194.

⁶⁰ "The difference between the primary guarantee and the secondary guarantee lies in their respective conditions. In the secondary guarantee, the guarantor is liable only if the principal defaults on the underlying obligation; in the primary guarantee, the guarantor is liable if the beneficiary satisfies the documentary conditions of the guarantee." John F. Dolan, 'Efforts at International Standardization of Bank Guarantees', (1990) 4 *Banking & Finance Law Review*, 237, 243.

⁶¹ Dolan, above n 15, [2-12].

⁶² Goode, above n 54, 196.

Banks in the United States have rejected the URDG as a means of regulating standby credits, preferring instead to use the UCP. It is assumed that, due to diversity of uses for which standby credits may be used, compared with ordinary demand guarantees, coupled with the perceived need of United States banks to have standby credits visibly equated with documentary credits, rather than with guarantees, there remained a strong feeling among the banks that the UCP was better attuned to their needs.⁶³

[3] UN Convention on Independent Guarantees and Standby-Letters of Credit

Working closely with the ICC, UNCITRAL was reviewing the URDG and making possible suggestions for its worldwide acceptance before finalising the provisions. At the same time, UNCITRAL was examining the desirability and feasibility of any future work relating to statutory law in this area. While some doubts were expressed about the practical need and usefulness of such a uniform law, there was wide support for the view that successful work in this direction was desirable in view of the practical problems that could only be dealt with at the statutory level, including fraud and procedural matters.⁶⁴ UNCITRAL entrusted to the Working Group the task of considering the desirability and feasibility of any future work at the level of statutory law. At its twenty-second session, UNCITRAL accepted the recommendation of the Working Group that work on a uniform law should be undertaken and launched a project.⁶⁵

One of the main objects of the Convention was to confirm that independent guarantees and standby credits share the same basic principles and characteristics. With a harmonised set of rules for both covered, the Convention intended to provide greater legal certainty in their use for day-to-day commercial transactions.⁶⁶ Another

⁶³ Ibid.

⁶⁴ *Report of the UN Commission on International Trade Law on the Work of its Twenty-first Session*, Official Record of General Assembly, 43rd Session, Supplement No. 17 (A/43/17).

⁶⁵ *Report of the U.N. Commission on International Trade Law on the Work of its Twenty-second Session*, Official Record of General Assembly, 44th Session, Supplement No. 17 (A/44/17).

⁶⁶ *Explanatory note by United Nations Convention on Independent Guarantees and Stand-by Letters of Credit* (A/CN.9/431).

main purpose, as mentioned above, was to establish greater uniformity internationally in the manner in which the guarantor/issuer and the courts respond to allegations of fraud or abuse in demands for payment under independent guarantees and stand-by letters of credit.⁶⁷

In December 1995, the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit was adopted by the General Assembly of the United Nations and presented for signature. After Tunisia gave its ratification as the fifth state, under article 28(1),⁶⁸ the UN Convention entered into force on 1st January 2000.⁶⁹

The Convention has chosen the term “undertaking” to describe both standby credits and independent guarantees. An undertaking is defined in Article 2(1):

For the purpose of this Convention, an undertaking is an independent commitment, known in international practice as an independent guarantee or as a stand-by letter of credit, given by a bank or other institution or person (“guarantor/issuer”) to pay to the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment is due because of a default in the performance of an obligation, or because of another contingency, or for money borrowed or advanced, or on account of any mature indebtedness undertaken by the principal/applicant or another person.

In addition, the Convention limits its application to independent undertakings in international settings. One reason given, which is not by itself determinative, was that the project was to work towards the progressive unification and harmonisation of international trade law.⁷⁰ It attempted to bridge the gap of legal theories of independent undertakings at the outset, then aimed to develop further unification and harmonisation in other commercial areas. Of more immediate significance is that

⁶⁷ Ibid.

⁶⁸ Article 28(1): This Convention enters into force on the first day of the month following the expiration of one year from the date of the deposit of the fifth instrument of ratification, acceptance, approval or accession.

⁶⁹ Ecuador ratified on 18th June 1997; Panama ratified on 21st May 1998; El Salvador ratified on 31st July 1998; Kuwait ratified on 28th October 1998; Tunisia ratified on 8th December 1998.

⁷⁰ *Report of the Working Group on International Contract Practices on the work of its thirteenth session*, (A/C/N.9/330).

many legislators who might be prepared to adopt the uniform law if it was restricted to international transactions might not be prepared to adopt it if it was also applicable to domestic transactions.⁷¹

[4] International Standby Practice (ISP98)

As the UNCITRAL deliberation progressed, the project to formulate standby credits and independent guarantees under a single regime fell short of the expectations of the United States banking community. Not only was there a serious lack of understanding of standby credits, but also many of the potential uses of standby credits were obscured by its misidentification with independent guarantee practice.⁷² There are significant differences between the typical uses of standby credits and independent guarantees. The United States banking community felt that these differences demanded different treatments.⁷³

It is likely that the United States banking community wanted more detailed transactional rules to regulate common standby credit transactions. The desired effect was to streamline its practice and secure its nature as a multi-purpose commercial device. The UN Convention, on the other hand, basically focused on confirming the principle that standby credits and independent guarantees are legally the same devices, emphasising the basic concepts embodied in the provisions, giving detailed consideration only to the matters dealt with at the statutory level, such as fraud or abusive call.

In any event, the ICC Banking Commission had decided not to make any adjustments addressing standby credit practices in the UCP and no project was commissioned to formulate separate standby credit rules.⁷⁴ The United States banking community felt compelled to fashion alternative rules for standby credits. Ultimately, the United

⁷¹ Ibid.

⁷² James E. Byrne, *The Official Commentary on the International Standby Practices* (1998) 'Introduction' xvi.

⁷³ Byrne, above n 44, 143.

⁷⁴ Ibid 149.

States Department of State requested the United States letters of credit community, in conjunction with the United States Council on International Banking⁷⁵ and the Institute of International Banking Law & Practice, to take the lead in formulating draft standby credit rules in consultation with letter of credit communities throughout the world.⁷⁶

This resulted in the International Standby Practices (ISP98). It should be noted that, during the drafting process, the UNCITRAL Secretariat and working groups associated with the ICC participated in the project. The ICC eventually endorsed the ISP98.

The ISP is quite distinct from other regimes in its detailed form. "Nature of Standby" is defined in Rule 1.06(a):

A Standby is an irrevocable, independent, documentary, and binding undertaking when issued and need not so state.

The independent nature of standby credits is defined in respect of the issuer's obligation in Rule 1.06(c):

Because a standby is independent, the enforceability of an issuer's obligations under a standby does not depend on:

- (i) the issuer's right or ability to obtain reimbursement from the applicant;
- (ii) the beneficiary's right to obtain payment from the applicant;
- (iii) a reference in the standby to any reimbursement agreement or underlying transaction;
or
- (iv) the issuer's knowledge of performance or breach of any reimbursement agreement or underlying transaction.

Furthermore, the independent nature of standby credits is clarified from the viewpoint of the independence from the relationship between the issuer and the applicant in Rule 1.07:

⁷⁵ The United States Council on International Banking is now known as the International Financial Services Association.

⁷⁶ Byrne, above n 44, 149. The project was supported by, besides these institutions, the National Law Center for Inter-American Free Trade, Baker & McKenzie, Citibank, NA, the Chase Manhattan Bank, NA ABN AMRO.

An issuer's obligations toward the beneficiary are not affected by the issuer's rights and obligations toward the applicant under any applicable agreement, practice, or law.

4 Transactional Features of Independent Undertakings from a Comparative Perspective of Standby Credits and Other Independent Undertakings

In this section, the transactional features of independent undertakings will be demonstrated, focussing on some practical differences between standby credits and other independent undertakings.

[1] Transactional Structure: Parties

Every independent undertaking, as has been seen, involves at least three parties; the principal or applicant, the beneficiary and the guarantor or issuer.⁷⁷ The terms "principal" and "guarantor" have been often used in the context of performance bonds, performance guarantees, or bank guarantees. On the other hand, in the context of standby credits, which have inherited transactional features from commercial credits, the terms "applicant" and "issuer" are used instead.

Although the relationships of all three parties are functionally related to each other, the issuer's obligation in the independent undertaking transaction is operationally independent from other two transactions, namely: the underlying contract between the applicant and the beneficiary; and the application contract between the applicant and the issuer. The issuer is placed as a neutral third party to the underlying contract relationship. Regardless of factual status of underlying contract, it is expected to pay simply upon the fulfilment of the payment conditions in the operative undertaking.

Furthermore, the relationship between the applicant and the issuer cannot affect the issuer's obligation either. In the application contract, the applicant provides full details of the independent undertaking, with regard to which the applicant and the

⁷⁷ See also Goode, above n 22, 1033.

beneficiary have previously agreed in the underlying contract, to the issuer. At the same time, it deals with matters relating to the method of the bank's reimbursement and any security interest the bank will hold pending reimbursement.⁷⁸ Even if the issuer knows the incomplete performance by the beneficiary in the underlying contract, or the applicant cannot fulfil his reimbursement obligation, the issuer is obliged to pay upon demand complying with the conditions.

The neutral position of the issuer is perceived as a doctrinally essential element for the autonomous nature of an independent undertaking. However, in practice, especially in the standby credit context, two-party transactions are not unusual.⁷⁹ This is the case where the issuer is making an undertaking on its own behalf (the applicant is also the issuer) or in favour of itself (the beneficiary is also the issuer). The former case arises when a bank issues an independent undertaking to secure the obligations of their agencies, or branches, or of themselves under commercial agreements. The latter usually arises where a bank is both the issuer and the trustee for the party or parties who ultimately benefit from the undertaking.⁸⁰

It is strongly submitted that these two-party independent undertakings are problematic because the independence of the undertaking suffers due to the lack of a neutral third party.⁸¹ In the former two-party transaction, where the issuer and the applicant are the same party, doctrinally the utility or advantage of such an undertaking is hard to see. And in the latter case, where the issuer and the beneficiary are the same party, there is an obvious conflict of interest between the parties because it may not be examined properly or determined fairly whether the demand complies with the terms and conditions of the operative undertaking.⁸²

⁷⁸ See Oelofse, above n 32, 112-113; Goode, above n 22, 966-969; Dolan, above n 15, [2-33]-[2-34].

⁷⁹ See John F Dolan, 'The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?' (1998) 13 *Banking & Finance Law Review*, 1, 21-22; Dolan, above n 15, [12-45]; Goode, above n 30, 12-13; Goode, above n 22, 1031.

⁸⁰ See Dolan, above n 79, 21-22.

⁸¹ *Ibid* 22.

⁸² *Ibid*.

Nonetheless, these two-party transactions are generally accepted from the viewpoint of practicality. The doctrinal arguments for treating one engagement as independent from the other are less compelling in these situations, though there is nothing particularly novel in an arrangement by which the payment obligation under a commercial contract is directed into a separate contract insulated from the main agreement.⁸³ Such an arrangement is typically found in a bill of exchange given as payment for goods or services and considered to generate a distinct contract between holder, drawer, and acceptor.⁸⁴ It is left to the parties to determine whether such an undertaking is acceptable and whether it complies with regulatory guidelines regarding safety and soundness of banking business.⁸⁵ Generally the rules and regulations mentioned in the previous section take the same view.⁸⁶

On the other hand, in international transactions, there are quite often more than three parties. Another bank, in the same country as the beneficiary, is appointed to issue the guarantee. This is to accommodate the request of the beneficiary that the guarantee should be issued by his local bank. In this context, the beneficiary's local bank (the

⁸³ Goode, above n 30, 13.

⁸⁴ *Ibid.*

⁸⁵ Byrne, above n 72, 37-38.

⁸⁶ UCP Article 2:

For the purpose of these Articles, the expressions "Documentary Credit(s) and Standby Litter(s) or Credit" (hereinafter referred to as "Credit(s)"), mean any arrangement, however named or described, whereby a bank (the "Issuing Bank") acting at the request and on the instruction of a customer (the "Applicant") or on its own behalf, ...

UN Convention Article 2(2):

The undertaking may be given:

- (a) At the request or on the instruction of the customer ('principal/applicant') of the guarantor/issuer;
- (b) On the instruction of another bank, institution or person ('instructing party') that acts at the request of the customer ('principal/applicant') of that instructing party; or
- (c) On behalf of the guarantor/issuer itself.

UCC Section 5-102(a)(10):

"Letters of credit" means a definite undertaking that satisfies the requirements of Section 5-104 by an issuer to a beneficiary at the request or for the account of an applicant or, in the case of a financial institution, to itself or for its own account, to honor a documentary presentation by payment or delivery of an item of value.

guarantor) issues the guarantee to him and applicant's bank issues another guarantee to indemnify payment by the guarantor. While a typical bank guarantee in which three parties are involved is called a "direct guarantee", in this four-party transaction, the guarantee issued by the beneficiary's local bank is called an "indirect guarantee". And the other guarantee, issued to indemnify payment by the local bank, is called a "counter-guarantee".⁸⁷ These two guarantees are conceptually independent from each other,⁸⁸ resulting in each guarantee having its own conditions for payment and operating according to them.

In this regard, standby credits, which operate as an extension to the conventional commercial credit concept, can be confirmed or another bank nominated for payment through the banking network. Some intermediate banks may also appear in the transaction under a reimbursement agreement with the issuer.

[2] Conditions for Payment: Documentary Nature

Article 5 of the revised UCC (1995 version) defines "letters of credit" as an undertaking to "honor a documentary presentation by payment or delivery of an item of value".⁸⁹ Documentary conditions are peculiar to contemporary letters of credit, but are linked to the use of valuable documents or documents of title in earlier times.⁹⁰ Doctrinally it has come to be recognised that the autonomous character of a letter of credit is linked to its documentary nature.⁹¹ By confining a letter of credit transaction

⁸⁷ Take the example of *Edward Owen Engineering Ltd v Barclays Bank International Ltd* ([1978] 1 QB 159). The underlying contract was that an English supplier (Edward Owen Engineering Ltd) agreed to supply and install glasshouses for a Libyan customer. To secure the performance of the English supplier, Umma Bank in Libya issued a guarantee in favour of the Libyan customer, then Barclays Bank issued the counter guarantee to indemnify the payment by Umma bank.

⁸⁸ Bertrams, above n 1, 137.

⁸⁹ See footnote 86 of this chapter. See also Dolan, above n 15, [2-9].

⁹⁰ James E Byrne, 'Fundamental Issues in the Unification and Harmonization of Letter of Credit Law' (1991) 37 *Loyola Law Review*, 1, 33.

⁹¹ Byrne, above n 44, 142; For an analysis from the point of view of non-documentary condition, see Agasha Mugasha, 'Non-Documentary Conditions in Letters of Credit and Bank Guarantees' (1990) 5 *Banking and Finance Law Review*, 283, 311-312.

to dealing with documents — to examine whether they have, on their face, complied with the stipulated conditions of the operative credit, the separation of it from other related contracts will be achieved and objectively ascertained. This principle naturally applied to standby credits as a sibling of the conventional commercial credit.

Furthermore, in the standby credit context, the documentary nature has significance through its validity in banking business. In the United States, as previously mentioned, banking law prohibits the issuance of secondary guarantees. It is important to distinguish standby credits from secondarily reliable guarantees. The documentary nature has become a key factor in this regard. In the often-cited case of *Wichita Eagle & Bacon Publishing Co v Pacific National Bank*,⁹² the bank issued an engagement denominated as a letter of credit to support the performance of a tenant's obligation to construct a parking garage. The payment conditions stipulated in the undertaking were not the presentation of the documents, but rather the occurrence or non-occurrence of factual events, such as “[the tenant] had failed to perform the terms and conditions of paragraph IV(a) of the Lease”.⁹³ The court observed that this undertaking strayed “too far from the basic purpose of letters of credit, namely providing a means of assuring payment cheaply by eliminating the need for the issuer to police the underlying contract”.⁹⁴ Therefore, it was determined that the arrangement was not a letter of credit, but a secondary guarantee. In *Bank of North Carolina, NA v Rock Island Bank*,⁹⁵ the court reinforced the distinction between a standby credit and a guarantee:

[T]he letter of credit creates a primary liability on an original obligation —to pay on the presentation of documents — whereas the contract of guaranty creates a secondary liability on the pre-existing obligation of another — to pay in the event that the other does not.⁹⁶

The issuer's primary obligation has been acknowledged as linked to the arrangement's documentary nature. This gives the documentary component in standby credits more

⁹² 343 F Supp. 332 (ND Cal 1971); rev'd, 493 F2d 1285 (9th Cir 1974). See, Dolan, above n 15, [2-18].

⁹³ 343 F Supp 332, 340. Paragraph IV(a) of the Lease required the tenant to exercise due diligence to obtain necessary permits and to commence and complete construction on the Property of a parking garage in accordance with a specified time schedule and having a minimum value of \$500,000.

⁹⁴ 493 F2d 1285, 1286.

⁹⁵ 570 F2d 202 (7th Cir 1978). See also Mugahsa, above n 91, 307.

⁹⁶ 570 F2d 202, 206.

significance.⁹⁷ In the context of a standby credit, its documentary nature is not only its attribution, but also a focal point to qualify an undertaking for a letter of credit, the issue of which is valid in banking business in the United States.

On the other hand, in Australia, as well as England and Canada, there is no restriction on the issuance of secondary guarantees in banking business. Banks are able to issue both conditional and unconditional guarantees. The nature of a performance bond or bank guarantee will be determined by their payment conditions.⁹⁸ As has been shown above, under an unconditional guarantee the guarantor will become liable merely when demand is made by the beneficiary.⁹⁹ Practically the demand has been made by writing, however the documentary nature has not been emphasised. In *Wood Hall Ltd v Pipeline Authority*,¹⁰⁰ Gibbs ACJ explained:

By each of the bank guarantees, the Bank “unconditionally” undertakes “to pay on demand” the sum demanded up to the limit specified in the bank guarantee. To hold that the bank guarantees are conditional upon the making of a demand that conforms to the requirements of the contract between the Authority and the contractor would of course be quite inconsistent with the express statement in the bank guarantees that the undertaking of the Bank is unconditional.¹⁰¹

Quite often, especially in English cases, the courts discussed the nature of performance guarantee by analogy to commercial credits, believing that “the performance guarantee stands on a similar footing to a letter of credit”.¹⁰² Nonetheless, it has been observed that the payment condition may not be strictly linked to the presentation of documents.¹⁰³ Roskill L.J. observed in *Howe Richardson Scale Co v Polimex-Cekop*:¹⁰⁴

⁹⁷ Mugasha, above n 91, 310.

⁹⁸ See G A Weaver and C R Craigie, *The Law Relating to Banker and Customer in Australia* (2nd ed, 1990) [26.60]; O’Donovan and Phillips, above n 6, 770-771.

⁹⁹ See O’Donovan and Phillips, above n 6, 769-770; Ellinger, above n 19, [23-240]; Andrews and Millett, above n 19, 447-451.

¹⁰⁰ (1979) 141 CLR 443.

¹⁰¹ *Ibid* 451.

¹⁰² *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] 1 QB 159, 171 (Lord Denning MR).

¹⁰³ See Mugasha, above n 91, 311-312.

¹⁰⁴ [1978] 1 Lloyd’s Rep. 161.

The bank, in principle, is in a position not identical with but very similar to the position of a bank which has opened a confirmed irrevocable letter of credit. Whether the obligation arises under a letter of credit or under a guarantee, the obligation of the bank is to perform that which it is required to perform by that particular contract...the bank here is simply concerned to see whether the event has happened upon which its obligation to pay has arisen.¹⁰⁵

However, it should be noted that the independent undertaking law, in order to clarify its autonomous nature, has developed substantially in relation to its documentary nature. At the very least, it requires the demand for payment be made in writing where such a demand is clearly a document. In this respect, the word “unconditional” is, to some extent, misleading, because some condition has always to be fulfilled, even if it is no more than the presentation of a document demanding for payment. In fact, it would be better to classify bonds as documentary.¹⁰⁶ The URDG recognises this principle in Article 2(a):

For the purpose of these Rules, a demand guarantee (hereinafter referred to as “Guarantee”) means any guarantee, bond or other payment undertaking, however named or described, by a bank, insurance company or other body or person (hereinafter called “the Guarantor”) given in writing for the payment of money on presentation in conformity with the terms of the undertaking of a written demand for payment and such other document(s) (for example, a certificate by an architect or engineer, a judgement or an arbitral award) as may be specified in the Guarantee, such undertaking being given ...

Given the process of recent rule making with regard to independent undertakings, and under the widely accepted notion that standby credits, performance bonds, performance guarantees and bank guarantees are legally the same devices, their autonomy may be fully recognised by the doctrinal linkage to their documentary nature.¹⁰⁷ This objectively ascertainable criterion for their autonomous nature will

¹⁰⁵ Ibid 165.

¹⁰⁶ Roy Goode, ‘Unconditional Bonds: The Common Law’ in Humphrey Lloyd (ed), *The Liability of Contractors* (1986) 99. See also Bertrams, above n 1, 39-40.

¹⁰⁷ UN Convention Article 2(1):

For the purposes of this Convention, an independent commitment, known in international practice as an independent guarantee or as a stand-by letter of credit, given by a bank or other institution or person (‘guarantor/issuer’) to pay to the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment is due because of a default in the performance of

confirm the independence of performance bonds, performance guarantees and bank guarantees from their underlying contracts, and other related contracts, especially in the jurisdictions where the two types of undertakings are possibly issued by the same institutions.

[3] Types of Independent Undertaking

Performance bonds, performance guarantees and bank guarantees may be linked to default situations.¹⁰⁸ They are particularly common in the construction industry and in the field of international sales contracts.¹⁰⁹ In the construction contract, different types of bank guarantees for different stages are issued so as to limit liability for each phase to the amount of the guarantee relating to that phase.¹¹⁰ The main types are the following:¹¹¹

- (1) Tender guarantee, providing for payment to the beneficiary if the principal, having tendered successfully for the contract, fails to sign it or to procure the issuer of any main performance guarantee required by the tender conditions. Payment serves as compensation for the time and expenditure incurred as a result of the employer (beneficiary) having to re-examine the tenders submitted by other contractors.
- (2) Performance guarantee, assuring payment to the beneficiary in the event that the principal has not, timely, completely, or properly fulfilled his obligation from the underlying contract.

an obligation, or because of another contingency, or for money borrowed or advanced, or account of any mature indebtedness by the principal/applicant or another person.

¹⁰⁸ Byrne, above n 44, 143.

¹⁰⁹ Andrew and Millett, above n 19, 446.

¹¹⁰ Goode, above n 22, 1035.

¹¹¹ See, Bertrams, above n 1, 29-33; Goode, above n 22 1035.

- (3) Advance payment (repayment) guarantee, providing repayment to the beneficiary of an advance payment made to the principal to finance the transaction in the initial stage of execution.
- (4) Retention guarantee, furnished to the beneficiary in exchange for release of retention monies, which is a percentage of interim payment retained by the beneficiary, and available to be called up if the principal fails to complete the contract or the work is defective.
- (5) Maintenance guarantee furnished to the beneficiary in exchange for release of retention monies held to cover the cost of defects arising during the defects liability period.

In the international sales contract, performance bonds are used to secure the seller's obligation, namely, to safeguard against late delivery, non-delivery or delivery of goods which are not in accordance with the contractual specification.¹¹²

Standby credits are, naturally, used in construction contracts and international sales contracts as described above, however their usage has been far more popular in the United States.¹¹³ Even in the sale of goods context, standby credits are issued in favour of the seller. Traditionally commercial credits were used in this context, however the examination of voluminous documents under commercial credit arrangements causes higher bank charges. Commercial parties arrange for payment of the price of the goods to be paid directly from the buyer to the seller, then issue standby credits just in case the buyer fails to pay. Also, significant usage of standby credits has been observed in the real estate industry in the United States, particularly in securing the developer's completion of the project and the purchaser's payment for the real estate.¹¹⁴ The Bank of International Settlements classifies these standby

¹¹² Andrew and Millett, above n 19, 451.

¹¹³ On the extensive usage of standby credits in the United States, see Dolan, above n 15, [1-24]-[1-38]; Burton V McCullough, *Letters of Credit* (2000) [1-114.31]-[1-114.42].

¹¹⁴ Dolan above n 15, [1-24]-[1-25]; McCullough, above n 113, [1-114.31]-[1-114.42].

credits as “performance standby”, which are used to assure performance of various undertakings which run the gamut of human and commercial conduct.¹¹⁵

Furthermore, standby credits have been used extensively to assure payment of principal and interest to the purchasers of bonds and commercial paper.¹¹⁶ Although standby credits provide for payment in the event of default in this context, they also provide for regular payment of interest and principal as the ordinary avenue of payment.¹¹⁷ Thus standby credits are not always linked to default situations and this makes it almost impossible to define them by their functional description.¹¹⁸

Accordingly, the United States Comptroller of the Currency has reformulated its interpretive ruling on letters of credit from the perspective of their transactional feature, namely their documentary nature, as follows:

General Authority. A national bank may issue and commit to issue letters of credit and other independent undertakings within the scope of the applicable laws of practice recognized by law. Under such letters of credit and other independent undertakings, the bank's obligation to honor depends upon the presentation of specified documents and not upon nondocumentary conditions or resolution of questions of fact or law at issue between the applicant and the beneficiary. A national bank may also confirm or otherwise undertake to honor or purchase specified documents upon their presentation under another person's independent undertaking within the scope of such laws or rules.¹¹⁹

While there is no exhaustive list of standby credit usage, the United States Secretary of State's Select Advisory Group formulated a draft of standby rules against the background of the proposed UNCITRAL rules on independent guarantees.¹²⁰ This work was a response to requests from other nations' delegations and observer organisations for better understanding of standby credits. These requests came after the UNCITRAL project fell short of expectations in bridging the differences between

¹¹⁵ Boris Kozolchyk, 'The Financial Standby: A Summary Description of Practice and Related Legal Problems', (1996) 28 *Uniform Commercial Code Law Journal*, 327, 331; Byrne, above n 44, 139.

¹¹⁶ See Kozolchyk, above n 115, 327.

¹¹⁷ Byrne, above n 44, 139.

¹¹⁸ *Ibid.*

¹¹⁹ 12 CFR 7.1016(a).

¹²⁰ UNCITRAL launched the project to codify internationally the law of standby credits and independent guarantees in 1988. The Advisory Group's discussion was based on the draft articles of the Working paper submitted to the Working Group on International Contract Practices at its sixteenth session (A/CN.9/WG.2/WP.73); Byrne, above n 44, 140.

standby credits and independent guarantees.¹²¹ The Advisory Group completed the “SELECT ADVISORY GROUP PROPOSED DRAFT STANDBY LETTER OF CREDIT RULES” in which the descriptive categories of standby credits were provided in Article 6 “Definition and Rules of Interpretation” as follows:

- (a) A financial standby, which provides for honour upon presentation of documents stating that payment is due for money borrowed or advanced, or on account of any mature indebtedness undertaken by the applicant or another person.
- (b) A performance standby, which provides for honour upon presentation of documents stating that payment is due because of a default in the performance of a non-financial or commercial obligation.
- (c) An advance payment standby, which provides for honour upon presentation of documents stating that an advance payment has been made and that its return is demanded.
- (d) A bid standby, which provides for honour upon presentation of documents stating that there has been a failure to tender a bid and/or to execute the award on the bid.
- (e) A commercial standby, which provides for honor upon presentation of documents stating that there has been a failure to deliver or to pay for delivery of goods or services under an underlying commercial transaction, supported or not by a commercial letter of credit.
- (f) A clean standby, which provides for honor solely upon the presentation of drafts or demands for payment.
- (g) A counter standby, which provides for honor upon presentation of documents stating that the beneficiary has honored or is obliged to honor its standby or commercial letter of credit, guarantee or other undertaking.

¹²¹ Boris Kozolchyk, ‘National Law Center/Select Advisory Group Rules and Comment on Standby Letters of Credit’ (1992) 9(2) *Arizona Journal of International & Comparative Law*, 361, 364.

The extent and diversity of the usage of independent undertakings will depend on many factors, including commercial and financial development, market competition and the regulations related to transactions. Because of the simplicity of their autonomous feature, independent undertakings offer great possibilities. Their flexibility enables them to respond to diverse commercial and financial needs in various transactions, which accords with the current commercial and financial status of certain countries.

This chapter has provided an outline of independent undertakings. Independent undertakings emerged in practice in response to commercial needs in various countries. In the United States, standby credits were devised due to restrictions on banks, which are prohibited from issuing secondary guarantees or surety ship. In other countries without similar restrictions, bank guarantees and performance bonds were used. Despite the different names and different origins, they share the same legal nature and facilitate the same commercial purpose. Furthermore, the concept of commercial credit has been equally a key element in developing principles underlying these instruments. In the next chapter, the autonomy principle — the governing principle of independent undertakings — will be examined in detail.

Chapter 2 The Autonomy Principle: Operational and Functional Features of Independent Undertakings

The autonomy principle constitutes the issuer's primary obligation, and requires the issuer to perform its obligation without regard to factors extraneous to the terms of the independent undertaking. The issuer's payment, however, cannot be "primary" in a practical sense as a payment solely for its own debt, because it also constitutes payment on behalf of the applicant to the beneficiary in the underlying contract. As has been seen, the independent undertaking is used by the parties to the underlying contract to achieve their commercial purpose. The autonomy principle — operationally defined as constituting the issuer's primary obligation — can be properly understood through its commercial significance within a multi-party relationship.

This chapter will clarify the significance of the autonomy principle through investigating the nature of independent undertakings by reference to their operational and functional features. This will be achieved by comparing devices that share the same autonomy principle, negotiable instruments, and also comparing instruments are used for the same purpose, traditional guarantees or suretyship. The analysis will attempt to distinguish the elements of a multi-party transaction to which the autonomy principle applies and elucidate the specific commercial role and purpose of independent undertakings.

1 Theoretical Structure of the Autonomy Principle in Contrast with Negotiable Instrument

The autonomous nature of independent undertakings has often been discussed by analogy with negotiable instruments.¹ Geoffrey Lane LJ in *Edward Owen*

¹ Due to its earlier advent, this analogy can be found in the commercial credit context to explain its autonomous nature. See Roy Goode, *Commercial Law* (2nd ed, 1995) 988; John F Dolan, *The Law of Letters of Credit* (rev ed, 1996) [3-17]. In legal writing of civil law, the attempt was made to explain the nature of independent guarantees through various traditional concepts including acceptance of bills of exchange. Reoland Bertrams, *Bank Guarantees in International Trade* (2nd ed, 1996) 55.

*Engineering Ltd v Barclays Bank International Ltd*² stated that “[a performance bond] has much more of the characteristics of a promissory note than the characteristics of a guarantee”.³ With this analogy, it was concluded that a performance bond should be distinguished from a traditional guarantee and that the principles governing a traditional guarantee could not apply to a performance bond. The courts have shown the same reluctance to allow contractual claims and defences arising from the underlying contract to be used to withhold the issuer’s payment in both negotiable instrument and independent undertaking transactions. Due to their autonomous nature, the “holder” or “beneficiary” is not subject to these contractual defences.⁴ However, the status of a beneficiary, in relation to the underlying contract in the independent undertaking context, and that of a holder, in the negotiable instrument context, are different. Whereas the beneficiary is a party to the underlying contract, the holder is usually a third party. Although these instruments share the same “autonomy principle”, it is founded on different reasoning and purposes.

Generally, with respect to “abstract payment undertaking”, including negotiable instruments, commercial credits and independent undertakings, two distinct but related objectives insulate them from the underlying contractual consideration: first, to avoid defences by the debtor (the applicant) based on the underlying contract; and second, to facilitate the marketing of the money claim by the creditor as an unconditional entitlement to payment, free of equity.⁵ The principal method to accomplish these objectives is to embody the parallel payment undertaking in a separate document.⁶

The negotiable instrument was originally conceived to achieve the second objective — to facilitate the marketing of the money claim. Given the rapid growth of commerce in England and Europe in the fifteenth and sixteenth centuries, it provided

² [1978] 1 QB, 159.

³ *Ibid* 175.

⁴ Dolan, above n 1, [3-17].

⁵ Roy Goode, ‘Abstract Payment Undertaking’, in P Cane *et al* (eds), *Essay for Patrick Atiyah* (1991) 211.

⁶ *Ibid*.

a more convenient and less risky method of credit transaction.⁷ Merchants developed a method to deal with intangible nature of money claims under the underlying contract, where such claims were merged in the document. Termed a “negotiation”, they were transferred in a specific way, either by delivery or by endorsement and delivery. For this purpose, it was imperative that an assurance of payment, upon which purchasers of instruments could rely, was provided. They should acquire title free from any defect in the title of the prior holder. Hence they developed the attribute of negotiable instruments that a person taking a negotiable instrument in good faith, for value and without actual notice of any defect in the transferor’s title obtains a valid title, although it may have been taken from a person who did not.⁸

It follows that a negotiable instrument cannot be treated as a form of abstract payment undertaking, operating by force of its own issue without more.⁹ A negotiable instrument has no legal effect unless value has been given by someone.¹⁰ A breach of the underlying contract giving rise to a total or partial failure of consideration for an instrument is *pro tanto* a defence to a claim on it.¹¹ The holder’s right to payment may, or may not be subject to the contractual defences, depending on his status.¹² Accordingly, the autonomy principle has evolved against a background of protecting the party with a certain status — a holder in due course — being involved in the transaction in the course of instrument circulation.

A commercial credit and an independent undertaking, on the other hand, were developed to achieve the first objective — to insulate them from the underlying contractual consideration. A beneficiary who is a party to the underlying contract enjoys the privilege of being protected from contractual defences “with much the same degree of insulation from the related contract as that enjoyed the holder in due

⁷ WS Weerasooria, *Banking Law and the Financial System in Australia* (5th ed, 2000) 111.

⁸ *Ibid* 115.

⁹ Goode, above n 1, 524.

¹⁰ Goode, above n 5, 216.

¹¹ Goode, above n 1, 524.

¹² These defences are called personal defences. They are not founded on the invalidity of the instrument but derived from factors external to those which affect the relationship between plaintiff and defendant. Goode, above n 1, 563.

course of a negotiable instrument".¹³ To accomplish this object, a commercial credit and an independent undertaking create another primary obligation, placed on the issuer (the guarantor), who is a third party to the underlying contract. Such an obligation runs parallel to the applicant's obligation in the underlying contract but is not correlated with it. It constitutes "a bargain between the banker [the issuer] and the vendor of goods [the beneficiary], which imposes upon the banker an absolute obligation to pay, irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not".¹⁴ This issuer's obligation is original and not derivative in that it runs directly from the issuer to the beneficiary.¹⁵

The issuer's obligation cannot be qualified by, or subject to, the terms and conditions of the underlying contract. It is derived from the operative undertaking. In the commercial credit context, the payment conditions, as has been seen, being autonomous from the underlying contract and susceptible to ascertainment by the issuer in the ordinary course of its business as a third party to the underlying contract, are documentary.¹⁶ The issuer is concerned only to ensure that the documents presented to it conform, on their face, to the terms of the operative credit. It is not concerned with checking the veracity of the statements contained in the documents, nor with examining the goods the subject of the contract of sale.¹⁷ In addition, since documentary conditions can be objectively determined, the issuer's liability is readily ascertainable.¹⁸

The theoretical structure of the autonomous nature of a commercial credit, which constitutes a discrete transaction between the issuer and the beneficiary, may give rise

¹³ Goode, above n 5, 219.

¹⁴ *Hamzeh Malas & Sons v British Imex Industries Ltd* [1957] 2 QB 127, 129. See Gordon B Graham and Benjamin Geva, 'Standby Credit in Canada' (1984) 9 *Canadian Law Journal*, 180, 190-191.

¹⁵ Dolan, above n 1, [2-5].

¹⁶ James E Byrne, 'Standby Rulemaking: A Glimpse at the Elements of Standardization and Harmonization of Banking' in Jacob S Ziegel (ed), *New Developments in International Commercial and Consumer Law Proceeding of the 8th Biennial Conference of the International Academy of Commercial and Consumer Law* (1998) 139, 142.

¹⁷ Goode, above n 1, 990-991.

¹⁸ Byrne, above n 16, 142.

to an argument that the issuer has his own interest in dealing with the documents.¹⁹ It is argued that the issuer has his interest “in the goods to which the documents relate, as security for the advance made by the bank [the issuer] to the buyer, when it pays the seller under the documentary credit”.²⁰ This theory has been advanced in order to justify refusal of payment by the issuer to avoid injustice where the beneficiary receives payment because of his breach of the underlying contract. In so far as it is based on a relationship between the issuer and the beneficiary, this analysis does not undermine, in theory at least, the autonomy of the commercial credit.²¹

However, in reality, the bank, as an issuer, does not substantially rely on the security of the goods.²² The issuance of a commercial credit is considered to be lending in banking business. The bank issues a commercial credit on the basis of the customer’s credit line and secures its disbursement in accordance with its internal lending regulations. Therefore, as long as the reimbursement for its “loan” is assured, the issuer is willing to pay for the integrity of the commercial credit transaction and the bank’s own reputation.²³

In any case, the analysis does not work in the context of independent undertakings, where the documents do not represent title to goods, that is, do not constitute security in the bank’s hands.²⁴ In independent undertaking transactions, quite often the beneficiary may simply demand payment or draw the draft without any documents being required. Even if documents are required, they may simply be a certificate from the beneficiary, stating that the applicant has defaulted on the underlying contract, or that the sum demanded is due, without satisfying a third party that the applicant has not, in fact, performed.²⁵

¹⁹ For example, *Maurice O’meara Co v National Park Bank of New York*, 146 NE 636 (NYCA 1925); *Sztejin v J Henry Schroder Banking Corporation*, 31 NYS2d 631 (SC 1941).

²⁰ *United City Merchants (Investments) Ltd v Royal Bank of Canada* [1983] AC 168, 186.

²¹ Graham and Geva, above n 14, 199.

²² *Ibid* 198.

²³ *Ibid* 199.

²⁴ *Ibid* 198.

²⁵ Dolan, above n 1, [1-42]-[1-43].

The issuer's interest in return for its payment is found, not in the independent undertaking transaction, but in the application and reimbursement contract with the applicant. The issuer's payment obligation in independent undertaking transactions is a creature of the underlying contract parties' agreement, to fulfil their commercial needs. In the following section, the functions of independent undertakings will be scrutinised from the perspective of the underlying contract parties' intentions.

2 Functions of Independent Undertaking

The autonomy principle legally constitutes the issuer's primary obligation to the beneficiary divorced from the underlying contractual consideration. This primary obligation brings, in practice, another significant benefit to the beneficiary, which is that the payment is assured by solvent financial institutions. It practically replaces the applicant's creditworthiness with a bank's or another financial institution's, whose creditworthiness is well recognised as being reliable. With these legal and practical effects, commercial credits and independent undertakings facilitate business by enabling parties to enter into contracts well assured that a party who is entitled to payment will be paid on time.²⁶

In the commercial credit context, these two effects correlatively enhance transactions. The beneficiary (the seller) is willing to release the control of the goods, relying on the issuer's creditworthiness and insulation from the applicant's (the buyer's) arbitral claims against him. In the independent undertaking context as well, these effects are closely related. Nonetheless, it can be observed that a slightly different emphasis is placed on one effect as regards the other depending on the type of the underlying contract.

In usual commercial transactions, for example, a supply of goods or services, where a party attempts to evenly balance his and the other party's performance or payment, the legal effect of avoiding defences from the underlying contract provides a major

²⁶ Agasha Mugasha, 'Non-Documentary Conditions in Letters of Credit and Bank Guarantees' (1990) 5 *Banking & Finance Law Review*, 283, 284.

incentive to arrange an independent undertaking. In this context, the independent undertaking functions to secure performance or payment by providing the agreed sum. On the other hand, in financial transactions such as loan agreements, the lender's (the beneficiary's) main concern is to secure his advance being repaid in due course. In this context, the lender relies on the bank's solvency, rather than the applicant's, at the time of concluding the contract.

In the following section, the aim is to illuminate the functions of the independent undertaking on the basis of commercial parties' intentions, focussing on the legal and practical effects.

[1] Secure Performance: Risk Allocation Device

In Australia, independent undertakings are typically used in construction contracts. Such large, long-term projects carry considerable risks at the different stages. The proprietor makes certain arrangements to complete the project within the contracted time, in accordance with the contracted quality. In the leading Australian case of *Wood Hall Ltd v The Pipeline Authority*,²⁷ the contractor was required to furnish security for his due and faithful performance. Also, the proprietor requested the retention money held by him against his progress payments until the work had been fully performed. Unconditional guarantees were provided as security for the contractor's performance and as a replacement for the retention money.

Several arrangements are possible in relation to this situation. As with the *Wood Hall* case, another option available to the contractor was that a specific percentage of the contract price should be provided by the contractor before the commencement of the project as a cash deposit. Likewise a specific percentage of the progress payment owed to the contractor could be held back as retention money — retained by the proprietor or kept in a separate account until financial redress is achieved between the parties. For the contractor, a cash deposit or retention money could cause a

²⁷ (1979) 141 CLR 443.

considerable burden, tying up his resources for a significant amount of time.²⁸ Further, the fund is occasionally placed in escrow. It may impose a burden on the proprietor to prove his entitlement to the fund since an escrow agreement often requires the escrowee's determination of the contractor's default.²⁹

As another alternative, a guarantee from a bank or an insurance company, called a "conditional bond" or "surety bond", has traditionally been provided by the contractor.³⁰ In the absence of a specific provision to the contrary, a guarantee or surety is an undertaking to answer for another's default.³¹ The default of the contractor has to be determined before the payment, which may put a burden on the proprietor to prove the contractor's default. Meantime, the guarantor holds the cash and the proprietor bears most of the cost of delay in performance.³² It may take time to determine the contractor's default, or at worst, involve litigation.³³ Furthermore, the obligation is accessory in that, in principle, the guarantor's obligation is correlated with the obligation of the principal debtor (the applicant) and is enforceable only to extent that the principal contract is enforceable.³⁴ Therefore, when the principal debtor has a defence, the guarantor may negate or reduce his liability.³⁵

An independent undertaking has been devised to satisfy the demand of the contractor (the applicant) to be relieved from the burden of paying a cash deposit, while at the same time giving the proprietor (the beneficiary) access to cash immediately in the case of the contractor's default. The contractor provides the independent undertaking instead of a cash deposit. The undertaking is payable upon demand or presentation of documents which comply with the stipulated conditions, and there is no requirement

²⁸ John F Dolan, 'Efforts at International Standardization of Bank Guarantees' (1990) 4 *Banking & Financial Law Review* 237, 246; Geraldine Andrews and Richard Millet, *Law of Guarantees* (2nd ed, 1995) 453.

²⁹ Dolan, above n 28, 247.

³⁰ Andrew and Millet, above n 28, 447.

³¹ Goode, above n 1, 821.

³² Dolan, above n 1, [1-19].

³³ Dolan, above n 28, 246.

³⁴ Goode, above n 1, 821.

³⁵ Alan L Tyree, *Banking Law in Australia* (3rd ed, 1998), 450.

to prove the factual sufficiency of the underlying contract. This gives the beneficiary the advantage that he will obtain payment before any underlying disputes are determined.³⁶ The Court of Appeal in England discussed this characteristic of independent undertakings in *Bolivinter Oil SA v Chase Manhattan Bank NA*³⁷ as follows:

The unique value of such a letter, bond or guarantee is that the beneficiary can be completely satisfied that whether disputes may thereafter arise between him and the bank's customer in relation to the performance or indeed existence of the underlying contract, the bank is personally undertaking to pay him provided that the specified conditions are met. In requesting his bank to issue such a letter, bond or guarantee, the customer is seeking to take advantage of this unique characteristic.³⁸

In practical terms, an independent undertaking puts the beneficiary in the same position as if a cash deposit was paid to him. The beneficiary can nullify at will the temporary monetary advantage that such an independent undertaking arrangement gives the contractor.³⁹

In this context, the issuer, who pays the beneficiary upon demand or presentation of documents which comply with the stipulated conditions, without ascertaining the factual sufficiency of the underlying contract, does not intend to absorb the risk of the applicant's default. Since the issuance of an independent undertaking is considered to be lending in banking practice, the issuer's reimbursement right for its "loan" to the applicant is usually secured at the outset of the transaction. Given this transactional feature, an independent undertaking does not avoid or spread the risk of applicant's default, but merely shifts it between the underlying contract parties.⁴⁰ Consequently, if there is a dispute between the parties, the applicant should initiate litigation based on

³⁶ Andrew and Millet, above n 28, 452.

³⁷ [1984] 1 WLR 392.

³⁸ Ibid 393.

³⁹ *Washington Construction Company Pty Ltd v Westpac Banking Corporation* [1982] 1 Qd R 179, 182.

⁴⁰ Dolan, above n 28, 247.

the underlying contract relationship after the payment under the independent undertaking is made. This is succinctly expressed as “pay now and litigate later”.⁴¹

This advantage to the beneficiary was specifically explained in the United States case of *Itek Corporation v First National Bank of Boston*:⁴²

Parties to a contract may use a letter of credit in order to make certain that contract disputes wend their way towards resolution with money in the beneficiary’s pocket rather than in the pocket of the [applicant].⁴³

Meantime, “the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them or stipulated in the contracts”.⁴⁴ Therefore, with an independent undertaking, the parties are assumed to agree to the following conditions in the case of litigation as to the contractual disputes: (1) the forum is the beneficiary’s business place; (2) the cost of litigation is borne by the applicant; and (3) the money in question has been held by the beneficiary until the dispute is resolved.⁴⁵

This function of independent undertakings has been described as the “allocation of risks”⁴⁶ or “risk redistributing”.⁴⁷ The beneficiary has access to immediate compensation without any proof of the factual status of the underlying contract on which the demand is based. After the payment, it is left to the applicant to claim back the money paid to the beneficiary on the basis of the underlying contract relationship. As one can easily imagine, this disadvantage to the applicant can be considerably

⁴¹ Jaqueline Lipton, ‘Uniform Regulation of Standby Letters of Credit and Other First Demand Security Instruments in International Transactions’ (1993) 10 *Journal of International Business Law* 402; Bertram, above n 1, 11. This mechanism naturally strengthens the beneficiary’s bargaining position. Andrew and Millet, above n 28, 452.

⁴² 730 F 2d 19 (1984).

⁴³ *Ibid* 24.

⁴⁴ *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] QB 146, 155-156.

⁴⁵ Bertrams, above n 1, 59-61. See also Dolan, above n 1, [3-29]-[3-34]. Prof. Dolan explains the function primarily related to commercial credits.

⁴⁶ Bertrams, above n 1, 59-61.

⁴⁷ Martin Coleman, ‘Performance Guarantees’ [1990] *Lloyd’s Maritime and Commercial Law Quarterly* 223, 238.

aggravated in international transactions where the law is unfamiliar and considerable costs of litigation are involved. It may be impossible to litigate successfully, or enforce the judgement practically, if there is a politically tense relationship between the countries. Nonetheless it will be justified that “[t]he allocation of such tactical litigation risk to the [applicant] is purchased by the beneficiary not contracting for any retention money”.⁴⁸

Payment under an independent undertaking is not founded on a provisional admission by the applicant of default, nor on a presumption or assumption of default.⁴⁹

Therefore, after the payment, if the applicant’s claim that he was not in default was determined to be correct by the court or the arbitrator, the beneficiary will be ordered to refund the money.⁵⁰ However it may not be a breach of contract for the beneficiary to make a demand under the independent undertaking when there has not, in fact, been a breach by the applicant. This is because the beneficiary has a right to payment as long as the demand complies with the stipulated conditions in the operative independent undertaking. The applicant’s claim for recovery is, therefore, regarded as one based on unjust enrichment.⁵¹

In relation to this proposition, a question arises as to the right to a surplus or balance after the beneficiary has utilised the funds to recoup his loss. It is of importance where the applicant is insolvent and will not be able to reimburse the issuer fully. In *Australian Conference Association Ltd v Mainline Constructions Proprietary Ltd*,⁵² the bank, as an issuer, argued that it was entitled to the surplus on basis of first, as an express or implied term of the bank guarantee by which it should be refunded to the bank and second, the principle of subrogation to the creditor’s right to any securities given by the applicant. The High Court of Australia refused both of these arguments and observed that “the parties to the guarantee mutually contemplated and agreed that

⁴⁸ Howard N Bennett, ‘Performance Bonds and the Principle of Autonomy’ (1994) *Journal of Business Law* 574, 580.

⁴⁹ Bertrams, above n 1, 61.

⁵⁰ *Ibid* 62; Andrew and Millet, above n 28, 481.

⁵¹ Andrew and Millet, above n 28, 481. Bertrams, above n 1, 62. Bertrams referred to the German law position in this regard.

⁵² (1978) 141 CLR 335.

the money when provided by the Bank would be dealt with as the building contract required".⁵³ As a general principle, Gibbs J opined that the surplus should be repayable to the applicant unless the bank guarantee otherwise provided.⁵⁴ In any event, in the present case the parties agreed to utilise the money paid to arrange for the completion of the project.

Additionally, the making of an excessive demand cannot be regarded as a breach of contract by the beneficiary under the independent undertaking. It is not a breach of contract to make a demand when in fact the beneficiary has no right, and still less it cannot be a breach of contract to make an excessive demand where he has at least the right to demand. Further, given that the surplus should be repayable to the applicant on the basis of unjust enrichment, the applicant is entitled to the excessive amount.⁵⁵

[2] Secure Payment Obligation in Financial Transactions: Credit Enhancement Device

Independent undertakings are most often used in connection with the supply of goods or services in Australia, though they can be used in purely financial transactions.⁵⁶ The use of independent undertakings in the context of financial transactions has been developed dramatically in the United States and is likely to grow in important European and Asian international financial centres.⁵⁷ In the United States, this particular standby credit is called a "financial standby".⁵⁸

⁵³ (1978) 141 CLR 335, 350.

⁵⁴ Gibbs ACJ observed that "[i]n my opinion under the contract it is [the contractor] that is entitled to any surplus remaining of the money provided under the security once the obligations of [the contractor] have been discharged". (1978) 141 CLR 335, 353. See E P Ellinger, 'Documentary Credits and Finance by Mercantile' in A G Guest *et al* (eds), *Benjamin's Sale of Goods* (5th ed, 1997) [23-255].

⁵⁵ Ellinger, above n 54, [23-255].

⁵⁶ Tyree, above n 35, 401.

⁵⁷ Boris Kozolchik, 'The Financial Standby: A Summary Description of Practice and Related Legal Problems' (1996) 28 *Uniform Commercial Code Law Journal* 327, 328.

⁵⁸ See generally Kozolchik, above n 57.

An independent undertaking, which embodies the issuer's primary obligation to the beneficiary, practically substitutes the creditworthiness of the issuer for that of the applicant. This practical effect is of great significance where creditworthiness is a key factor in facilitating transactions, primarily in financial transactions. Unlike usual commercial transactions, where the party's interest is mainly to counterbalance his performance, or payment, with the other party's, the creditor (the beneficiary) in financial transactions, whose right to receive payment of principal or interest will be established on a certain date in the future, is more concerned with the debtor's creditworthiness and whether it is reliable in terms of repayment. The term "credit enhancement" is used to describe this practical effect obtained by the applicant through an independent undertaking.⁵⁹

The credit enhancement effect facilitates transactions where the borrower's creditworthiness is unknown or unsatisfactory to the creditor. One example is where several contractors join a large-scale project which is financed by a major city bank that does not deal with the individual contractor. If the contractor's repayment obligation is secured by an independent undertaking issued by his own bank, which is familiar with his financial situation, the creditor can rely on the bank's primary engagement for payment. Consequently, this obviates the need for the creditor to investigate the borrower's financial standing.⁶⁰

Another example is where a borrower wishes to raise capital in a public market through the issue of industrial revenue, a development municipal bond, or a corporation's commercial paper, purchased by investors. Where the creditworthiness of the debt instruments' issuer (the borrower) is unknown to the financial market or not sufficient to have his instruments purchased, the financial institution will issue an independent undertaking to secure the repayment obligation of the instruments. The holder, or potential holder, of the instrument may not value the promise of the borrower to pay, but they do value the creditworthiness of the issuer of the independent undertaking.⁶¹

⁵⁹ *Burton V McCullough, Letters of Credit* (1989) [7-3].

⁶⁰ Dolan, above n 1, 1-27.

⁶¹ McCullough, above n 59, [7-3]; Dolan, above n 1, [1-27].

Furthermore, it may improve the credit rating of the instrument sufficiently to reduce the interest rate of the repayment agreement.⁶² The borrower can choose a suitable financial plan covering the total sum of the interest rate payable on the instruments and the fee payable to the bank for the independent undertaking, the interest rate for the direct bank loan, and other conditions.

This use of independent undertaking as a credit enhancement device has resulted in specific transactional features in the United States.⁶³ Beneficiaries are usually the trustees of the holders of bonds or other obligations evidencing indebtedness of large amounts of principal and interest by public or private sector borrowers. These trustees act for the individual investors, who have ultimate claim for payment in the underlying financial transaction.⁶⁴ Unlike commercial credit where the applicant reposes considerable trust in the beneficiary to ship the goods in accordance with the underlying contract,⁶⁵ the beneficiary, as trustee of holders of instruments, is institutional and has no such personal attachment. The beneficiary may be replaced, and will probably be replaced more than once.

Moreover, in some standby credits in financial transactions, the beneficiary is initially supposed to demand of the issuer payment at the maturity of its obligation. In this context, the issuer's payment promise is not only the primary engagement but also the primary means of payment of the financial obligation, not as a secondary or alternative method to be used in the event of the applicant's default.⁶⁶ This is called a "direct pay" standby credit.

In Australia, the use of independent undertakings as a credit enhancement device has been rarely observed. Although the purpose of issuing independent undertaking cannot be practically identified as a credit enhancement of the applicant, there is a

⁶² McCullough, above n 59, [7-3].

⁶³ For the detailed transactional feature, see generally Kozolchik, above n 57; McCullough, above n 59, "CHAPTER 7 Credit Enhancement".

⁶⁴ Boris Kozolchik, above n 57, 334.

⁶⁵ Dolan, above n 1, [3-13].

model case which may illustrate the structure of this transaction. In the Federal Court case of *Equuscorp Pty Ltd v Perpetual Trustees WA Ltd*,⁶⁷ Balmedie Pty Ltd entered into a Production Service Agreement with Perpetual as trustee for the investors who purchased units of the trust fund for the film production. The investors were guaranteed 125% of the original investment, which was called a Base Production Service Fee. Under the Production Service Agreement, Balmedie was to provide security for the payment of the fee due to the investors by way of a letter of credit, or bank guarantee, or through means otherwise acceptable to and approved by Perpetual. Perpetual obtained letters of credit from Equuscorp and the National Mutual Royal Bank. Additionally, the method of payment of the Base Production Service Fee was to be exclusively by way of calling these securities.

The whole arrangement was complicated, including a contract under which Equuscorp, one of the issuers of letters of credit, lent money to the majority of investors purchasing the units of the trust fund. That is, Perpetual had the right to receive payment under the letters of credit, at the same time, it obliged to repay to Equuscorp for the investors who borrowed the money from Equuscorp. In this regard, there was an agreement between them to exchange cheques for the settlement on the drawdown dates under the letter of credit. The focal issue of the instant case was whether a notice of statutory demand under the section 459C of the *Corporations Law* — whereby Perpetual claimed the debt owed by Equuscorp pursuant to the letter of credit — should be set aside or varied on the basis of off-setting claim.

Unfortunately, the primary purpose for choosing this financial method for the parties concerned is not clear from the report of the case. Further, the decision was based on constructing the provisions as to statutory demand under the *Corporations Law*. The court simply dismissed the contention by Perpetual that the letter of credit created an unconditional obligation on the part of Equuscorp, and therefore no off-setting claim could be made out, on the ground of the agreement for the settlement between Perpetual and Equuscorp — an exchange of cheques.

⁶⁶ Boris Kozolchik, above n 57, 332.

⁶⁷ Unreported, French, Kiefel, and Sundberg JJ, 5 December 1997.

In any event, depending on how financial regulation governs investment markets, and how the markets facilitate protection of the investors through a fair assessment system for debt instruments, this method will provide great possibilities in relation to various financial demands from commercial borrowers in Australia.

3 Significance of the Autonomy Principle in Post-Payment Period

In this section, by analysing the issuer's right after payment, namely the right of reimbursement and subrogation, the significance of the autonomy principle will be illustrated in the post-payment period of the independent undertaking transaction.

[1] Reimbursement

When the applicant instructs the issuer to issue an independent undertaking, there will usually be an express clause in the application agreement that the applicant will reimburse the issuer for carrying out its payment obligation properly. Some rules and regulations clearly stipulate this obligation of the applicant to the issuer. The revised Article 5 of the Uniform Commercial Code, Section 5-108(i), provides that "if an issuer has honored a presentation as permitted or required by this article, [it] is entitled to reimbursement from the applicant in immediately available funds not later than the date of its payment of funds". Likewise, the ISP 98 Rule 8.01 provides that "where payment is made against a complying presentation in accordance with these Rules, reimbursement must be made by an applicant to an issuer requested to issue a standby".⁶⁸

⁶⁸ Since the UCP and the URDG mainly focus on governing the relationship between the issuer and the beneficiary, the applicant's reimbursement obligation is indirectly mentioned. The UCP Article 18(a) provides:

Banks Utilizing the services of another bank or other banks for the purpose of giving effect to the instructions of the Applicant do so for the account and at the risk of such Applicant.

The URDG Article 14(a) similarly provides:

Guarantor and Instructing Parties utilising the services of another party for the purpose of giving effect to the instructions of a Principal do so for the account and at the risk of that Principal.

It is considered that the relationship between an applicant and issuer embodies a mandate.⁶⁹ Mainly in civil law countries where the law of mandate has been established distinctively, this submission may be useful in explaining that the applicant as a mandator has to reimburse any amount that the mandatary has expended in properly carrying out the mandate in the case where there is no explicit provision relating to the applicant's reimbursement obligation in the application agreement.⁷⁰ Nonetheless, because a mandate may relate to a wide range of very dissimilar contracts, it is doubtful whether safe and clear guidance can be gleaned from this premise in relation to specific issues which may arise in the independent undertaking context.⁷¹ To a large extent, the relationship between the applicant and issuer has been recognised as contractual one and this practice has developed distinctive rules.

The issuer owes the usual duties of a bank to strictly observe the terms of the mandate, and to act in other respects with reasonable care and skill in relation to the independent undertaking.⁷² It should be noted, however, that in the independent undertaking context, "observing the terms of the mandate" or "carrying out instruction properly" is not always interpreted as "following the applicant's instruction at any stage." The independent undertaking, issued upon the applicant's instruction, constitutes the issuer's autonomous engagement to the beneficiary, in which the issuer acts as principal, not as agent for the applicant.⁷³ The applicant is not entitled to give instruction to the issuer to withhold payment or to deviate from the terms of the

On the other hand, the UN Convention has no rule regarding this.

⁶⁹ Roy Goode, *Guide to the ICC Uniform Rules for Demand Guarantees* (ICC Publication No 510, 1992) 18; Bertrams, above n 1, 97-98. In this respect, there is no distinction between the law of commercial credit and the law of independent undertaking. See Bertrams, above n 1, 98:

A great deal of the law neatly tailored to the relationship between customer and bank is already available, namely the law developed in the context of documentary credit. Both the nature and structure of the documentary credit as a multi-party relationship and the nature and structure of the relationship between account party and bank are the same as those in guarantees.

⁷⁰ AN Oelofse, *The Law of Documentary Letters of Credit in Comparative Perspective* (1997), 140.

⁷¹ Bertrams, above n 1, 98.

⁷² Goode, above n 1, 998.

⁷³ *Ibid.*

operative undertaking.⁷⁴ The issuer — the sole judge of whether the payment should be made, upon the examination of the presented documents or the formality of the demand — is occasionally obliged to pay over the objection of an applicant..

Accordingly, it is considered there is an agreement between the issuer and the applicant that the issuer will not avail himself of any defence arising from the underlying contract by choosing the independent undertaking. In the context of the suretyship or the traditional secondary guarantee, on the other hand, it varies from one guarantee to another. The guarantor and the debtor may arrange various payment conditions, including whether or not the guarantor should avail himself of defences arising from the underlying contract, which correspond to an indemnity right.⁷⁵ The parties have no such option in the independent undertaking context. The autonomy principle demands that the right to reimbursement is not affected by defences which the applicant may have against the beneficiary on the basis of the underlying contract relationship.⁷⁶

[2] Subrogation

To secure its reimbursement right, the issuer usually requires the applicant to furnish sufficient security for its disbursement. For many reasons, however, the issuer may not always be so careful and conservative. Or, for a time, the furnished security may lose its original value. In addition, advance payment or cash collateral of the entire amount would defeat one of the objects of independent undertaking, that being to dispense with the need for a cash deposit with the beneficiary.⁷⁷

When the issuer finds out that the applicant is not able to carry out his reimbursement obligation fully, after the issuer has disbursed the sum stipulated in the independent

⁷⁴ Ibid.

⁷⁵ If the guarantor pays the amount demanded by the creditor without availing herself or himself as guarantor might still be entitled to indemnity from the debtor based on an express or implied contract. James O'donovan and John Phillips, *The Modern Contract of Guarantee* (3rd ed, 1996) 597.

⁷⁶ Bertrams, above n 1, 71.

⁷⁷ Ibid 102.

undertaking to the beneficiary, it will seek to be subrogated to other parties' claims to fulfil its disbursement. Subrogation is well recognised as the guarantor's right in the traditional guarantee or suretyship context. Once the principal debt or obligation has been wholly satisfied, a guarantor has the right to be subrogated to the rights of the creditor.⁷⁸

While independent undertakings can be interchangeably used with traditional guarantees, there is an essential difference between them in relation to payment conditions, which is the effect of the autonomy principle in pre-payment period. This section will investigate the significance of the autonomy principle in the post-payment period through the issuer's subrogation right.

a Subrogation and the Autonomy Principle

In every case where the doctrine of subrogation applies there will be a tripartite relationship between a person who owes an obligation, a person to whom it is owed, and a person claiming a subrogation equity who has discharged the obligation owed by another with his assets.⁷⁹ The person discharging the liability or paying the indemnity is able to "stand in the shoes" of another and to exercise rights which are or were available to that other person.⁸⁰ According to the nature of the claim, subrogation is made to the rights of different parties in the tripartite relationship.⁸¹ Lord Diplock described subrogation generally in the leading modern case in England, *Orakpo v Manson Investments Ltd*⁸² as "a transfer of rights from one person to another, without assignment or assent of the person from whom the rights are transferred and which takes place by operation of law".⁸³

⁷⁸ O'Donovan and Phillips, above n 75, 653.

⁷⁹ LBC, *The Laws of Australia*, vol 15 (at 1 January 1993) 15 Equity, 15.3 Contribution, Subrogation and Marshalling, '3 Subrogation' [16].

⁸⁰ *Re National Permanent Benefit Building Society; Ex parte Williamson* (1869) 5 Ch App 309; *John Edwards and Co v Motor Union Insurance Co Ltd* [1992] 2 KB 249.

⁸¹ LBC, *The Laws of Australia*, above n 79, [16].

⁸² [1978] AC 95.

⁸³ *Ibid* 104.

The reception of subrogation into the English legal system is uncharted.⁸⁴ Lord Diplock in the *Orakpo* case stated that subrogation is a kind of specific remedy in particular cases of what might be classified as unjust enrichment in a legal system that is based upon the civil law. Despite the fact that little is known of its early history, it is clear that subrogation was originally a creature of equity.⁸⁵ In England, it developed primarily out of the principal-surety relationship, where the court of equity allowed the guarantor a remedy. Relief was granted on principles borrowed from the civil law and administered with regard to the respective rights and immunities of all parties subject to contribution.⁸⁶ In this context, once the guarantor has satisfied the principal obligation, he has the right to stand in the shoes of the creditor in enforcing the principal obligation of the debtor, as well as to take under any securities, priorities or remedies which the creditor enjoyed prior to the performance of the principal obligation.⁸⁷ Here subrogation is a method of adjusting the rights of parties in the interests of justice.⁸⁸

Also, the doctrine of subrogation has been extensively developed in insurance contracts to prevent double recovery by the insured.⁸⁹ Where a person insures property against damage and that property is damaged by the tortious conduct of

⁸⁴ O'Donovan and Phillips, above n 75, 653.

⁸⁵ *Australasian Conference Association Ltd v Mainline Construction Pty Ltd* (1978) 141 CLR 335; *Re Trivan Pty Ltd* (1996) 134 FLR 368. See R P Meagher, W M C Gummow and J R F Lehane, *Equity Doctrines and Remedies* (3rd ed, 1992) 261; O'Donovan and Phillips, above n 75, 653. Lord Diplock in *Orakpo* expressed the divergent view that some rights by subrogation are contractual in their origin, while others defeat classification except as an empirical remedy to prevent a particular kind of unjust enrichment. *Orakpo v Manson Investments Ltd* [1978] AC 95, 104.

⁸⁶ O'Donovan and Phillips, above n 75, 653-654.

⁸⁷ *Duncan Fox & Co v North and South Wales Bank* (1880) 6 App Cas 1; *Traders Finance Corporation Ltd v Marks* [1993] NZLR 1176; *Craythorne v Swinburne* (1807) 14 Ves Jun 160 [33 ER 482]. See also O'donovan and Phillips, above n 75, 653.

⁸⁸ *Aldrich v Cooper* (1803) 8 Ves Jun 382 [32 ER 402], approved by the High Court in *Australasian Conference Association Ltd v Mainline Constructions Proprietary Ltd* (1978) 141 CLR 335 [53 ALJR 66; 22 ALR 1]. See also O'donovan and Phillips, above n 75, 653; Andrew and Millett, above n 28, 339-340.

⁸⁹ Kevin Patrick McGuinness, *The Law of Guarantee* (2nd ed, 1996), 760.

another person, the insured has two rights of recovery with respect to the damage which his property has sustained.⁹⁰ Under the doctrine of subrogation, the insurer stands in the shoes of the insured as a result of making payment under the policy, and is entitled to receive and exercise all rights accruing to the insured by virtue of the circumstances of the loss or by which the loss can be diminished.⁹¹

The equitable doctrine of subrogation functions in order to avoid injustice. A transfer of rights based on subrogation can possibly take place in a whole variety of circumstances, and therefore its application is not restricted to closed categories.⁹²

Lord Salmon stated in the *Orakpo* case:

The test as to whether the courts will apply the doctrine of subrogation to the facts of any particular case is entirely empirical. It is, I think, impossible to formulate any narrower principle than that the doctrine will be applied only when the courts are satisfied that reason and justice demand that it should be.⁹³

Thus the doctrine of subrogation itself does not necessarily exclude its availability in the independent undertaking context of tripartite relationship where payment by the issuer has discharged the applicant's obligation.⁹⁴ Nonetheless, in some jurisdictions, the issuer's attempt to be subrogated to the beneficiary's, or the applicant's, right has largely failed due to the autonomous nature of the independent undertaking. It should be noted, however, that the argument that the autonomous nature of an independent undertaking demands different treatment between an independent undertaking and a traditional guarantee, seems to dominate the whole controversy without substantial analysis of the applicability of subrogation to the independent undertaking context.

⁹⁰ *Ibid.*

⁹¹ *Castellain v Preston* (1883) 11 QBD 380 (CA). See McGuinness, above n 89, 762.

⁹² See *Re Trivan Pty Ltd* (1996) 134 FLR 368. For an extensive analysis of English cases, see Alan Ward and Gerard McCormack, 'Subrogation and Bankers' Autonomous Undertakings' (2000) 116 *Law Quarterly Report* 121. The article concluded that the availability of subrogation is not limited to sureties and insurers and its potential application to others cannot be excluded by simply stating that the liabilities undertaken were not those of the surety or the insurer (at p 134).

⁹³ *Orakpo v Manson Investments Ltd* [1978] AC 95, 110 (Lord Salmon).

⁹⁴ Ward and McCormack, above n 92, 134.

The primary ground used to refuse an issuer's subrogation right has been found in a primary and secondary obligation dichotomy.⁹⁵ Subrogation is only available to a person who has discharged another person's obligation — he is secondarily liable for the obligation. Such a person would be a guarantor in a suretyship. An independent undertaking, on the other hand, which constitutes the issuer's "primary obligation", does not fulfil this requirement. In the Canadian case of *Westpac Banking Corporation v The Duke Group Ltd*,⁹⁶ the Ontario court observed:

A brief examination of the elements necessary to establish the rights of the guarantor or subrogee confirms that a letter of credit does not technically fulfil the requirements. As noted above, a guarantee is in essence a secondary obligation requiring the guarantor to pay only in the event of a default by the principal obligor... [I]t is also clear that the doctrine of equitable subrogation has as one of its elements that the plaintiffs be secondarily liable on the underlying debt.⁹⁷

The Ontario Court then referred to *In Re East Texas Steel Facilities, Inc.*,⁹⁸ which enumerated the requirements for equitable subrogation as follows: (1) the claimant must have made payment to protect his own interests; (2) the claimant must not have been a volunteer; (3) the payment must satisfy debt for which the claimant was not primarily liable; (4) the entire debt must have been paid; and (5) subrogation must not cause injustice to the rights of others.⁹⁹ The court refused the issuer's subrogation claim in the present case on the basis of non-fulfilment of requirement (3), and it concluded that "[i]t is clear that subrogation is not available as a result of the payment of principal obligation under a letter of credit."¹⁰⁰

This line of argument has been extensively brought before the courts of the United States.¹⁰¹ The reasoning used to deny subrogation is demonstrated by the majority

⁹⁵ See also Ellinger, above n 54, [23-234]; Bertrams, above n 1, 128-129.

⁹⁶ [1994] 31-237262 Ont C J LEXIS 2937 (Aug 25, 1994). See also McGuinness, above n 89, 817-818.

⁹⁷ *Westpac Banking Corporation v The Duke Group Ltd* [1994] 31-237262 Ont C J LEXIS 2937, [18]-[19] (Aug 25, 1994).

⁹⁸ 117 BR 235 (Banker ND Tex 1990).

⁹⁹ *Ibid* 241.

¹⁰⁰ *Westpac Banking Corporation v The Duke Group Ltd* [1994] 31-237262 Ont C J LEXIS 2937, [19] (Aug 25, 1994).

¹⁰¹ See James J White, 'Rights of Subrogation in Letters of Credit Transaction' (1996) 41 *Saint Louis University Law Journal* 47-48.

opinion in *Tudor Development Group inc v United States Fidelity & Guaranty Company*:¹⁰²

[T]he key distinction between letters of credit and guarantees is that the issuer's obligation under a letter of credit is primary whereas a guarantor's obligation is secondary — the guarantor is *only* obligate to pay if the principal defaults on the debt the principal owes. In contrast, while the issuing bank in the letter of credit situation may be secondarily liable in temporal sense, since its obligation to pay does not arise until after its customer fails to satisfy some obligation, it is satisfying its own absolute and primary obligation to make payment rather than satisfying an obligation of its customer. Having paid its own debt, as it has contractually undertaken to do, the issuer "cannot then step into the shoes of the creditor to seek subrogation, reimbursement or contribution from the [customer]."¹⁰³

In Australia, on the other hand, the issue has not been thoroughly examined. There was a case where the bank, having issued an unconditional guarantee, sought subrogation to the proprietor's (the beneficiary's) right, though the dichotomy of "primary" and "secondary" obligation was not argued. In *Australian Conference Association Ltd v Mainline Constructions Pty Ltd*,¹⁰⁴ the High Court of Australia observed:

Although the liability assumed by the Bank was in form absolute, it was, to the knowledge of the [beneficiary], only undertaken for the purpose of affording security for the performance by [the applicant] of its obligations; the undertaking was collateral in substance, although not in form. The contract between the [beneficiary] and the Bank appears to fall within the description of "guarantee" At the very least the relation between the [beneficiary] and the Bank was analogous to that which exists between creditor and surety. It was submitted that in these circumstances the Bank had a right to be subrogated to the remedies of the [beneficiary] against [the applicant]; in other words that upon satisfying the obligations of [the applicant] it was entitled to resort to any securities given by [the applicant] to the [beneficiary] for the performance of those obligations....¹⁰⁵

The theory which the High Court of Australia relied on is that an unconditional guarantee is basically a kind of guarantee. It is assumed that the difference between an unconditional guarantee and traditional secondary guarantee is simply payment conditions. Unconditional guarantees are, to a large extent, subject to the rules governing traditional guarantees. Accordingly, subrogation is available in the unconditional guarantee context whenever equity demands.

¹⁰² 968 F2d 357 (3rd Cir 1992).

¹⁰³ *Ibid* 362.

¹⁰⁴ (1978) 141 CLR 335.

¹⁰⁵ *Ibid* 347-348.

Moreover, the “primary” and “secondary” obligation dichotomy was directly challenged by the dissenting opinion in *Tudor Development Group inc v United States Fidelity & Guaranty Company*.¹⁰⁶ Becker J pointed out that the wording of “primarily liable” or “primary obligation” was used with some confusion and observed:

Certainly, [the issuer] was “primary” liable in one temporal sense, in that, pursuant to the letter of credit arrangement, it had to pay the [beneficiary] immediately on the [beneficiary’s] proper demand, with (unlike a guarantor or surety) no right to assert any defenses that [the applicant] may have had.... I agree with the majority that [the issuer] was “primarily” liable in the sense that (like a surety) it was directly liable, under its own contractual agreement, to make a payment to the [beneficiary]. But that is not the relevant meaning of “primary” liability in the subrogation context, for if it were, then no guarantor or surety would ever qualify for equitable subrogation.¹⁰⁷

It has been cogently submitted that this “primary-secondary” dichotomy serves a different purpose in each context, and yet the distinction is often recited indiscriminately without any complete analysis of what is meant.¹⁰⁸ Both the issuer of an independent undertaking and the guarantor of a suretyship pay their own debt, and that payment also constitutes payment on behalf of the principal debtor to the creditor.¹⁰⁹ When the law of subrogation is considered, the key inquiry is whether the person seeking subrogation or the person against whom subrogation is sought, ultimately should be liable for paying the debt.¹¹⁰

The issuer’s “primary” obligation in the independent undertaking context, derived from the operation of the autonomy principle, it is autonomous from the underlying contract, while the guarantor’s obligation in the suretyship context is secondary, being derivative from the underlying contract.¹¹¹ As has been repeatedly mentioned, the issuer’s obligation is simply triggered by a demand which complies with the terms of

¹⁰⁶ 968 F2d 357.

¹⁰⁷ *Ibid* 365.

¹⁰⁸ Amelia H Boss, ‘Symposium: The Restatement of Suretyship: Suretyship and Letters of Credit: Subrogation Revisited’ (1993) 34 *William and Mary Law Review* 1088, 1105.

¹⁰⁹ Bertrams, above n 1, 163-164.

¹¹⁰ Boss, above n 108, 1116.

¹¹¹ John F Dolan, ‘A Study of Subrogation Mostly in Letter of Credit and Other Abstract Obligation Transactions’ (1999) 64 *Missouri Law Review* 789, 799.

the operative undertaking. That is, the issuer cannot refuse payment by invoking the defences based on the underlying contract or other related contracts. More specifically, Becker J in the *Tudor* case explained the meaning of the autonomy principle as follows:

The independence principle ensures the beneficiary of prompt payment and basically determines that the beneficiary will have the dollars in its pocket if there is a dispute between it and the customer over the underlying transaction. As discussed above, this distinguishes a letter of credit from an ordinary guaranty: a guaranty is not independent in this sense, and guarantors may generally assert defenses available to the party whose obligation is guaranteed.¹¹²

This description of autonomy principle makes it clear that it obviously applies to an independent undertaking in the pre-payment stage.¹¹³ An independent undertaking transaction is basically the temporal money transfer mechanism created by the underlying contract parties, to fulfil their commercial needs, as analysed in the previous section. The beneficiary receives what is owed to him when it is owed to him by the bank and the applicant, by virtue of their agreement.¹¹⁴ The autonomy principle does not mean that the issuer's obligation is completely and for all purposes independent.¹¹⁵

It follows that the autonomy principle does not govern the post-payment period of the independent undertaking transaction when the issuer attempts to recover its disbursement. Subrogation is the post-payment doctrine. The equitable right of subrogation only arises when the creditor is paid in full.¹¹⁶ Thus, the autonomy principle has no bearing on the issue of subrogation.¹¹⁷

¹¹² 968 F2d 357, 368.

¹¹³ Boss, above n 108, 1113.

¹¹⁴ Bertrams, above n 1, 163.

¹¹⁵ Boss, above n 108, 1125.

¹¹⁶ *Duncan Fox & Co v North & South Wales Bank* (1880) LR 6 App Cas 1; *Ex p Brett; Re Howe* (1871) LR 6 Ch App 838; *Dixon v Steel* [1901] 2 Ch 602.

¹¹⁷ Bertrams, above n 1, 128.

b Some Implications for the Application of Subrogation

A conclusive reason cannot be found to justify prohibition of subrogation in the independent undertaking context, yet it is argued that its application to independent undertakings should be carefully confined to a narrower scope than to that given to a surety or guarantee. There are two reasons submitted for this disparate treatment.¹¹⁸

First, subrogation corrodes the autonomy principle by its effect on the issuer's behaviour.¹¹⁹ If subrogation is available, an issuer will have an incentive to confront a beneficiary because both know that the issuer can eventually raise the claim related to the underlying contract.¹²⁰ The issuer might act strategically, for instance, to negotiate the amount of payment to be reduced by claiming the subsequent award in the different suit.¹²¹ Even a large issuer with a strong reputation will succumb to this temptation from time to time.¹²² Additionally it cannot be negated completely that the court might act against the principle to avoid this circuitous litigation.¹²³

This argument is, however, criticised as being an insufficient reason to prohibit the application of subrogation to independent undertaking transactions. There is a more severe factor which encourages an unwilling issuer to refuse payment upon a good draw, namely the applicant's allegations of fraud, yet the law has long recognised this exception to the autonomy principle in the interest of justice.¹²⁴ Also, unscrupulous issuers will, in any case, make judgements about the beneficiary's resources and willingness to resort to litigation before deciding whether to pay on an insufficiently secured independent obligation, something the autonomy principle is powerless to prevent.¹²⁵

¹¹⁸ Dolan, above n 111, 822.

¹¹⁹ *Ibid* 806.

¹²⁰ *Ibid* 808.

¹²¹ *Ibid* 809.

¹²² *Ibid*.

¹²³ *Ibid*.

¹²⁴ Ward and McCormack, above n 92, 140-141.

¹²⁵ *Ibid*.

The second reason for the disparate treatment is that in an independent undertaking transaction the essential ingredient of subrogation, unfairness, is usually missing.¹²⁶ The guarantor of suretyship ultimately assumes risk, and is in no position to take collateral or security from the principal; whereas the issuer of an independent undertaking is risk averse, and judges the applicant's creditworthiness to determine whether it makes a loan or not. In this scenario, unjust enrichment in the suretyship context is illustrated where a fidelity bond is issued to a bank to protect it against the dishonest acts of its depositors. In such a case, subrogation corrects unjust enrichment to prevent the bank from two recoveries (one from the fidelity company and one from the depositor), and, or to prevent the dishonest depositor from being freed of liability.¹²⁷

In the independent undertaking context, on the other hand, issuing an undertaking is a loan agreement with the applicant, whereby the parties can pre-determine their liabilities. It is a bad loan or misjudgment of the applicant's creditworthiness when the issuer cannot be fully reimbursed by him. Therefore, in the independent undertaking context, where the parties can freely arrange security or collateral for reimbursement at the outset, even though there may be enrichment at the expense of the issuer, the enrichment is not unjust.¹²⁸ Subrogation upsets the risk structure and substitutes a different allocation of costs and risks from the one the parties themselves fashioned when they entered into the transaction.¹²⁹

The notion of unjust enrichment illustrated above seems to be narrowly confined to a typical insurance context, which is certainly one source for equitable rights of subrogation. However, as has been seen above, in general unjust enrichment for subrogation is more broadly interpreted to achieve ultimate justice by adjusting the rights and interests of parties relating to the guaranteed or discharged obligation.

¹²⁶ Dolan, above n 111, 823.

¹²⁷ *Ibid* 823.

¹²⁸ *Ibid*.

¹²⁹ *Ibid* 827.

Furthermore, the position of an issuer in an independent undertaking who is seeking subrogation to the beneficiary's right is akin to the guarantor in the suretyship context in which the doctrine of subrogation enables him to stand in the shoes of creditor, who holds multiple means to secure his right against the principal. Unjust enrichment is the principle to adjust the contribution among these multiple means to secure the creditor's right to be satisfied. The guarantor's rights in suretyship with respect to securities existing in respect of the guaranteed obligation are derived from the equitable doctrine imposed upon the principal debtor to indemnify the guarantor.¹³⁰ Specifically, it rests on the guarantor's equity not to have the entire burden of the debt cast upon the guarantor simply by the creditor's choice not to resort to other remedies or securities available to the creditor.¹³¹ The fact that the issuer could have protected its own right by taking a security at the outset of the transaction can be one of the factors to determine the applicability of subrogation since it is an equitable right.¹³² However, this fact cannot be conclusive of the prohibition of subrogation.

For the scope of subrogation in the independent undertaking context the law of guarantee or suretyship is a helpful guideline. The revised Uniform Commercial Code, section 5-117, provides:

- (a) An issuer that honors a beneficiary's presentation is subrogated to the rights of the beneficiary to the same extent as of the issuer were a secondary obligor of the underlying obligation owed to the beneficiary and of the applicant to the same extent as of the issuer were the secondary obligor of the underlying obligation owed to the applicant.

The Official Comment clarifies that the section grants only the right that would exist if the person seeking subrogation "were a secondary obligor", being a surety, guarantor, or other person against whom or whose property an obligee has recourse with respect to the obligation of a third party. And most importantly, section 5-117(d)

¹³⁰ *Nicholas v Ridley* [1904] 1 Ch 192 (CA). See also, McGuinness, above n 89, 414.

¹³¹ *Aldrich v Cooper* (1803) 8 Ves Jun 382 [32 ER 402]; *Craythorne v Swinburne* (1807) 14 Ves Jun 160 [33 ER 482]; *Duncan Fox & Co v North & South Wales Bank* (1880) LR 6 App Cas 1.

¹³² See White, above n 101, 59-60. "[O]ne might argue that [the issuer] could have protected its own rights by taking a security interest originally from [the applicant] as to all of these assets, and equity should not help it where it failed to help itself".

provides that only one who has completed its performance in a letter of credit transaction can have a right to subrogation.¹³³

In this respect, the law in Australia basically entitles a surety to subrogation to all the securities held by the creditor in respect of the principal debt or obligation.¹³⁴

Furthermore, the right of subrogation extends to such securities whether or not the guarantor was aware of their existence and whether or not the guarantor relied upon them when he or she furnished the guarantee.¹³⁵ That is, the issuer will be subrogated to any securities and elevated claims held by the beneficiary in respect of the applicant's obligation once it pays the beneficiary. Basically, the application of subrogation to an independent undertaking in each case would be scrutinised from the perspective of the surety or guarantor context.

Still, it is worth noting again that the subrogation right will not come into being unless the issuer performs its payment obligation in accordance with the terms of the operative undertaking. The issuer may neither refuse its obligation on the ground that it is subrogated to another person's right, nor complain after payment that its subrogation rights have been impaired by any good faith dealings between the beneficiary and the applicant or any other person.¹³⁶ In the suretyship context if the creditor has abandoned any securities, or accepted substitutes for them, without the consent of the guarantor this may reduce the guarantor's liability.¹³⁷ In contrast, in the context of an independent undertaking no such duty can be imposed on the beneficiary in the interests of the issuer. This is because the issuer's obligation is independent and determined by the terms of the operative undertaking. The various equitable defences and rights available to a guarantor before payment, which are

¹³³ Section 5-117(d): Notwithstanding any agreement or term to the contrary, the rights of subrogation stated in subsections (a) and (b) do not arise until the issuer honors the letter of credit or otherwise pays and the rights in subsection (c) do not arise until the nominated person pays or otherwise gives value. Until then, the issuer, nominated person, and the applicant do not derive under this section present or prospective rights forming the basis of a claim, defense, or excuse.

¹³⁴ O'Donovan and Phillips, above n 75, 666-667.

¹³⁵ *Ibid.*

¹³⁶ See Official Comment of UCC section 5-117, 2.

¹³⁷ O'Donovan and Phillips, above n 75, 668; McGuinness, above n 89, [71.4].

derived from the secondary nature of guarantees, are not available to the issuer in the independent undertaking context. In this regard, the issuer's subrogation right to the beneficiary may be practically confined to quite limited situations.

The issuer will be also subrogated to the applicant's claim against the beneficiary. This will occur, for example, where the beneficiary breaches his performance in the underlying contract, and the issuer cannot be reimbursed because of the applicant's intervening insolvency. The issuer is subrogated to the applicant's right against the beneficiary in the underlying contract. This kind of claim is typical in the independent undertaking context, where the issuer cannot refuse payment upon the demand by the beneficiary on the basis of underlying contractual disputes.

As Gibbs J observed in *Australasian Conference Association Ltd v Mainline Constructions Pty Ltd*,¹³⁸ if there is a surplus or balance existing after the beneficiary has utilised the funds to recoup his loss, it should be payable to the applicant. The issuer could have been subrogated to the insolvent applicant's right against the beneficiary, but not to the beneficiary's right as it actually did in the instant case. The surplus should be ultimately paid to the issuer on the basis of the principle of subrogation, and should not form part of the general assets of the applicant.¹³⁹ In any event, the underlying contract in the instant case indicated that the money paid by the bank should be used for the completion of the project. Thus there was no actual surplus.

In banking practice issuing an independent undertaking is categorised as lending, which is regulated and supervised under the general scheme of financial regulation. This is done in order to maintain sound and prudent banking practice. Certainly in the majority of cases, the issuer secures his reimbursement right at the outset of the independent undertaking transaction. In the normal course of an independent undertaking transaction, once the beneficiary's claim is satisfied by the issuer, the applicant will reimburse the issuer and a final adjustment will be executed between the beneficiary and the applicant. However, in the event of misjudgment or

¹³⁸ *Australasian Conference Association Ltd v Mainline Constructions Pty Ltd* (1978) 141 CLR 335.

¹³⁹ Cf O'Donovan and Phillips, above n 75, 783.

misfortune, if the issuer is not reimbursed fully, then, for the sake of justice, the final adjustment should be carried out among these three parties. As long as the autonomy principle is preserved, and thereby its commercial purpose achieved, there is no overwhelming reason to prohibit the issuer's subrogation right, something which may result in enriching the beneficiary or the applicant at the expense of the issuer.

This chapter has attempted to clarify the significance of the autonomy principle as the product of an interplay between operational and functional features of independent undertakings. The operational and functional features are most appropriately elucidated within a multi-party relationship between the applicant, the beneficiary and the issuer. This is because the independent undertaking is created by the underlying contract parties to achieve their commercial purpose. Although the autonomy principle is a governing principle of independent undertaking, its practical significance is measured by the effect of its operation on other relationships. Given this the next chapter will focus specifically on the significance of the autonomy principle in the underlying contract relationship.

Chapter 3 Significance of Independent Undertaking in Underlying Contract

It has been observed that there is the possibility of qualifying the beneficiary's right to demand payment under the independent undertaking through the underlying contract terms. The basis for this theory is the fact that, though the autonomy principle governs the independent undertaking relationship between the beneficiary and the issuer, it does not affect the underlying contractual relationship. The practical effect is that, whereas the issuer's obligation to pay the beneficiary is independent from the underlying contract, the beneficiary's right to demand under the independent undertaking may be restricted to accord with the factual status of the underlying contract. The applicant may possibly obtain injunctive relief to stop the operation of the independent undertaking, not against the issuer but against the beneficiary on the basis of the underlying contractual relationship.

In a sense, this use of injunctive relief is sensible in not seeking to restrain the issuer, who is not an appropriate body to adjudicate and assess evidence in respect of underlying contractual disputes.¹ However, the possibility of the applicant obtaining an injunction in the way described above may not only detract from the value of an independent undertaking in the eyes of a beneficiary,² but also seems to represent a loop-hole in its operation. The commercial purpose of an independent undertaking is to allow the beneficiary to receive payment under certain conditions stipulated in it. This will be impeded by an injunction which not only restrains the bank from paying, but also restrains the beneficiary from demanding. In this chapter, this issue will be scrutinised through a discussion of Australian cases and a resolution will be sought which protects the viability of independent undertakings and strikes a balance between the interests of commercial parties.

¹ James O'Donovan and John Phillips, *The Modern Contract Law of Guarantee* (3rd ed, 1996) 774. *Boliventer Oil SA v Chase Manhattan Bank NA* [1984] 1 WLR 392, 393. *Washington Constructions Co Pty Ltd v Westpac Banking Corp* [1983] 1 Qd R 179, 180.

² O'Donovan and Phillips, above n 1, 774; Richard Perrington, 'Performance Bonds and Standby Letters of Credit: The Australian Experience' (1991) *Journal of Banking Finance Law Practice* 157, 165.

1 Qualification upon the Beneficiary's Right to Demand in the Underlying Contract

[1] *Wood Hall* case

In Australia, the nature of a bank guarantee, where a bank unconditionally undertakes to pay on demand, was thoroughly analysed in the leading case of *Wood Hall Ltd v The Pipeline Authority*.³ The underlying contract dealt with the construction of a pipeline. The Authority (the beneficiary) required the contractor (the applicant) to provide a cash security for his due and faithful performance of the work, and retention money against the progressive payment until the work had been performed and accepted in accordance with the contract. To satisfy these requirements, the applicant procured certain bank guarantees, instead of cash. These bank guarantees payment conditions provided that “[t]he Bank unconditionally undertakes and covenants to pay on demand any sum or sums which may from time to time be demanded in writing by [the beneficiary] up to maximum aggregate sum”. When the contractor’s work was nearing completion, the beneficiary demanded from the bank payment in full of the sum payable under each of the bank guarantees. The applicant initiated proceedings to restrain the bank from paying under the bank guarantees.

The contractor argued that, whether the bank was bound to pay depended on a further question, being whether the Authority had the right to demand payment in the context of the underlying contract. This argument was based on the view that the bank’s payment obligation under the guarantees was accessory and imposed only in the event of the contractor’s default. Gibbs J clearly rejected this argument and described the nature of the bank’s obligation as follows:

By each of the bank guarantees, the Bank “unconditionally” undertakes “to pay on demand” the sum demanded up to the limit specified in the bank guarantees. To hold that the bank guarantees are conditional upon the making of a demand that conforms to the requirements of the contract between the [beneficiary] and the [applicant] would of course be quite inconsistent with the express statement in the bank guarantees that the undertaking of the Bank is unconditional. To hold that the Bank should not pay on receiving a demand, but should be bound to enquire into the rights of the [beneficiary] and the [applicant] under a

³ [1979] 141 CLR 443.

contract to which the Bank was not a party would be to depart from the ordinary meaning of the undertaking that the Bank is to pay on demand. It would be contrary to the settled rules governing the implication of terms in contracts to imply provisions that would contradict the ordinary meaning of the words of the bank guarantees in this way.⁴

Stephen J cited the observation of Lord Diplock in *Edward Owen Engineering Ltd v Barclays Bank International Ltd*,⁵ that “the performance guarantee [or bank guarantee] stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour according to its terms”.⁶ The use of the guarantees was as an equivalent to cash, and therefore, “[o]nce a document of this character ceases to be the equivalent of a cash payment, being instantly and unconditionally convertible to cash, it necessarily loses acceptability”.⁷ Stephen J emphasised that the guarantees were placed in lieu of payment of cash, and the position of a beneficiary should be exactly the same as if a cash payment was made.

Despite his clear vision of the nature of unconditional guarantees, Stephen J took the view that there was a possibility of qualifying the beneficiary’s right to demand under the guarantees by the use of certain terms in the underlying contract:

Had the construction contract itself contained some qualification upon the [beneficiary’s] power to make a demand under a performance guarantee, the position might well have been different.⁸

The relief envisaged here is not to obtain an injunction against the bank, which must pay according to the unconditional terms of the bond, but against the beneficiary who would be restrained from making a demand upon the bank and thus converting the bond into cash.⁹ In the independent undertaking transaction, though the underlying contract has absolutely no bearing on the issuer’s obligation, it may prevent the beneficiary from demanding. This may represent a double standard in the injunctive relief that the applicant may obtain under a single independent undertaking operation;

⁴ Ibid 451. See also W S Weerasooria, *Bank Lending and Securities in Australia* (1998) [11.34].

⁵ [1978] 1QB 159.

⁶ Ibid 171.

⁷ [1979] 141 CLR 443, 457.

⁸ Ibid 459.

⁹ O’Donovan and Phillips, above n 1, 774.

one standard applies against the beneficiary, and another against the issuer. In any event, “the contract [was] silent on the matter”¹⁰ in the *Wood Hall* case.

[2] Actual Application of the Dictum

The dictum of Stephen J that there is a possibility that the underlying contract may qualify the beneficiary’s right to demand became a controversial issue in later cases. It was actually applied in *Pearson Bridge (NSW) Pty Ltd v The State Rail Authority of New South Wales*¹¹ through constructing a provision in the standard form of construction contract. The underlying contract was to construct a tunnel and complete associated works. The contract provided that the Contractor (the applicant) should supply security for due performance. Clause 5.3 “Form of Security” stated that “the security shall be in the form of cash, or an unconditional undertaking or certificate in a form approved in writing by the Principal and given by a bank approved in writing by the Principal.” The Contractor procured the unconditional type of bank guarantee as security upon the principal’s consent. When the Principal cancelled the contract by reason of breaches committed by the Contractor, and informed the Contractor of his intention to demand payment under the bank guarantee, the Contractor sought an injunction.

The Principal’s entitlement to money under the bank guarantee was basically disputed on the construction of clause 5.5 “Conversion of Security”. The clause stipulated that “[i]f the Principal becomes entitled to exercise all or any of his rights under the Contract in respect of the security the Principal may convert into money the security that does not consist of money. The Principal shall not be liable for any loss occasioned by such a conversion”. The Contractor submitted that, upon its proper construction, clause 5.5 would permit the Principal to require payment if, and only if, the “Principal becomes entitled to exercise all or any of his rights under the contract in respect of the security”. It was, so it was argued, constructed to govern and restrict the

¹⁰ [1979] 141 CLR 443, 459.

¹¹ (1982) 1 ACLR 81.

circumstances in which, as a matter of the underlying contract, the Principal could call up the security.

Yeldham J, citing the *Wood Hall* case with approval, described the Principal's (the beneficiary's) right under the bank guarantee:

It is plain that unless there is some contractual stipulation to the contrary, an owner of works is entitled in general to demand and be paid the amount of a performance guarantee, whether or not there has been a want of due and faithful performance of the work, and any moneys paid thereunder must be held as security for the contractor's proper performance of it.¹²

However, the decision was simply based upon the construction of clause 5.5:

[C]ause 5.5 is explicit in permitting [the Principal] to convert any other security, where such security has been accepted in lieu of cash, into money only if it becomes entitled to exercise any of its other contractual rights concerning security. A perusal of the contract as a whole leaves a firm impression that the parties intended that, where [the Contractor] was in default and in consequence [the Principal] suffered damage, then where necessary it should have resort to the retention moneys and only to the security if the former should prove insufficient.¹³

The point argued by the Principal that under clause 5.5 he might, from the outset, require the deposit of cash, was dismissed because it would have made the clause mere surplusage. Accordingly, this clause was interpreted to restrict the circumstances under which resort could be had to the bank guarantees, and this case distinguished from the *Wood Hall* case where, as Stephen J remarked, such a provision was absent in the underlying contract.

This line of judgements was followed in a similar case, again dealing with a construction contract. In *Selvas Pty Ltd v Hansen & Yuncken (SA) Pty Ltd*,¹⁴ the sub-contractor agreed to supply and install dry wall partitions in a building to be contracted by the contractor. The sub-contractor was required to provide security for due and proper performance under the sub-contract. In accordance with this requirement the sub-contractor obtained from its banks two forms of unconditional "Banker's Guarantee". During the course of performance by the sub-contractor,

¹² Ibid 83.

¹³ Ibid 86.

¹⁴ (1986) 6 ACLR 36.

various disputes arose between him and the contractor. When the contractor made a demand under the Banker's Guarantee, the sub-contractor sought an injunction to restrain the contractor from demanding payment.

In the sub-contract, clause 7(e) was relevant to the issue of security:

Any security provided by the sub-contractor [the plaintiff] in terms of this contract shall be available to the contractor [the 1st defendant] upon default of the sub-contractor or whenever the contractor may be otherwise entitled to the payment of moneys by the sub-contractor under or in consequence of this contract or whenever the contractor may be entitled to reimbursement of any moneys paid to the other under this contract, in all such cases as if the security were a sum of money due or to become due to the sub-contractor by the contractor.¹⁵

Master Burley, citing the dictum of Stephen J in the *Wood Hall* case, approved the possibility that the construction contract might itself contain a qualification upon the beneficiary's power to make a demand under a bank guarantee. Following the *Pearson Bridge* case, Master Burley distinguished the instant case from the *Wood Hall* case and observed:

[T]he sub-contract in this case contains a provision which can be interpreted as defining the circumstances under which the [contractor (the beneficiary)] was to have recourse to the banker's guarantee. There is real dispute, both factual and legal, between the parties as to whether or not the [contractor (the beneficiary)] does have the right to have recourse to the banker's guarantee and to that extent I am satisfied that there is a serious question to be tried in these proceedings.¹⁶

*Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd*¹⁷ was also a case which arose in the context of a construction contract. The contract contained provisions as to the security required for the purpose of ensuring due and proper performance.

5.3 Form of Security. The Contractor may provide the security in the form of —
(a) cash, interest-bearing deposit, Government Bonds or Government Inscribed Stock; or
(b) a Banker's undertaking, insurance bond, insurance guarantee policy, or other security (in all cases the form and provisions of the security to be approved by the Principal whose approval shall not be unreasonably withheld).
...

¹⁵ Ibid 37.

¹⁶ Ibid 40.

¹⁷ (1991) 23 NSWLR 451.

5.6 Conversion of security. If the Principal becomes entitled to exercise all or any of his rights under the Contract in respect of the security the Principal may convert into money the security that does not consist of money. The Principal shall not be liable for any loss occasioned by such a conversion.

In compliance with this provision, the insurance company issued a document as security which read:

WHEREAS [the Obligee] has entered into a written agreement with [the Contractor] for the performance of Contract ... [A]t the request of the Contractor AND IN CONSIDERATION of the Obligee agreeing to accept this undertaking in lieu of the lodgement by the Contractor of a cash security in the amount of ... [the Security Sum] the Surety UNCONDITIONALLY UNDERTAKES to pay on demand to the Obligee any sum which may from time to time be demanded by the Obligee to maximum to [the Security Sum]... Should the Obligee notify the Surety that it desires payment to be made to it of the whole or any part or parts of the Security Sum IT IS UNCONDITIONALLY AGREED by the Surety that such payment or payments will be made to the Obligee forthwith and without further reference to the Contractor and notwithstanding any notice given by the Contractor to the Surety not to pay the same PROVIDED that the liability of the Surety shall not exceed the Security Sum in the aggregate.

Rolfe J distinguished the *Barclay Mowlem* case from the *Wood Hall* case on the following grounds: first, clause 5.6 dealt explicitly with pre-conditions for the beneficiary to exercise the right to call upon the bond; and second, the bond referred to the underlying contract, and therefore the contractual position between the parties may be looked at in order to determine whether the Obligee should be prevented from calling on the bond. The decision followed the *Pearson Bridge* case and the *Selvas* case in deciding that clause 5.6 restricted the beneficiary's right to demand under the guarantee, citing with approval the dictum of Stephen J in the *Wood Hall* case.

From these cases,¹⁸ the following factual points may be summarised. The underlying contract is typically a construction contract and contains a provision as to security to ensure the contractor's due performance. Security is furnished in the form of a performance bond or a bank guarantee, in which the issuer is obliged to pay unconditionally. The construction contract, on the other hand, stipulates preconditions for the beneficiary's right to call up the security, or for converting non-cash security into cash. It states, for example, that "upon default of the contractor", "the beneficiary becomes entitled to exercise all or any of his right under the contract in respect of the

¹⁸ For another example, see *J H Evins Industries (NT) Pty v Diano Nominees Pty Ltd* (Unreported, Supreme Court of NT, Kearney J, 30 January 1989), which interpreted the relevant clause in the same way, though, the injunction was refused on another ground.

security". When serious disputes arose between the parties as to the contractor's performance, the contractor attempted to restrain the beneficiary from demanding payment on the basis of these preconditions in the underlying contract.

As a matter of law, the courts approved the legal effect of the provision in qualifying the right of the beneficiary to call on the security, and justified the use of injunctive relief to restrain him from so doing. The applicability and efficacy of the provision in the underlying contract are invariably grounded on the dictum of Stephen J in the *Wood Hall* case. Simply put, the nature of the performance bond, or bank guarantee, is overlooked and not argued at all, even by the beneficiary, as the basis of his right to demand.

A similar argument was also found in a sales contract. In *Tenore Pty Ltd v Roleystone Pty Ltd*,¹⁹ the underlying contract was a share sale agreement. Under this agreement, the vendor was obligated to procure an unconditional undertaking to secure the surviving warranties. Furthermore, the vendor was also obliged to procure a replacement undertaking until all the matters relating to the sales agreement were settled. When the vendor failed to provide a replacement undertaking in accordance with the terms of clause 42, the purchaser submitted that he should be entitled to demand payment under the undertaking. Clause 42(c) provided:

In the event the Purchaser notifies the Vendor of any issue in regard to the matters addressed in ... the Purchase Agreement arising out of the Surviving Warranties no later than 14 days prior to the expiry date of the Substitute Undertaking, the Vendor will procure, ... delivery to the Purchaser of a replacement unconditional irrevocable undertaking....²⁰

Giles J confirmed that the Substitute Undertaking was unconditional and required the bank to pay upon demand, the Undertaking being independent of the contractual position as between the purchaser and the vendor. However, clause 42 supported the vendor's submission that he had not come under an obligation to provide a replacement undertaking since the purchaser failed to give notice no later than 14 days prior to the expiration of the previous undertaking. Giles J observed:

¹⁹ Unreported, Supreme Court, NSW, Giles J, 14 September 1990 (BC9002008).

The result as between the purchaser and the bank, the purchaser was entitled to have the \$15,000,000 paid to the nominated account. As between the purchaser and the vendor, the purchaser was not entitled to make the demand having that result. Equity will intervene to restrain the purchaser from obtaining the benefit of the demand and, the interlocutory injunction having prevented payment by the bank, will do so by restraining the bank from making the payment.²¹

In the instant case as well, the precondition for the beneficiary's right to demand under the unconditional undertaking was stipulated in the underlying contract. Giles J clearly distinguished between the duty of the bank to pay and the right of the beneficiary to demand under a single independent undertaking. Nonetheless, he concluded that the court would enjoin the bank from making the payment in order to prevent the beneficiary from obtaining it.

In the recent case of *Reed Construction Services Pty Ltd v Kheng Seng (Australia) Pty Ltd*,²² this specific provision of the underlying contract was finally elevated to the status as one of the exceptions to the proposition that the performance of an independent undertaking is an event into which the court will not intervene at all — the autonomy principle. Austin J stated:

There are three principal exceptions [to the autonomy principle]. The first, ... is that the Court will enjoin the party in whose favour the bond has been given from acting fraudulently. The second exception, ... is that the Court will intervene to restrain the party for whose benefit the bond was given from acting unconscionably for the purpose of s51AA of the *Trade Practices Act 1974* (Cth). There is third exception, which is based on contract and is the most important for present purposes. A line of cases has recognised that whilst the Court will not restrain the issuer of the bond from acting on the unqualified promise to honour it, if the party in whose favour the bond has been given has made a contract promising not call upon the bond, breach of that contractual promise may be enjoined on normal principles relating to the enforcement by injunction of negative stipulation in contracts.²³

The analysis of the applicability of this third exception is incomplete without consideration of the significance of independent undertakings in relation to the underlying contracts. Given that the autonomy principle — the governing principle of independent undertaking relationship — is premised on the fact that an independent undertaking is autonomous from other related transactions, it does not seem to have

²⁰ BC9002008, [10].

²¹ BC9002008, [48].

²² Unreported, Supreme Court of NSW, Austin J, 20 November 1998 (BC9806316).

²³ *Ibid* BC9806316, [12]-[13].

any significance in relation to the underlying contract. However, the underlying contract and the independent undertaking are in fact interdependent in the sense that it is a tripartite transaction involving the applicant, the beneficiary, and the issuer. The ultimate purpose in having the independent undertaking being autonomous is to allow the beneficiary to receive payment under certain conditions. The three parties agree at the outset to these conditions, which are transposed as the issuer's obligation to pay and the beneficiary's right to demand. If an injunction is granted in the way shown in the above cases, it is not only disturbing for the beneficiary, but also quite inconsistent with the commercial parties' original intention to furnish an independent undertaking.

[3] Different Construction on the Similar Provision

There are some cases where the injunction was refused in relation to similar provisions through a different interpretation. In *Hughes Bros Pty Ltd v Telede Pty Ltd*,²⁴ the underlying contract was to construct a commercial building. The builder was required to provide security for his performance. The relevant clause was that:

10.25 Any security provided by the Builder in terms of this Agreement shall be available to the Proprietor whenever the Proprietor may be entitled to the payment of moneys by the Builder under or in consequence of this Agreement or whenever the Proprietor may be entitled to reimbursement of any moneys paid to others under this Agreement, in all such cases as if the security were a sum of money due or to become to the Builder [sic] by the Proprietor [sic].²⁵

The security provided by the builder was a "Performance Guarantee", where the issuer "UNCONDITIONALLY UNDERTAKES to pay on demand". The parties disputed the entitlement to money as a matter of construction of the above clause in connection with serious issues arising from the building contract. Accordingly, Cole J approached the matter upon the basis that the right of the proprietor to call upon the guarantees was determined by this clause and stated:

In my view cl.10.25 permits the proprietor to have recourse to the securities in circumstances where the proprietor has a claimed entitlement to moneys under or in consequence of the agreement, provided such claimed entitlement is not specious or fanciful. "Available" in the

²⁴ [1989] 7 BCL 210.

²⁵ *Ibid* 212.

clause refers to the availability of moneys the subject of the security, rather than the securities themselves. “May be entitled” cannot be read as “is entitled”.²⁶

It was observed that the securities in the form of performance guarantees were “available” to the proprietor as repayment of the money paid by the proprietor, or by way of damages resulting from determination of the employment of the builder, or repudiation of the contract by the builder. Cole J took the view that there was no finding on these matters, however, “it is sufficient to trigger the operation of cl.10.25 that the proprietor *may be entitled* to payment of moneys in consequence of a finding of either occurrence (emphasis added)”.²⁷ In this respect, “[i]t was not submitted by the builder that there was no reasonable basis for the claim of the proprietor to an entitlement to moneys flowing from either determination of employment or repudiation of the contract”.²⁸ Cole J observed that in this circumstance the proprietor’s claimed entitlement was not fanciful or far fetched.

Similarly, in *Matthew Hall Mechanical Electrical & Engineers Pty Ltd v Boulderstone Pty Ltd*,²⁹ an injunction was denied in relation to the same provision as in the *Hughes Bros* case. Phillips J interpreted it as follows:

[C]l 7.4³⁰ is plainly intended to govern the relationship of the parties in respect of the security, be it cash in the first instance or cash which is yielded by a demand on the bank under the bank guarantees. These funds are in the hands of the [contractor]; for the contract requires as much. Clause 7.4 then provides that, in any of the three situations mentioned, those funds are to be treated as owing by the contractor to the subcontractor and thus available by way of set-off to answer for any liability by the subcontractor to the contractor arising under the subcontract.³¹

²⁶ *Ibid* 216.

²⁷ *Ibid* 217.

²⁸ *Ibid*.

²⁹ (1994) 10 BCL 148.

³⁰ Cl 7.4 provides:

Any security provided by the Sub-Contractor in terms of this Contract shall be available to the Contractor upon default of the Sub-Contractor or whenever the Contractor may be otherwise entitled to the payment of moneys by the Sub-Contractor under or in consequence of this Contract or whenever the Contractor may be entitled to reimbursement of any moneys paid to others under this Contract, in all such cases as if the security were a sum of money due or to become due to the Sub-Contractor.

³¹ (1994) 10 BCL 148, 150.

The court took the view that the provision in question did not govern the beneficiary's entitlement to make a demand, but was merely descriptive of how those funds (when collected) might be applied.³²

Both courts took pains, through an elaborate interpretation, to explain that a purported precondition in the underlying contract was not to prevent the beneficiary from demanding under the unconditional guarantees. This is because of the way in which the matter was disputed between the parties. It was common ground that the bank guarantee in question was an unconditional type between the beneficiary and the bank, under which payment would be triggered upon demand. In other words, the beneficiary had a right to demand and receive payment, irrespective of the status of the underlying contract. However, no submission was advanced on behalf of the beneficiary that because of the nature of the guarantee the underlying contract could not limit his power to make a demand upon the guarantee.³³

It should be also noted that the provisions in question are identical to the one found in *Selvas Pty Ltd v Hansen & Yuncken (SA) Pty Ltd*,³⁴ where an injunction was granted, though neither case cited this earlier decision. The reason why almost identical terms quite often become a matter for construction is that the parties use standard contract forms. Since the standard form attempts to cover variations and alterations of conditions agreed to by the contract parties, the original terms are in a general form, with permissible ambiguity, and enumerate possible choices from which the parties may select. For example, the standard form used in *Pearson Bridge* enumerated the forms of security, including "cash, or an unconditional undertaking or certificate in a

³² See O'Donovan and Phillips, above n 1, 775.

³³ Under this circumstance, Cole J remarked:

I accordingly approach the matter upon the basis that the right of the proprietor that the right of the proprietor to call upon the guarantee is determined by the provision of cl 10.25.

Had it been necessary for me to decide the matter, I would have held that parties, by their contract, could limit the terms upon a performance guarantee, even if the performance guarantee as between the guarantor and the proprietor was unconditional. (1989) 7 BCL 210, 215.

³⁴ (1986) 6 Australian Construction LR 36.

form approved in writing by the Principal and given by a bank approved in writing by the Principal". The last form shows the possibility of arranging various kinds of security in accordance with the parties' agreement. In this respect, if the standard form provides for options in the various sections, it will be necessary to construe certain parts of the contract as being consistent with other parts.

[4] Some Implication from English Cases

The English courts have also faced similar issues. However, in the following two cases the arguments focused on whether the courts should imply a term in the underlying contract restricting the beneficiary's right to demand under the bank guarantee, since there was no explicit clause. In *Costain International Ltd v Davy McKee (London) Ltd*,³⁵ the underlying contract was a subcontract for the design and construction of the piping and mechanical works at a refinery. The subcontract required the subcontractor to furnish an irrevocable bank guarantee in lieu of the retention money. The bank guarantee, issued by Standard Chartered Bank, stated:

[W]e hereby unconditionally and irrevocably guarantee to pay [Contractor] on its first demand in writing without reference to any other authorisation or justification a sum or sums in the aggregate not exceeding the sum of £557,000.

When serious disputes arose between the parties, the contractor made a call on the bank pursuant to the terms of the bank guarantee. The subcontractor sought an injunction and submitted that the contractor could claim on the bank only if it could demonstrate that it had a reasonably arguable cross-claim against the subcontractor in terms of the underlying contract. Russell J acknowledged that a real dispute existed between the parties, but nonetheless refused the subcontractor's contention as a misconception. He claimed that it would strike at the very object of the guarantee, which is to provide a safeguard and security for the contractor "counterbalanced by the advantage which had accrued to [the subcontractor] in obtaining 100 per cent of the value of the work as it progressed."

³⁵ Unreported, Court of Appeal (Civil Division), Neill LJ, Russell LJ, 26 November 1990. See Geraldine Andrew and Richard Millet, *Law of Guarantees* (2nd ed, 1995) 473-474.

This reasoning was supported by Shaw J in *State Trading Corporation of India Ltd v ED & F Man (Sugar) Ltd*.³⁶ In a sales of sugar contract, the seller provided a performance bond, whereby the issuer irrevocably and unconditionally undertakes to pay to the beneficiary (the buyer), to secure his due performance. The sales contract specifically provided that disputes were to be submitted to the Refined Sugar Association in London for settlement in accordance with the Rules of the Association. There was also a force majeure clause in the usual form providing that the period of delivery could be extended by 30 days, and if delivery had still not occurred by the end of the extended period, the Buyer had the option of cancelling the contract. When a government ban was placed on the export of sugar from India and the delivery of sugar was prevented, the seller alleged that he was not in default and was entitled to rely on the force majeure clause. The seller submitted that a term must be implied in the agreement of sale between the parties that the buyer would not serve the notice of default on the bank except when there was reasonable and just cause for doing so.

Shaw LJ observed:

[I]n order to give business efficacy to the performance bond which is expressed to be an integral part of the sale contract, it is necessary to imply a term in that contract that the buyer will not give notice to the bank unless there is an actual default on the part of the seller. It seems to me that the implication of such a term so far from giving business efficacy to the arrangement relating to the provision of a performance bond goes far to erode its legitimate commercial object.

English courts have clearly established that they will not imply a term in the underlying contract between the beneficiary and applicant, or construe it as giving rise to an obligation on the part of the beneficiary not to make a demand under the guarantee.³⁷

Another case, *Cargill International SA v Bangladesh Sugar & Food Industries Corp*,³⁸ is more similar to the Australian cases discussed above. The underlying contract was for the sale of sugar. The seller provided a performance bond for the

³⁶ Unreported, Shaw J, 17 July 1981.

³⁷ Andrew and Millet, above n 35, 473.

³⁸ [1996] 2 Lloyd's Rep 524.

buyer amounting to 10 per cent of the contract price. The performance bond stipulated that “we ... hereby undertake and guarantee due signing and acceptance and performance by the [seller] and we unconditionally and absolutely bind ourselves ... to make payment ... without any question whatsoever”. The underlying contract, on the other hand, contained clause 13, which provided as follows:

The performance Bond is liable to be forfeited by the BUYER if the SELLER fails to fulfil any of the terms and conditions of this contract ... and also if any loss/damage occurs to the BUYER due to any fault of the SELLER.

Furthermore, clause 16 provided that if the seller failed to adhere to the delivery date, the buyer was entitled to forfeit the performance bond. The buyer alleged a breach of contract on the grounds of, over-age of, and late arrival of, the vessel used to ship the sugar, and attempted to demand payment under the performance bond. The seller contended that the buyer suffered no loss by these alleged breaches and that on a proper construction of clause 13, or if necessary, as a matter of an implied term, the buyer was not entitled to demand payment under the performance bond. He further argued that:

The fact that the bond is itself unconditional, as between the buyer and the bank, is immaterial. The bank is ... not in a position to judge whether the buyer is rightly asserting a breach and will, in the absence of any successful legal intervention by the seller, be entitled, and obliged, to pay on a buyer's demand, at least if that demand is made in good faith.

Morison J refused this argument on the basis of the commercial purpose of a performance bond as follows:

[A] bond is, effectively, as valuable as promissory note and is intended to affect the “tempo of parties” obligation in the sense that when an allegation of breach of contract is made (in good faith), the beneficiary can call the bond and receive its value pending the resolution of the contractual disputes. He does not have to await the final determination of his rights before he receives some moneys. On application for an injunction, it is, therefore, not pertinent that the beneficiary may be wrong to have called the bond because, after a trial of arbitration, the breach of contract may not be established; otherwise, the Court would be frustrating the commercial purpose of the bond. The concept that money must be paid without question, and the rights and wrongs argued about later, is a familiar one in international trade, and substantial building contracts.³⁹

³⁹ Ibid 528.

It was observed that the beneficiary was entitled to make a demand for the full amount of the performance bond, no matter how the factual status of the underlying contract affected his position.

2 Parties' Intention in Furnishing Independent Undertaking

In the preceding decisions of Australian cases that started with *Pearson Bridge*, the courts basically concentrated on construing a specific provision, which may possibly qualify the beneficiary's right to demand under the independent undertaking. The nature of the undertaking is not the issue there. Contrarily, when proceedings were instituted against the issuer, the courts analysed the nature of the undertaking more thoroughly. This was well illustrated in *Burleigh Forest Estate Management Pty Ltd v Cigna Insurance Australia Ltd*,⁴⁰ where the issuer demurred to payment under the unconditional bonds by asserting matters arising under the underlying building contract. These bonds were issued in accordance with the underlying contract, whereby a builder avoided the deduction of retention moneys in exchange for arranging for the receipt of a bond in favour of the owner, as security for due performance on the builder's part. Thomas J fully relied on the *Wood Hall* case and remarked of the bond in the instant case:

[T]he most familiar (of which the present case is an example) is an unconditional promise by a financial institution, at the request of an account party, to provide a guarantee in favour of a beneficiary. The existence of the underlying contract is usually disclosed in the recitals, but the rights of the parties inter se under that contract are not made a condition of the bank's obligation to carry out its promise to the beneficiary. Obviously the settling of a final account between the two contracting parties, or the ascertainment of their rights may be a time-consuming process and the commercial certainty of the bond has been preferred by the parties.⁴¹

With respect to the right of the beneficiary to demand, however, Thomas J conceded the issuer's submission that it might be possible for the builder to restrain the owner

⁴⁰ (1992) 2 Qd R 54. See also, *BI (Australia) Pty Ltd v Cigna Insurance Australia Ltd* (1990) 11 BCL 64. Giles J explained that the commercial purpose of the guarantee in the present case is to release "the retention money which would otherwise have been held by [the beneficiary] and available to be employed for the purposes of the construction contract."

⁴¹ *Ibid* 58.

from calling for payment, such as where there is a breach of contract affecting his entitlement. It is submitted that “the duty of the bank to pay and the right of the beneficiary to claim are not simply opposite sides of the same coin”.⁴² While the duty of the bank arises only under the unconditional bond, the right of the beneficiary to claim ultimately depends upon the terms of the underlying contract.⁴³ Thomas J was eager to conclude that “the adverse party may have an equity to restrain [the beneficiary] from making such a demand”.⁴⁴

The point being missed in this argument is the commercial role of the independent undertaking, or the commercial purpose for which the underlying contract parties chose the unconditional guarantee. Surprisingly, Thomas J answered the question in the instant case. He observed that the commercial desirability of this kind of bond or guarantee is that it is “as good as cash”.⁴⁵

As has been seen, in construction contracts it is a common practice to provide for a cash deposit and retention money as security. While “they are moneys to which final entitlements are not yet established”,⁴⁶ the parties agree that they are held back by the proprietor, or kept in a separate account. In the event of default by the contractor, the proprietor is spared the need to resort to legal process to secure financial redress in so far as he may simply keep the money.⁴⁷

Unconditional guarantees emerged as a replacement for the cash deposit and retention money in order to release the contractor from the financial burden being tied up his working capital. With this arrangement, the contractor enjoys the advantage to obtain the full amount of money for payment by the proprietor. Yet it does not equate that the proprietor has forfeited his privileged position having the money in his hand

⁴² Ibid. Thomas J referred to the article by Coleman. Martin Coleman, ‘Performance bond’ (1990) *Lloyd’s Maritime and Commercial Quarterly*, 223, 224.

⁴³ Colman, above n 42, 24.

⁴⁴ [1992] 2 Qd R 54, 60.

⁴⁵ Citing Stephen J’s remark in *Wood Hall v The Pipeline Authority* [1979] 141 CLR 443.

⁴⁶ *Washington Constructions Co Pty Ltd v Westpac Banking Corp* [1983] 1 Qd R 179, 182.

⁴⁷ Howard N Bennett, ‘Performance Bonds and the Principle of Autonomy’ (1994) *Journal of Business Law* 574.

pending the litigation over the entitlement to it. That is, the advantage given to the contractor under the unconditional guarantee is at the proprietor's mercy:

[I]n most, if not all cases, the contract provides for a bond which the proprietor can at his discretion demand. Thus, in the usual situation, the proprietor can nullify at will the temporary monetary advantage that such an arrangement gives the [contractor].⁴⁸

The mechanism of an unconditional bond is further explained:

[The underlying contract parties] give the owner the right to control the movement of moneys, at the same time giving the builder the benefit of avoiding automatic withholding of substantial moneys in retention funds. Through this mechanism, in the vast majority of building contracts the builder gets the benefit of receiving moneys which would otherwise have been withheld. He gets this benefit for the price of the low interest that it costs to procure the issue of the guarantee. In cases where a serious dispute arises in relation to defects or other matters of contention, the owner will call up the guarantee and the builder will in any event still have the benefit of the higher payment under the contract, unmitigated by retention. Eventually litigation may settle the entitlement inter se of the builder and owner, and if the owner's demand has been in breach of the owner's duties under the contract, the builder may obtain any consequential losses by way of damages.⁴⁹

Being equivalent with cash, unconditional guarantees need be convertible into cash simply upon demand by the proprietor. This intention was represented in the wording of the guarantee in the *Wood Hall* case where the bank "unconditionally" undertook to pay on demand. In *Hortico (Aust) Pty Ltd v Energy Equipment Co (Aust) Pty Ltd*,⁵⁰ it was found that the bank undertook "to hold itself responsible to you for the sum of \$570,000" and indicated that upon notification it will pay "forthwith to you without reference to *Hortico* and notwithstanding any notice given by them to the bank not to pay same".⁵¹

The use of an unconditional guarantee, which has the same effect as a cash payment, without actual cash movement, enables the underlying contract parties to arrange security in a more beneficial manner for both parties. Thus, if an injunction was granted against the beneficiary, on the basis of a provision in the underlying contract

⁴⁸ *Ibid.*

⁴⁹ [1992] 2 Qd R 54, 59-60.

⁵⁰ (1985) 1 NSWLR 545.

⁵¹ *Ibid.* 550. While there is a difference in wording between these two cases, it was considered that there was no difference in intent. See O'Donovan and Phillips, above n 1, 771.

which qualifies his right to demand, it would exhibit total ignorance of the agreement between the parties discussed above, and severely undermine the integrity of the operation of independent undertakings.

3 Integrity of Independent Undertaking

[1] Re-consideration of the *Wood Hall* case

All the cases that have allowed the possibility of qualifying the beneficiary's right to demand by reference to a term in the underlying contract have derived from the dictum of Stephen J in the *Wood Hall* case. The foregoing sections have attempted to demonstrate that the results are problematic and that the arguments have overlooked an important aspect of independent undertakings, that being their significance in the underlying agreement. In this section, the observation of Stephen J in *Wood Hall* will be re-examined and the dictum will be analysed within a broader framework.

In the *Wood Hall* case, the contractor sought relief on the basis that the beneficiary was in fact in breach of underlying contract in making a demand under the bank guarantee. Stephen J stated that the parties' intention in arranging an unconditional guarantee can be inferred from its unconditional description or promise:

Since [the bank guarantee's] terms provided for an unqualified right to demand payment at any time, this must be taken to have represented the intention of the parties when agreeing to the substitution of these guarantees in place of payments of cash. The advantages of choosing the independent undertaking are advanced: the contractor deferred for the time being, and perhaps altogether, the need to make any payment of security moneys, the employer, while thus assisting the contractor so far as the latter's liquidity was concerned, at the same time preserved to itself the right at any time, by making a demand, immediately to obtain payment of the full amount of the security moneys.⁵²

With an unconditional guarantee, the parties intend that, in terms of security, their positions will remain exactly the same as if cash was actually paid. And most importantly, a bank guarantee, being payable upon demand, will be equivalent to cash.

⁵² *Wood Hall Ltd v The Pipeline Authority*, [1979] 141 CLR 443, 458.

The controversial dictum of Stephen J, discussed at length above, followed immediately upon his analysis of the intention of the parties. However, if the underlying contract qualifies the beneficiary's right to demand under the guarantee, it is no longer payable upon demand. A bank guarantee will not remain unconditional where the parties intend that its operation should not be triggered upon demand. It must be taken that the parties intend to arrange something other than unconditional guarantees. Hence, it is almost impossible to accept the proposition, in a consistent manner, that the underlying contract may possibly qualify the beneficiary's right to demand under an unconditional guarantee.

It is not certain that Stephen J truly meant to accept this proposition or simply overlooked the inconsistency in the proposition, or that he carelessly proposed that the parties were free to re-negotiate the type of security, instead of keeping to the original intention of providing for cash payment, while leaving the form of guarantee unchanged. The line of the cases that started with *Pearson Bridge* may have focused on the dictum without a full analysis of the observation of Stephen J. It is true that the plain reading of the dictum supports the decisions of these cases. However, since Stephen J viewed that the form of guarantee is strongly connected with the parties' intention, it seems intuitively incorrect to interpret the dictum in this way.

Further, Stephen J stated that the parties might possibly agree to substitute a different type of security, even though it would be unusual to affect the secured position of the party detrimentally:

Yet this is a necessary consequence of the acceptance of the contractor's submission, since it is said that the [beneficiary] must first establish some want of due and faithful performance on the contractor's part before it may, be making a demand, place itself in as favourable a position as it would have occupied had the security originally been provided in cash. To regard this as the consequence of the giving by the contractor of the present performance guarantees, *unqualified as they are in form, appears to me to be more curious still* (emphasis added).⁵³

Stephen J, at least, reconsidered the form of the guarantee as an important factor in determining the parties' intention, from which the nature of guarantee is derived.

⁵³ *Ibid* 459.

Guarantees are a contractual undertaking, and so the parties can freely negotiate their terms and conditions. Among other instruments, unconditional guarantees are well recognised in a commercial society. The commercial parties surely acknowledge their unique nature and operational feature, and take advantage, or accept disadvantage, arising from them.

[2] Standby Credit Cases

The same kind of disputes have been found in recent cases where standby credits were issued instead of bank guarantees. In *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd*⁵⁴ the underlying contract, which dealt with constructing a co-generation plant, specifically required the Contractor to furnish security “in the form of an unconditional undertaking in favour of the Owner”. Pursuant to the agreement the Contractor provided an irrevocable standby letter of credit. When disputes arose between the parties, the Contractor sought an injunction to restrain the Owner from demanding payment under the standby credit. The Contractor principally submitted that, according to the provisions of the underlying contract, the Owner was only entitled to resort to security in the event of an undisputed entitlement to damages for failure to complete the plant by the date for hand-over.⁵⁵

⁵⁴ [1998] 3 VR 812.

⁵⁵ Clause 3.13 provided:

- (a) If [Fletcher] does not reach Handover by the Date for Handover, it must pay Time Damages at the rate in Annexure A for every Operating Day after the Date for Handover until it reaches Handover or the Contract is terminated, whichever is first.
- (b) The Owner may deduct Time Damages from any money due from the Owner to [Fletcher] under the Contract and if that is insufficient, [Fletcher] must pay the balance of Time Damages to the Owner within ten Business Days of delivery of a notice to [Fletcher] from the Owner demanding payment. If [Fletcher] fails to pay the balance within the ten Business Day period, the Owner may have recourse to [Fletcher’s] security to obtain the balance.

Charles JA referred to *Pearson Bridge* and other cases following it,⁵⁶ but cast some doubt over these decisions by citing *Hudson's on Building and Engineering Contracts* that “the *Pearson Bridge* case ... does not seem entirely convincing”.⁵⁷ Additionally, reference was made to the *Hughes Bros* case,⁵⁸ which arose in the same context as *Pearson Bridge*, but which did not follow the *Pearson Bridge* decision that the proprietor should be allowed recourse to the security provided that his claim was not specious or fanciful.

In light of the agreement to provide the security, which is “in the form of an unconditional undertaking to pay in favour of” the Owner, Charles JA explained that “the commercial purpose of this agreement was to provide an allocation of risk and that [the Owner] is entitled ... to call on the security provided by [the Contractor] notwithstanding that there is a genuine dispute and a serious issue to be tried as to whether Handover has been reached”.⁵⁹ This view was grounded in the following paragraph of *Hudson's on Building and Engineering Contracts*:

Insofar as a construction contract may make clear provision for the furnishing of an unconditional guarantee as security for due performance, the normal interpretation, ... will be that, in response to the stipulated demand, an unqualified transfer of the sums in question is intended, provided only that there is a bona fide dispute or claim on the secured party's part, and that any further investigation of its merits or extent is not usually intended by the contract.⁶⁰

On the other hand, Callaway JA took the view that the beneficiary, unlike the bank, may be restrained if there is an express prohibition in the underlying contract against calling upon the guarantee. “In theory an implicit or implied prohibition is just as good”.⁶¹ However, practically it is much harder to establish the prohibition because

⁵⁶ *Selvas Pty Ltd v Hansen & Yuncken (SA) Pty Ltd*, (1986) 6 Australian Construction LR 36; *Barclay Mowlem Construction v Simon Engineering (Australia) Pty Ltd*, (1991) 23 NSWLR 451; *JH Evans Industries (NT) Pty Ltd v Diano Nominees Pty Ltd*, unreported, NT Sup Ct, 30 January 1989.

⁵⁷ I N Duncan Wallace, *Hudson's Building and Engineering Contracts* (11th ed, 1995) [17-075].

⁵⁸ [1989] 7 BCL 210.

⁵⁹ [1998] 3 VR 812, 821.

⁶⁰ Wallace, above n 57 [17-075].

⁶¹ [1998] 3 VR 812, 826.

“the implication cannot be made if it would stultify, or even if it would be inconsistent with, the purpose for which the guarantee was taken”.⁶²

Callaway JA furnished two reasons for why the beneficiary may have demanded a guarantee: the first reason is to provide security in case there are difficulties recovering from the party in default, in which case the beneficiary has recourse against the bank; and the second reason, which is additional to the first, is to allocate the risk as to who shall be out of pocket pending resolution of a dispute.⁶³ It is a question of construction of the underlying contract whether the guarantee is provided solely by way of security or also as a risk allocation device. With respect to standby credits, performance bonds and guarantees in lieu of retention moneys, “the [second] purpose is often present and commercial practice plays a large part in construing the contract”.⁶⁴ Under these circumstances, “no implication may be made that is inconsistent with an agreed allocation of risk ... and clauses in the contract that do not expressly inhibit the beneficiary from calling upon the security should not be too readily construed to have that effect”.⁶⁵

The court attempted to interpret the clause in question⁶⁶ consistently with the nature of a standby credit and the parties’ intention in providing it. On the basis of the commercial purpose of standby credits as a risk allocation device, achieved by a simple money transfer mechanism, it was concluded that there was no qualification upon the Owner’s right to call on the security.

Another standby credit case is *Bachmann Pty Ltd v BHP Power New Zealand Ltd*.⁶⁷ The underlying contract was for the design, supply, manufacture and commissioning of boiler bypass dampers. The conditions of the contract were based on the standard form with some modification agreed by the parties. Clause 5.3, dealing with the form of security that should be supplied in favour of the purchaser, provided:

⁶² *Ibid.*

⁶³ *Ibid.*

⁶⁴ *Ibid* 827.

⁶⁵ *Ibid.*

⁶⁶ Clause 3.13. See footnote 56.

The security shall be in the form of cash, bonds or inscribed stock issued by the Australian Government or the Government of a State or Territory of Australia, interest bearing deposit in a trading bank carrying on business in Australia, an approved unconditional undertaking given by an approved financial institution or insurance company, or other form approved by the party having the benefit of the security.

The party having the benefit of the security shall have a discretion to approve or disapprove of the form of an unconditional undertaking and the financial institution or insurance company giving it or other form of security offered. The form of unconditional undertaking attached to these General Conditions is approved....

Pursuant to this clause, the supplier arranged for its bank to establish two irrevocable letters of credit in favour of the purchaser. When a dispute arose between the parties and the purchaser presented the required documents to the issuing bank, the supplier sought an injunction to restrain the purchaser from demanding or receiving any money under the credit. The supplier asserted that clause 5.5 disabled the purchaser from seeking payment from the bank. That clause provided:

A party shall not convert into money security that does not consist of money until the party becomes entitled to exercise a right under the Contract in respect of the security. The party shall not be liable for any loss occasioned by conversion pursuant to the Contract.

It is plain that clause 5.5 is an express, albeit qualified, contractual prohibition on conversion of a security into cash. As to the purchaser's entitlement to exercise a right in respect of the security, clause 22.4 was the only relevant provision. It stated:

The Purchaser may deduct from moneys otherwise due to the Supplier any moneys due from the Supplier to the Purchaser and if those moneys are insufficient, the Purchaser can have recourse to the security under the Contract.

The court carefully reviewed the line of cases that began with *Pearson Bridge* and analysed the nature of a standby credit, especially the autonomy principle. Regard was had as to whether use could be made, in construing clause 5.5, of the fact that the particular form of security which the parties employed was a standby credit. The view generally accepted in the United States, where standby credits have been in common use for the last 30 years, is that "standby credits are intended by the buyer and supplier — or other parties to the underlying contract — to require the supplier to stand out of the amount of the credit in favour of the buyer pending resolution of the

⁶⁷ [1999] 1 VR 420.

underlying dispute”.⁶⁸ Brooking J cited the United States case of *Mellon Bank NA v General Electric Credit Corporation*:⁶⁹

The purpose of the independence principle, ... is to provide the beneficiary with an unfettered, immediate remedy upon occurrence of the triggering event on a standby letter of credit. The purpose is not to prevent any subsequent challenge to the validity of the beneficiary's claim, but to ensure that 'contractual disputes wend their way towards resolution with money in the beneficiary's pocket rather than in the pocket of the contracting party'.⁷⁰

In light of the fact that clause 5.3 contemplated an unconditional undertaking including standby credits, the court placed great emphasis on the parties' intention in choosing this particular kind of security. In so doing, the court attempted to treat clause 5.5 and 22.4 in harmony with the parties' intention as to the security of a standby credit. It was concluded that the purchaser would have recourse to the security “where according to a bona fide claim made by the purchaser moneys are due to it from the supplier which exceed any money due from it to the supplier”.⁷¹ By the choice of a standby credit as security, “the parties contemplated that it was the supplier who should be out of pocket pending the resolution of any dispute”.⁷²

It has been found that doubts remain as to the equation of letters of credit with bank guarantees.⁷³ Although the difference between standby credits and bank guarantees has not been defined by the courts,⁷⁴ it seems one of the bases for rejecting an

⁶⁸ Ibid 436.

⁶⁹ 724 F Supp 360, 365 (1989).

⁷⁰ This quote was from *Itek Corp v First National Bank of Boston*, 730 F2d 19, 24 (1st Cir 1984); *CKB & Associates v Moore McCormick Petroleum*, 734 SW2d 653, 655 (Tex 1987). This remark was quoted with approval in *Certrifugal Casting Machine Co Inc v American Bank & Trust Co*, 966 F2d 1348 (1992); *Rose Developments Inc v Pearson Properties Inc*, 832 SW 2d 286 (1992).

⁷¹ [1999] 1 VR 420, 437.

⁷² Ibid.

⁷³ Templeman J in *Anstral Ships Pty Ltd v National Australia Bank Ltd* (Unreported, Supreme Court of WA, Templeman J, 13 February 1997), took a further step to state that “there is, I think, force ... that a letter of credit is a different kind of instrument from a bank guarantee or undertaking with which Giles J was concerned in *Tenore* (Unreported, Supreme Court, NSW, Giles J, 14 September 1990). In any event, the difference between them was not defined in this case either.

⁷⁴ See William Mark Jones, 'Injunctions Restraining Contractor's Bank Guarantees' (1999) 15(4) *Building and Construction Law* 229, 237.

application for an injunction in standby credit cases. It may also distinguish the standby credit cases from the cases of successful applications for injunctions started from *Pearson Bridge*.

However, it should be questioned whether there is any practical difference, in terms of the parties' intention, between standby credits and bank guarantees which are payable upon demand — “unconditional” bank guarantees. The purpose of using standby credits as security — allocating risk and placing money in the hand of the beneficiary — is exactly the same purpose that the parties intend by choosing bank guarantees as replacements for cash. Callaway J expressed his dissatisfaction with the judicial treatment of unconditional guarantees in the line of cases following *Pearson Bridge*:⁷⁵

In Australia it is complicated by the doubt attending the line of cases that begins with *Pearson Bridge (NSW) Pty Ltd v State Rail Authority*.⁷⁶ ... Guarantees are an efficient substitute for cash. It would be unfortunate if the law made them unattractive.

[3] Independent Undertaking: Bank Guarantee, Performance Bond and Standby Credit

Letters of credit have a long history of commercial use, and therefore their legal nature and commercial function have been well established and recognised. In this regard letters of credit may to a large extent have acquired the status of “a device by which legal consequences result automatically from a classification without regard to the intent of the parties”.⁷⁷ Nonetheless, it is worth noting that in their history the nature of standby credits as siblings of commercial credit, adopting the autonomy principle, has been carefully scrutinised and distinguished from a “guaranty” that is ancillary — a surety contract.⁷⁸ The courts in the United States do not rely on nomenclature in determining whether a particular instrument brought before them is a letter of credit. Even if the document is denoted as a letter of credit, the court is still

⁷⁵ *Ibid.*

⁷⁶ (1982) 1 ACLR 81.

⁷⁷ James E Byrne, ‘Fundamental Issues in the Unification and Harmonization of Letter of Credit Law’ (1991) 37 *Loyola Law Review* 1, 8.

⁷⁸ John F Dolan, *The law of Letters of Credit* (rev ed, 1996) [1-18]-[1-22].

willing to examine carefully the nature of the bank's undertaking.⁷⁹ It is suggested that if the banking industry were to begin marketing a primary obligation that was: (1) payable against the presentation of documents; and (2) independent of the underlying transaction, whatever the banks were to call that product, letter of credit law would be applicable to it.⁸⁰

On the other hand, terminologically and conceptually, ambiguity remains in the area of guarantees.⁸¹ Unlike letters of credit, the term "performance guarantee" or "performance bond" does not demonstrate the specific nature of the instrument. They may be an unconditional undertaking, or they may be used to denote a genuine contract of guarantee or indemnity.⁸² Furthermore, there is a continuum in the form of undertaking, ranging from one which pays the beneficiary on simple demand to one which pays only upon proof of default by the applicant.⁸³ Due to the absence of common terminology or long established course of dealing, and the lack of judicial familiarity, it is impossible to treat all bank guarantees in the same way.⁸⁴ Each guarantee must be carefully scrutinised to ascertain its nature.

In any event, it has been acknowledged that bank guarantees which are unconditional in nature, occasionally described as performance guarantees or performance bonds, have served the same function as standby credits from an early stage.⁸⁵ As has been seen in Chapter 1, some practical differences exist between them. The technique of standby credits, particularly in light of their origins, is more closely aligned to

⁷⁹ Eg *Wichita Eagle & Beacon Publishing Co v Pacific National Bank*, 493 F2d 1285 (9th Cir 1974).

The bank issued an engagement denominated as letters of credit, however its undertaking did not rest on the presentation of documents, rather on the occurrence or non-occurrence of certain conditions. The court held the document was not a letter of credit because the bank's undertaking strayed "too far from the basic purpose of letters of credit, namely, providing a means of assuring payment cheaply by eliminating the need for the issuer to police the underlying contract." See, Dolan, above n 78, [2-18]-[2-20].

⁸⁰ Dolan, above n 78, [1-22].

⁸¹ Reoland Bertrams, *Bank Guarantees in International Trades* (2nd ed, 1996) 3.

⁸² Andrew and Millet, above n 35, 443.

⁸³ Coleman, above n 42, 228; Andrew and Millet, above n 35, 443.

⁸⁴ Coleman, above n 42, 228.

⁸⁵ E P Ellinger, 'Standby Letters of Credit' (1978) 6 *International Business Lawyer* 604, 619.

commercial credits.⁸⁶ However, in terms of the nature of the obligation assumed and the type of institution likely to enter into the undertaking, it would seem that standby credits and unconditional guarantees are synonymous.⁸⁷ In other words, as long as the instruments share the same fundamental feature, they should be placed in the same category and treated in the same way.⁸⁸

The UN Convention on Independent Guarantees and Stand-by Credit takes this view. The explanatory note from the UNCITRAL secretariat stated:

The scope of the Convention is confined to instruments of the type understood in practice as independent guarantees (referred to as e.g. “demand”, “first demand”, “simple demand” or “bank” guarantees) or stand-by letters of credit. Those instruments can be covered by the umbrella of the Convention because they share a wide area of common use. Both types of instruments, which are payable upon presentation of any stipulated documents, are used to secure against the possibility that some contingency may occur. It may be noted that another major use in particular of stand-by letters of credit is as an instrument to effectuate payment of mature indebtedness.⁸⁹

Although the Convention confines its application to instruments used in international transactions, the description of independent undertakings may provide a useful guide when considering domestic transactions as well. Article 2(1) provides that:

For the purpose of this Convention, an undertaking is an independent commitment, known in international practice as an independent guarantee or as a stand-by letter of credit, given by a bank or other institution or person (“guarantor/issuer”) to pay to the beneficiary a certain or determinable amount upon simple demand or upon demand accompanied by other documents, in conformity with the terms and any documentary conditions of the undertaking, indicating, or from which it is to be inferred, that payment is due because of a default in the performance of an obligation, or because of another contingency, or for money borrowed or advanced, or on account of any mature indebtedness undertaken by the principal/applicant or another person.

As a corollary, once the undertaking is determined to be unconditional, or independent, the rules are applied.

⁸⁶ Bertrams, above n 81, 6.

⁸⁷ Kevin Patrick McGuinness, *The Law of Guarantee* (2nd ed, 1995) 832.

⁸⁸ Dolan, above n 78, [2-11]-[2-12]; Bertrams, above n 81, 6; Boris Kozolchik, ‘Bank Guarantees and Letters of Credit: Time for a Return to the Fold’ (1989) 11 *University of Pennsylvania Journal of International Business Law* 1.

⁸⁹ A/CN.9/43 and Corr.1, ¶9.

[4] Proposed Solution

The proceeding discussion leads to two conclusions. First, the nature of an undertaking should be determined on its own terms. The denomination of an instrument should not be relied on. This is a matter of construction of the undertaking in question. The critical question is whether the issuer's payment obligation is triggered upon demand or presentation of certain documents. That is the basic premise in regard to the issuer's obligation — the terms of the underlying contract, about which the issuer is not supposed to have any knowledge, should have no effect. In this respect, Australian courts have properly assessed the nature of independent undertakings in proceedings brought against the issuer. Giles J in *BI (Australia) Pty Ltd v Cigna Insurance Australia Ltd*⁹⁰ observed:

Even in the absence of the [underlying] contract, and perforce paying regard only to the terms of the guarantee, I am satisfied that the [issuer's] undertaking was not subject to the condition for which it contended, and I am not dissuaded from that view by fear of what the [underlying] contract may contain.⁹¹

Second, the tripartite transaction — which consists of an independent undertaking transaction, an underlying contract and an application and reimbursement contract — should operate in an integral manner. In this sense, while the autonomy principle only applies to the independent undertaking transaction, the parties in the other two contracts agree, or are assumed to agree, to the consequences which follow the operation of the independent undertaking as a part of their contracts. Even where there is a provision which may seem to conflict with the nature of independent undertakings, it should be construed in accordance with their operation. This conclusion is strongly supported by standby credit cases, which have concluded that the choice of standby credits results from the commercial parties' specific intention, and such parties are assumed to have enough knowledge of their commercial practice.

In the Australian cases analysed in this chapter, the underlying contract parties intended the unconditional guarantees to be a cash replacement of security, or

⁹⁰ (1990) 11 BCL 64.

⁹¹ *Ibid.*

retention money, that is, for “moneys to which final entitlements are not yet established.”⁹² Through furnishing unconditional guarantees, parties arranged who should be out of pocket pending resolution of a dispute. Unconditional guarantees share exactly the same commercial purpose as standby credits. Thus, independent undertakings with different names, but operating according to the same principles, in order to achieve the same purpose, should be treated in the same manner.

Accordingly, the line of cases starting with *Pearson Bridge* is unsatisfactory and unconvincing. Furthermore they create serious uncertainty with respect to the integrity of the operation of unconditional guarantees and performance bonds. Staughton LJ observed in *Group Josi Re v Walbrook Insurance Co Ltd*,⁹³ that “[t]he effect on the lifeblood of commerce will be precisely the same whether the bank is restrained from paying or the beneficiary is restrained from asking for payment”.⁹⁴ It has been submitted that:

Only if satisfied by evidence that no bona fide and arguable claim or complaint of the kind envisaged by the contract exists will the Court usually be justified in overriding the contractual intention to be inferred from the unconditional description or intention of the guarantee, namely that the sum claimed under the bond is to be treated as effectively cash in hand without regard to the degree or extent of the beneficiary’s complaint, provided it is colourable and bona fide.⁹⁵

It is worth noting, however, that support for this court approach of granting injunctions has been found, which encourages the courts to restrain a demand under the independent undertaking by looking into the underlying contract.⁹⁶ The logic behind this is that the autonomy principle should not apply to the same degree in independent undertakings, such as standby credits and bank guarantees, as it does in commercial credits. It is submitted that the rigid application of the autonomy principle does not treat the matter of “unfair demands” well. If this tendency of the courts,

⁹² *Washington Constructions Co Pty Ltd Westpac Banking Corp* [1983] 1 Qd R 179, 182.

⁹³ *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd and others; Group Josi Re (formerly known as Group Josi Reinsurance SA) v Walbrook Insurance Co Ltd and others* [1996] 1 All ER 791.

⁹⁴ *Ibid* 801.

⁹⁵ Wallace, above n 60, [17-075].

⁹⁶ Ross P Buckley, ‘Potential Pitfalls with Letters of Credit’ (1996) 70 *Australian Law Journal* 217, 230-232.

starting with *Pearson Bridge*, results in a counter reaction against unfair demands on independent undertakings, then the exception to the autonomy principle should be reconsidered within the whole framework of independent undertaking law. Given this consideration, the next chapter will re-examine the fraud exception established in common law jurisdictions — the sole ground for ceasing the operation of the autonomy principle within the framework of independent undertaking transactions.

Application to Cease the Operation of Fraud Exception in Underlying Contract

In *Levy* and other commercial agreements were at the present, the courts have adopted a more "hands off" approach, and it does not appear to me that anything has changed. Thus, I would favour the Court in referring, though it can be said to be a case that is not directly on point, to the principle of *Levy* as a guide to the application of the fraud exception.¹

In the recent Australian case of *Olex Energy Pty Ltd v Skovgaard Co Ltd*,² Baff J described the fraud exception as follows:

If a principle is clearly established in the previous case, it is not a ground for departing from it unless there are exceptional circumstances. In such a case, or under a statutory provable power of appeal, will be the proper course in a case of fraud, of which the law is clearly stated in the law of public international law, with the case of *Levy* of course.³

The exception to the autonomy principle in independent undertakings has been adopted from that developed in common law jurisdictions. When a conflict, with respect to the autonomy principle and the exception, the courts have adopted independent undertakings with contractual credit.⁴ In the long history of commercial credit transactions, the exception to the autonomy principle has been extended in an extremely limited application in order to protect the transaction of "the thinking" of international commerce.⁵ Given the commercial necessity and actual operation with contractual credit, the courts have been quite reluctant to restrict the *Levy* test.

[1982] 1 Lloyd's Rep 343.

² 124 F.T.R. 244.

³ 124 F.T.R. 244, 261.

⁴ 124 F.T.R. 244.

⁵ See *Whitcomb v McGregor & Co Ltd* (1962) 115 S.R. 211.

⁶ See *Levy* (1978) 124 F.T.R. 244, 261; *Levy* (1978) 124 F.T.R. 244, 261.

Chapter 4 The Exception to the Autonomy Principle and Injunction

The exception to the autonomy principle that has been well recognised in common law jurisdictions is the fraud exception. In Australia, this principle was first acknowledged, in the context of a bank guarantee, in *Hortico (Aust) Pty Ltd v Energy Equipment Co (Aust) Pty Ltd*.¹ When the applicant instituted an action for an injunction to restrain the beneficiary from demanding, Young J remarked:

As I have said, with commercial transactions such as the present, the courts have consistently taken a “hands off” approach, and it does not seem to me that anything short of actual fraud would warrant this Court in intervening, though it may be that in some cases (not this one), the unconscionable conduct may be so gross as to lead to exercise of the discretionary power.²

In the recent Australian case of *Olex Focas Pty Ltd v Skodaexport Co Ltd*,³ Batt J described the fraud exception as follows:

[T]he principle is clearly established that payment by a bank and a demand therefore by a beneficiary under an unconditional performance bond or guarantee, as under a confirmed irrevocable letter of credit, will not be restrained except in a clear case of fraud, of which the bank is clearly aware at the time of, probably, the proposed payment, or in the case of forgery of documents⁴

The exception to the autonomy principle in independent undertakings has been adopted from that developed in commercial credit transactions. More accurately, with respect to the autonomy principle and its exception, the courts have equated independent undertakings with commercial credits.⁵ In the long history of commercial credit transactions, the exception to the autonomy principle has been established in an extremely limited application in order to protect the mechanism of “the lifeblood of international commerce”.⁶ Given the perceived similarity, and indeed equation with commercial credits, the courts have been quite reluctant to restrain the issuer from

¹ [1985] 1 NSWLR 545.

² *Ibid* 554.

³ [1996] 134 FLR 331.

⁴ *Ibid* 348.

⁵ W S Weerasooria, *Bank Lending and Securities in Australia* (1998) [11.31].

⁶ *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146, 155 (Kerr J).

making payment, or the beneficiary from demanding, under independent undertakings.

However, commercial credits and independent undertakings are utilised in entirely different commercial settings. Even though the same autonomy principle applies to these instruments, the commercial purposes intended to be achieved by the parties are different. Naturally, the repetitive rhetoric that has attempted to define the fraud exception in the commercial credit context cannot appropriately embody the principle in the independent undertaking context.

Furthermore, in the *Olex Focas* case, though Batt J found no clear fraud, he granted an injunction restraining the beneficiary from making a demand on the different ground of unconscionable conduct, provided in s. 51AA of the *Trade Practices Act*. The outcome of the case has been largely considered laudable, however the extension of the exception principle to embrace statutory unconscionability has been severely criticised.⁷ There exists anxiety with respect to the introduction of the equitable notion of unconscionability into the typical commercial relationship of independent undertaking, something which may bring great uncertainty into transactions.

This also gives rise to argument of whether the fraud exception is actually exploitable when it is necessary. In other words, the question is whether this issue has been explored enough cogently to deny the injunction in the *Olex Focas* case, which eventually required another ground for granting the injunction, for the sake of justice. In the instant case, Batt J made extensive reference to the English authorities on the fraud exception. It is submitted, however, that the English courts have long held that the only fraud sufficient to warrant interfering with the autonomy principle of a letter of credit is common law fraud known to the seller and the bank, and this no longer provides the most clearly or cogently reasoned jurisprudence in this field.⁸ English

⁷ See generally, Ross P Buckley, 'Unconscionability Amok, or Two Readily Distinguishable Cases?' (1998) 26 *Australian Business Law Review* 323; Jefferey J Browne, 'The Fraud Exception to Standby Letters of Credit in Australia: Does It Embrace Statutory Unconscionability?' (1999) 11(1) *Bond Law Review* 98.

⁸ Buckley, above n 7, 328.

courts have been so reluctant to interfere with the issuer's absolute and unconditional undertaking that they have denied the injunction by simply stating that clear fraud has not been established. In this regard, the concept of the fraud exception seems to remain overlapped with common law fraud in general. It is pointed out that the term "fraud" itself is inherently vague, and more importantly its concept has been generally applied and developed in contexts which are quite different from independent undertakings.⁹

In this chapter, the fraud exception will be re-examined in isolation from the common law fraud concept. However the autonomy principle is defined, it is basically a creature of the underlying contract relationship. The parties enter into independent undertakings to achieve their commercial purpose. In this regard, the exception to the autonomy principle cannot be properly defined without recognising the interdependent aspect of independent undertakings. The exception principle should be formulated from the perspective of commercial purpose, as being that the autonomy principle no longer legitimately facilitates the parties' commercial purpose.

1 Symmetry and Asymmetry with Commercial Credit

[1] Question about Perceived View of Symmetry

The nature of independent undertakings has been often explained by analogy with commercial credits. In *Edward Owen Engineering Ltd v Barclays Bank International Ltd*,¹⁰ Lord Denning MR remarked that "the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour according to its terms."¹¹ The common feature of these instruments is that an

⁹ "Abuse", "bad faith", and "arbitrariness" are also vague and general. See Reoland Bertrams, *Bank Guarantees in International Trade* (2nd ed, 1996) 276.

¹⁰ [1977] 1QB 159.

¹¹ *Ibid* 171. As to other examples: "The bank, in principle, is in a position not identical with but very similar to the position of a bank which has opened a confirmed irrevocable letter of credit." *Howe Richardson Scale Co Ltd v Polimex-Cekop* [1978] 1 Lloyd's Rep 161, 165 (Roskill LJ); "Irrevocable

issuer is obliged to pay a beneficiary upon demand in compliance with the conditions stipulated in the operative undertaking. This analogy with commercial credits is a useful method to confirm the nature of independent undertakings, especially when the courts are faced with solving problems by distinguishing them from other commercial devices such as traditional guarantees. As far as the autonomy principle and its exception are concerned, the courts have cited cases of commercial credits and independent undertakings indiscriminately.

The fraud exception in commercial credits, however, has developed in its specific context. Historically the focus of the fraud exception was recognised as being forged documents or misdescription in documents.¹² This is based on the notion that in commercial credit transactions the parties are dealing with the document, which represent a certain value, not the goods of the underlying contract.¹³ The term “fraud” in the common law was applied to express the exceptional situations where the autonomy principle ceased to operate despite the fulfilment of documentary conditions supposedly triggering the issuer’s obligation.

In commercial reality, however, though the distinction between misdescription in documents and defects in goods is specious, they are inextricably intertwined.¹⁴ In the United States, once the underlying contract disputes were taken into account with respect to the fraud exception, greater focus was placed on the degree of fraud involved. The arguments were based on the notion of common law fraud, and attempted to distinguish between the fraud in the commercial credit transaction and fraud in the underlying contract. The standard descriptions for the fraud exception,

letters of credit and bank guarantees given in circumstances such that they are the equivalent of an irrevocable letter of credit have been said to be the life blood of commerce.” *Intraco Ltd v Notis Shipping Corporation* [1981] 2 Lloyd’s 256, 257 (Donaldson LJ).

¹² *Société Métallurgique d’Aubrives & Villerupt v British Bank for Foreign Trade*, (1922) 11 LI L Rep 168; *Old Colony Trust Co v Lawyer’s Title & Trust Co*, 297 F 152 (1924); *Maurice O’meara Co v National Park Bank of New York*, 146 NE 636 (1925).

¹³ The UCP Article 4 provides: In Credit operations all parties concerned deal with documents, and not with goods, service and/or other performance to which the documents may relate.

¹⁴ Edward L Symons Jr, ‘Letters of Credit: Fraud, Good faith and the Basis for Injunction Relief’ (1980) 54 *Tulane Law Review* 338, 361.

including “egregious fraud”,¹⁵ “intentional fraud”, “active fraud”, and “constructive fraud”, were espoused by courts and commentators.¹⁶ These terms were far from precise, though they attempted to embody certain concepts within the fraud exception, for example where no goods had been shipped, or where documents were forged. At least attention was paid to certain factual situations in order to clarify the concept of the fraud exception.¹⁷

On the other hand, though the earlier English authorities on commercial credits recognised the exception to the autonomy principle, they did not substantially attempt to explore the concept of fraud. They placed great emphasis upon the issuer’s absolute obligation for payment, to protect the mechanism of commercial credits. Jenkins LJ remarked in *Hamzeh Malas & Sons v British Imex Industries Ltd*,¹⁸

We have been referred to a number of authorities, and it seems to be plain enough that the opening of a confirmed letter of credit constitutes a bargain between the banker and the vendor of the goods, which imposes upon the banker an absolute obligation to pay irrespective of any dispute there may be between the parties as to whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that bankers’ confirmed credits are of that character, and, in my judgement, it would be wrong for this court in the present case to interfere with that established practice.¹⁹

Megarry J in *Discount Records Ltd v Barclays Bank International Ltd*,²⁰ made this point in a similar tenor:

¹⁵ Henry Harfield, ‘Enjoining Letter of Credit Transaction’ (1978) 95 *Banking Law Journal* 596, 603.

¹⁶ For the detailed analysis of this argument, see, Symons, above n 14; Greg A Fellingner, ‘Letters of Credit: The Autonomy Principle and the Fraud Exception’ [1990] *Journal of Banking and Finance Law and Practice* 4, Ho Peng Kee, ‘The Fraud Rule in Letters of Credit Transactions’ in C M Chinkin *et al* (eds), *Current Problems of International Trade Financing* (1983) 235.

¹⁷ As an example, Shientag J in *Asbury Park & Ocean Grove Bank v National City Bank* (35 NYS2d 985, 988-989) remarked:

The authorities also agree that the letters of credit are contracts which are independent of the contract of purchase between the seller and the purchaser unless there was such a fraud on the part of the seller that there were no goods shipped even though shipping tickets were presented.

¹⁸ [1958] 2 QB 127.

¹⁹ *Ibid* 129. Sellers LJ agreed, but stated that “[t]here may well be cases where the court would exercise jurisdiction as in a case where there is a fraudulent transaction”.

²⁰ [1975] Lloyd’s Rep 444.

I would be slow to interfere with banker's irrevocable credits, and not least in the sphere of international banking unless a sufficiently grave cause is shown; for interventions by the Court that are too ready or too frequent might gravely impair the reliance which, quite properly, is placed on such credits.²¹

The English courts, in performance bond cases, have followed the same approach towards the allegation of fraud. The cases of *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd*²² and *Edward Owen*²³ sufficiently represent this attitude. In both cases, the courts acknowledged that the beneficiary of a performance bond breached the underlying contract obligation to open the proper commercial credit, yet injunctions to restrain the issuer from paying to them were denied. Kerr J in the *Harbottle* case remarked that “[the commitments of banks] must be allowed to be honoured, free from interference by the courts. Otherwise, trust in international commerce could be irreparably damaged”.²⁴ In so doing, the courts have established the formula for the exception to the autonomy principle — “the case of what is called established or obvious fraud to the knowledge of the bank”.²⁵ With this narrowly construed notion of “established” fraud, and the requirement of the bank’s knowledge, the question as to what kind of fact situations, if proven, amount to fraud has largely remained unexplored.²⁶

This court attitude is criticised as being unduly rigorous in refusing to draw inferences of fraud, “[b]earing in mind that the performance bond is frequently not part of a transaction balanced by countervailing commercial credit for payment by the purchaser, as in many international sales contracts, and also the fact involved, unlike

²¹ *Ibid* 448.

²² [1978] 1 QB 146.

²³ *Edward Owen Engineering Ltd v Barclays Bank* [1978] 1 QB 159.

²⁴ *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146, 156.

²⁵ *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1977] 1QB 159, 169. “Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to the or stipulated in the contracts,” *R D Harbottle (Mercantile) Ltd v National Westminster Bank Ltd* [1978] 1 QB 146, 155-156.

²⁶ See Bertrams, above n 9, 266.

the case of commercial credits covering payment obligations”.²⁷ Moreover, while the English cases contain many judicial references to the importance of safeguarding the status of commercial credits, it is difficult to see any real analogy between commercial credits and unconditional performance bonds.²⁸ This analogy has been directly questioned when an unfair or abusive demand has resulted in serious injustice in performance bond cases. Eveleigh LJ in *Potton Homes Ltd v Coleman Contractors Ltd*²⁹ expressed reservations over the extent to which parallels could be drawn between commercial credits and performance bonds:³⁰

Unlike the letter of credit, the bond is in its infancy, although it is developing rapidly. There are several features of the bond which have not yet been universally established. One is the extent to which it is to be regarded as independent of the underlying contract.³¹

The disagreement over equal treatment between independent undertakings and commercial credits has culminated around the availability of the exception to the autonomy principle,³² especially in situations where an independent undertaking is payable upon the applicant’s default. It is suggested that independent undertakings should be judicially disentangled from commercial credits and repatriated to their natural habitat — the underlying contract, and a greater readiness to grant injunctive relief, based on a fair and practical allocation of the burden of the proof, is welcomed.³³ In light of the greater potential for abuse in independent undertakings, the degree of autonomy need not be the same in each case.³⁴ Eventually, the courts should be encouraged, where necessary, to be more willing to look behind

²⁷ I N Duncan Wallace QC, *Hudson’s Building and Engineering Contracts* (11th ed, 1995) [17-070].

²⁸ *Ibid* [17-071].

²⁹ [1984] 28 BLR 19.

³⁰ See Howard N Bennett, ‘Performance Bonds and the Principle of Autonomy’ (1994) *Journal of Business Law* 574, 580.

³¹ *Potton Homes Ltd v Coleman Contractors Ltd* [1984] 28 BLR 19, 26.

³² See Kurkela, above n 40, 202.

³³ Charles Debattista, ‘Performance Bonds and Letters of Credit: a Cracked Mirror Image’ [1997] *Journal of Business Law*, 289, 304.

³⁴ Ross P Buckley, ‘Potential Pitfalls with Letters of Credit’ (1996) 70 *Australian Law Journal* 217, 232.

independent undertakings to do justice, and not be constrained by the impact of their judgements upon the doctrine of autonomy for commercial credits.³⁵

If the tenor of the arguments is that the state of the underlying contract should be closely examined and considered to determine whether the demand under the independent undertaking is justified, and that the actual payment should correlate with it, it would be a substantial inroad into the integral operation of the independent undertaking. It would blur the distinction between independent undertaking and other commercial devices such as the surety and traditional guarantee, under which payment is made after the rights and obligations between the parties are finalised. Clearly, independent undertakings do not operate in this way.

On the other hand, standby credits, as siblings of commercial credit, have generally adopted the fraud exception to the extent of the commercial credit concept. More importantly, in the United States the autonomy principle has a validating role in standby credits,³⁶ distinguishing them from traditional secondary guarantees or surety that banks are prohibited from issuing. Accordingly, arguments directly concerned with the extent, or degree, of autonomy should not be considered. Nonetheless, in the early standby credit case of *Dynamic Corporation of America v The Citizens and Southern National Bank*,³⁷ the court recognised the substantial difference in the application of the fraud exception between commercial credits and standby credits:

[T]he court is not faced with the relatively simple problem of determining whether a seller who has certified in accordance with the terms of a letter of credit that he shipped goods to his buyer who, in fact, shipped garbage has committed fraud so as to forfeit the rights that normally accrue to the beneficiary of a letter of credit. Instead, the court is faced with a certification of unspecified breach of contract and fact and whose ultimate truth or falsity, ... may not be readily determined and is not the concern of the court.³⁸

Further, the court demonstrated its approach towards the matter of the fraud exception in the standby credit context:

³⁵ *Ibid* 231.

³⁶ Agasha Mugasha, 'Non-Documentary Conditions in Letters of Credit and Bank Guarantees' (1990) 5 *Banking & Finance Law Review* 284, 312.

³⁷ 356 F Supp 991.

³⁸ *Ibid* 999.

[T]he court views its task in this case as merely guaranteeing that [the beneficiary] not be allowed to take unconscientious advantage of the situation and run off with [the applicant's] money on a *pro forma* declaration which has absolutely no basis in fact.³⁹

It is submitted that the different factual setting of the standby credit context gives rise to a potentially differing application of the governing principles.⁴⁰ Where the commercial purposes of standby credits are different from these of commercial credits in terms of the application of the autonomy principle, its exception should be based on different grounds.

[2] The Autonomy Principle in Commercial Credit

Commercial credits, a kind of letter of credit, are used as a payment mechanism in the international sale of goods. In the normal course of a transaction, all parties anticipate that payment will be made when the documents are presented. That is, where: (a) the demand for payment thereunder by the beneficiary is *prima facie* justified; and (b) the payment means carrying out a major contractual obligation for and on behalf of the applicant (the buyer) which he was obligated to do.⁴¹ Payment is consistent with normal performance of the underlying sales agreement in a commercial credit context.⁴²

Furthermore, due to the essential feature of the autonomy principle, the payment under commercial credits is a direct promise by the issuer to the beneficiary (the seller), payable upon the presentation of documents, not the state of the underlying contract. In other words, the demand is literally justified without any evaluation or investigation of the factual state of the underlying contract, but merely by compliance with the documentary conditions. The justification of the demand for payment is

³⁹ *Ibid.*

⁴⁰ Gordon B Graham and Benjamin Geva, 'Standby Credit in Canada' (1984) 9 *Canadian Business Law Journal* 180, 212. See also Matti Kurkela, *Letters of Credit under International Trade Law: UCC, UCP and Law Merchant* (1984) 191-193.

⁴¹ Kurkela, above n 40, 190.

⁴² John F Dolan, *The Law of Letters of Credit* (rev ed, 1996) [1-17].

independent of the underlying contract and payment thereunder cannot be enjoined or refused for any reasons based on an evaluation of the underlying contract.⁴³ This practice is to a large extent factually justified as well in a sale of goods transaction because of the nature of the presented documents. They are mainly shipping documents produced from a third party in the course of the beneficiary's performance. Therefore, the parties duly conceive that the documents demonstrate that the beneficiary (the seller) has taken affirmative step to comply with his obligation.⁴⁴

Accordingly, the mechanism of commercial credits propels payment. The whole rationale of the commercial credit in international transactions is to provide the beneficiary with a secure and swiftly-operating instrument to obtain payment, to the exclusion of any disputes that may arise with respect to the underlying contract of sale.⁴⁵ With this security, the seller is willing to release the control of goods, which enables parties unknown to each other, typically in an international setting, to initiate a transaction.

Furthermore, the transactional pattern of the underlying contract is well anticipated in the commercial credit context. Once a commercial credit is issued, the beneficiary is rarely burdened with any specific obligation in the underlying contract relationship besides shipping the goods in accordance with the agreed conditions. In this respect, contractual disputes, namely the beneficiary's (the seller's) non-performance or defective performance can result from two categories — those factors within his control and those beyond his control.

The first category is mainly concerned with disputes as to defects of goods in the underlying contract. From the early cases, the courts have recognised that this kind of dispute should not affect a commercial credit operation and that payment should be made "irrespective any dispute there may be between the parties as to whether the goods are up to contract or not".⁴⁶ The fraud exception originally developed facing

⁴³ Kurkela, above n 40, 191.

⁴⁴ Dolan, above n 42, [1-16].

⁴⁵ AN Oleofse, *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) 376.

⁴⁶ *Hamzeh Malas & Sons v British Imex Industries Ltd* [1958] 2 QB 127, 129 (CA).

this kind of dispute.⁴⁷ The court took pains to distinguish fraud in commercial credits from contractual claims concerning goods delivered. The fraud exception should not refer simply to “a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise”.⁴⁸

As to the second category, examples include: political crisis, governmental interference, natural disaster, currency fluctuation, and market fluctuation. The underlying contract may or may not provide a resolution for these matters. Unless it is clearly established at the time of presentation of documents that the applicant is not responsible for payment in these situations according to the underlying contract provisions, these risks are imposed on the applicant. The logic is that the applicant will eventually be able to recover the money paid, which belongs to him, in litigation based on the underlying relationship. It may not be practical, for example, if a politically tense relationship exists between the countries. Nonetheless, it is justified on the basis that the parties agree, or are assumed to agree, that any kind of burden concerning litigation, including financial difficulties, an unknown forum and unfamiliar law, is imposed upon the applicant (the buyer) by furnishing a commercial credit as a payment method.

Eventually, at the time of the presentation of documents, it is assumed that the beneficiary has completed his obligation and is entitled to payment. Thus, the situations where the autonomy principle frustrates the original expectation of the parties are extremely limited.

Additionally, a series of financial transactions and credit facilities often depends on the normal execution of commercial credit.⁴⁹ In some arrangements, including transferable credits and back-to-back credits, as well as the procedure for the assignment of the proceeds of the credit, there are other persons in addition to the

⁴⁷ See *Société Metallurgique d'Aubrives & Villerupt v British Bank of Foreign Trade* [1922] 11 LI L Rep 168; *Hamzeh Malas & Sons v British Imex Industries Ltd* [1958] 2 QB 127 (CA); *Maurice O'meara Co v National Park Bank of New York*, 146 NE 636 (1925).

⁴⁸ *Sztejn v J Henry Schroder Banking Co*, 31 NYS 2d 631, 634 (1941).

⁴⁹ Bertrams, above n 9, 303.

beneficiary who may rely on the bank's undertaking. These transactions are only useful on the footing that commercial credits are fully paid according to their tenor.⁵⁰ If the courts were more in favour of the defence of fraud, and if they were more readily inclined to intervene than they are at present, it would have a considerably unsettling effect on the viability of commercial credits.⁵¹

[3] The Autonomy Principle in Independent Undertaking

There are two significant differences between commercial credits and independent undertakings. First, while payment under commercial credits is anticipated as a part of fulfilling the contractual obligation, payment under independent undertakings is not necessarily anticipated. Rather, in the majority of cases it is anticipated that independent undertakings will not be resorted to in the ordinary course of the transaction. This is the case where the parties arrange independent undertakings as security and not part of fulfilling the contractual obligation in the underlying contract. In such a case payment will be made only if the applicant fails to render payment or performance to the beneficiary in the underlying contract.⁵²

Second, unlike commercial credits, in independent undertaking transactions the demand, or the documents presented for payment, are exclusively under the beneficiary's control. In themselves, documents in independent undertakings have no significance, whereas in commercial credits they are generally produced by a third party showing the justification for payment. Independent undertakings are payable upon demand, or by presentation of documents, which are usually simple statements by the beneficiary that a certain event has occurred, or that the applicant has failed to perform.

⁵⁰ Agasha Mugasha, 'Set-Off and Letters of Credit: Hong Kong and Shanghai Banking Corp v Kloeckner Co' [1992] 7 *Banking & Finance Law Review* 307, 315. The article discusses the matter in the context of a set-off claim by the issuer against the beneficiary.

⁵¹ Bertrams, above n 9, 303.

⁵² See Kurkela, above n 40, 191.

Given these different features, the mechanism of independent undertakings does not propel payment as much as the mechanism underlying commercial credits. Rather, the regime of independent undertakings lacks a mechanism to justify demand for payment without an actual evaluation of performance in the underlying contract. Independent undertakings are inherently vulnerable to abusive demands by the beneficiary, and therefore more disputes are expected in relation to demand being made for payment.

Nonetheless, the justification for the demand for payment is independent as well. In light of the nature of the demand, or documents presented — there is no practical justification of the demand for payment within the mechanism of independent undertaking transactions — the applicant is assumed to forfeit any claim against the demand and to concede to transfer the stipulated sum of money to the beneficiary at the time of demanding. As has been seen, by furnishing independent undertakings the parties agree, or are assumed to agree, that the beneficiary is the party to hold the money paid under the independent undertaking during the time-consuming, complicated litigation which will determine the final entitlement to it.⁵³

It should be noted that the transactional pattern of the underlying contracts is diverse in the independent undertaking context. Unlike in commercial credit transactions, where the underlying contract is a sale of goods, contractual disputes in independent undertakings, from which the beneficiary is immune by the application of the autonomy principle, can be varied in one case from another. Take the example of construction contracts where, as has been seen in Chapter 1, the parties may furnish several independent undertakings, payable on the default of the contractor at different stages of a project in order to limit the liability of each undertaking. Such undertakings may include tender guarantees, performance guarantees, repayment guarantees, and retention guarantees. Payment under each undertaking cannot be enjoined on the basis of an evaluation of the factual status. Still, the demand must relate to the stage of the construction contract which has been guaranteed.

The parties may arrange an independent undertaking payable upon various situations in various kinds of underlying contracts, and even payable on specific contingencies,

⁵³ Dolan, above n 42, [1-18]-[1-19].

to bring about a certain situation. It is critical to determine upon what kind of situation, and by what kind of contingency, the independent undertaking will be payable. Thus, as long as the given situation allowing the beneficiary to demand payment — the occurrence or non-occurrence of a specific contingency — cannot be entirely denied, payment should be duly made.

[4] Impact of *Edward Owen*

*Edward Owen Ltd v Barclays Bank*⁵⁴ is a landmark case which established the autonomy principle, and its exception for performance bonds, on the basis of an equation with commercial credits. More significantly, the extremely high threshold for an injunction restraining the issuer from paying was established by this case, a test which has strongly affected decisions in later cases. It would appear that the court almost excluded any possibility of an injunctive remedy in performance bond cases.

The applicant contracted to supply and install glass houses for a Libyan customer. The payment was to be made by an irrevocable confirmed letter of credit. In the meantime, to secure the applicant's performance, the Libyan local bank issued a performance guarantee that was backed by another performance guarantee issued by a bank in London. The latter performance guarantee was payable upon demand by the Libyan bank without any conditions or proof. Even though the Libyan customer did not provide the proper letter of credit according to the underlying contract, he still demanded payment under the performance guarantee. In turn, the Libyan local bank demanded indemnity under the performance guarantee issued by the bank in London. Lord Denning MR stated the general principle of performance guarantees, or performance bonds:

[A performance bond] has many similarities to a letter of credit, with which of course we are very familiar. It has been long established that when a letter of credit is issued and confirmed by a bank, the bank must pay it if the documents are in order and the terms of the credit are satisfied. Any dispute between buyer and seller must be settled between themselves.⁵⁵

⁵⁴ [1978] 1 QB 159.

⁵⁵ *Ibid* 169.

Lord Denning MR then described the exception to this general principle: “there is an exception in the case of what is called established or obvious fraud to the knowledge of the bank”.⁵⁶ This was explained further by Justice Shientag’s statement in the leading United States case of *Sztejn v J Henry Schroder Banking Co.*:⁵⁷

[O]n the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller’s fraud has been called to the bank’s attention before the drafts and documents have been presented for payment, the principle of the independence of the bank’s obligation under the letter of credit should not be extended to protect the unscrupulous seller.⁵⁸

Lord Denning MR formulated this exception as being that:

[T]he bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances when there is no right to payment.⁵⁹

As a matter of finding of fact, Lord Denning MR acknowledged the beneficiary’s breach of contract and stated that:

[The applicant] is not in default at all. He has not shipped the goods because he has not been paid. The [beneficiary] has not provided the confirmed letter of credit. It is still open to the [beneficiary] to make some allegation of default against the [applicant] — as for instance not doing the preliminary work or not being ready and willing — and on that allegation to claim payment under the performance guarantee.⁶⁰

This was a case of non-fulfilment of a condition precedent obliged by the beneficiary in the underlying contract. Lord Denning MR clearly observed that the applicant was not in default in the present case. Moreover, Browne LJ was prepared to assume that “as a result the [applicant was] entitled to treat the contract as repudiated by the [beneficiary] and to cancel it”.⁶¹ Nonetheless, the court strongly enforced the payment upon the demand in formal compliance with the payment conditions. Browne LJ

⁵⁶ *Ibid.*

⁵⁷ 31 NYS2d 631 (1941).

⁵⁸ *Ibid* 634.

⁵⁹ [1978] 1 QB 159, 169.

⁶⁰ *Ibid* 170.

⁶¹ *Ibid* 173.

stated that “even if these assumptions are right, this does not come anywhere near establishing fraud on the part of the [beneficiary] or the [Libyan local bank]”.⁶²

In the instant case, the performance bond was issued to secure performance by the applicant to supply and install the glass house. In this context, any claim against payment based on non-performance, or defective performance of this obligation, regardless of his own fault or other external factors, should be duly disregarded within the parties’ expectation, given the very fact of furnishing the performance bond. However, the applicant’s obligation will generally not be incurred until the condition precedent is fulfilled.

Certainly there are cases where the applicant will be responsible in this situation by virtue of the agreement between the parties. Lord Denning MR emphasised the ambiguous wording of the payment conditions⁶³ and the fact that the English supplier agreed to arrange for a performance bond to be given before the contract was actually signed. Considering these facts, Lord Denning MR came to the conclusion, quoted above,⁶⁴ that “[i]t [was] still open to the Libyan customer to make some allegation of default against the English supplier”.⁶⁵ However, from the general role of the performance bond in this context — guaranteeing the supplier’s performance under the underlying contract — the beneficiary’s entitlement to payment before satisfying any conditions precedent, cannot be supported.

The failure to furnish a proper commercial credit is normally considered a fundamental breach of the underlying contract, and therefore the applicant has the right to rescind it immediately. If the beneficiary’s breach of contract is such as to

⁶² *Ibid.*

⁶³ It read:

[W]e ... agree to keep you indemnified ... and ... irrevocably authorise you to make any payments and comply with any demands which maybe claimed or made under the said ... guarantee ... and agree that any payment which you shall make ... shall be binding upon ... us and shall be accepted by ... us conclusive evidence that you were liable to make such payment or comply with such demand. *Ibid.* 167.

⁶⁴ Quot at page 105, cited at footnote 60.

⁶⁵ *Ibid.* 170.

entitle the applicant to rescind the contract without incurring any liability, the beneficiary's demand for payment frustrates the parties' original expectation and should be considered fraudulent.⁶⁶ In this circumstance, the legal consequence is clear — the entitlement to the money in question is readily determined as not belonging to the beneficiary without the need for further investigation. In contrast, if complex issues were disputed and further examination was required concerning entitlement to the money, then payment should be duly made. In any event, the denial of injunctive relief under this factual circumstance in the instant case has established a formidable hurdle to the granting of an injunction in later cases.

2 Notion of the Exception to the Autonomy Principle

[1] Development of Recent Independent Undertaking Law

In last five years or so, the drafting of rules for independent undertaking has been described as “something of a cottage industry”.⁶⁷ As has been seen previously, there are three regimes of private rules available for commercial parties and banks in independent undertaking transactions: the Uniform Customs and Practice for Documentary Credits, the Uniform Rules for Demand Guarantees, and the International Standby Practice (ISP 98). As to statutory regulations, in the United States the Uniform Commercial Code, Article 5, promulgates comprehensive provisions for letters of credit. And at the international level, the UN Convention on Independent Guarantees and Stand-by Letters of Credit is available for ratifying countries.

While the private rules, the UCP, the URDG,⁶⁸ and the ISP 98 leave the matter of the exception principle, or the fraud exception, to national law, the Uniform Commercial

⁶⁶ Bertrams, above n 9, 288.

⁶⁷ John F Dolan, ‘The UN Convention on International Independent Undertakings: Do States with Mature Letter-of Credit Regimes Need It?’ (1998) 13 *Banking & Finance Law Review*, 1,2.

⁶⁸ The URDG attempts to prevent fraud passively by requiring the beneficiary to submit the written statement of reasons for calling on the guarantee (Article 20).

Code in the United States and the UN Convention on Independent Guarantees and Stand-by Letters of Credit stipulate particular provisions. The UCC is a national law in the United States, but does not have any force beyond the territorial limits of the state which enacted the statute. The court cases which interpreted the statute rarely have much precedential value in jurisdictions that do not enforce the same statute,⁶⁹ though a definite influence can be observed in Australia. In the commercial credit case of *Inflatable Toy Pty Ltd v Bank of New South Wales*,⁷⁰ the court attempted to clarify the concept of fraud by referring to section 5-114 of the old UCC, and by making reference to cases in the United States:

The fraud which must be involved is a wrongdoing of the beneficiary that has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer's obligation would no longer be served.⁷¹

Article 5 of the UCC was revised in 1995. The recodification naturally reflects the case development in the last 30 years in the United States. More importantly, it provided an opportunity to specify problems with the old provisions and present factors to reconsider in order to approach the various issues of letter of credit in a better way.

The UN Convention on Independent Guarantees and Stand-by Letters of Credit, on the other hand, is an international effort designed to achieve a greater degree of certainty and uniformity in independent undertaking law. One of the main purposes of the Convention is to establish uniformity and internationality in the manner in which guarantor/issuers and courts respond to allegations of fraud or abuse in demand for payment under independent guarantees and stand-by letters of credit.⁷²

⁶⁹ Agasha Mugasha, 'The Relevance of the Uniform Commercial Code to Australian Commercial Law' in Agasha Mugasha (ed), *Perspective on Commercial Law* (1999) 29.

⁷⁰ (1994) 34 NSWLR 243.

⁷¹ *Ibid* 250. See also Mugasha, above n 69, 34.

⁷² Explanatory note by the UNCITRAL secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit. A/CN.9/431, ¶46. Before making a decision to prepare the uniform law, UNCITRAL expressed its desirability at the twenty first session as follows:

While some doubts were expressed as to the practical need and usefulness of such a uniform law, there was wide support for the view that successful work in this direction was desirable in

With relatively fewer cases concerning the exception principle or the fraud exception and the insurmountable authority of the *Edward Owen* case, the law in this area in Australia has been explored in a limited manner. The analysis of the revised UCC Article 5 and the UN Convention will contribute to a clarification of the concept of the exception principle and give inspiration for establishing a legal theory in Anglo-Australian law. Furthermore, the deliberation of UNCITRAL to codify and unify the matter of the exception principle in various legal systems, through analysing the cases and extracting principles from them, will give an insight into the legal development in Australia, from the perspective of not only the common law in other jurisdictions, but also civil law and other legal systems.

a Uniform Commercial Code

In the late 1980s, the enormous project to comprehensively study Article 5 was undertaken by the Task Force.⁷³ The Task Force Report⁷⁴ pointed out numerous problems with the 1962 version of the Code.

view of the practical problems that could only be dealt with at the statutory level. The Commission was aware of the difficulties inherent in such an effort relating to fundamental concepts of law, such as fraud or similar matters. Nevertheless, it was felt that, in view of the desirability of legal uniformity and certainty, a serious effort should be made.

Report of the United Nations Commission on International Trade Law on the work of its twenty-first session (1988), ¶24.

⁷³ The Task Force on the study of UCC Article 5 was appointed by Stanley F Farrar, then Chair of the Uniform Commercial Code Committee's Letter of Credit Subcommittee on April 12, 1986. James G Barnes and James E Byrne, 'Revision of U.C.C. Article 5' (1995) 50 *The Business Lawyer* 1449, 1450-1451. James J White, 'The Influence of International Practice on the Revision of Article 5 of the UCC' (1995-1996) 16 *Northern Journal of International Law & Business* 189, 192-193. James G Barnes, 'Internationalization of Revised UCC Article 5 (Letter of Credit)' (1995-1996) 16 *Northern Journal of International Law & Business* 215, 217-219.

⁷⁴ The Task Force on the Study of UCC Article 5 published a comprehensive report on UCC Article 5. 'An Examination of UCC Article 5 (Letters of Credit)' (1990) 45 *Business Lawyer* 1521. This report has been presented to the Letter of Credit Subcommittee of the Uniform Commercial Code Committee of the American Bar Association's Business Law Section and the US Council on International Banking, Inc.

Concerning the fraud exception, the Task Force concluded that the reported cases indicated a general agreement that the defence of fraud in a transaction must be based on serious misconduct that “has so vitiated the entire transaction that the legitimate purposes of the independence of the issuer’s obligation would no longer be served”.⁷⁵ Though the term fraud has the advantage of familiarity, it may be an ambiguous notion, depending on the context in which it is used. The Task Force regarded letter of credit fraud — that is, conduct warranting judicial interference — as not being the same as common law fraud.⁷⁶ Letter of credit fraud should be considered in light of the critical importance played by the independence of the credit transaction from the underlying transaction, and not just any fraud will suffice.⁷⁷

The revised Article 5 section 5-109, following this Task Force opinion, embraces “materiality” as a key concept to distinguish fraud, for the purposes of relief under Article 5, from common law fraud.⁷⁸ Section 5-109 provides:

- (a) If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant: ...

The Official Comment enumerated some decisions in order to clarify the circumstances in which the fraud exception is applied. It endorsed the courts’ articulation that such a relief is available where: the beneficiary has no “colorable right”⁷⁹ to demand; the beneficiary’s demand for payment has “absolutely no basis in fact”;⁸⁰ the beneficiary’s conduct has “so vitiated the entire transaction that the

⁷⁵ *Intraword Industry, Inc v Girard Trust Bank*, 336 A2d 316, 324 (1975).

⁷⁶ Cf *The Emery-Waterhouse Company v Rhode Island Hospital Trust National Bank*, 757 F2d 399 (1985).

⁷⁷ The Task Force on the Study of UCC Article 5, above n 74, 1615.

⁷⁸ Brooke Wunnicke, Diane B Wunnicke and Paul S Turner, *Standby and Commercial Letters of Credit* (2nd ed, 1996) 168.

⁷⁹ *Itek Corp v The First National Bank of Boston*, 730 F 2d 19, 24 (1984).

⁸⁰ *Dynamic Corporation of America v The Citizens and Southern National Bank*, 356 F Supp 991, 999 (1973).

legitimate purposes of the independence of the issuer's obligation would no longer be served".⁸¹

United States courts have been developing a specific concept of fraud in the letters of credit context, though in quite general language, by determining the severity or vitiation of the demand with reference to the underlying relationship. This is an effective and practical approach to clarifying letter of credit fraud in light of its commercial role in the underlying contract. "The factual base for the demand" and "the legitimate purposes of independence" will be assessed by the commercial purpose intended by the parties in each case. The particular circumstances where the beneficiary is absolutely not entitled to payment under the letter of credit at the time of presentation of documents falls into the fraud exception. These formulae are objective tests disregarding the state of mind of the beneficiary, and therefore it is submitted that they do not necessarily exclude equitable fraud.⁸²

Furthermore, the relief for the applicant who may seek an injunction enjoining the issuer from paying, or the beneficiary from demanding, for payment, is not available unless the applicant satisfies further conditions. These conditions have been imposed by courts of equity in the past, but not all the time.⁸³ Section 5-109 narrows the scope of fraud by imposing them uniformly.⁸⁴ The provision is based on two principles: first, the protection of other concerned parties; and second, the protection of the viability of the letter of credit system.

In terms of the former consideration, Section 5-109(b)(2) provides that the court may require the applicant to post a bond or the like. The courts must find that the beneficiary, issuer or nominated person who may be adversely affected if an injunction is granted, is adequately protected. With respect to the latter consideration, Section 5-109(b)(3) requires the applicant to satisfy all the conditions which entitle him to the relief under the state law. The following have been recognised as

⁸¹ *Intraworld Industries, Inc v Girard Trust Bank*, 336 A2d 316, 324-325 (1975).

⁸² Buckley, above n 7, 328.

⁸³ Wunnicke, Wunnicke and Turner, above n 78, 174.

⁸⁴ *Ibid.*

prerequisites for the equitable remedy: (1) the plaintiff will suffer irreparable injury if the injunction is not granted; (2) such injury outweighs any harm which granting injunctive relief would inflict on the defendant; (3) the plaintiff has exhibited a likelihood of success on the merits; and (4) the public interest will not be adversely affected by the granting of the injunction.⁸⁵ Condition (3) is separately provided in Section 5-109(b)(4).⁸⁶

b UN Convention on Independent Guarantees and Stand-by Letters of Credit

Codifying the exception principle in a rule to govern both independent guarantees and standby credits was a main purpose of the UNCITRAL project. To begin with, the Working Group exchanged information on currently used concepts of “fraud” and “abuse”. The definition of fraud was stated as: causing by illegitimate means a misunderstanding on the part of another person; presenting documents that contain expressly or by implication material representation of fact that the presenter knows to be untrue; disloyal conduct with the intention to do harm or seek an illicit gain or unjust enrichment.⁸⁷ In other jurisdictions, it was stated that “fraud” meant the absence of a colourable basis for demanding, in which there was no element of intent.⁸⁸ In addition, it was pointed out that the interpretation of fraud was often influenced by criminal law notions.⁸⁹

As regards the concept of abuse, general definitions submitted as applicable included the following: exceeding the limits of the normal exercise of a right by a reasonable person; or exercising a right for a purpose other than that for which it was granted.⁹⁰ These general statements are applied in the same way as with any other right

⁸⁵ *Itek Corp v First National Bank of Boston*, 511 F Supp 1341 (1981); *Planned Parenthood League of Massachusetts v Francis X Bellotti*, 641 F 2d 1006 (1981).

⁸⁶ Section 5-109(b)(4): on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1).

⁸⁷ A/CN.9/345, ¶40.

⁸⁸ *Ibid.*

⁸⁹ *Ibid.*

⁹⁰ A/CN.9/345, ¶41.

exercised by a person. In the independent undertaking context, it is also defined as being a “demand for payment despite the obvious non occurrence of any contingency or risk covered expressly or impliedly by the purpose of the independent undertaking”.⁹¹

The Working Group noted that the concepts of fraud and abuse were not only defined in different ways but also had considerable disparity and uncertainty in their application to individual cases.⁹² At the same time, it was noted that both concepts were often used interchangeably and that no clear distinction could be drawn between them.⁹³ Accordingly, the Working Group agreed to use the general term “improper demand” as the exception to the autonomy principle,⁹⁴ avoiding the terms “fraud” or “abuse” and attempted to clarify the exception with a commonly understood description.⁹⁵ In the second draft by the Secretariat, Article 19 set out three substantive grounds for an improper demand:

- (a) [the beneficiary knows that] any document is forged;
- (b) the beneficiary knows or cannot be unaware that no payment is due [on the basis asserted in the demand and the supporting documents]; or
- (c) judging by the type and purpose of the guaranty letter, the demand has no conceivable basis.⁹⁶

With respect to the concept of improper demand, the Working Group considered whether its scope should be restricted by a subjective criterion or should be objective. It was noted that the courts of some jurisdictions have held that the issuer/guarantor is obliged to pay if the beneficiary was unaware of tampering with the documents.⁹⁷ However, since the forged character of a document should be objectively perceivable, and a determination as to whether a document presented for demand was forged could be made by the issuer/guarantor, there was no need for any assessment as to what the

⁹¹ *Ibid.*

⁹² *Ibid.* ¶42.

⁹³ *Ibid.*

⁹⁴ A/CN.9/WG.[2]/WP.73 and Add.1, Article 19. Improper demand.

⁹⁵ A/CN.9/361, ¶77.

⁹⁶ A/CN.9/WG.[2]/WP.76 and Add.1.

⁹⁷ A/CN.9/361, ¶83.

beneficiary knew, or ought to have known.⁹⁸ It was also noted that a significant factor in the cases requiring the beneficiary's involvement or awareness, absent in the types of undertakings covered by the draft Convention, was that the commercial value of the documents survived the falsification unimpaired.⁹⁹ These cases were in the commercial credit setting where documents of title were involved. The courts might put forward the beneficiary's involvement or awareness as an excuse for refusing an injunction where the documents retained their commercial value, despite falsification in them. In any event, it will not happen in the context of standby credits and bank guarantees where documents have no such significance. Eventually, the Working Group agreed that the nature of the document itself should be a determinable element.

This matter was further discussed in relation to subparagraph (b) — whether the knowledge of the beneficiary should be a precondition to the applicability of the provision. It was decided that it should not, for the same reason.¹⁰⁰ Although concern was expressed that it was necessary to protect a beneficiary acting in a good faith, the prevailing view was that, irrespective of whether the beneficiary was aware or not of the manoeuvres that resulted in a demand being made where payment was not, in fact, due, no payment should be authorised.¹⁰¹

A distinct paragraph was drafted to describe situations falling into subparagraph (c), where “the demand has no conceivable basis.”¹⁰² To be a useful guideline to

⁹⁸ A/CN.9/388, ¶17.

⁹⁹ A/CN.9/408, ¶76.

¹⁰⁰ *Ibid* ¶20.

¹⁰¹ A/CN.9/388, ¶20.

¹⁰² Variant X:

The following are types of situations in which a demand has no conceivable basis:

- (a) The contingency or risk against which the guaranty letter was designed to secure the beneficiary has undoubtedly not materialized;
- (b) The underlying obligation of the principal has been declared invalid by a court or arbitral tribunal;
- (c) The secured obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;
- (d) Fulfilment of the underlying obligation has clearly been prevented solely by wilful misconduct of the beneficiary.

Variant Y:

determine whether a demand is improper due to a lack of a conceivable basis, the Working Group refined the wording, giving a non-exhaustive list of general situations, rather than a specific list of different cases, according to the types of independent undertaking.¹⁰³

In the final modification, improper demand, or the exception to the autonomy principle, is set out in Article 19 as follows:

Article 19. Exception to payment obligation

- (1) If it is manifest and clear that:
 - (a) Any document is not genuine or has been falsified;
 - (b) No payment is due on the basis asserted in the demand and the supporting documents; or
 - (c) Judging by the type and purpose of the undertaking, the demand has no conceivable basis, the guarantor/issuer, acting good faith, has a right, as against the beneficiary, to withhold payment.
- (2) For the purpose of subparagraph (c) of paragraph (1) of this article, the following are types of situations in which a demand has no conceivable basis:
 - (a) The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized;
 - (b) The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;

Instances of a demand that has no conceivable basis include [,but are not limited to,] the following, unless otherwise indicated in the guaranty letter:

- (a) In the case of a guaranty letter that support the financial obligation of a third party, neither the principal amount nor any interest is due [and the third party has not become insolvent];
- (b) In the case of tender guaranty letter, the contract has not been awarded to the principal or, if so awarded, the principal has signed the contract and procured any required performance guaranty letter;
- (c) In the case of a repayment guaranty letter, no advance payment has been made or it has been repaid in full;
- (d) In the case of a performance guaranty letter, the underlying obligation of the principal has been declared invalid in a final decision of a competent court or arbitral tribunal, or it has been completely fulfilled [to the satisfaction of the beneficiary], or its fulfilment has been prevented exclusively by wilful misconduct of the beneficiary;
- (e) In the case of a counter-guaranty letter, the beneficiary has not received a demand for payment under the guaranty letter issued by it, of the beneficiary has paid upon such a demand although it was obliged [under the law applicable to its guaranty letter] to reject the demand [as lacking conformity or as being improper].

(A/CN.9/WG.II/WP.76)

¹⁰³ A/CN.9/388, ¶26.

- (c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;
- (d) Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary ...

It is submitted that the disadvantage of this open formulation is that judges from various contracting states could interpret this provision in different ways.¹⁰⁴ Furthermore, due to the policy of promoting “uniformity in its application and the observance of good faith in the international practice of independent guarantees and stand-by letters of credit”, there is a concern that courts in countries with less developed law may broaden the grounds for stopping payment on the basis of mischievous interpretation of the issuer’s “good faith” in the context of independent undertakings.¹⁰⁵ However, the description of the exception remains extremely limited. This is based on the case law in various countries, especially those where independent undertaking law is well developed.¹⁰⁶ The case law in these countries is freely accessible. Thus, the risk of the text being interpreted in different directions may be controlled by sufficient information being available in other countries.¹⁰⁷

The Working Group also discussed the applicability and desirability of incorporating procedural law matters. Often the principal/applicant may seek injunctive relief in the case of fraud. While injunctions are generally known, and based on similar requirements in the various jurisdictions, the judicial attitude towards ordering an injunction in favour of applicants is far from uniform.¹⁰⁸ The Working Papers

¹⁰⁴ Filip De Ly, ‘The UN Convention on Independent Guarantees and Stand-by Credit’ (1999) 33(3) *The International Lawyer* 831, 842.

¹⁰⁵ Dolan, above n 67, 20. Article 14 (Standard of conduct and liability of guarantor/issuer) is criticised that “the good-faith obligation introduces undesirably vague standards for measuring the guarantor/issuer’s duty against the firmer standard of determining that the documents comply with the terms and conditions of the credit” (Ibid 15). Article 14 provides:

- (1) In discharging its obligations under the undertaking and this Convention, the guarantor/issuer shall act in good faith and exercise reasonable care having due regard to generally accepted standards of international practice of independent guarantees or stand-by letters of credit.
- (2) A guarantor/issuer may not be exempted from liability for its failure to act in good faith or for any grossly negligent conduct.

¹⁰⁶ A/CN.9/WG.II/WP.70, ¶10-¶114.

¹⁰⁷ De Ly, above n 104, 843.

¹⁰⁸ A/CN.9/WG.II/WP.70, ¶94.

demonstrated disparities in various jurisdictions concerning the types of injunction and the requirements for granting it, including: a cause of action, irreparable harm, and balance of convenience.¹⁰⁹ Further, in some jurisdictions injunction procedures do not exist. Since procedures differed from state to state, there was a degree of hesitation in incorporating provisions providing procedural matter, something which might be better left to local law.¹¹⁰ It was also suggested that the acceptability of the uniform law would be adversely affected if it presented legislatures with the prospect of having to revamp established rules governing injunctions for one particular area of law.¹¹¹

In favour of retaining a provision on injunctions, on the other hand, it was stated that such a provision was an integral element of the provisions dealing with fraud and abuse.¹¹² Both with respect to such states where injunction procedures did not exist, as well as to the problem of diversity of national approaches, it was submitted that the inclusion of provisions was beneficial for international uniformity and for the protection of the integrity of independent undertakings.¹¹³ This matter was ultimately decided by UNCITRAL at its twenty-eighth session for the consideration of the draft article completed and presented by the Working Group. The Commission decided to retain the provision since it was considered important to establish the right of access to the court by the principal/applicant when that was necessary to prevent the beneficiary from receiving payment in the cases specified in draft article 19. Furthermore the right of court access, where variations existed in many jurisdictions, should be clearly circumscribed so as to avoid undue interference with courts in payments under independent undertakings.¹¹⁴

¹⁰⁹ Ibid ¶95-107.

¹¹⁰ A/CN.9/361, ¶102.

¹¹¹ Ibid.

¹¹² Ibid ¶103.

¹¹³ Ibid.

¹¹⁴ Report of the United Nations Commission on International Trade Law on the work of its twenty-eighth session, General Assembly Official Records • Fiftieth Session Supplement No 17 (A/50/17), ¶144. It further states that “the provision did not attempt to deal in detail with procedural questions, which were left to the national law. Furthermore, as repeatedly stated during the preparatory work, one of the main purposes of the draft Convention was to harmonize the law in the area of fraud without

In terms of a standard of proof, various views were expressed. One view was that the standard should be the highest possible in order that the reliability of independent undertakings not be jeopardised. However, such a high standard of “manifestly and clearly improper” could, in many jurisdictions, result in no provisional measures being available. A determination as to the “manifestly and clearly” improper character of a demand could be made only by the court that could make the final decision on the merits of the demand.¹¹⁵ This may not be a realistic standard for a preliminary procedure.

The slightly lower standards of proof of “high probability”, or “very high likelihood” were expressed. The test of “high probability” was criticised as opening too broad an avenue for the issuance of provisional court measures. A more defined test was sought to limit interference on the basis of mere suspicion, something which would seriously compromise the independence of the undertaking.¹¹⁶ Still, in support of maintaining the test of “high probability”, it was stated that it was important to use terms that did not have a unique meaning in any particular jurisdiction or legal system, but that clearly indicated to the judge that provisional measures should not be granted lightly.¹¹⁷

In the second draft, the Secretariat prepared a provision enjoining: (1) the issuer from meeting the demand, or from debiting the account of the principal; and (2) the beneficiary from accepting payment or ordering the beneficiary to withdraw the demand. No objection was made in paragraph (1) against the provision enjoining the issuer from meeting the demand, though the restriction on “debiting the account of the principal” was deemed problematic. This is because it could leave the issuer in conflict — not debiting the account of the principal, but still obligated to pay the beneficiary. It also concerned an aspect of the principal-issuer relationship and

thereby compromising the independent nature of the undertaking; that purpose could only be achieved by addressing provisional court relief’ (Ibid).

¹¹⁵ A/CN.9/388, ¶47.

¹¹⁶ A/CN.9/405, ¶37.

¹¹⁷ Ibid ¶38.

therefore was not within the main focus of the draft Convention.¹¹⁸ Furthermore, the court measure of enjoining the beneficiary from accepting payment was unknown in many jurisdictions.¹¹⁹ Eventually, the two types were combined and replaced with the subparagraph: “a provisional order to the effect that the beneficiary shall not receive payment”.¹²⁰

Regarding the precondition of “serious harm” or “irreparable loss”, that the principal/applicant would be likely to suffer in the absence of preliminary court order, it was widely felt that the provision would have the desired effect of narrowing the availability of a preliminary injunction. The Working Group concentrated on refining the words. The word “irreparable” was criticised as being vague and potentially too high as an across-the-board standard. The prevailing view supported the words “serious harm.”¹²¹

Additionally, the Working Group accepted the provision that the court may require the applicant to furnish appropriate security before granting a provisional measure. It was observed that such a provision was fair and reflected some balance in the consideration of the interests of the applicant and the respondent.¹²² It was further noted that this might have a disciplinary effect, precluding applicants from submitting frivolous applications, and as such might have an educational value.¹²³

The provisional court measure is set out in Article 20 (Provisional court measures) as follows:

- (1) Where, on an application by the principal/applicant or the instructing party, it is shown that there is a high probability that, with regard to a demand made, or expected to be made, by the beneficiary, one of the circumstances referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19 is present, the court, on the basis of immediately available strong evidence, may:

¹¹⁸ A/CN.9/388, ¶54.

¹¹⁹ *Ibid* ¶55.

¹²⁰ *Ibid* ¶56.

¹²¹ *Ibid* ¶60.

¹²² *Ibid* ¶62.

¹²³ *Ibid*.

- (a) Issue a provisional order to the effect that the beneficiary does not receive payment, including an order that the guarantor/issuer hold the amount of the undertaking, or
- (b) Issue a provisional court order to the effect that the proceeds of the undertaking paid to the beneficiary are blocked, taking into account whether in the absence of such an order the principal/applicant would be likely to suffer serious harm.
- (2) The court, when issuing a provisional order referred to in paragraph (1) of this article, may require the person applying therefor to furnish such form of security as the court deems appropriate.
- (3) The court may not issue a provisional order of the kind referred to in paragraph (1) of this article based on any objection to payment other than those referred to in subparagraphs (a), (b) and (c) of paragraph (1) of article 19, or use of the undertaking for a criminal purpose.

The concept of fraud or abuse, which is defined as an improper demand within the general formula, is based on the theoretical development of various jurisdictions in the specific context of the independent undertaking. Specifically, “it is difficult to deny that the new definition is inspired by American case law”.¹²⁴ Furthermore, other prerequisites for granting injunctive relief, which play an important role in balancing the interests of the parties concerned, and the utility of independent undertakings in the interlocutory proceeding context, may be observed as having similar features with the provisions of the UCC in the United States.

Even in transactions governed by either the UCC or the UN Convention, it will be a difficult task to apply the provision of fraud or improper demand to concrete facts. As the UCC now clearly allows the court to look into the underlying contract, it is inevitably necessary to investigate matters outside the independent undertaking transaction in a limited manner. A finding of fraud or abuse could be derived from the whole of the circumstances on the basis of the court’s experience, common sense, mercantile usage, the smell of a case and so forth.¹²⁵ This is the very nature of the interdependent aspect of independent undertakings.

[2] The Exception to the Autonomy Principle in Specific Factual Situations

The foregoing sections have demonstrated that the matter of the exception to the autonomy principle should be approached through an understanding of the

¹²⁴ De Ly, above n 104, 842, note 34. See *Dynamic Corp v Citizens and Southern Nat’l Bank*, 356 F Supp (1973).

¹²⁵ Bertrams, above n 9, 279.

commercial purposes intended by parties, as exhibited by the furnishing of independent undertakings. The commercial purposes achieved by independent undertakings are varied across different cases, and therefore it is critical to determine in what kinds of situation, and in what contingencies in an underlying contract an independent undertaking is payable. More importantly, this study has elucidated that the mechanism of independent undertakings allows the beneficiary to receive payment in disputed situations in relation to his entitlement to money. Payment under independent undertakings does not equate to the beneficiary's ultimate entitlement to the money in the underlying contract. This should be settled in the underlying contract relationship after the payment.

Where commercial parties disagree over payment under an independent undertaking, as between them, the autonomy principle will be interpreted as a part of their agreement, or implied as a term of the underlying contract, to deal with various situations where the contract is not executed in the way they expected. Since the parties agreed that payment would be made regardless of the factual situation of the underlying contract, in the majority of these unexpected situations they agree, or are assumed to agree, that the beneficiary would hold the money until the ultimate entitlement was finalised. However, there are extraordinary situations where it is readily determinable that the money does not conclusively belong to the beneficiary at the time of demanding for payment. It is no use transferring the money to the beneficiary. Thus, the beneficiary's demand should be refused if it is clearly established that it has no conceivable basis under the underlying relationship at the time of demanding.¹²⁶

On the basis of this proposition, the exception principle may operate in the following circumstances.¹²⁷ First, it applies where the situation upon which the independent undertaking is payable does not exist. For example, where the independent undertaking is payable upon the applicant's default, but he has clearly completed his performance to the beneficiary's satisfaction. Second, even where a given situation exists, if the demand is made upon a contingency which is obviously not secured by

¹²⁶ Ibid 302.

¹²⁷ See also *ibid*.

the operative independent undertaking, this will fall into the scope of exception principle as well. Third, the beneficiary's conduct may vitiate a demand under independent undertakings. This is the case where the beneficiary's misconduct is so fundamental that the applicant is entitled to rescind the underlying contract immediately. However, as long as the beneficiary's entitlement to money is duly disputed, the exception principle will not operate.

The following section will exemplify the application of the exception principle through examining the factual situations of several selected Australian and English cases, and by analysing the courts approaches to the matter.

a Applicant Claims Obligation Completed (or That Under No Obligation)

In *Potton Homes Ltd v Coleman Contractors Ltd*,¹²⁸ the seller (the applicant) agreed to supply the buyer (the beneficiary) with prefabricated building units. The contract provided that payment would be made by instalments at various stages, and a performance bond was issued in favour of the buyer, securing the seller's due performance. Despite the fact that the buyer was in arrears in his payments, he alleged a number of defects in the building units and made a demand upon the performance bond. The seller sought an injunction restraining the buyer from demanding for payment.

As mentioned previously, Eveleigh J took a less strict view of the scope of the exception principle, especially in litigation between the underlying contract parties. However, in the present case Eveleigh J held that "it cannot be said that the [seller has] proved that there are no breaches of the original contract and that a demand would therefore be fraudulent".¹²⁹

¹²⁸ [1984] 28 BLR 19.

¹²⁹ Ibid 30.

Since the performance bond secured the seller's due performance, the seller has to prove that his performance of the underlying contract has been duly completed,¹³⁰ or at least that he was not liable for the particular defects under the underlying contract, something which was not covered by the performance bond.¹³¹ The factual situation in the present case did not clearly show that the beneficiary's claim for defects in the supplied goods was totally fanciful and without any factual base.

In *Hortico (Aust) Pty Ltd v Energy Equipment Co (Aust) Pty Ltd*¹³², the underlying contract was for the design and installation of a boiler. The applicant's payment obligation to the beneficiary, for the boiler, was secured by a bank guarantee.

The boiler was to be delivered on the 6th of May, 1985, however the applicant had cancelled the underlying contract on the 24th of January, 1985. The applicant claimed that the essential time condition — for the delivery of the boiler — could not be met and that there had been a breach of contract by the beneficiary. Therefore, the contract had been validly terminated. The beneficiary, on the other hand, denied that he was in breach of contract, and said that due to the autonomous nature of a bank guarantee his claim for damages on cancellation for the contract came within the terms of the guarantee for payment. When a demand for payment was made upon the bank, the applicant instituted an action for an injunction.

The applicant's argument was that the bank guarantee would only be called upon if the contract had been performed or performed to practical completion stage. The bank guarantee in the present case, however, simply stated that it was issued "with regard to design, supply, installation and commissioning of one fluidised finafire boiler and

¹³⁰ Bertrams, above n 9, 283. Bertrams referred to many civil law cases to illustrate the relevant factors to confirm that completion of the applicant's performance has been established. A number of certificates issued by several independent and reputable agencies can be evidence of proper performance. In another case, the beneficiary's suspicious behaviour persuaded the court to restrain the payment.

¹³¹ Bertrams, above n 9, 286. Whether the particular defects are the applicant's liability cannot be generalised.

¹³² [1985] 1 NSWLR 545.

housing to be installed at Yallah NSW".¹³³ Young J took the view that the bank guarantee did purport to secure the beneficiary's claim against the applicant in various situations where any kind of contractual dispute arises, and stated as follows:

In my view, bearing the general use of the phrase in mind, and also remembering that this is a commercial transaction that the bank is to process expeditiously and not spend considerable time in weighing various arguments put to it as to the meaning of the document, the view of [the beneficiary] is correct and that the words "with regard to design" etc connote obligations arising not only in connection with performance of the contract, but in connection with its discharge, and cover claims for damages made for repudiation.¹³⁴

If the bank guarantee in the instant case had purported to secure the applicant's payment obligation in the specific stage of the underlying contract, the question whether time is of the essence may have become a focal point. Had time been of the essence, and had the applicant been able to rescind the contract under this ground, the exception principle may have applied to deny the beneficiary's demand.

b Demand Vitiating by Beneficiary's Conduct

In *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd*,¹³⁵ the applicant alleged that he could validly rescind the underlying contract because the beneficiary failed to disclose certain information in the course of concluding the contract. The underlying contract was a reinsurance contract. The reinsurer (the applicant) procured a letter of credit in favour of the reinsured (the beneficiary), which provided for payment against a sight draft accompanied by debit notes, covering the liability of the reinsurer for outstanding loss reserves up to specified maximum amounts. When the reinsured demanded payment, the reinsurer claimed that there was a seriously arguable case in relation to the beneficiary's entitlement to payment because the reinsurance contract had been duly avoided for fraudulent misrepresentation and non-disclosure by the beneficiary.

¹³³ Ibid 548.

¹³⁴ Ibid 556.

¹³⁵ [1994] 4 All ER 181.

Phillip J stated that “the court will not grant an injunction restraining a bank from paying under a letter of credit unless the court is satisfied that there is a clear prima facie case that the beneficiary is acting fraudulently in drawing the credit”.¹³⁶ He questioned the reinsurer’s contention that the reinsured had no right to payment. This was because the non-disclosed matter had no impact on the risks being reinsured by the reinsurer. Phillip J observed that “in these circumstances the reinsures have not made out a clear case that the reinsured will be acting fraudulently if they draw on the letter of credit.”¹³⁷

As another example, there was a case where the underlying contract was induced fraudulently by the beneficiary’s misrepresentation. In *Themehelp Ltd v West*,¹³⁸ the underlying contract was for the purchase of shares in a manufacturing company. The payment was to be made in instalments and the buyer furnished a performance guarantee to secure his third instalment. After the first two instalments were paid, the buyer discovered that the seller had made a misrepresentation on a fact which was material to the buyer assuming the business future of the manufacturing company. He refused further payment and commenced a proceeding for rescission and/or damages for misrepresentation, and sought an injunction to restrain the seller from demanding under the performance guarantee.

In terms of the concept of the fraud exception, Waite LJ referred to *United City Merchants (Investments) Ltd v Royal Bank of Canada*,¹³⁹ where Lord Diplock formulated the exception principle in a commercial credit transaction:

[T]here is one established exception: that is, where the seller, for the purpose of drawing on the credit, fraudulently presents to the confirming bank documents that contain, expressly or by implication, material representations of fact that to his knowledge are untrue.¹⁴⁰

¹³⁶ *Ibid* 196.

¹³⁷ *Ibid* 200. This case went on appeal. The Court of Appeal took the view that there had been no non-disclosure or misrepresentation with respect to the underlying contract. Accordingly, it did not raise the issue whether a claim on the letter of credit could be fraudulent.

¹³⁸ [1996] QB 84.

¹³⁹ [1983] 1 AC 168.

¹⁴⁰ *Ibid* 183.

Nonetheless, there was no detailed examination of whether the present case would fall into the ambit of the formulae developed by the House of Lords. Waite LJ simply concluded that:

The judge was entitled, in my view, to take all this into account in reaching his conclusion that the buyers had satisfied the onus of showing, for the purposes of interlocutory relief, that they had an arguable case at trial that fraud was the only realistic inference.¹⁴¹

The majority opinion found that the fraudulent misrepresentation on the part of the beneficiary was material to the validity of the underlying contract. This fact made it an arguable case at trial to justify injunctive relief for the applicant under the performance guarantee.

On the other hand, Evans LJ delivered the dissenting opinion that there was no investigation in the majority judgement into whether the fraud exception formulated in *United City Merchants* would be available in the present case, if demand was made.¹⁴² Evans LJ also found that the underlying contract still remained binding on the parties even though the applicant made a formal claim for rescission because: he did not take any further steps to rescind or avoid the contract; and nor did he suggest that the purchased shares should be restored by the beneficiary. The applicant even claimed damages. Under these circumstances, the beneficiary should be entitled to claim payment since the underlying contract was affirmed, or could no longer be avoided, notwithstanding the alleged fraud in it.¹⁴³

¹⁴¹ *Themehelp Ltd v West* [1996] QB 84, 100.

¹⁴² See Oleofse, above n 45, 405. In note 182, the author states that Evans J's view is in literal accordance with the "fraud exception" formulated by the House of Lords. In terms of this established principle, the alleged fraud in *Themehelp* is analysed by Geraldine Andrew and Richard Millett, *Law of Guarantees* (2nd ed, 1995) 470:

[T]he alleged fraud was not of the usual character, ie a fraudulent misrepresentation to the bank that the beneficiary was entitled to be paid. Instead, it was an allegedly fraudulent misrepresentation which induced the innocent party to enter into the underlying contract. It was not argued that this fraudulent misrepresentation also induced the procuring of the performance guarantee, and of course that could not have affected the position as between the bank and the beneficiary. If the fraud had no effect upon the validity of the demand, the grounds well outside the established parameters.

¹⁴³ Additionally, Evans LJ found that there was no finding that the applicant (the buyer) was induced to enter the underlying contract by the alleged misrepresentation ([1996] QB 84, 104).

Underlying contracts may be invalid for various reasons. In general, the mere invalidity of the underlying contract will not automatically give rise to the exception principle in relation to independent undertaking operation with which it is related.¹⁴⁴ This is because an independent undertaking may be payable upon the beneficiary's claim under such a circumstance. If no such payment condition has been agreed to by the parties, the exception principle should apply to situations where the applicant is entitled to rescind the underlying contract due to the beneficiary's fundamental misconduct, and where it is clearly established that the beneficiary has no right to demand.¹⁴⁵

c Demand upon Contingency Not Secured by Independent Undertaking

In *United Trading Corp v Allied Arab Bank*,¹⁴⁶ the underlying contract was for the sale of substantial volume of foodstuffs. The Iraqi customer (the beneficiary) required the applicant to secure his performance by performance bonds. The applicant instructed his bank to instruct the Iraqi local bank to issue the performance bonds in favour of the beneficiary. Due to the war between Iraqi and Iran, the delivery of foodstuffs were delayed and diverted. The contract for the sale of a billion eggs became the focal point of considerable disputes since they had to be destroyed at their final destination or had deteriorated badly before being reforwarded. When the negotiation between the parties came to a deadlock, the beneficiary demanded payment under the performance bond. The applicant took the view that the performance bond upon which the demand was made did not relate to the disputed contract, and was therefore fraudulent.

Ackner J found the restrictive approach taken by previous cases unsatisfactory, and suggested the standard of proof for granting injunctive relief as follows:

¹⁴⁴ The German law took this position. See Oleofse, above n 45, 447.

¹⁴⁵ Oleofse, above n 45, 452; Bertrams, above n 9, 296.

¹⁴⁶ [1985] 2 Lloyd's Rep 554.

We would expect the Court to require strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyer. In general, for the evidence of fraud to be clear, we would also expect the buyer to have been given an opportunity to answer the allegation and to have failed to provide any, or any adequate answer in circumstances where one could properly be expected. If the Court considers that on the material before it the only realistic inference to draw is that of fraud, then the seller would have made out a sufficient case of fraud.¹⁴⁷

Between the parties, there were multiple contracts concluded and multiple performance bonds issued to secure the applicant's performance. Ackner LJ, on the basis of the material before him, rejected the applicant's argument: (1) except in regard to the billion egg contract, there had been no recent complaints or disputes; (2) there had been full compliance with each contract; (3) the beneficiary agreed that, the billion egg contract apart, he owed the applicant a very large sum of money. Under this circumstance, it could not be concluded that, as a matter of a finding of fact, that either: the beneficiary's claim for damages was brought about as a result of the billion egg contract; or the applicant's performance of the contract which related to the performance bond, under which the demand was made, was completed. If it had been established that the demand for payment was made in connection with a contract which was not covered by the independent undertaking, then the exception principle would be applied.¹⁴⁸

In sum, the above discussion has demonstrated that cases where the exception principle should be applied — where the beneficiary's demand for payment has no conceivable basis under the underlying contract — are extremely limited. The majority of cases analysed above gave rise to complex legal issues in terms of the beneficiary's entitlement, which was duly disputed at the time of demanding. Even though disputes as to a demand for payment are well anticipated, the regime of independent undertakings inevitably promotes payment that conforms with the parties' intention in choosing this specific type of undertaking.

¹⁴⁷ *Ibid* 561.

¹⁴⁸ Bertrams, above n 9, 298.

2 Unconscionability and the Exception to the Autonomy Principle

[1] Unconscionability in Independent Undertaking Cases

Young J in *Hortico (Aust) Pty Ltd v Energy Equipment Co (Aust) Pty Ltd*¹⁴⁹ stated that “actual fraud” or “gross unconscionability”¹⁵⁰ might warrant the courts intervening in transactions to provide an equitable remedy. Even a hands-off policy would better serve commercial activities, though the court of equity has always recognised that there is a time to interfere in commercial activities.¹⁵¹ Whereas Young J introduced the notion of “unconscionability” into the scope of the exception to the autonomy principle, its substance was not clarified in the instant case. It still remains to be seen whether “gross unconscionability” is a distinct ground for the application of the exception principle, and therefore, whether the scope of the exception principle in Australia is wider than in other jurisdictions.

Further, Batt J in *Olex Focas Pty Ltd v Skodaexport Co Ltd*,¹⁵² extended the scope of the exception to statutory unconscionability under s. 51AA of the *Trade Practices Act* 1974.¹⁵³ The plaintiff (the applicant) entered into a contract with the defendant (the beneficiary) to supply and install telecommunications, telesupervisory and instrumentation systems in connection with the construction of an oil pipeline in India. The beneficiary agreed to pay the applicant (the contractor) an initial mobilisation advance of 15 per cent of the contract price against the presentation of a

¹⁴⁹ [1985] 1 NSWLR 545.

¹⁵⁰ *Ibid* 554.

¹⁵¹ *Ibid* 553.

¹⁵² (1996) 134 FLR 331.

¹⁵³ See generally Robert Baxt and Joel Mahemoff, ‘Unconscionable Conduct Under the Trade Practices Act — An Unfair Response By the Government: A Preliminary View’ (1998) 26 *Australian Business Law Review*, 5; Alan tyree, ‘Performande Bonds and Section 51AA of the Trade Practices Act’ (1997) 8 *Journal of Banking Finance Law and Practice* 338; Warren Pengilley, ‘Unconscionability: Are the Litigation Floodgates Opening in Relation to Commercial Transactions?’ (1997) 13(1) *Australian & New Zealand Trade Practices Law Bulletin* 11; Robert Baxt, ‘Unconscionability Taken One Step Too Far?’ (1997) 25 *Australian Business Law Review*, 301; Buckley, above n 7.

bank guarantee. The bank guarantee in exchange for the mobilisation advance was to secure repayment of this advance in lieu of a security deposit. When various disputes arose between the parties, and the beneficiary allegedly threatened the applicant that he would demand under the bank guarantee unless the applicant agreed to accept a reduction in the amount of payment, the applicant sought an injunction against the beneficiary demanding and the issuer paying.

Batt J first analysed the exception to the autonomy principle under the general law — the fraud exception — by reference to an extensive array of English and Australian cases. He found the guiding principle to be that an injunction on the basis of the fraud exception should be granted only where “clear fraud [was] shown or shown to be known by the bank”.¹⁵⁴ Batt J confirmed that it would not constitute fraud where the payment or demand for payment was made when the beneficiary knew that the claim was disputed, or in order to apply pressure. And in the present case, since there was no detailed material as to the state of the beneficiary and the issuer’s knowledge, it could not be said to be a clear case of fraud.

Second, Batt J rejected “gross unconscionability” falling short of actual fraud, discussed in *Hortico*, as being an exception to the autonomy principle under the general law. Batt J took the view if it were a ground for an injunction it should have been mentioned in earlier cases, especially in the light of the considerable growth in importance of unconscionability in Australian jurisprudence.¹⁵⁵

Finally, Batt J considered the applicability of the *Trade Practices Act* 1974, s. 51AA, as a ground for an injunction. Section 51AA provides:

A corporation must not, in trade or commerce, engage in conduct that is unconscionable within the meaning of the unwritten law, from time to time, of the States and Territories.

The concept of unconscionability under this provision was explored by referring to the *Oxford English Dictionary*,¹⁵⁶ *The Laws of Australia* and *Annotated Trades*

¹⁵⁴ (1996) 134 FLR 331, 352.

¹⁵⁵ *Ibid* 354.

¹⁵⁶ *The Oxford English Dictionary* (2nd ed, 1989).

*Practices Act*¹⁵⁷. Additionally the following statement in *Stern v McArthur*¹⁵⁸ was cited:

The general underlying notion is that which has long been identified as underlying much of equity's traditional jurisdiction to grant relief against unconscientious conduct, namely, a person should not be permitted to use or insist upon his legal rights to take advantage of another's special vulnerability or misadventure for the unjust enrichment of himself.¹⁵⁹

From this dictum, Batt J extracted the principle that "if one is acting within one's rights one may still engage in unconscionable conduct".¹⁶⁰ It must follow that "even if one believes, wrongly, that one is acting within one's rights, one can thereby engage in unconscionable conduct".¹⁶¹

As a matter of a finding of fact in the present case, Batt J indicated: (1) the guarantee in question was in relation to the mobilisation advance, and not for any other purposes; (2) it was not really disputed, if disputed at all, that the advance had largely been re-paid. He concluded that there was a serious question to be tried. Considering these facts and against the background of the unconscionability provision analysed above, Batt J observed that:

[The beneficiary's] conduct based on its legal rights, or on its perception of its legal rights, ... according to ordinary human standards, quite against conscience. ... At the least there is a serious question, and that is all I need to find, that its conduct is shown to be unconscientious and unconscionable in demanding the full amount of guarantees securing advances, the greater part of which had been re-paid.¹⁶²

Batt J obviously interpreted unconscionability in s. 51AA in a general sense, which has developed in various contexts. And he applied it to a typical commercial context as a ground for the exception to the autonomy principle, fearing:

¹⁵⁷ RV Miller, *Annotated Trade Practices Act* (17th ed, 1996).

¹⁵⁸ (1988) 165 CLR 489.

¹⁵⁹ *Ibid* 526.

¹⁶⁰ *Olex Focas Pty Ltd v Skodaewport Co Ltd* (1996) 134 FLR 331, 357.

¹⁶¹ *Ibid* 358.

¹⁶² *Ibid*.

The effect of the statute, applying as it does to international trade and commerce, is to work a substantial inroad into the well-established common law autonomy of letters of credit and performance bonds and other bank guarantees. I must apply the Act as I understand it.¹⁶³

The above cases have brought out two points of the equitable doctrine of unconscionability in independent undertakings for close scrutiny. First, the scope of unconscionability in s. 51AA should be clarified, and especially whether it is intended that s. 51AA should be interpreted in such a general sense as in *Olex Focas*. And second, the proper application of the equitable doctrine of unconscionability, including s. 51AA, in the context of independent undertakings should be examined to see if it is consistent with the foregoing analysis of the exception principle.

[2] Unconscionability in *Trade Practices Act 1974* Section 51AA

Section 51AA of the *Trade Practices Act 1974*, introduced in 1993,¹⁶⁴ was intended to provide a remedy in cases of unconscionable conduct in commercial transactions.¹⁶⁵ The advantages of providing a statutory prohibition for conduct which is already dealt with by equity lie in: (1) the availability of remedies under the Act; (2) the potential involvement of the Commission, including the possibility of representative actions; and (3) the educative and deterrent effect of a legislative prohibition in the Act. It is pointed out that the section simply embodies “the unwritten law”.¹⁶⁶ However, described as a “pejorative adjective”¹⁶⁷ and a “universal talisman in many fields of equity”,¹⁶⁸ “unconscionable conduct” has been used extensively in various

¹⁶³ Ibid.

¹⁶⁴ Regarding the history of amendments to the provision, see Deborah Healey, ‘Unconscionable Conduct in Commercial Dealings’ (1993) 1 *Trade Practices Law Journal* 169.

¹⁶⁵ See *Russel V Miller*, *Miller’s Annotated Trade Practices Act* (20th ed, 1999) 269-272; Ray Steinwall, *Trade Practices Act 1974* (2000 ed, 2000) 175-176.

¹⁶⁶ See PD Finn, ‘The Fiduciary Principle’ in TG Youdan (ed), *Equity, Fiduciaries and Trusts* (1989) 1, 6-10; PD Finn, ‘Equity and Contract’ in PD Finn (ed), *Essays on Contract* (1987) 104, 130-134.

¹⁶⁷ Finn, above n 166, ‘Equity and Contract’ 106, 110.

¹⁶⁸ The Hon. Sir Anthony Mason, ‘Themes and Prospects’, in PD Finn (ed), *Essays in Equity* (1985) 242, 244.

situations,¹⁶⁹ and an attempt to define it in a precise sense has not succeeded. The problem is that the current limits of the unwritten law are not defined.¹⁷⁰

In this respect, according to the Explanatory Memorandum to the Trade Practices Legislation Amendment Bill 1992, s. 51AA embodies the equitable concept of unconscionable conduct as recognised by the High Court in *Blomley v Ryan*,¹⁷¹ and *Commercial Bank of Australia v Amadio*.¹⁷² The meaning of “the unwritten law” in this context suggests a limited application of unconscionability.¹⁷³ French J in *Australian Competition and Consumer Commission v C G Berbatis Holding Pty Ltd*,¹⁷⁴ described the particular category of cases as follows:

Australian case law has been concerned about unconscionable conduct within the framework of specific doctrines identifying particular classes of conduct albeit their boundaries tend to be blurred by the generality of the notion of unconscionability in equitable doctrine. One such class of conduct is the unconscientious exploitation by one person of the serious disadvantage of another to secure the disposition of property or the assumption of contractual or other obligations by the weaker party.¹⁷⁵

In the *Amadio* case, Mason J embraced the specific concept of “special disability” to categorise these cases:

[R]elief on the ground of “unconscionable conduct” is usually taken to refer to the class of case in which a party makes unconscientious use of his superior position or bargaining power to the detriment of a party who suffers from some special disability or is placed in some special situation of disadvantage¹⁷⁶

¹⁶⁹ The broad usage of “unconscionable conduct” is categorised into four areas according to Prof. Finn. It is used as: (1) an organising idea informing specific equitable doctrine; (2) the basis for intervention in situations of estoppel, unilateral mistake, relief against forfeiture, and undue influence; (3) one species of unconscionable conduct in a discrete doctrine; (4) a cause of action. Paul Finn, ‘Unconscionable Conduct’ (1994) 8 *Journal of Contract* 37,38-39. See also Lynden Griggs, ‘Unconscionability and s51AA of the Trade Practices Act 1974’ (1998) 72(10) *Law Institute Journal* 68, 70-71.

¹⁷⁰ Baxt and Mahemoff, above n 153, 10.

¹⁷¹ (1956) 99 CLR 362.

¹⁷² (1983) 151 CLR 447. See 130-134.

¹⁷³ Baxt and Mahemoff, above n 153, 10-11

¹⁷⁴ (2000) 169 ALR 324.

¹⁷⁵ *Ibid* 331.

¹⁷⁶ *Commercial Bank of Australia v Amadio* (1983) 151 CLR 447, 461.

It was further explained that a “special disability”, arises where there is an absence of any reasonable degree of equality between the parties, and where this is sufficiently evident to the stronger party to make it prima facie unfair or “unconscientious” that he procure or accept the weaker party’s assent to the impugned transaction.¹⁷⁷ Fullagar J in *Blomley v Ryan* enumerated the factors which may give rise to a special disability:

Among them are poverty or need of any kind, sickness, age, sex, infirmity of body or mind, drunkenness, illiteracy or lack of education, lack of assistance or explanation where assistance or explanation is necessary.¹⁷⁸

It is fair to say that s. 51AA has adopted these specific doctrines to identify the particular categories of unconscionable conduct, rather than embodying a generic usage to inform a fundamental principle according to which equity acts.¹⁷⁹ Furthermore, according to the Explanatory Memorandum, s. 51AA is not intended to extend the principles of unconscionable conduct beyond those recognised by the courts. Under this circumstance, it is submitted that the factors for a special disability enumerated in *Blomley v Ryan* have been construed to be those of a personal nature, which has not for the most part been successfully applied to commercial transactions.¹⁸⁰ In commercial settings, there is a cogent premise that sophisticated parties are contracting at arm’s length. These parties are, or should be, well capable of protecting their own interests. Therefore, within the framework of the requirement of special disability, the operation of s. 51AA will be limited to situations where a certain dependency can be found in the relationship between the parties, such as a subsidiary company’s dependence upon the controlling company.¹⁸¹

However, it is submitted:

¹⁷⁷ Ibid 474.

¹⁷⁸ (1956) 99 CLR 362.

¹⁷⁹ *Australian Competition and Consumer Commission v C G Holdings Pty Ltd* (2000) 169 ALR 324, 334. See also J D Heydon, *Trade Practices Law* (1997) [16.85]; Buckley, above n 7, 326.

¹⁸⁰ Baxt and Mahemoff, above n 153, 11.

¹⁸¹ Ibid.

[T]he boundary defined by the union of these classes of case is potentially unstable as the taxonomy of applications of unconscionable conduct may shift under the unwritten law to the level of a general unifying concept or be subsumed in the more accurate idea of “unconscientious” conduct.¹⁸²

Evidently, what constitutes a special disability is not a definitive concept. Its scope appears to have been expanded beyond the physical or intellectual disabilities described in *Blomley v Ryan*. And it would seem to include emotional influence, disparity of knowledge, overt reliance and like disadvantages based on trust and confidence rather than permanent disability.¹⁸³ Furthermore, the concept of unconscionability is a developing notion, in accordance with the underlying values and expectations of society. As the provision stipulates that unconscionability has “the meaning of the unwritten law, from time to time, of the States and Territories”, the substance of special disability may expand or shift, and other criteria may be substituted for the requirement of special disability as the law develops in this area.

In sum, the meaning of the unwritten law embodied in s. 51AA is limited to certain situations within the legislative intention. At present, the requirement of special disability established in *Blomley v Ryan* and *Amadio* has a limiting role in distinguishing cases brought under s. 51AA from unconscionable cases in general. If the court does not rely on this traditional requirement, it should offer a cogent replacement, or provide reasons or identify factors which explain why the requirement is no longer necessary in the particular case. Otherwise, the decision will be unconvincing, or bring considerable uncertainty and confusion.

¹⁸² *Australian Competition and Consumer Commission v C G Berbatis Holding Pty Ltd* (2000) 169 ALR 324, 335.

¹⁸³ Daniel Clough, ‘Trends in the Law of Unconscionability’ (1999) 18 *Australian Bar Review* 1, 27-28. Cf *Garcia v National Australian Bank Ltd* (1998) 155 ALR 614; *George Collings (Aust) Pty Ltd v HF Stevenson (Aust) Pty Ltd* [1991] ATPR 52,167; *Louth v Diprose* (1992) 175 CLR 621; *Begbie v State Bank of New South Wales* [1994] ATPR 41,881.

[3] Unconscionability and the Exception Principle of Independent Undertakings

The doctrine of unconscionability provides a remedy “to the parties previously left relatively unprotected by the law”.¹⁸⁴ At the expense of the foundation of contract law — the freedom and sanctity of contract — the doctrine of unconscionability has served this purpose by: (1) enforcing an agreement that does not meet the legal requirements for a contract; and (2) denying the enforcement of a validly constituted contract.¹⁸⁵ The latter use of the doctrine has been discussed in relation to the exception to the autonomy principle — whether a demand should be denied. The right to demand established by the terms of the independent undertaking relationship, may give rise to argument concerning unconscionability. Technically, this is not a ground for the exception principle to apply within the framework of the independent undertaking transaction analysed in the foregoing sections. Rather, it is a ground to deny the enforcement of the beneficiary’s right in order to achieve justice.

On the other hand, the exception principle, as analysed in previous sections, is applicable in situations where the beneficiary has no conceivable basis for making a demand under the underlying contract relationship. Under this principle, the question is whether the beneficiary in fact has a right to demand in the independent undertaking relationship. In this respect, the exception principle and the doctrine of unconscionability are established upon different premises. Whereas these principles result in the same legal consequence — the beneficiary’s demand is denied — they apply to different aspects of the transactions. Accordingly, one analytical approach would be as follows. First, consideration should be given whether the exception principle applies in a particular case. Once it is determined that the exception principle does not apply — the beneficiary has a right to demand under the independent undertaking — an analysis should be made as to whether the doctrine of unconscionability applies.

¹⁸⁴ Finn, above n 169, 44.

¹⁸⁵ G Dal Pont, ‘The Varying Shades of “Unconscionable” Conduct — Same Term, Different Meaning’ (2000) 19(2) *Australian Bar Review* 135, 136.

However, in relation to its application, the courts have taken a hands-off approach when dealing with commercial transactions. Kirby P in *Austotel Pty Ltd v Franklins Selfserve Pty Ltd*¹⁸⁶ elucidated the point as follows:

The wellsprings of the conduct of commercial people are self-evidently important for the efficient operation of the economy. Their actions typically depend on self-interest and profit-making not conscience or fairness. In particular circumstances protection from unconscionable conduct will be entirely appropriate. But courts should, in my view, be wary lest they distort the relationships of substantial, well-advised corporations in commercial transactions by subjecting them to the overly tender consciences of judges. Such consciences, as the cases show, will typically be refined and sharpened by circumstances arising in quite different relationships where it is more apt to talk of conscience and to provide relief against offence to it.¹⁸⁷

This observation is based on the cogent premise that sophisticated commercial parties are contracting at arm's length and should be expected to take reasonable steps to protect their own interests.¹⁸⁸ As has been seen in the analysis of s. 51AA, the doctrine of unconscionability does not arm the court "with a general power to set aside bargains simply because, in the eyes of the judges, they appear to be unfair, harsh or unconscionable".¹⁸⁹ Much debate has been entered into regarding factors which might limit the cases where the doctrine should be truly applied. A limiting factor in distinguishing cases brought under the doctrine is found in one party's relative power or position to exploit the vulnerability of the other. Although the facts of each case should be scrutinised individually,¹⁹⁰ this factor is to a large extent irrelevant in commercial transactions, especially the corporations that s.51AA is applied.

Furthermore, the agreements of commercial parties who are capable of protecting their own interests should be assumed to be the result of their deliberate intention, no

¹⁸⁶ (1989) 16 NSWLR 582.

¹⁸⁷ *Ibid* 586.

¹⁸⁸ See Agasha Mugasha, 'Evolving Standards of Conduct (Fiduciary, Good Faith and Reasonableness) and Commercial Certainty in Multi-Lender Contracts (2000) 45(4) *The Wayne Law Review* 1789. The article discusses the tension between the equitable doctrine of fiduciary duty and commercial certainty in a multi-lending context.

¹⁸⁹ *Louth v Diprose* (1992) 175 CLR 621, 654. See also Dal Pont, above n 185, 138.

¹⁹⁰ See Jane P Mallor, 'Unconscionability in Contracts between Merchants' (1986) 40 *Southwestern Law Journal* 1065, 1086.

matter how inequitable or unfair they may sound. Their agreement should not be easily interfered with. The hands-off approach can be understood as follows:

[it] merely [demonstrates], albeit in a very tortured way, that before giving commercial actors the benefit of equity's protection, courts will have close regard to the risks the parties should properly be taken to have assumed in their dealings ...¹⁹¹

In the context of independent undertakings, as a typical commercial relationship, the parties at arm's length agree to furnish this specific undertaking. They should be well aware the nature of the undertaking and pre-determine their rights and obligations in relation to the undertaking. Under this arrangement, litigation risks are taken by the applicant when disputes arise. Unless the exception principle applies — where the beneficiary's demand for payment has no conceivable basis under the underlying contract — the parties intend, or are assumed to intend, that the payment should be made as exhibited by the furnishing of independent undertakings.

In appropriate cases, equitable doctrines penetrate commercial transactions. Moreover, under the current Australia's enthusiasm for the doctrine of unconscionability, it may develop to signify something which is "unfair" in more broad sense.¹⁹² Nonetheless, the commercial purpose of independent undertakings as a replacement for a cash deposit, may be severely undermined if the courts intervene in order to achieve justice.

3 Integral Application of the Exception Principle and the Role of the Issuer

The exception to the autonomy principle, as the foregoing discussion has demonstrated, is purely a matter of the underlying contract relationship. The position of the bank gives no direction as to whether a demand under an independent undertaking falls within the scope of the exception principle. Even though the bank appears as a defendant where an injunction is sought to restrain it from making payment, in a practical sense the adverse party is the beneficiary.

¹⁹¹ Finn, above n 169, 44.

Therefore, the exception principle should apply equally, no matter against whom an injunction is sought. Some formulae for the exception principle, established in the context of specific case law, have already been discussed. There are two issues which need to be examined to streamline the above proposition: (1) whether the criteria for the application of the exception principle should be less strict in the case of an injunction against the beneficiary; and (2) whether the bank should have knowledge of the beneficiary's fraud.

First, some have argued that the exception principle should be applied less strictly in the case of an injunction restraining the beneficiary from making a demand. Eveleigh J in *Potton Homes Ltd v Coleman Contractors Ltd*¹⁹³ stated:

As between buyer and seller the underlying contract cannot be disregarded so readily. If the seller has lawfully avoided the contract *prima facie*, it seems to me he should be entitled to restrain the buyer from making use of the performance bond. Moreover, in principle I do not think it possible to say that in no circumstances whatsoever, apart from fraud, will the court restrain the buyer. The facts of each case must be considered. If the contract is avoided or if there is a failure of consideration between buyer and seller for which the seller undertook to procure the issue of the performance bond, I do not see why, as between seller and buyer, the seller should not be unable [sic] to prevent a call upon the bond by the mere assertion that the bond is to be treated as cash in hand.¹⁹⁴

Eveleigh J distinguished the instant case from the *Edward Owen Ltd v Barclays Bank*.¹⁹⁵ In that case it was unsuccessfully submitted that the failure of the buyer to procure a letter of credit, in accordance with the contract terms, should entitle the applicant to an injunction against the bank. He stated:

[The *Edward Owen* case], however, was not concerned with the position as between buyer and seller, and any statements as to the irrelevance of the failure to provide the letter of credit must be seen in that context.¹⁹⁶

¹⁹² A F Mason, 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *The Law Quarterly Review* 66, 89-90.

¹⁹³ [1984] 28 BLR 19.

¹⁹⁴ *Ibid* 28.

¹⁹⁵ [1978] 1 QB 159.

¹⁹⁶ [1984] 28 BLR 19, 28.

Even if *Edward Owen* is an insurmountable authority, an approach which divides the test for the applicability of the exception principle, according to the person against whom an injunction is sought, is problematic. In *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd*,¹⁹⁷ the reinsurer (the applicant) submitted that a different test should be applied where an injunction is sought against the beneficiary, as opposed to the bank. Phillip J rightly rejected this argument:

Where a letter of credit is issued by way of conditional payment under an underlying contract, I do not consider that it is correct to imply a term into the underlying contract that the beneficiary will not draw on the letter of credit unless payment under the underlying contract is due. On the contrary, I consider that the correct contractual inference that should normally be drawn is that the beneficiary will be entitled to draw on the letter of credit provided that he has a bona fide claim to payment under the underlying contract. If this is correct, there is no basis for the suggestion that the court should apply a different test when considering an application to restrain a beneficiary, rather than a bank, from effecting payment under a letter of credit.¹⁹⁸

This observation was confirmed in the Court of Appeal.¹⁹⁹ Staughton LJ stated that “[t]he effect on the lifeblood of commerce will be precisely the same whether the bank is restrained from paying or the beneficiary is restrained from asking for payment”.²⁰⁰

In *Themehelp Ltd v West*,²⁰¹ an injunction was sought against the beneficiary even before he made a demand for payment. The beneficiary contended that according to the exception principle, the law allowed the applicant to apply for an injunction against both the issuer and the beneficiary only after a demand was made. Waite LJ refused this argument and stated:

In a case where fraud is raised as between the parties to the main transaction at an early stage, before any question of the enforcement of the guarantee, as between the beneficiary and the guarantor, has yet arisen at all, it does not seem to me that the slightest threat is involved to

¹⁹⁷ [1994] 4 All ER 181.

¹⁹⁸ *Ibid* 196.

¹⁹⁹ *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd and others; Group Josi Re (formerly known as Group Josi Reinsurance SA) v Walbrook Insurance Co Ltd and others* [1996] 1 All ER 791.

²⁰⁰ *Ibid* 801.

²⁰¹ [1996] QB 84.

the autonomy of the performance guarantee if the beneficiary is enjoined from enforcing it in proceedings to which the guarantor is not a party.²⁰²

The independent undertaking relationship between the issuer and the beneficiary is a creation of the applicant and the beneficiary, implementing their agreement under their underlying contract.²⁰³ Any suggestion that the autonomy principle and its exception have a meaning and effect in the relationship between the applicant and the beneficiary, which differs from that arising in the relationship between the issuer and the beneficiary, or between the applicant and the issuer, is erroneous.²⁰⁴

In terms of the second issue, as pointed out above, the *Edward Owen* case has established the general formula for the fraud exception thus: “[t]he only exception is when there is a clear fraud of which the bank has notice”.²⁰⁵ The additional requirement of evidence of the bank’s knowledge has been reiterated in later cases, however it seems pointless where an injunction is sought against the beneficiary. Moreover, it should be questioned whether the requirement is even relevant in proceedings against a bank, where the practical effect is to prevent the beneficiary from receiving payment, not to determine the issuer’s liability. Phillips J in *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd*,²⁰⁶ denied the requirement for the following reason:

[T]he requirement that there must be clear evidence of the bank’s knowledge of fraud is academic once the proceedings have reached the inter partes stage. At this point the evidence of fraud will be placed simultaneously before the court and before the bank, which is party to the proceedings. If the court concludes that there is clear evidence of fraud, it will necessarily conclude that the bank has acquired knowledge of the fraud.²⁰⁷

It is argued, however, that the relevant knowledge must be possessed by the bank at, or prior to, the date on which the bank is served within the demand.²⁰⁸ This would fit within the traditional view that the bank has the prima facie right to be the sole

²⁰² Ibid 98-99.

²⁰³ Bertrams, above n 9, 314.

²⁰⁴ Ibid.

²⁰⁵ [1978] 1 QB 159, 171.

²⁰⁶ [1994] 4 All ER 181.

²⁰⁷ Ibid 195.

²⁰⁸ James O’Donovan and John Phillips, *The Modern Contract of Guarantee* (3rd ed, 1996) 779.

arbitrator of whether or not the demand for payment should be refused on the grounds of fraud.²⁰⁹

This matter should be approached from the perspective of the bank's role in independent undertaking transactions. The bank's role as sole arbitrator in determining payment, as the above argument demonstrated, is a foundation of the mechanism of independent undertakings. In order to maintain the viability of independent undertakings, it is essential that the bank can determine whether it should pay or not. It must be allowed to examine a demand and decide, without any intervention, whether it complies with the stipulated conditions.

Banks are expected to perform this role in the normal course of a transaction where formal compliance with a demand is at issue. However, the exception principle is alleged where, though a demand is formally complied with, the parties nonetheless dispute payment under the independent undertaking. Furthermore, the dispute is, practically, in the underlying contract relationship. In this context, the bank's role as sole arbitrator in determining the formal compliance with a demand, has no significance.

The issue of the exception principle is ultimately a judicial decision. To obtain injunctive relief, not only against the beneficiary, but also against the bank, the applicant should simply concentrate on providing clear evidence of an exceptional case to the court's satisfaction.²¹⁰ The additional requirement of the bank's knowledge is in fact irrelevant.²¹¹

The bank has an interest in staying away from the whole process of the proceeding. The utility of independent undertakings and the proper operation of the exception principle depend on protecting banks that fulfil their limited role of examining formal

²⁰⁹ *Ibid.*

²¹⁰ On the basis of a comparative study, this proposition is strongly supported. Bertrams, above n 9, 320.

²¹¹ Bertrams, above n 9, 320.

compliance with demands and transferring the stipulated money. Given these considerations, the bank's situation can be summarised as follows:

- (1) The bank, in the context of the exception principle being alleged, is not and should not be concerned in any way with the rights and wrongs of the underlying transaction.²¹² The bank has no obligation, or right, to investigate the factual matters of the underlying contract.
- (2) The bank will be reimbursed as long as it has paid in good faith.²¹³ Thus, if the applicant himself is not able to produce compelling evidence that fraud has been committed, the bank is within its rights to pay under independent undertakings unless previously restrained by injunction.²¹⁴

This chapter has attempted to re-formulate the fraud exception in isolation from the notion of common law fraud. The formula established on the basis of common law fraud that developed in various contexts may not be relevant to the exception principle in the specific context of independent undertakings. As has been seen, the

²¹² *Siporex Trade SA v Banque Indosuez* [1982] 2 Lloyd's Rep 146, 158.

²¹³ The Uniform Commercial Code takes the same position.

²¹⁴ Roy Goode, *Commercial Law* (2nd ed, 1995) 1009. Prof. Goode added in a footnote that "[t]he prudent course for the bank faced with what appears to be strong evidence of fraud is to give its customer a limited opportunity to apply to the court for an injunction". Article 17 of the Uniform Rules for Demand Guarantees follows this approach and provides:

Without prejudice to the terms of Article 10, in the event of a demand the Guarantor shall without delay so inform the Principal or, where applicable, his Instructing Party, and in that case the Instructing Party shall so inform the Principal.

See also Bertrams, above n 9, 308. The International Standby Practices (ISP 98), on the other hand, does not follow this approach. Rule 3.10 provides: An issuer is not required to notify the applicant of receipt of a presentation under the standby. The commentary explains:

The concern raised by giving notice to the applicant before payment is that the applicant might seek to prevent payment by seeking a judicial order restraining payment. While such relief may be appropriate in the case of an abusive or fraudulent drawing, it is not appropriate in the event of a contractual dispute between the applicant and beneficiary. Indeed, many standbys are meant to be drawn upon in just such a situation. To posit a duty to give notice calls into question the neutrality of the issuer, a concept at the heart of the standby's commercial value.

independent undertaking is created by the underlying contract parties to achieve their commercial purpose. Regard should be had as to the commercial purpose intended by the parties through furnishing independent undertakings. Analysing the exception principle in functional terms provides a cogent and convincing ground for determining its application in actual cases.

This study has attempted to clarify the significance of the autonomy principle, the underlying principle of independent undertakings, from the perspective of multi-party relationships. The autonomy principle not only governs the relationship between the beneficiary and the issuer, but also forms part of agreements in other relationships – between the beneficiary and the applicant, and between the issuer and applicant. With this approach, the specific nature, mechanism and purpose of independent undertakings in general are distinguished.

The formulation of this study has been to analyse the nature of independent undertakings from the perspective of their operational and functional features. The characteristics of independent undertakings is the interplay between the autonomy principle – the operational feature, and the commercial purpose – the functional feature. The methodology was to compare independent undertakings with other commercial devices.

The first conclusion may be drawn with respect to injunctions, which show the autonomy principle. This was done to delineate a functional structure for an independent undertaking and to provide the underlying reasons for its existence, of its functional feature. While the main aim of a beneficiary instrument is to protect the holder, the third party to the underlying contract, in order to provide the circulation of the instrument, independent undertakings basically aim to avoid contractual relations between the underlying contract parties. The main object is to allow payment to the first beneficiary to be made.

¹ See, for example, *Bankers Trust International v West London Insurance Co* (1982) 1 All ER 709, 117 CLR 674, 53 BCLR 121, 20 BCLR 222 (1982) 121, 222.

Chapter 5 Conclusion

Independent undertakings emerged in practice as a response to the needs of the mercantile community. They are *sui generis*,¹ and operate in accordance with their own principles.

This study has attempted to clarify the significance of the autonomy principle, the underlying principle of independent undertakings, from the perspective of multi-party relationships. The autonomy principle not only governs the relationship between the beneficiary and the issuer, but also forms part of agreements in other relationships — between the beneficiary and the applicant, and between the issuer and applicant. With this approach, the specific nature, mechanics and purpose of independent undertakings can be illuminated.

The foundation of this study has been to analyse the nature of independent undertakings from the perspective of their operational and functional features. The unique nature of independent undertakings is the interplay between the autonomy principle — its operational feature, and the commercial purpose — its functional feature. This method used was to compare independent undertakings with other commercial devices.

The first comparison made was with negotiable instruments, which share the same autonomy principle. This was done to illuminate a theoretical structure for the independent undertaking and to provide the underlying premise for an analysis of its functional feature. While the main aim of a negotiable instrument is to protect the holder, the third party to the underlying contract, in order to promote the circulation of the instrument, independent undertakings basically aim to avoid contractual defences between the underlying contract parties. The main object is to assure payment in full when a demand is made.

¹ John F Dolan, 'Efforts at International Standardization of Bank Guarantees' (1990) 4 *Banking & Finance Law Review*, 237, 261-264; Reoland Bertrams, *Bank Guarantees in International Trade* (2nd ed, 1996) 55-56.

It is worth noting, however, that payment under an independent undertaking does not equate to the beneficiary's ultimate eligibility in the underlying contract. It is simply a part of the underlying contract parties' agreement that "the contractual disputes wend their way towards resolution with money in the beneficiary's pocket rather than in the pocket of the [applicant]".² In other words, they agree to put the burden arising from the process of resolving contractual disputes on the applicant.

Furthermore, given the fact that a solvent financial institution assures payment, an independent undertaking practically substitutes for the creditworthiness of the commercial party. Naturally, an independent undertaking is used in transactions where the parties anticipate full payment, due on a certain date, and where the performance of the other party, which counterbalances the payment, is not of concern. In this context, the purpose of the independent undertaking is to enhance the creditworthiness of the commercial party, and it is mainly used in financial transactions.

The second comparison made was between independent undertakings and traditional guarantees, which are used for the same commercial purpose — to secure one party's performance. This was done to clarify the operational feature of independent undertakings. This study shed light on the operational feature of independent undertaking in the post-payment period in terms of the issuer's subrogation right. Independent undertaking law has distinguished their operational features — the issuer's primary obligation in independent undertakings versus the guarantor's secondary obligation in traditional guarantees — and it has clarified that the autonomy principle has no bearing on the post-payment period of independent undertaking transactions.

On the basis of these analyses, two legal issues were addressed. The first was the possibility of qualifying the beneficiary's right to demand under the independent undertaking by the underlying contract terms. The second was the substance and scope of the exception to the autonomy principle — the "fraud exception".

² *Itek Corp v First National Bank of Boston*, 730 F2d 19, 24 (1st Cir 1984).

As to the former issue, this study critically examined some Australian cases where injunctions were granted on the basis of underlying contract terms which qualified the beneficiary's right to demand. It took the view that the courts' treatment severely undermined the integral operation of independent undertakings. By arranging the independent undertaking, the underlying contract parties have agreed that the beneficiary would receive payment under stipulated conditions in the operative undertaking, irrespective of the status of the underlying contract. The beneficiary's right to payment, as a result of the application of the autonomy principle in the independent undertaking, is also a part of the contract between the beneficiary and the applicant.

In relation to the latter issue — the exception to the autonomy principle — the fraud exception has been well established in common law jurisdictions. However, its scope and substance seem to remain unexplored in Australia under the vague and general term of "common law fraud". This study has attempted to crystallise the exception principle outside the common law fraud notion, by analysing commercial purpose and function of independent undertakings, based on the underlying contract parties' intention and expectation. This is premised on a recognition that this issue is purely a matter of the underlying contract relationship, even though the issuer is a party to the independent undertaking transaction and appears as the adverse party in litigation. It is concluded that the exception to the autonomy principle, established as the fraud exception, is a contractual defence against the beneficiary only in extreme extenuating circumstances, where it is obvious at the time of demanding, without further investigation, that the beneficiary has no right to the payment.

In almost all the cases where this issue was raised, the underlying contracts were commercial, for the supply of goods and services. Parties utilise independent undertakings to counterbalance their interests in the course of transactions. Since the occurrence of a payment obligation is uncertain in this context, depending on actual performance or payment being executed by the other party, contractual disputes are naturally expected to arise for various reasons.

This study suggests that independent undertakings exhibit the parties' intention that contractual disputes should be resolved after payment. Accordingly, this puts the

beneficiary in a strong position for the final settlement, and so the applicant is tempted to withhold the payment, alleging the exception principle — the fraud exception in common law jurisdictions — to independent undertakings. The court should be careful in dealing with such allegations, so as not to alter the original agreement between the parties. In sum, when payment is disputed at the time a demand is made, the court should have regard to their original agreement and not intervene in the operation of independent undertakings.

This proposition is equally applicable to independent undertakings used as a credit enhancement device. In fact, contractual disputes rarely arise in this context. This is because of the transactional feature of the underlying contract, which mainly concerns financial transactions, in which payment will be due on a certain date without the satisfaction of any further performance, or payment, in the underlying contract relationship.

Further, this study has examined the equitable doctrine of “unconscionability” as a possible ground for the exception principle. It has clarified that, technically, the doctrine of unconscionability is not a ground for the exception principle within the framework of the independent undertaking transaction. Rather, it is a ground to deny the enforcement of the beneficiary’s right in order to achieve justice. If sophisticated commercial parties have furnished independent undertakings, and as long as the exception principle does not apply, they are assumed to agree that payment will be made. The doctrine of unconscionability may alter this original arrangement. Thus, while considerable growth in the importance of unconscionability has been observed under the current environment of Australian legal society, its application to independent undertaking transactions should be extremely limited.

Finally it has been observed that the utility of independent undertakings shows immense possibilities in various transactions due to their simple operational features. A dramatic expansion of their usage has been observed in standby credit transactions in the United States.

Given the diverse usage of standby credits, certain practical differences with other independent undertakings have been demonstrated. This occasionally encourages the

argument that a different level of the autonomy principle should be applied to each instrument, including performance guarantees, bank guarantees and standby credits. This argument exposed that the difficulty that lies in harmonising rules to govern these instruments under a single regime, as seen in the process of the UNCITRAL project of the UN Convention on Independent Guarantees and Stand-by Letters of Credit.

This study has constantly taken the position that these instruments are the same devices. It has also discussed the proposition that different business settings might require different applications of governing principle — the autonomy principle and its exception. The differences should not be put forward to provoke arguments concerning the legal nature of these instruments. At the abstract level of law the diversity of their usage does not demonstrate any differences in the autonomous nature of independent undertakings. Thus, all standby credits are alike and, more importantly, not materially different from commercial credits or, for that matter, other independent undertakings.³

In conclusion, the law of independent undertakings is shaped by the responsiveness of the courts to the needs of the commercial community.⁴ It serves to uphold merchants' acceptable customs and practices,⁵ and to facilitate their business transactions. As has been seen, independent undertakings emerged in various countries without any practical linkage between them. Given the fact that independent undertakings have been often used in international settings, there has been an increasing demand for harmonisation in the law from these countries. Official or private, national or international organisations have responded to this demand, which resulted in

³ James E Byrne, 'Standby Rulemaking: A Glimpse at the Elements of Standardization and Harmonization of Banking Practice', in Jacob S Ziegel (ed), *New Developments in International Commercial and Consumer Law Proceeding of the 8th Biennial Conference of the International Academy of Commercial and Consumer Law* (1998) 139, 140-141.

⁴ See Roy Goode, 'Abstract Payment Undertakings' in P Cane (ed), *Essay for Partrick Atiyah* (1991) 235.

⁵ See Roy Goode, *Commercial Law* (2nd ed, 1995) 1206. "[T]he commercial law is characterized primarily by those principles, rules and statutory provisions which are concerned to uphold and protect the acceptable customs and practices of merchants".

international convention and uniform rules. Furthermore, the courts have consciously or unconsciously observed theories and principles developed in different countries.⁶ These facts are the source to keep and update the commercial efficacy of independent undertakings in responding to the needs of market, which is changing rapidly and growing globally.

⁶ See also Roy Goode, *Commercial Law in the Next Millennium* (1998) 92.

Bibliography

- Andrews, G and Millett, R, *Law of Guarantees* (2nd ed, 1995)
- Barclay, A D J, 'Court Orders against Payment under First Demand Guarantees Used in International Trade' (1989) 3 *Journal of International Business Law* 110
- Barnes, J G and Byrne, J E, 'Revision of U.C.C. Article 5' (1995) 50 *The Business Lawyer* 1449
- Barnes, J G, 'Internationalization of Revised UCC Article 5 (Letter of Credit)' (1995-1996) 16 *Northwestern Journal of International Law & Business* 215
- Barnes, J G and Byrne, J E, 'Survey: Letters of Credit: 1998 Cases' (1999) 54 *The Business Lawyer* 1885
- Barski, K A, 'An Analysis of the Recent Revision to Article Five of the Uniform Commercial Code: Letters of Credit' (1996) 101 *Commercial Law Journal* 177
- Baxt, R, 'Unconscionability Taken One Step Too Far?' (1997) 25 *Australian Business Law Review* 301
- Baxt, R and Mahemoff, J, 'Unconscionable Conduct Under the Trade Practices Act — An Unfair Response by the Government: A Preliminary View' (1998) 26 *Australian Business Law Review* 5
- Bennett, H, 'Performance Bonds and the Principle of Autonomy' [1994] *Journal of Business Law*, 574
- Bergsten, E E, 'A New Regime for International Independent Guarantees and Standby Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters' (1993) 27 *The International Lawyer* 859
- Bertrams, R, *Bank Guarantees in International Trade* (2nd ed, 1996)
- Boss, A H, 'Symposium: The Restatement of Suretyship: Suretyship and Letters of Credit: Subrogation Revisited' (1993) 34 *William and Mary Law Review* 1088
- Brown, J J, 'The Fraud Exception to Standby Letters of Credit in Australia: Does It Embrace Statutory Unconscionability?' (1999) 11(1) *Bond Law Review* 98
- Buckley, R P, 'Potential Pitfalls with Letters of Credit' (1996) 70 *Australian Law Journal* 217
- Buckley, R P, 'Unconscionability Amok, or Two Readily Distinguishable Cases?' (1998) 26 *Australian Business Law Review* 323
- Burton, G, *Australian Financial Transaction Law* (1991)

- Byrne, J E, 'The Revision of U.C.C. Article 5: A Strategy for Success' (1990) 56 *Brooklyn Law Review* 13
- Byrne, J E, 'Fundamental Issues in the Unification and Harmonization of Letter of Credit Law' (1991) 37 *Loyola Law Review*, 1
- Byrne, J E, 'Standby Rulemaking: A Glimpse at the Elements of Standardization and Harmonization of Banking Practice' in Jacob S Ziegel (ed), *New Development in International Commercial and Consumer Law Proceeding of the 8th Biennial Conference of the International Academy of Commercial and Consumer Law* (1998) 139
- Byrne, J E, *The Official Commentary on the International Standby Practices* (1998)
- Clough, Daniel, 'Trends in the Law of Unconscionability' (1999) 18 *Australian Bar Review* 1
- Coleman, M, 'Performance Guarantees' [1990] *Lloyd's Maritime and Commercial Law Quarterly* 223
- Dal Pont, G, 'The Varying Shades of "Unconscionable" Conduct — Same Term, Different Meaning' (2000) 19(2) *Australian Bar Review* 135
- Debatista, C, 'Performance Bonds and Letters of Credit: A Cracked Mirror Image' [1997] *Journal of Business Law* 289
- De Ly, Filip, 'The UN Convention on Independent Guarantees and Stand-by Credit' (1999) 33(3) *The International Lawyer* 831
- Dolan, J F, 'Efforts at International Standardization of Bank Guarantees' (1990) 4 *Banking & Finance Law Review*, 237
- Dolan, J F, 'The Correspondent Bank in the Letter-of-Credit Transaction' (1992) 109 *Banking Law Journal* 396
- Dolan, J F, *The Law of Letters of Credit* (rev ed, 1996)
- Dolan, J F, 'The UN Convention on International Independent Undertakings: Do States with Mature Letter-of-Credit Regimes Need It?' (1998) 13 *Banking & Finance Law Review*, 1
- Dolan, J F, 'A Study of Subrogation Mostly in Letter of Credit and Other Abstract Obligation Transactions' (1999) 64 *Missouri Law Review* 789
- Edward, R, 'Bank Cheques (Ricky Yan) and Letters of Credit (Inflatable Toy Company): A Comparison in Independence' (1997) 71 *The Australian Law Journal* 36

- Ellinger, E P, 'Standby Letters of Credit' (1978) 6 *International Business Lawyer*, 604
- Ellinger, E P, 'Documentary Credits and Finance by Mercantile Houses' in A G Guest (ed), *Benjamin's Sale of Goods* (5th ed, 1997)
- Fellinger, G A, 'Letters of Credit: The Autonomy Principle and the Fraud Exception' (1990) 1 *Journal of Banking and Finance Law and Practice* 4
- Finn, P D, 'Equity and Contract' in P D Finn (ed), *Essays on Contract* (1987) 104
- Finn, P D, 'The Fiduciary Principle' in T G Youdan (ed), *Equity, Fiduciaries and Trusts* (1989) 1
- Finn, P D, 'Unconscionable Conduct' (1994) 8 *Journal of Contract* 37
- Goode, R, 'Unconditional Bonds: The Common Law' in Humphery Lloyd (ed), *The Liability of Contractors* (1986) 99
- Goode, R, 'Abstract Payment Undertakings' in P Cane (eds), *Essays for Patrick Atiyah* (1991)
- Goode, R, 'The New I.C.C. Uniform Rules for Demand Guarantees' [1992] *Lloyd's Maritime and Commercial Law Quarterly*, 190
- Goode, R, *Guide to the ICC Uniform Rules for Demand Guarantees*, ICC Publication No 510 (1992)
- Goode, R, *Commercial Law* (2nd ed, 1995)
- Goode, R, 'Abstract Payment Undertakings in International Transactions' (1996) 22 *Brooklyn Journal of International Law*, 1
- Graham, G B and Geva, B, 'Standby Credit in Canada' (1984) 9 *Canadian Business Law Journal*, 180
- Griggs, Lynden, 'Unconscionability and s51AA of the Trade Practices Act 1974' (1998) 72(10) *Law Institute Journal* 68
- Harfield, H, 'Enjoining Letter of Credit Transaction' (1978) 95 *Banking Law Journal* 596
- Harfield, H, 'Identity Crisis in Letter of Credit Law' (1982) 24 *Arizona Law Review* 239.
- Healey, Deborah, 'Unconscionable Conduct in Commercial Dealings' (1993) 1 *Trade Practices Law Journal* 169
- Heydon, J D, *Trade Practices Law* (1997)
- Hjerner, L A E, 'Contract Guarantees' in Petar Šarčević and Paul Volken (eds), *International Contracts and Payments* (1991)

- Ho Peng Kee, 'The Fraud Rule in Letters of Credit Transactions' in C M Chinkin et al (eds), *Current Problems of International Trade Financing* (1983) 235
- International Chamber of Commerce, *Documentary Credits UCP 500 & 400 Compared* (Charles Del Busto ed 1993)
- Jack, R, *Documentary Credits* (2nd ed, 1993)
- Jones, William Mark, 'Injunctions Restraining Contractor's Bank Guarantees' (1999) 15(4) *Building and Construction Law* 229
- Kozolchyk, B, 'Letters of Credit' in Jacob S Ziegel (eds), *International Encyclopedia of Comparative Law* (1979)
- Kozolchyk, B, 'Bank Guarantees and Letters of Credit: Time for Return to the Fold' (1989) 11 *University of Pennsylvania Journal of International Business Law* 1
- Kozolchyk, B, 'National Law Center/Select Advisory Group Rules and Comment on Standby Letters of Credit' (1992) 9 *Arizona Journal of International & Comparative Law* 365
- Kozolchyk, B, 'The Paperless Letter of Credit and Related Documents of Title' (1992) 55 *Law and Contemporary Problems* 39
- Kozolchyk, B, 'Towards New Customs and Practices for Documentary Credits: The Methodology of the Proposed Revision' [1993] *Commercial Law Annual* 371
- Kozolchyk, B, 'Financial Standby: A Summary Description of Practice and Related Legal Problems' (1996) 28 *Uniform Commercial Code Law Journal* 327
- Kurkela, M, *Letters of Credit under International Trade Law* (1985)
- Lee, D W, 'Letter of Credit: What does revised Article 5 Have to Offer to Issuers, Applicants, and Beneficiaries?' (1996) 101 *Commercial Law Journal* 234
- Lipton, J, 'Uniform Regulation of Standby Letters of Credit and Other First Demand Security Instruments in International Transactions' (1993) 10 *Journal of International Business Law*, 402
- Mallor, J P, 'Unconscionability in Contracts between Merchants' (1986) 40 *Southwestern Law Journal* 1065
- Mason, A, 'Themes and Prospects' in PD Finn (ed) *Essays in Equity* (1985) 242
- Mason, A F, 'Contracts, Good Faith and Equitable Standards in Fair Dealing' (2000) 116 *The Law Quarterly Review* 66
- McGlough, B V, *Letters of Credit* (2000)
- McGuinness, K P, *The Law of Guarantee* (2nd ed, 1996)

- Meagher, R P, Gummow, W M and Lehane, J R F, *Equity Doctrines and Remedies* (3rd ed, 1992)
- Mugasha, A, 'Set-off against a Letter of Credit Claim' in John Prebble (ed), *Dimensions in Banking and Foreign Exchange Law* (1992) 27
- Mugasha, A, 'Non-Documentary Conditions in Letters of Credit and Bank Guarantees' (1990) 5 *Banking & Finance Law Review* 283
- Mugasha, A, 'Set-Off and Letters of Credit: Hong Kong and Shanghai Banking Corp v Kloeckner Co' [1992] 7 *Banking & Finance Law Review* 307
- Mugasha, A, 'The Relevance on the Uniform Commercial Code to Australia Commercial Law' in Agasha Mugasha (ed), *Perspective on Commercial Law* (1999)
- Mugasha, A, 'Evolving Standards of Conduct (Fiduciary, Good Faith and Reasonableness) and Commercial Certainty in Multi-Lender Contracts' (2000) 45(4) *The Wayne Law Review* 1789
- O'Donovan, J & Phillips, J, *The Modern Contract of Guarantees* (3rd ed, 1996)
- Oelofse, A N, *The Law of Documentary Letters of Credit in Comparative Perspective* (1997)
- Pengilly, Warren, 'Unconscionability: Are the Litigation Floodgates Opening in Relation to Commercial Transactions?' (1997) 13(1) *Australian & New Zealand Trade Practices Law Bulletin* 11
- Penn, G A, Shea, A M and Arora, A, *The law and Practice of International Banking* (1987)
- Perrington, R, 'Performance Bonds and Standby Letters of Credit: The Australian Experience' (1991) *Journal of Banking and Financial Law Practice* 157
- Quentin Loh and Tang Hang Wu, 'Injunctions Restraining Calls on Performance Bonds — Is Fraud the Only Ground in Singapore?' [2000] *Lloyd's Maritime and Commercial Law Quarterly* 348
- Schroeder, M R, 'The 1995 Revision to UCC Article 5, Letters of Credit' (1997) 29 *Uniform Commercial Code Law Journal* 331
- Symons E L Jr, 'Letters of Credit: Fraud, Good Faith and the Basis for Injunction Relief' (1980) 54 *Tulane Law Review* 338
- Task Force on the Study of U.C.C. Article 5, 'An Examination of UCC Article 5 (Letters of Credit)' (1990) 45 *The Business Lawyer* 1521

- Turner, P S, 'Revised UCC Article 5: The New U.S. Uniform Law on Letters of Credit' (1996) 11 *Banking & Finance Law Review* 205
- Turner, P S, 'The United Nations Convention on International Standby Letters of Credit: How Would It Change Existing Letter of Credit Law in the United States?' (1997) 114 *Banking Law Journal* 790
- Turner, P S, 'New Rules for Standby Letters of Credit: The International Standby Practices' (1999) 14 *Banking & Finance Law Review* 457
- Tyree, A L, 'Performance Bonds and Section 51AA of the Trade Practices Act' (1997) 8 *Journal of Banking and Finance Law and Practice* 338
- Tyree, A L, *Banking Law in Australia* (3rd ed, 1998)
- Wallace, I N D, *Hudson's Building and Engineering Contracts* (11th ed, 1995)
- Weerasooria, W S, *Bank Lending and Securities in Australia* (1998)
- Weerasooria, W S, *Banking Law and the Financial System in Australia* (5th ed, 2000)
- Ward, A and McCormack, G, 'Subrogation and Bankers' Autonomous Undertakings' (2000) 116 *Law Quarterly Report* 121
- White, J J and Summers R S, *Uniform Commercial Code* (4th ed, 1995)
- White, J J, 'The Influence of International Practice on the Revision of Article 5 of the UCC' (1995-1996) 16 *Northwestern Journal of International Law & Business* 189
- White, J J, 'Rights of Subrogation in Letters of Credit Transaction' (1996) 41 *Saint Louis University Law Journal* 47
- Wunnicke, B, Wunnicke, D B and Turner, P S, *Standby and Commercial Letters of Credit* (2nd ed, 1996)
- Zohrab, P, 'Standby Letters of Credit: Autonomy' [1996] *New Zealand Law Journal* 417