Injunctions against encashment of demand guarantees:

To look; or not to look at the underlying contract?

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"The principles of law laid down by the Judges in the 19th century- however suited to social conditions of that time- are not suited to the social necessities and social opinion of the 20th century. They should be moulded and shaped to meet the needs and opinion of today."

- *Lord Denning*[3]

A demand guarantee is a guarantee that imposes a primary obligation on the issuer ("bank") to pay the beneficiary on its first demand (or on demand) where the primary obligor ("the principal") fails to perform the underlying contract or transaction. "Demand guarantees are the undertaking of a bank to pay a beneficiary, independent of the principal contract, possibly on written demand, possibly on presentation of a certificate by some independent third party, or possibly on submission of a court judgment or an arbitral award"[4]. Although bank guarantees are given part of a contract between two Parties other than the bank, by their nature, bank guarantees are separate transactions from the contract on which they are based or they are related to. Therefore, whenever the Guarantee demands for the payment, under that separate contract, the Guarantor is expected to pay that amount. It is noteworthy that, in Article 2 of the ICC Uniform Rules for Demand Guarantees (URDG 758) defines demand guarantee as "any signed

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[3] Alfred Denning, The Discipline of Law (Butterworths 1979)
[4] Ross Cranston, Principles of Banking Law (2nd edn, Oxford University Press 2002) 390

undertaking, however named or described, providing for payment on presentation of a complying demand"[5], and Article 5(a) of states that:

> "A guarantee is by its nature independent of the underlying relationship and the application, and the guarantor is in no way concerned with or bound by such relationship. A reference in the guarantee to the underlying relationship for the purpose of identifying it does not change the independent nature of the guarantee. The undertaking of a guarantor to pay under the guarantee is not subject to claims or defences arising from any relationship other than a relationship between the guarantor and the beneficiary."[6]

This principle is also known as the autonomy principle or the independency principle (as they refer to in the United States), *i.e.* the bank guarantee is independent to the underlying contract it is related to. Despite the autonomy principle of the demand guarantee, in reality, the demand guarantee cannot be isolated or detached from its underlying contract because, to put it in précis, if there is no underlying contract or transaction there won't be a demand guarantee at all. However, we can observe that the British courts, and from it, the commonwealth courts, and even the United States courts have been reluctant to injunct banks from honouring demand guarantees, save for very limited exception of "clear fraud".

Justice Kerr in the case of *R. D. Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd*[7] held that:

> "It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. Such obligations are regarded as collateral to the underlying rights and

[5] Article 2, ICC Uniform Rules for Demand Guarantees (URDG 758)
[6] Article 5(a), ICC Uniform Rules for Demand Guarantees (URDG 758)
[7] [1977] 3 W.L.R. 752

obligations between the merchants at either end of the banking chain. 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..... The courts are not concerned with their difficulties to enforce such claims : these are risks which the merchants take. In this case the plaintiffs took the risk of the unconditional wording of the guarantees. The machinery and commitments of banks are on a different level. They must be allowed to be honoured, free from interference by the courts. Otherwise, trust in international commerce could be irreparably damaged."

This dicta of Justice Kerr explains the rationale justifying the principle of autonomy, in brief .

Lord Denning's dictum in the classic English case *Edward Owen Engineering Ltd v Barclays Bank International Ltd*[8] remains an influential authority in upholding the autonomy principle pertaining to demand guarantees. In this case, one Edward Owen had bid on a proposal to supply a Libyan firm with big industrial greenhouses. They were required to construct a performance bond issued locally in Libya through Barclays Bank and its Libyan correspondent bank, Umma Bank, as part of the deal. Barclays granted a counter-guarantee in favour of Umma Bank, the performance bond issuer, that was "payable on demand without proof or conditions." To pay for the greenhouses, the Libyan buyer was obliged to produce a letter of credit in Edward Owen's favour. The letter of credit was provided by the Libyan issuing bank, but it was specifically stated that it could not be confirmed, which Edward Owen found unsatisfactory. It was necessary for the contract shipment to take place, and without it, Edward Owen informed the Libyan buyers that, they would not be shipping the products under the contract. However, the performance bond put in place at Edward Owen's request was not contractually contingent on the issuing of the letter of credit.

[8] [1977] 3 W.L.R. 764

The Libyan buyers then filed a claim for the local performance bond, while Umma Bank filed a claim under the counter-guarantee supplied by Barclays Bank. Edward Owen then went to the English court seeking to prevent Barclays Bank from honouring its counter-guarantee. The court first granted an *ex parte* injunction to block payment by Barclays Bank, but the order was later revoked when the parties returned to the judge to hear the case in person. In appeal, Lord Denning acknowledged the misfortune faced by the British supplier, but stated the court had no choice but to dismiss the appeal. In the Court of Appeal judgement, Lord Denning held:

> "All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is a clear fraud of which the bank has notice."

The rationale for fraud being recognised as the only exception is enunciated by Lord Diplock in his judgement in *United City Merchants (Investments) Ltd v Royal Bank of Canada*[9]:

> "The exception for fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim *ex turpi causa non oritur actio* or, if plain English is to be preferred, "fraud unravels all". The courts will not allow their process to be used by a dishonest person to carry out a fraud."

[9] [1982] 2 All ER 720

The English courts have also gone to the extent to distinguish the cases where injunctions are sought against the encashment of demand guarantees vis-à-vis other injunction cases. Lloyd LJ in *Dong Jin Metal Co Ltd v Raymet Ltd*[10] held:

> "I do not think it makes much difference whether one says that the letter of credit cases are special cases within the American Cyanamid guidelines (see American Cyanamid Co v Ethicon Ltd [1975] 1 All ER 504 at 511, [1975] AC 396 at 409 per Lord Diplock) because of the special factors which apply in such cases or whether one says that such cases fall outside the guidelines altogether. I prefer the former view."

The English case, *Edward Owen Engineering Ltd v Barclays Bank International Ltd*[11], has been referred to in with endorsement by the Sri Lankan Court of Appeal in *Indica Traders (Private) Limited v Seoul Lanka Construction (Private) Limited and Others*[12]; *Hemas Marketing (Pvt) Ltd v Chandrasiri and Others*[13]; *Pan Asia Bank Ltd v Kandy Multi Purpose Co-Operative Society and Others*[14]; *Pan Asia Bank Ltd v Bentota MPCS Ltd and Another*[15]; and by the Sri Lankan Supreme Court in *Commercial Bank of Ceylon PLC v Ace Containers (Pvt) Ltd*[16].

In *Indica Traders (Private) Limited v Seoul Lanka Construction (Private) Limited and Others*[17], Sarath N Silva J (as he was then), referred to *Edward Owen Engineering Ltd v Barclays Bank International Ltd*[18], and Sir John Donaldson MR's judgement in *Bolivinter Oil SA v Chase Manhattan Bank NA*[19], in which he held:

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[10] [1993] Unreported, CA Transcript 945, referred with approval by Staughton LJ in *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Walbrook Insurance Co Ltd and others* [1996] 1 All ER 791
[11] [1977] 3 W.L.R. 764
[12] [1994] 3 S.L.R. 387
[13] [1994] 2 S.L.R. 181
[14] [2012] 1 S.L.R. 78
[15] [2012] 1 S.L.R. 51
[16] [2015] 1 S.L.R. 223
[17] [1994] 3 S.L.R. 387
[18] [1977] 3 W.L.R. 764
[19] [1984] 1 W.L.R. 392

"Before leaving this appeal, we should like to add a word about the circumstances in which an ex parte injunction should be issued which prohibits a bank from paying under an irrevocable letter of credit or a purchase bond or guarantee. The unique value of such a letter, bond or guarantee is that the beneficiary can be completely satisfied that whatever disputes may thereafter arise between him and the bank's customer in relation to the performance or indeed existence of the underlying contract, the bank is personally undertaking to pay him provided that the specified conditions are met. In requesting his bank to issue such a letter, bond or guarantee, the customer is seeking to take advantage of this unique characteristic. If, save in the most exceptional cases, he is to be allowed to derogate from the bank's personal and irrevocable undertaking, given be it again noted at his request, by obtaining an injunction restraining the bank from honouring that undertaking, he will undermine what is the bank's greatest asset, however large and rich it may be, namely its reputation for financial and contractual probity. Furthermore, if this happens at all frequently, the value of all irrevocable letters of credit and performance bonds and guarantees will be undermined.

Judges who are asked, often at short notice and ex parte, to issue an injunction restraining payment by a bank under an irrevocable letter of credit or performance bond or guarantee should ask whether there is any challenge to the validity of the letter, bond or guarantee itself. If there is not or if the challenge is not substantial, prima facie no injunction should be granted and the bank should be left free to honour its contractual obligation, although restrictions may well be imposed upon the freedom of the beneficiary to deal with the money after he has received it. The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which may thereafter be made will clearly be fraudulent. But the evidence must be clear, both as to the fact of fraud and as to the bank's knowledge. It would certainly not normally be sufficient that this rests upon the uncorroborated statement of the

customer, for irreparable damage can be done to a bank's credit in the relatively brief time which must elapse between the granting of such an injunction and an application by the bank to have it discharged."

In following the aforesaid dicta in the English cases, Sarath N Silva J held that:

"It is thus clear that business transactions between a bank and a beneficiary, constituted in the nature of a performance bond, a performance guarantee, letter of guarantee or a irrevocable letter of credit, whereby the bank is obliged to pay money to a beneficiary, are not tripartite transactions between the bank (surety), the beneficiary (creditor) and the party at whose instance the bond, guarantee or letter is issued (the principal debtor) but, simply transactions between the bank and the beneficiary. A bank thereby guarantees to the beneficiary payment of money and is obliged to honour that guarantee according to its terms. Any dispute that may arise between the beneficiary (creditor) and the party at whose instance the guarantee or letter is given (the principal debtor), on the underlying contract, cannot be urged to restrain the bank from honouring the guarantee or letter according to its terms. In an application for an injunction to restrain the bank from making payment, the Court has to consider whether there is a challenge to the validity of the bond, guarantee or letter itself, upon which payment is claimed and whether the conditions as specified in the writing are satisfied. If the challenge to the validity is not substantial and the conditions as specified in the writing are met, prima facie no injunction should be granted and the bank should be left free to honour its obligation.

The only exception to this general rule is where it is established by the party applying for the injunction that a claim for payment upon such bond, guarantee or letter is clearly fraudulent. A mere plea of fraud put in for the purpose of bringing the case within this exception and which rest on the uncorroborated statement of the applicant will not suffice. An injunction .may be granted only in

circumstances where the Court is satisfied that the bank should not effect payment.

Therefore, an injunction may be granted on the ground of fraud only where there is clear evidence as to: (i) the fact of fraud and, (ii) the knowledge of the bank as to the facts constituting the fraud."

We can observe that this has been the consistent, and unmoved position of Sri Lankan courts[20]. The Sri Lankan Supreme Court in *Commercial Bank of Ceylon PLC v Ace Containers (Pvt) Ltd*[21] referred to the aforesaid and other English cases, and in upholding the autonomy principle pertaining to demand guarantees held that:

"Paget's Law of Banking 12th edition Chapter 34.2 at page 730 describes the characteristics of Demand Guarantees as follows "The essential difference between a guarantee in the strict sense (i.e, a contract of suretyship) and a demand guarantee is that liability of a surety is secondary, whereas the liability of the issuer of a demand guarantee is primary. A surety's liability is co-extensive with that of the principal debtor and, if default by the principal debtor is disputed by the surety, it must be proved by the creditor Neither proposition applies to a demand guarantee. The principle which underlies demand guarantees is that each contract is autonomous. In particular, the obligations of the guarantor are not affected by disputes under the underlining contract between the beneficiary and the principal. If the beneficiary makes an honest demand, it matters not whether as between himself and the principal he is entitled to payment. The guarantor must honour

[20] *Indica Traders (Private) Limited v Seoul Lanka Construction (Private) Limited and Others* [1994] 3 S.L.R. 387; *Hemas Marketing (Pvt) Ltd v Chandrasiri and Others* [1994] 2 S.L.R. 181; *Pan Asia Bank Ltd v Kandy Multi Purpose Co-Operative Society and Others* [2012] 1 S.L.R. 78; *Pan Asia Bank Ltd v Bentota MPCS Ltd and Another* [2012] 1 S.L.R. 51; *Commercial Bank of Ceylon PLC v Ace Containers (Pvt) Ltd* [2015] 1 S.L.R. 223; *Galle Multipurpose Co-operative Society Limited v Morawakkoralage Gajeru Waluwe Anton Buddhika Abayakoon and others* [2016] Unreported, CA (LA) 455/2005, Court of Appeal Minutes of 26.07.2016

[21] [2015] 1 S.L.R. 223

the demand, the principal must reimburse the guarantor (or counter-guarantor) and any disputes between the principal and the beneficiary, including any claim by the principal that the drawing was a breach of the contract between them, must be resolved in separate proceedings to which the bank will not be a party."

Hence, in précis, the established legal position in Sri Lanka is that unless there is a substantial challenge to the validity of the demand guarantee, and the conditions contained therein are not met[22], and/or there is clear evidence as to the fact of fraud and, the knowledge of the bank as to the facts constituting the fraud, the Courts would uphold the autonomy principle and not injunct the encashment of a bank guarantee.

We can also observe that the Indian position pertaining to demand guarantees is fundamentally similar to that of the English position. In one of the earliest cases in 1978, Sabyasachi Mukharji J of the Calcutta High Court in *Texmaco Ltd. v State Bank Of India and Others*[23], referred to aforementioned dicta of Justice Kerr, and Lord Denning, and held:

"In my opinion, the position in law is as follows, whether the bank is obliged to pay and pay on what terms must depend upon both in the case of bank guarantee and in the case of letter of credit on the terms of the document. With respect to the Court of Appeal, it is not necessary for this Court to go to the extent of saying whether the performance guarantee stands on a similar footing of a letter of credit but so far as the Court of Appeal says the bank must pay according to the guarantee on demand, if so stipulated, without proof or conditions, I respectfully agree."

[22] Galle Multipurpose Co-operative Society Limited v Morawakkoralage Gajeru Waluwe Anton Buddhika Abayakoon and others [2016] Unreported, CA (LA) 455/2005, Court of Appeal Minutes of 26.07.2016
[23] AIR 1979 Cal 44

However, Sabyasachi Mukharji J, went on to identify two exceptions to the aforesaid rule. He went on to state:

> "The Court of Appeal has referred to the exception of a clear fraud. I venture to suggest there may be another exception in the form of special equities arising from a particular situation which might entitle the party to an injunction restraining the performance of bank guarantee. But in the absence of such special equities and in the absence of any clear fraud, the Bank must pay on demand, if so stipulated, and whether the terms are such must have to be found out from the performance guarantee as such."

Following the Indian Supreme Court's judgement in *Svenska Handelsbanken v. Indian Charge Chrome*[24], there arose an academic debate as to whether the aforesaid two exceptions were actually two exceptions or one combined exception. However, the subsequent decisions of the Indian Supreme Court have stipulated them to be two exceptions to the rule rather than one combined exception.

The Indian Supreme Court in *State Of Maharashtra & Another v M/S National Construction Company*[25] held that:

> "The rule is well established that a bank issuing a guarantee is not concerned with the underlying contract between the parties to the contract. The duty of the bank under a performance guarantee is created by the document itself. Once the documents are in order, the bank giving the guarantee must honour the same and make payment. Ordinarily, unless there is an allegation of fraud or the like, the Courts will not interfere, directly or indirectly, to withhold payment, otherwise trust in commerce, internal and international, would be irreparably damaged. But that does not mean that the parties to the underlying contract cannot settle their

[24] [1994] SCC (2) 155
[25] [1996] SCC (1) 735

disputes with respect to allegations of breach by resorting to litigation or arbitration as stipulated in the contract. The remedy arising ex-contract is not barred and the cause of action for the same is independent of enforcement of the guarantee…

The legal position, therefore, is that a bank guarantee is ordinarily a contract quite distinct and independent of the underlying contract, the performance of which it seeks to secure. To that extent it can be said to give rise to a cause of action separate from that of the underlying contract."

The Indian Supreme Court in *U.P. State Sugar Corporation v. Sumac International Ltd*[26], in reiterating the position in India pertaining to injunctions against encashment of bank guarantees held that:

"These bank guarantees which are irrevocable in nature, in terms, provide that they are payable by the guarantor to the appellant on demand without demur. They further provide that the appellant shall be the sole judge of whether and to what extent the amount has become recoverable from the respondent or whether the respondent has committed any breach of the terms and conditions of the agreement. The bank guarantees further provide that the right of the purchaser to recover from the guarantor any amount shall not be affected or suspended by reason of any disputes that may have been raised by the respondent with regard to its liability or on the ground that proceedings are pending before any Tribunal, Arbitrator or Court with regard to such dispute. The guarantor shall immediately pay the guaranteed amount to the appellant-purchasers on demand.

The law relating to invocation of such bank guarantees is by now well settled. When in the course of commercial dealings an unconditional bank guarantee is

[26] [1997] 1 SCC 568

given or accepted, the beneficiary is entitled to realize such a bank guarantee in terms thereof irrespective of any pending disputes. The bank giving such a guarantee is bound to honour it as per its terms irrespective of any dispute raised by its customer. The very purpose of giving such a bank guarantee would otherwise be defeated. The courts should, therefore, be slow in granting an injunction to restrain the realization of such a bank guarantee."

It further proceeded to analyse the two limited exceptions to the rule, and held:

"The courts have carved out only two exceptions. A fraud in connection with such a bank guarantee would vitiate the very foundation of such a bank guarantee. Hence if there is such a fraud of which the beneficiary seeks to take advantage, he can be restrained from doing so. The second exception relates to cases where allowing the encashment of an unconditional bank guarantee would result in irretrievable harm or injustice to one of the parties concerned. Since in most cases payment of money under such a bank guarantee would adversely affect the bank and its customer at whose instance the guarantee is given, the harm or injustice contemplated under this head must be of such an exceptional and irretrievable nature as would override the terms of the guarantee and the adverse effect of such an injunction on commercial dealings in the country. The two grounds are not necessarily connected, though both may co-exist in some cases….

The bank which gives the guarantee is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the suppler has performed his contractual obligation or not, nor with the question whether the supplier is in default or not. The bank must pay according to the tenor of its guarantee on demand without proof or condition. There are only two exceptions to this rule. The first exception is a case when there is a clear fraud of which the bank has notice. The fraud must be of an egregious nature such as to vitiate the entire underlying transaction…

On the question of irretrievable injury which is the second exception to the rule against granting of injunctions when unconditional bank guarantees are sought to be realised the court said in the above case that the irretrievable injury must be of the kind which was the subject-matter of the decision in the Itek Corporation case. In that case an exporter in the U.S.A. entered into an agreement with the Imperial Government of Iran and sought an order terminating its liability on stand by letters of credit issued by an American bank in favour of an Iranian Bank as part of the contract. The relief was sought on account of the situation created after the Iranian revolution when the American Government cancelled the export licences in relation to Iran and the Iranian Government had forcibly taken 52 American citizens as hostages. The U.S. Government had blocked all Iranian assets under the jurisdiction of United States and had cancelled the export contract. The court upheld the contention of the exporter that any claim for damages against the purchaser if decreed by the American Courts would not be executable in Iran under these circumstances and realisation of the bank guarantee/Letters of credit would cause irreparable harm to the plaintiff. This contention was upheld. To avail of this exception, therefore, exceptional circumstances which make it impossible for the guarantor to reimburse himself if the ultimately succeeds, will have to be decisively established. Clearly, a mere apprehension that the other party will not be able to pay, is not enough. In the Itek case (supra) there was a certainty on this issue. Secondly, there was good reason, in that case for the court to be prima facie satisfied that the guarantors i.e. the bank and its customer would be found entitled to receive the amount paid under the guarantee."

This position was once again reiterated by the Supreme Court of India in *Himadri Chemicals Industries Ltd v Coal Tar Refining Company*[27]. The Supreme Court of India held:

[27] [2007] 8 SCC 110

"The law relating to grant or refusal to grant injunction in the matter of invocation of a Bank Guarantee or a Letter of Credit is now well settled by a plethora of decisions not only of this court but also of the different High Courts in India. In U.P. State Sugar Corporation Vs. Sumac International Ltd. [(1997) 1 SCC 568], this court considered its various earlier decisions. In this decision, the principle that has been laid down clearly on the enforcement of a Bank guarantee or a Letter of Credit is that in respect of a Bank Guarantee or a Letter of Credit which is sought to be encashed by a beneficiary, the bank giving such a guarantee is bound to honour it as per its terms irrespective of any dispute raised by its customer. Accordingly this Court held that the courts should be slow in granting an order of injunction to restrain the realization of such a Bank Guarantee. It has also been held by this court in that decision that the existence of any dispute between the parties to the contract is not a ground to restrain the enforcement of Bank guarantees or Letters of Credit. However this court made two exceptions for grant of an order of injunction to restrain the enforcement of a Bank Guarantee or a Letter of Credit. (i) Fraud committed in the notice of the bank which would vitiate the very foundation of guarantee; (ii) injustice of the kind which would make it impossible for the guarantor to reimburse himself.

Except under these circumstances, the courts should not readily issue injunction to restrain the realization of a Bank Guarantee or a Letter of Credit. So far as the first exception is concerned, i.e. of fraud, one has to satisfy the court that the fraud in connection with the Bank Guarantee or Letter of Credit would vitiate the very foundation of such a Bank Guarantee or Letter of Credit. So far as the second exception is concerned, this court has held in that decision that it relates to cases where allowing encashment of an unconditional bank guarantee would result in irretrievable harm or injustice to one of the parties concerned."

Then, the Supreme Court went on to identify certain principles pertaining to the granting or refusal of injunctions pertaining to bank guarantees:

"From the discussions made hereinabove relating to the principles for grant or refusal to grant of injunction to restrain enforcement of a Bank Guarantee or a Letter of Credit, we find that the following principles should be noted in the matter of injunction to restrain the encashment of a Bank Guarantee or a Letter of Credit :-

(i) While dealing with an application for injunction in the course of commercial dealings, and when an unconditional Bank Guarantee or Letter of Credit is given or accepted, the Beneficiary is entitled to realize such a Bank Guarantee or a Letter of Credit in terms thereof irrespective of any pending disputes relating to the terms of the contract.

(ii) The Bank giving such guarantee is bound to honour it as per its terms irrespective of any dispute raised by its customer.

(iii) The Courts should be slow in granting an order of injunction to restrain the realization of a Bank Guarantee or a Letter of Credit.

(iv) Since a Bank Guarantee or a Letter of Credit is an independent and a separate contract and is absolute in nature, the existence of any dispute between the parties to the contract is not a ground for issuing an order of injunction to restrain enforcement of Bank Guarantees or Letters of Credit.

(v) Fraud of an egregious nature which would vitiate the very foundation of such a Bank Guarantee or Letter of Credit and the beneficiary seeks to take advantage of the situation.

(vi) Allowing encashment of an unconditional Bank Guarantee or a Letter of Credit would result in irretrievable harm or injustice to one of the parties concerned."

Hence, we can observe that, the Indian courts have transcended beyond the traditional English exceptions, and recognise "special equities" as a sperate kind of exception to the rule. However, the scope of "special equities" is limited to events which "would result in irretrievable harm or injustice to one of the parties". We can also observe that, this development in Indian law is also influenced by the US decisions, especially the dicta of *Itek Corp. v First National Bank of Boston*[28]. The facts of this case is summarised above in the Indian Supreme Court's dicta in *U.P. State Sugar Corporation v. Sumac International Ltd*[29]. In this case, the U.S. District Court for the District of Massachusetts analysed the irreparability of harm, balance of injury, likelihood of success on the merits, and public interest pertaining to the question of whether to grant the inunction or not from the encashment of the bank guarantee and held that:

"the plaintiff has demonstrated that it is likely to suffer irreparable harm if an injunction does not issue, that such injury outweighs any harm to be inflicted upon the defendants, that the plaintiff has demonstrated a sufficient likelihood of success on the merits, and that the public interest will not be adversely affected by the granting of the requested relief. Accordingly, the plaintiff's motion for a preliminary injunction is hereby granted."

The "special equities" exception recognised by the Indian Courts, although thus far interpreted very rigidly, could still allow certain flexibility for the Courts to do justice based on the peculiarities of the facts of each case. An interesting proposition pertaining to the possibility of proportionality being included within the scope of "special equities" exception is contained in the latest judgement of the Delhi High Court in *Hindustan*

[28] 566 Fed. Supp. 1210 (D. Mass. 1983)
[29] [1997] 1 SCC 568

Construction Co. Ltd v National Hydro Electric Power Corporation Limited[30]. In this case the Delhi High Court held:

> "It appears, therefore, necessary to examine whether proportionality would constitute yet another kind of special equities, where relatively speaking, the crystallized liability of the guarantor formed only a small portion of the amount assured by way of BGs…
>
> While proportionality could be included in the exception of special equities, in our view, it can be applied only where the crystallized liability is significantly lower than the value of the BG [Bank Guarantee] furnished and the contract is a concluded one."

It evinces from this judgement, and the "special equities" exception, that although autonomy principle attempts to detach the underlying contract from the demand guarantees, in reality, the demand guarantees cannot be looked in isolation. Schwank, in his 1987 article "New Trends in International Bank Guarantees"[31] observes that in certain civil law countries, and mostly in Latin American countries, jurisprudence does not consider the underlying contract completely isolated from documentary commitment. In these countries, jurists have found difficulties in understanding the concept of the autonomy of independent undertakings because of the principle of "cause" is deeply rooted in civil law tradition.

Be that as it may, injunctions by nature are equitable reliefs and are discretionary remedies which are granted where damages shall not be adequate remedy. Hence, a court exercising an equitable jurisdiction ought not to be stuck within rigid confines and mechanically exercise its discretion. It is not suggested that the court exercising equitable

[30] [2020] Unreported, FAO(OS)(COMM) 106/2020, decided on 22nd September 2020
[31] Friedrich Schwank, 'New Trends in International Bank Guarantees' [1987] 6(37) International Banking Law 35-40

jurisdiction would have the freedom of the "wild ass", but it should not stand at the pole opposite of the spectrum either.

An interesting case in this regard is the *M/S Haliburton Offshore Services v Vedanta Limited & another*[32]. In this case the Delhi High Court considered the situation of the inability to perform a contract due to Covid-19 lockdown as falling within "special equities" in issuing an injunction preventing the calling of the performance bonds. Whilst this decision invited severe criticism from various quarters, overall, it appears to be a just and equitable order considering the peculiar circumstances. Thus, it could be said that the learned Judge has exercised the equitable jurisdiction pertaining to the issuance of injunction rightly and appropriately.

On the other hand, there appears to be some notable discussions in English judgements as to taking into consideration the underlying contract or transaction in determining the issue of granting of injunctions preventing the encashment of demand guarantees. In *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Same*[33], Phillips J in the Queen's Bench Division stated that:

> "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."

In the 2003 English case *Sirius International Insurance Company v FAI General Insurance Ltd and others*[34], where in an insurance and banking dispute with regard to the benefit of a letter of credit, the Parties had entered into a settlement agreement, but the parties then disagreed as to the meaning of the settlement and thereby the question arose whether

[32] [2020] Unreported, Delhi High Court O.M.P (I) (COMM.) No. 88/2020 & I.A. 3697/2020, decided on 29.05.2020
[33] [1995] 1 WLR 1017
[34] [2003] EWCA Civ 470

one party is entitled to the proceeds of the letter of credit in the escrow account based on the settlement entered into, May LJ in the Court of Appeal of England and Wales held that:

> "Sirius should not, as between themselves and FAI, be regarded as entitled to do that which they expressly agreed not to do."

The Court has effectively taken into consideration the settlement agreement entered into between the Parties, where it expressly restricted the circumstances in which a party can draw on a letter of credit and where a party is not entitled to draw down.

In appeal, although the House of Lords over turned the final decision of the Court of Appeal, it was done so on different grounds pertaining to the interpretation of the settlement, and the House of Lords did not consider other matters expressed in the Court of Appeal judgement.

In the 2011 English case, *Simon Carves Ltd v Ensus UK Ltd*[35], in the Queen's Bench Division judgement, Akenhead J, taking into consideration, *inter alia*, the judgements in *Deutsche Ruckversicherung AG v Walbrook Insurance Co Ltd and others; Group Josi Re (formerly known as Group Josi Reassurance SA) v Same*[36], and *Sirius International Insurance Company v FAI General Insurance Ltd and others*[37], identified the following principles pertaining to the issuance of injunction preventing the encashment of demand guarantees:

> "In my judgement one can draw from the authorities the following:
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> (a) Unless material fraud is established at a final trial or there is clear evidence of fraud at the without notice or interim injunction stage, the

[35] [2011] EWHC 657 (TCC)
[36] [1995] 1 WLR 1017
[37] [2003] EWCA Civ 470

Court will not act to prevent a bank from paying out on an on demand bond provided that the conditions of the bond itself have been complied with (such as formal notice in writing). However, fraud is not the only ground upon which a call on the bond can be restrained by injunction.

(b) The same applies in relation to a beneficiary seeking payment under the bond.

(c) There is no legal authority which permits the beneficiary to make a call on the bond when it is expressly disentitled from doing so.

(d) In principle, if the underlying contract, in relation to which the bond has been provided by way of security, clearly and expressly prevents the beneficiary party to the contract from making a demand under the bond, it can be restrained by the Court from making a demand under the bond.

(e) The Court when considering the case at a final trial will be able to determine finally what the underlying contract provides by way of restriction on the beneficiary party in calling on the bond. The position is necessarily different at the without notice or interim injunction stage because the Court can only very rarely form a final view as to what the contract means. However, given the importance of bonds and letters of credit in the commercial world, it would be necessary at this early stage for the Court to be satisfied on the arguments and evidence put before it that the party seeking an injunction against the beneficiary had a strong case. It can not be expected that the court at that stage will make in effect what is a final ruling."

These principles clearly suggest that even the English courts, in appropriate cases, would take into consideration the underlying contract/transaction in determining whether to

grant an injunction or not. This is more so when the underlying contract/transaction contains limitations or conditions as to the encashment of the demand guarantees provided under or in relation to the underlying contract or conditions.

Nevertheless, it must be said that the norm, whether in Sri Lanka, India or the UK, still remains that the contract of bank guarantee is an independent contract between the banker and the creditor and therefore operates independent of any disputes that may have arisen between the creditor and the principal debtor; and commitment of banks must be honoured as far as possible without the interference of courts; else trust in commerce would be irreparably damaged. The only common exception to this norm recognised in Sri Lanka, India or the UK is fraud. But, the additional exception of "special equities" recognised by the Indian courts grants the flexibility to courts to deliver just and equitable decisions in appropriate cases. After all, injunctions by their nature are equitable remedies, and dispensing of equity for the sake of legal rigidity defeats the notion of equity altogether. In this regard it also noteworthy that the Singapore courts recognise "unconscionability" as a distinct ground upon which the court can grant an injunction restraining a beneficiary of a performance bond from calling on the bond[38]. The Singapore Court of Appeal in enunciating the rationale for recognising "unconscionability" as a distinct exception, stated that:

> "The juridical basis for adopting unconscionability as a relevant ground (separate from and independent of fraud) lies in the equitable nature of the injunction. Considerations of conscionability are applicable in relation to the use of the injunction in other areas of the law, and there is no reason why these considerations should not be applied for the purposes of determining whether a call on a performance bond should be restrained so as to achieve a fair balance between the interests of the beneficiary and those of the obligor."[39]

[38] Bocotra Construction Pte Ltd and others v Attorney-General [1995] 2 SLR(R) 262; BS Mount Sophia Pte Ltd v Join-Aim Pte Ltd [2012] SGCA 28

[39] JBE Properties Pte Ltd v Gammon Pte Ltd [2011] 2 SLR 47

However, it must be noted that Singapore courts, unlike the UK courts, distinguishes between performance guarantees, and letters of credit. Whilst fraud remains the only recognised exception pertaining to letters of credit, fraud, and unconscionability is recognised as a distinct exceptions pertaining to performance guarantees in Singapore. This distinction is based on the different commercial character of both these instruments[40]. This is clearly enunciated in the case *Chartered Electronic Industries Pte Ltd v. The Development Bank of Singapore Ltd*[41], where Chan J held:

> "A performance guarantee does not perform the same function as a documentary letter of credit in international trade, nor does it cause the same degree of hardship to the party concerned if a temporary restraining order is granted. The former is merely a security whereas the letter of credit is an established mode of payment in exchange for goods. The letter of credit has been the life blood of commerce in international trade for hundreds of years. But the same cannot be said of the performance guarantee or the performance bond…. A merchant who has to ship his goods to a buyer abroad should be protected as to his right of payment. A beneficiary under a performance guarantee should be protected as to the integrity of his security in the case of non-performance…. A temporary restraining order does not affect the security nor the beneficiary's rights in it. It merely postpones the realisation of the security until the plaintiff is given an opportunity to prove his case."

The Singaporean approach seems pragmatic in the sense it takes into consideration practical realities of contemporary commerce, and grant the flexibility to the Courts to exercise its discretion on equitable basis in order to prevent abusive encashment of

[40] LP Thean, 'The Enforcement of a Performance Bond: The Perspective of the Underlying Contract' [1998] 19 Singapore Law Review 389
[41] [1999] 4 S.L.R. 665

demand guarantees, rather than be stuck into rigid confines ignoring the commercial realities, and be a mere spectator to an abuse of performance guarantees taking place.

Whilst the autonomy principle seems the norm in UK, India, Singapore, and Sri Lanka, the legal position pertaining to the exceptions to the autonomy principle in the UK, India, Singapore, and Sri Lanka with regard to demand guarantees can be stated in précis as follows:

In the UK, fraud is a long recognised exception. However, there seems to be some flexibility, as espoused in *Simon Carves Ltd v Ensus UK Ltd*[42], in looking into the underlying contract for any restrictions on the beneficiary in encashing the demand guarantee.

In India, fraud, and "special equities" are recognised exceptions. Although, originally "special equities" were stringently interpreted, we can observe a contemporary trend of a fair and equitable approach by the Indian courts in interpreting "special equities" where "proportionality"[43], and even "*force majeure*"[44] pertaining to the underlying contract are taken into consideration.

In Singapore, with regard to demand guarantees, fraud and "unconscionability" are recognised exceptions.

In Sri Lanka, fraud remains the only exception to the principle of autonomy pertaining to demand guarantees. Regrettably, this is an outdated and stagnant position compared to the developments that have occurred in the UK, India, and Singapore.

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[42] [2011] EWHC 657 (TCC)

[43] Hindustan Construction Co. Ltd v National Hydro Electric Power Corporation Limited [2020] Unreported, FAO(OS)(COMM) 106/2020, decided on 22nd September 2020

[44] M/S Haliburton Offshore Services v Vedanta Limited & another [2020] Unreported, Delhi High Court O.M.P (I) (COMM.) No. 88/2020 & I.A. 3697/2020, decided on 29.05.2020

In consideration of the aforesaid, it appears to be more prudent and equitable for the Sri Lankan courts to adopt the Indian, and Singaporean approach in recognising "special equities", and "unconscionability" as distinct exceptions in addition to fraud to the principle of autonomy, where the Courts could look beyond the demand guarantee between the bank and beneficiary, and exercise its equitable jurisdiction and grant injunction preventing the inequitable and/or unconscionable encashment of demand guarantees. There is nothing to suggest that this would be anathematic, or contrary to the laws of Sri Lanka. Even Lord Denning, whose dicta is the bedrock of the Sri Lankan legal position on the instant topic, in his celebrated book "The Discipline of Law"[45] states:

> "The principles of law laid down by the Judges in the 19th century- however suited to social conditions of that time- are not suited to the social necessities and social opinion of the 20th century. They should be moulded and shaped to meet the needs and opinion of today."[46]

Nevertheless, even if the Sri Lankan Courts are reluctant to tread the more equitable path of the Indian, and Singaporean Courts, in accordance with the provisions of Section 3 of The Introduction of Laws of England (Civil Law Ordinance) No. 5 of 1852 (as amended) are bound by the English law as it prevails at the corresponding period. The said section provides that:

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

[45] Alfred Denning, The Discipline of Law (Butterworths 1979)
[46] ibid v

> Provided that nothing herein contained shall be taken to introduce into Sri Lanka any part of the Law of England relating to the tenure or conveyance, or assurance of, or succession to, any land or other immovable property, or any estate, right, or interest therein."

Hence, the Sri Lankan Courts, by law, are bound to follow the developments in English law. In this regard the principles laid out in the latest English case *Simon Carves Ltd v Ensus UK Ltd*[47] clearly stipulates that where there are restrictions imposed in the underlying contract pertaining to the encashment of the demand guarantees, the Court must look at it and uphold such restrictions.

[47] [2011] EWHC 657 (TCC)