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## Fairness at the Expense of Commercial Certainty: The International Emergence of Unconscionability and Illegality as Exceptions to the Independence Principle of Letters of Credit and Bank Guarantees

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# Fairness at the Expense of Commercial Certainty: The International Emergence of Unconscionability and Illegality as Exceptions to the Independence Principle of Letters of Credit and Bank Guarantees

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## I. INTRODUCTION

Transacting business in the international arena involves an array of risks.<sup>1</sup> One of these risks arises from variations in the legal landscape from one jurisdiction to the next.<sup>2</sup> Effective risk appraisal and the formulation of

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1. See VIRGINIA HAUFLE, DANGEROUS COMMERCE: INSURANCE AND THE MANAGEMENT OF INTERNATIONAL RISK 4-6 (1997) (describing types and nature of international business risks).

2. See generally CYNTHIA D. WALLACE, LEGAL CONTROL OF THE MULTINATIONAL ENTERPRISE (1983) (providing a comprehensive treatment of the legal risks arising from doing business in multiple jurisdictions).

risk-limiting strategies must take these variations into account.<sup>3</sup> While it is impossible, and probably undesirable, that the law remain static, the emergence of nonuniformities in areas of concern to the global business community can be threatening to settled expectations and practices.<sup>4</sup> The focus here is on the emergence of new variations in the legal landscape surrounding letters of credit and bank guarantees—variations that threaten the settled expectations of those engaging in transactions dependent upon such instruments.

Proceeding on the assumption that transaction risk cannot be eliminated, but that it can be limited, we examine emerging threats to the effectiveness with which letters of credit and bank guarantees perform their risk-limiting function. Institutionalized risk-shifting schemes exist for virtually every aspect of business. Performance bonds exist to ensure that contractors properly build buildings,<sup>5</sup> directors and officers insurance exists to ensure against the risk of defalcation by corporate directors and executives,<sup>6</sup> credit default swaps offer protection against default by issuers of various types of debt securities,<sup>7</sup> and so on. A persistent risk, at the level of individual commercial transactions, occurs between parties who do not know each other well enough (or, through unfortunate past dealings, know each other too well) to trust each other.<sup>8</sup> The typical standoff would sound something like, “I’ll ship the goods as soon as your payment arrives,” versus “I’ll send payment as soon as your goods arrive.” Another version of this would occur when one party undertakes to construct a building or a vessel for another

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3. See RALPH H. FOLSOM, MICHAEL WALLACE GORDON & JOHN A. SPANOGLE, JR., INTERNATIONAL BUSINESS TRANSACTIONS §§ 32.8-32.26 (2d ed. 2001) (explaining the necessary understanding of and techniques for managing risks associated with international transactions).

4. See generally Roxane DeLaurell, *The Role of the Legal Regimes in New Industrial Economic Theory*, 5 ASPER REV. INT’L BUS. & TRADE L. 195 (2005) (describing the interplay between uniformity of law, uncertainty, the formation of contracts, and international trade practices); see also Sandeep Gopalan, *Transnational Commercial Law: The Way Forward*, 18 AM. U. INT’L L. REV. 803 (2003) (describing the difficulties posed by non-uniformity in the rules applicable to international transactions and setting forth the value of harmonization).

5. See JEFFREY S. RUSSELL, SURETY BONDS FOR CONSTRUCTION CONTRACTS 39-40 (2000) (explaining the use of performance bonds in the building construction industry).

6. See Joseph M. Smick & Edward J. Kirk, *Scope of Coverage*, in DIRECTORS & OFFICERS LIABILITY INSURANCE DESKBOOK 75-97 (Martin O’Leary ed., 2007) (describing the nature of directors and officers insurance and the types of activities against which coverage is offered).

7. MARK J. P. ANSON ET AL., CREDIT DERIVATIVES: INSTRUMENTS, APPLICATIONS, AND PRICING 47-48 (2004) (describing the functions of credit default swaps in the securities markets).

8. See Egon Guttman, *U.C.C. Article 5 Symposium: Bank Guarantees and Standby Letters of Credit: Moving Toward a Uniform Approach*, 56 BROOK. L. REV. 167, 168 (1990) (describing the risk inherent in transacting at a distance with unknown parties).

party, implicating the risk of failure to build or to build correctly, and the risk of nonpayment.<sup>9</sup> Neither party in either scenario wants to commit resources or incur an opportunity cost, unless the risk of loss due to the other party's failure has been reduced to an acceptable level. Each party needs some assurance that the other party will perform as agreed, or failing that, that an independent mechanism exists to provide either substitute performance or the means to purchase substitute performance. In transactions for the sale of goods, documentary letters of credit are routinely used to provide this assurance.<sup>10</sup> For construction contracts, standby letters of credit (and, outside the United States, bank guarantees) and performance bonds are the instruments of choice.<sup>11</sup> The fundamentals of these instruments are explained in Part II below.

Letters of credit and bank guarantees facilitate commercial transactions by shifting transaction risk from the buyer of goods or services onto a trusted independent third party<sup>12</sup>—a phenomenon known as credit substitution<sup>13</sup>—by engaging the third party to pay the appropriate party to the commercial transaction when presented with proper demand to do so.<sup>14</sup> The

9. RUSSELL, *supra* note 5, at 39-40.

10. See Christopher Leon, *Letters of Credit: A Primer*, 45 MD. L. REV. 432, 449 (1986) (describing the sale transaction support functions of documentary letters of credit).

11. David J. Barru, *How to Guarantee Contractor Performance on International Construction Projects: Comparing Surety Bonds with Bank Guarantees and Standby Letters of Credit*, 37 GEO. WASH. INT'L L. REV. 51, 53 (2005) (stating that in the construction industry, “[i]n the United States, an owner will usually require that its contractors provide a performance bond . . . . Outside the United States, the owner will usually require that its contracts furnish a bank guarantee or standby letter of credit . . . .”).

12. See Robert D. Aicher et al., *Credit Enhancement: Letters of Credit, Guaranties, Insurance and Swaps (The Clash of Cultures)*, 59 BUS. LAW. 897, 901 (2004) (“With respect to the beneficiary, the critical economic effect of the letter of credit is to substitute the credit and creditworthiness of the issuer for the credit and creditworthiness of the [buyer.]”); see also U.C.C. § 5-102(a)(10) (2009). Section 5-102(a)(10) defines a letter of credit as

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.

*Id.*; International Chamber of Commerce Uniform Customs & Practice for Documentary Credits 2007 Revision (Pub. No. 600) art. 2 [hereinafter UCP 600] (defining a letter of credit as “any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation.”); Edward L. Symons, Jr., *Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief*, 54 TUL. L. REV. 338, 341-42 (1980) (providing a basic description of the function and purpose of letters of credit).

13. See Aicher, et al., *supra* note 12, at 903.

14. See Leon, *supra* note 10, at 432-34.

Letters of credit are used to facilitate marketplace transactions by providing the credit of a third party, generally a bank, as an

value of these instruments rests upon the reliability of payment by the independent third party,<sup>15</sup> and that depends, in part, on the level of judicial respect for the fact that the third party's obligation to pay is independent of the obligations of the parties to the underlying commercial transaction.<sup>16</sup> Under the rules that govern these instruments, proper demand means formally proper demand, not necessarily substantively proper demand.<sup>17</sup> If the

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independent assurance of payment to protect [the] parties . . . [and that the third party] issues such a credit letter promising to pay . . . upon presentation of a draft and appropriate documents specified in the letter.

*Id.*

15. See, e.g., Ronald J. Mann, *The Role of Letters of Credit in Payment Transactions*, 98 MICH. L. REV. 2494, 2519 (2000) (describing the certainty of enforceability against the issuer as "the key benefit offered by the letter of credit" and describing the reliability and certainty of payment by the third party as the critical feature of a letter of credit).

16. See, e.g., Leon, *supra* note 10, at 441-42.

Courts, however, have acknowledged that the general rules respecting interpretation of contracts should be tempered in the context of letters of credit. First, a construction permitting enforcement is preferred over a construction that results in an unenforceable provision. Second, the unique nature of a letter of credit and, in particular, the independence principle discussed below, dictate that courts are not to review the underlying contract between the beneficiary and customer to interpret a letter of credit.

*Id.*

17. See, e.g., U.C.C. § 5-109 (2009).

(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:

(1) the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and

(2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.

*Id.*; see also Symons, Jr., *supra* note 12, at 343.

[I]t is universally accepted as a general principle that the issuer deals in documents, not in goods, and the beneficiary is assured of receiving payment if the documents comply with the letter of credit, whether or not the goods conform to the under-

party to the underlying contract for whose benefit the instrument was created presents a demand in proper form, it must, with only one exception (until recently), be honored.<sup>18</sup> This can cause problems when one party to the underlying transaction believes that the other has presented a demand that is formally but not substantively proper and, therefore, should not be paid by the third party. For example, the buyer of goods would not want the seller of goods to be paid if, the seller had shipped defective or nonconforming goods but had nevertheless submitted formally (but not substantively) proper demand for payment. The buyer, in this case, might seek to enjoin either the seller from seeking payment, or the third party from making payment.<sup>19</sup> The independence of the third party is intended to keep such injunctions at bay to isolate the rights and obligations of the parties to the underlying transaction from the third party's obligation to pay upon receiving formally proper demand, by shielding the third party's obligation to pay from interference by a disgruntled party to the underlying transaction.<sup>20</sup> From a purely logical perspective, to the extent one party to the underlying transaction believes that the other can control the third party through injunction, the value of the third party's obligation to pay becomes suspect. Thus, a key variable in the level of judicial respect for the independence principle is the ease with which a party to the underlying transaction can

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lying sales contract. . . . The commercial significance of this assurance of *payment against documents alone* cannot be overemphasized.

*Id.* (emphasis added).

18. See, e.g., U.C.C. § 5-109 (2009); see also Symons, Jr., *supra* note 12, at 343.

19. See Mark S. Blodgett & Donald O. Mayer, *International Letters of Credit: Arbitral Alternatives to Litigating Fraud*, 35 AM. BUS. L.J. 443, at \*1-2 (1998) ("Along with its increased use, however, has come a growing volume of litigation, particularly litigation over fraud. Buyers in one country, alleging fraud on the part of sellers in another, have often sought *injunctions to prevent issuing banks from honoring payment demands* by sellers.") (emphasis added); see also, e.g., *McIngvale v. AGM, LLC*, No. G-07-0228, 2007 U.S. Dist. LEXIS 54581 (S.D. Tex. July 27, 2007) (involving a plaintiff-applicant seeking to have a court enjoin defendant-beneficiary from seeking payment under the letter of credit).

20. See, e.g., Rocco D'Ascenzo, *The Supreme Court of Ohio's Decision in Mid-America Tire, Inc. v. Ptz Trading Ltd., and the Weakening of the Independence Principle*, 32 CAP. U. L. REV. 1097, 1097 (2004).

The Independence Principle is the foundation of the Letter of Credit transaction. In theory, its primary function is to completely separate an underlying contract for the sale of goods from the contract for payment to the beneficiary. Because of the Independence Principle, letters of credit have become an integral part of international transactions involving the importing and exporting of goods.

*Id.* (footnotes omitted).

persuade a court to enjoin payment by the third party,<sup>21</sup> with the value of the third party's obligation being inversely related to the ease of its enjoynability.

Until recently, the circumstances under which a court could be persuaded to enjoin payment under letters of credit or bank guarantees have been extremely limited. With only occasional, isolated deviations, these circumstances have been limited to some sort of fraud.<sup>22</sup> Over the last several years, however, some foreign courts have begun to recognize unconscionability and illegality as additional exceptions to the independence of the third party's obligations.<sup>23</sup> This article chronicles the evolution and spread of unconscionability and illegality as grounds for enjoining payment under letters of credit and bank guarantees, and examines the threat their exaltation of fairness over contractual certainty poses to the continuing value of these instruments.

## II. FUNDAMENTALS OF LETTERS OF CREDIT AND BANK GUARANTEES

Letters of credit exist in two basic forms: commercial (or documentary) letters of credit, and standby letters of credit.<sup>24</sup> Documentary letters of

21. See *Bank of Nova Scotia v. Angelica-Whitewear Ltd.*, [1987] D.L.R. 161, 168 (Can.). This case held, with respect to the enjoynability of a letter of credit, that the potential scope of the fraud exception must not be a means of creating serious uncertainty and lack of confidence in the operation of letter of credit transactions; at the same time the application of the principle of autonomy must not serve to encourage or facilitate fraud in such transactions.

*Id.* See also Leon, *supra* note 10, at 432.

The critical feature of a letter of credit is its reliability, i.e., its certainty of payment. Hence, parties who might otherwise hesitate to enter into a transaction are encouraged to participate because they can rely upon a secure source of credit and thereby more accurately assess the possible risks in the undertaking.

*Id.*

22. See John F. Dolan, *Tethering the Fraud Inquiry in Letter of Credit Law*, 21 BANKING & FIN. L. REV. 479, 485 (2006).

In common law states engaging in international trade and commerce, courts generally support the independence principle but have fashioned an important exception to it. That exception is the fraud exception . . . There are other exceptions, though they tend to have limited application and, to date, have not threatened the efficacy of independent obligations as commercial devices to the extent the fraud exception has done and threatens to do.

*Id.* (footnotes omitted).

23. See *infra* Part IV.

24. See JOHN F. DOLAN, *THE LAW OF LETTERS OF CREDIT: COMMERCIAL AND STANDBY CREDITS 1-1* (4th ed. 2007) (describing the two basic types of letters of credit).

credit are designed to facilitate commercial transactions by giving some degree of comfort to buyers and sellers of goods that shipment of the goods and payment of the price, respectively, will be forthcoming.<sup>25</sup> Standby letters of credit are used in the United States to perform the same functions as bank guarantees in other countries.<sup>26</sup> Both instruments are used to shift the risks associated with other contracts.<sup>27</sup> Letters of credit are typically one of a set of three interrelated contracts:<sup>28</sup> (1) an underlying contract that gives rise to the need for the letter of credit; (2) a contract between the applicant for the letter of credit, who is also a party to the underlying contract, and the person issuing the letter of credit; and (3) the letter of credit itself, which is a contract between the issuer and the beneficiary of the letter of credit, who is the other party to the underlying contract.<sup>29</sup> In some instances, there is a fourth contract between the issuer of the credit and a party designated to advise or confirm the existence and availability of the credit to the beneficiary.<sup>30</sup>

Issuers of letters of credit,<sup>31</sup> which are usually the applicant's bank,<sup>32</sup> will typically issue a letter at the request of the applicant, who is either the buyer of goods or the producer of some service specified in the underlying

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25. See, e.g., Leon, *supra* note 10, at 442. Leon describes commercial letters of credit as

a payment mechanism whereby a seller of goods, upon presentation of a draft or other specified documents, will receive payment directly from a bank or other source of credit. The issuer does not need to inquire into the underlying agreement; its obligation is to make payment upon presentation of complying documents. Hence, the seller is assured of the purchase price from a secure source of credit, independent of any disagreements with the buyer.

*Id.* (footnotes omitted).

26. See Barru, *supra* note 11, at 53.

27. See FOLSOM, ET AL., *supra* note 3, §§ 6.2, 7.3 (regarding the contractual context of documentary letters of credit and the functional context of standby letters of credit).

28. See, e.g., Aicher, et al., *supra* note 12, at 899-900 (describing the three contract context in which letters of credit exist).

29. *Id.*

30. See Leon, *supra* note 10, at 436-38 (describing the roles of the various fourth party intermediaries: confirming banks, advising banks, paying banks, and negotiating banks); see also U.C.C. §§ 5-102(1), (4), (11) (2009) (defining advisers, confirmers, and nominated persons, respectively).

31. See Aicher, et al., *supra* note 12, at 900 ("Letters of credit have principally been offered by commercial banks.").

32. Adam Bobraw, *Letters of Credit*, U.S. DEPT. OF COMMERCE – OFFICE OF GENERAL COUNSEL, <http://www.osec.doc.gov/ogc/occic/letcred.html> (last visited Mar. 4, 2009) ("The [Applicant] applies with the Issuing Bank (typically the [Applicant]'s own bank) for a commercial credit that satisfies the specifications in the sales contract.").

contract.<sup>33</sup> For example, a seller who is unsure of the buyer's willingness or ability to pay for the goods can, as a condition of shipment of the goods, demand that the applicant-buyer have its bank issue a letter of credit for the benefit of the seller.<sup>34</sup> The buyer will, thereupon, apply to its bank for the issuance of the credit, directing the bank to pay the seller the amount agreed to in the underlying contract upon the seller's presentation of a specified set of documents to the issuing bank.<sup>35</sup> The required documents would be calculated to give the buyer some assurance that the seller has shipped the goods and would include such things as a bill of lading, an insurance certificate, export and import licenses in the case of international transactions, inspection certificates, and a draft drawn by the seller-beneficiary on the issuer and payable to the seller-beneficiary.<sup>36</sup> The issuer's obligation to pay the draft is conditioned only upon the seller's timely submission<sup>37</sup> of the complete set of documents, which conform to the specifications stated in the letter of credit,<sup>38</sup> not upon proof of the truth of the matter asserted in the documents.<sup>39</sup> Such obligations on the part of the third party issuer are primary obligations, in that proof of default on the underlying obligation is not required<sup>40</sup>—they are not contingent upon whether the underlying obligations have been performed.<sup>41</sup> Once the issuing bank has determined that the seller has complied with the terms of payment specified in the letter of credit, the issuing bank will pay (or accept) the draft.<sup>42</sup>

33. *Id.* (“The commercial credit functions as the method of payment in a sales contract between the [Applicant] (the buyer) and the Beneficiary (the seller),” and that “[s]tandby credits are comparable to performance bonds.”) (emphasis added).

34. *Id.* (“(2) Substituting Credit: The Beneficiary may be reluctant to sell on open account if it does not know enough about the credit worthiness of the [applicant]. The credit helps to overcome the Beneficiary's reluctance to do business with the Account Party.”).

35. *Id.* §§ I.A.-I.C.

36. See FOLSOM, ET AL., *supra* note 3, § 6.2.

37. Richard F. Dole, Jr., *The Effect of UCP 600 upon U.C.C. Article 5 with Respect to Negotiation Credits and the Immunity of Negotiating Banks from Letter-Of-Credit Fraud*, 54 WAYNE L. REV. 735, 745 (2008) (“The issuer and a confirmer typically commit to honor their definite and irrevocable undertakings by paying the beneficiary upon the timely presentation of the required documents.”).

38. See U.C.C. § 5-102(a)(10) (2009) (defining a letter of credit as “a definite undertaking . . . by an issuer to a beneficiary . . . to honor a documentary presentation by payment . . . .”); U.C.C. § 5-109(a)(1)(2009) (“If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit . . . the issuer shall honor the presentation . . . .”).

39. See Symons, Jr., *supra* note 12.

40. *Id.* at 342.

41. *Id.*

42. See G. Hamp Uzzelle, III, *Letters of Credit*, 10 TUL. MAR. L.J. 47, 54 (1985) (“Probably the most often litigated question with regard to letters of credit is whether or not the documents presented conform to the requirements of the letter. Traditionally, the courts have required strict compliance with the terms of the letter.”).

Outside the United States, bank guaranties can serve as the functional equivalents of standby letters of credit,<sup>43</sup> by reallocating transaction risk from the provider of a good or service to a trusted independent party,<sup>44</sup> and they are subject to the same legal treatment as standby letters of credit when they allow the beneficiary to demand payment by asserting, but not proving, that the applicant has defaulted on the underlying contract.<sup>45</sup> Such bank guarantees, like letters of credit, give rise to primary obligations on the part of the issuer.<sup>46</sup> In contrast, instruments payable only upon default or proof of default create secondary obligations<sup>47</sup> and, by definition, would not be independent of the underlying contract.<sup>48</sup>

### III. THE INDEPENDENCE PRINCIPLE

The independence of the obligations of the third party issuer from those of the parties to the underlying contract has been enshrined in the independence principle.<sup>49</sup> As noted above, this independence is designed to

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43. See Barru, *supra* note 11, at 61-62.

Performance bonds are less common outside of the United States. On international projects, contractor performance is usually guaranteed through the use of a bank guarantee or a standby letter of credit. These two instruments are functionally equivalent. Their primary difference pertains to nomenclature: Standby letters of credit are instruments issued by banks in the United States, whereas bank guarantees are instruments issued by banks throughout the rest of the world. In simplest terms, bank guarantees and standby letters of credit are undertakings or engagements whereby a bank, as opposed to a surety, promises to make payment to a third party—the beneficiary—on the presentation of documents that conform to the requirements set forth in the instrument itself.

*Id.* (footnotes omitted).

44. *Id.* at 52.

45. *Id.* at 62-63.

46. *Id.*

47. See Aicher, et al., *supra* note 12, at 902 (“This independence principle distinguishes the letter of credit . . . from a guaranty, which is a secondary obligation by the guarantor.”) (footnotes omitted); see also U.C.C. § 5-103 cmt. 1 (2002) (“[I]n the United States the word ‘guarantee’ is more typically used to describe a suretyship transaction in which the ‘guarantor’ is only secondarily liable and has the right to assert the underlying debtor’s defenses.”).

48. See Aicher, et al., *supra* note 12, at 912 (defining a secondary obligation as one on which the obligor is required to pay only upon default of the obligor on the underlying debt); see also, *R. I. Hosp. Trust Nat’l Bank v. Ohio Cas. Ins. Co.*, 789 F.2d 74, 77-78 (1st Cir. 1986) (observing that a secondary obligation is one contingent upon default of the principal obligor).

49. See U.C.C. § 5-103(d) (2002). This section embodies the independence principle in its statement that the

preserve the original allocation of transaction risk agreed to by the parties to the underlying transaction,<sup>50</sup> but because the beneficiary will have greater

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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 nonperformance 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.

*Id.*; U.C.P. art. 3(a) (1993) (“Credits, by their nature, are separate transactions, from the sales or other contract(s) upon which they may be based . . . .”); *see also* Mann, *supra* note 15, at 2500 (“Central to the letter-of-credit system is the concept of independence: the bank’s obligation of the letter of credit is completely separate from any of the contractual obligations of the underlying transaction . . . .”); D’Ascenzo, *supra* note 20, at 1097.

The Independence Principle is the foundation of the Letter of Credit transaction. In theory, its primary function is to completely separate an underlying contract for the sale of goods from the contract for payment to the beneficiary. Because of the Independence Principle, letters of credit have become an integral part of international transactions involving the importing and exporting of goods.

*Id.* (footnotes omitted). The significance of the independence principle can be inferred from the UCC prohibition against its waiver by contract. *See* U.C.C. § 5-103(c) (2002).

*With the exception of this subsection, subsections [5-103](a) and [5-103](d), Sections 5-102(a)(9) and (10), 5-106(d), and 5-114(d), and except to the extent prohibited in Sections 1-302 and 5-117(d), the effect of this article may be varied by agreement or by a provision stated or incorporated by reference in an undertaking. A term in an agreement or undertaking generally excusing liability or generally limiting remedies for failure to perform obligations is not sufficient to vary obligations prescribed by this article.*

*Id.* (emphasis added).

50. *See* Dolan, *supra* note 22, at 480 (discussing how the independence principle serves the “pay now, argue later” allocation of risks between applicant-buyers and beneficiary-sellers); *but see* Charmain Wang Come, Rethinking the Law of Letters of Credit (March 27, 2006) (unpublished S.J.D. thesis, University of Sydney), *available at* <http://ses.library.usyd.edu.au/bitstream/2123/660/4/adt-NU20051027.16310702chapter1.pdf>. Charmain Wang Come argues that

overemphasis and overprotection of the “independence principle”, and the failure to encourage substantial realisation of “good faith” on the part of the banks or beneficiaries, or the proper exercise by banks of “reasonable care”, invariably leads to opportunities for fraudulent sellers to cheat on the documents and obtain payment without the need to actually perform their duties to banks and buyers — a situation that threatens to have a serious impact on the integrity of the overall letter of credit system.

opportunities than the applicant to commit fraud, the greater part of the transaction risk remains with the buyer.<sup>51</sup> The beneficiaries' fraud opportunities are greater because they can seek and obtain payment by submitting evidence supporting the appearance of entitlement to payment without actually being entitled by either (1) submitting fraudulent documents, or (2) in cases of contracts for the sale of goods, by submitting genuine documents in the wake of a fraudulent failure to ship the agreed goods or any goods at all.<sup>52</sup> In any event, use of letters of credit and bank guarantees reflects a conscious decision by the parties to the underlying contract to allow beneficiaries to obtain payment before, and independently of, the resolution of any disputes arising out of the underlying contract.<sup>53</sup> Despite this asymmetry in protection, the independence principle preserves the utility of these instruments by reducing payment and delivery risks to levels the parties nevertheless find acceptable.<sup>54</sup> The independence, however, is not absolute.

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*Id.* (footnotes omitted); Ross P. Buckley & Xiang Gao, *The Development of the Fraud Rule in Letter of Credit Law: The Journey So Far and the Road Ahead*, 23 U. PA. J. INT'L ECON. L. 663, 663-64 (2002).

The potential scope of the fraud exception must not be a means of creating serious uncertainty and lack of confidence in the operation of letter of credit transactions; at the same time the application of the principle of autonomy must not serve to encourage or facilitate fraud in such transactions.

*Id.* (citations omitted).

51. See Buckley & Gao, *supra* note 50, at 663-67 (discussing the applicant's relatively greater vulnerability to fraud at the hands of the beneficiary).

52. *Id.*

53. See Xiang Gao & Ross P Buckley, *A Comparative Analysis of the Standard of Fraud Required Under the Fraud Rule in Letter of Credit Law*, OXFORD U. COMP. L. F. 3 (2003), available at ouclf.iuscomp.org ("[L]etters of credit are instruments employed by contractual parties to reduce and allocate their risks in the underlying transaction."); Reade H. Ryan, Jr., *U.C.C. Article 5 Symposium: Who Should Be Immune from the "Fraud In The Transaction" Defense in a Letter of Credit Transaction?*, 56 BROOK. L. REV. 119, 123 (1990) ("[A] letter of credit often reflects a conscious bargain as to risk allocation between an account party and a beneficiary.").

54. See, e.g., Avery Wiener Katz, *An Economic Analysis of the Guaranty Contract*, 66 U. CHI. L. REV. 47, 105 (1999).

In the orthodox view, the letter of credit's documentary nature, which formally separates it from the underlying transaction for which it serves as security, is deemed critical to its commercial utility. Indeed, this feature of the letter of credit is considered so important that it has been reified and given a special name: the 'independence principle.'

*Id.* See also Symons, Jr., *supra* note 12, at 343 (observing that with properly functioning letters of credit, "sellers are encouraged to deliver their goods to buyers, which in turn fosters the continuous, stable flow of goods in commerce.").

Historically, fraud has been the only generally recognized exception to the independence principle,<sup>55</sup> and the only basis upon which injunctions were available.<sup>56</sup> Although fraud—as a basis for enjoining payment under letters of credit—has been around for centuries,<sup>57</sup> the modern era of its usage<sup>58</sup> began in 1941 with *Sztejn v. J. Henry Schroder Banking Corp.*,<sup>59</sup> in which a New York state court enjoined payment by the issuer because the beneficiary had submitted a fraudulent document in support of its demand for payment.<sup>60</sup> During the nearly seventy years since the *Sztejn* decision, courts, legislatures, scholars, and international nongovernmental organizations have wrestled with the mechanics and theoretical underpinnings of fraud as a basis for enjoining payment;<sup>61</sup> and various judicial,<sup>62</sup> statutory,<sup>63</sup> and contractual<sup>64</sup> schemes have been devised to limit the availability of

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55. See Symons, Jr., *supra* note 12, at 339.

The doctrinal theory necessary to answer this question has been obscured by the writings of highly respected practitioners who claim that the historic and proper standard for issuance of an injunction is proof of “egregious” or “gross” fraud, and nothing less, with the result that an injunction against the issuing bank should rarely, if ever, issue.

*Id.*

56. *Id.*

57. See Zsuzsanna Tóth, *Documentary Credits In International Commercial Transactions With Special Focus On The Fraud Rule* (2006) (unpublished Ph.D. dissertation, Pázmány Péter Catholic University) (on file with the authors) (tracing the origin of fraud as the basis for judicial interference in letters of credit back to 1756).

58. See Blodgett & Mayer, *supra* note 19, at 450 (describing the *Sztejn* decision as the “decision that originates the modern-day exception to the independence principle.”).

59. 31 N.Y.S.2d 631 (1941).

60. *Id.* at 720, 721-22, 723.

61. See, e.g., Symons, Jr., *supra* note 12, at 339 (describing the disparity of scholarly opinion on the proper basis for injunctions against payment of letters of credit).

62. See, e.g., *Higgins v. Steinharter*, 175 N.Y.S. 279 (1919) (allowing injunction against payment of letter of credit on the basis of breach of the underlying contract and that the submission of false documents by the beneficiary rendered payment by the issuer unauthorized); *Old Colony Trust Co. v. Lawyers' Title & Trust Co.*, 297 F. 152, 158 (2d Cir. 1924) (holding that the submission of false documents rendered payment under the letter of credit inappropriate because of the beneficiary’s noncompliance with the letter of credit); *Sztejn*, 31 N.Y.S.2d 631 (maintaining an injunction on the basis of fraud in the underlying transaction, when the issuer had been notified of the fraud prior to payment).

63. See U.C.C. § 5-114 (1952); U.C.C. § 5-109 (1995) (successor provision to 1952 U.C.C.); see generally Buckley & Gao, *supra* note 50 (chronicling the development of the fraud basis of letter of credit injunctions).

64. See U.N. Convention on Independent Guarantees and Stand-By Letters of Credit, G.A. 50/48 (Jan. 26, 1996), arts. 19-20; International Chamber of Commerce, *Uniform Customs and Practices for Documentary Credits*, Pub. 500 (1993), Pub. 600 (2006), and *International Standby Practices*, Pub. 590 (1998); see also Robert J. Spjut, *Standby Letters of Credit*, <http://library.findlaw.com/1999/Sep/1/131155.html#13> (last visited Mar. 4, 2010), at

such injunctions. And, even though the proper doctrinal standard for determining the appropriateness of fraud-based injunctions has been the subject of judicial disagreement and scholarly debate<sup>65</sup>—with the general weight of scholarly opinion being against the easy issuance of such injunctions<sup>66</sup>—the common concern among all stakeholders is that as the ease with which letters of credit and bank guarantees can be enjoined increases their commercial utility decreases.<sup>67</sup>

While recognition of the fraud exception may reflect a legitimate societal decision to make things come out right,<sup>68</sup> it nevertheless disrupts the original risk allocation and the original intent of the parties. To the extent injunctions based on disputes arising out of the underlying contract impede the beneficiary's ability to obtain payment or the issuer's ability to pay, the value of the credit is diminished and the ability of the beneficiary to obtain

n.12-24 and accompanying text (describing incorporation of provisions from treaties and non-governmental organization publications in letters of credit).

65. See, e.g., Symons, Jr., *supra* note 12, at 340.

A review of pre-Code cases and commentary reveals that there was a wide disparity of opinion about the proper standard of review, with three being suggested. For purposes of categorization, they may be listed as the egregious fraud standard, the intentional fraud standard, and the breach of warranty or innocent misrepresentation standard. Interestingly, eminent pre-Code commentators opted for the third standard. Today all agree that this standard is incorrect. It destroys one major commercial purpose of the letter of credit—that of enabling the beneficiary of the letter to reallocate the risk of nonpayment for delivered goods that allegedly do not conform to the underlying sales contract.

*Id.* (footnotes omitted); Ryan, Jr., *supra* note 53, at 119.

Statutory and case law, and commentators, all agree that two conflicting principles underlie all letter of credit transactions: the independence principle and its exception, the “fraud in the transaction” defense. However, statutory and case law are not clear, and commentators do not agree, where the independence principle stops and the fraud defense starts.

*Id.*; see also Buckley & Gao, *supra* note 50 (describing, in detail, the nature and evolution of the fraud standard in major jurisdictions around the world).

66. See, e.g., Dolan, *supra* note 22, at 480 (advocating strict limitation of the use of fraud-based injunctions).

67. See Symons, Jr., *supra* note 12, at 343 (discussing the diminished utility that flows from the fraud exception, in general); Dolan, *supra* note 22, at 481 (discussing the diminished utility that flows from the degree to which the fraud exception is extended to encompass fraud in the underlying contract); Michael Stern, *The Independence Rule in Standby Letters of Credit*, 52 U. CHI. L. REV. 218 (1985) (capturing the debate over the degree to which the scope of the fraud exception serves or undermines the utility of letters of credit and the expectations of the parties).

68. See, e.g., Dolan, *supra* note 22, at 481 (characterizing certain judicial handling of the fraud exception as an attempt to be fair).

payment becomes less certain, causing future sellers to become increasingly reluctant to accept letters of credit, thereby decreasing their utility.<sup>69</sup> Optimization of the relationship between letters of credit and bank guarantees and injunctions demands that the possibility of injunction be minimal and predictable. This has, heretofore, been achieved by limiting the basis of injunctions to fraud and through uniformity of the law governing the fraud basis. At present, the Uniform Commercial Code (UCC) achieves this in the United States by limiting injunctions to cases of *material* fraud, and even then, only under highly constrained conditions.<sup>70</sup> As we show here, the exclusivity of fraud as basis for injunctions has begun to erode, and new exceptions to the independence principle are emerging, diminishing the certainty of payment represented by letters of credit and bank guarantees.

#### IV. NEW EXCEPTIONS TO THE INDEPENDENCE PRINCIPLE

The emergence of unconscionability and illegality as bases for injunctions has vindicated the fears of those who considered *Sztejn* significant because it was the first step down the slippery slope toward a more pervasive impairment of the utility of letters of credit.<sup>71</sup> While political exigencies have, from time to time, given rise to temporally localized disruptions

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69. See U.C.C. § 5-103 cmt. 1 (2009).

Only staunch recognition of [the independence] principle by the issuers and the courts will give letters of credit the continuing vitality that arises from the certainty and speed of payment under letters of credit. To that end, it is important that the law not carry into letter of credit transactions rules that properly apply only to secondary guarantees or to other forms of engagement.

*Id.* See also Dolan, *supra* note 22, at 53 (“It is axiomatic that courts and legislatures must tether the fraud inquiry in independent obligations law, for untethered, the inquiry destroys these independent commercial devices, which are crucial to international trade and domestic commerce.”) (footnote omitted).

70. See U.C.C. § 5-109(b) (2009) (permitting fraud based injunctions only when: (1) it would not be prohibited by the law applicable to drafts or deferred obligations; (2) those adversely affected would be adequately protected; (3) the criteria of applicable state injunction law are met, the injunction seeker is more likely than not to succeed on the merits of his claim; and, (4) the person demanding honor is not within the class of persons protected against injunction); see also Dole, Jr., *supra* note 37, at 752-53 (providing a basic description of the persons protected against injunction).

71. See generally Symons, Jr., *supra* note 12 (chronicling the judicial and legislative difficulties associated with containing the deleterious potential of *Sztejn*); David J. Kalson, Note, *The International Monetary Fund Agreement and Letters of Credit: A Balancing of Purposes*, 44 U. PITT. L. REV. 1061, 1065 (1983) (“It may be argued that the chipping away at the foundation of letter-of-credit law which *Sztejn* initiated has been continued in recent years.”).

in the predictability and viability of letters of credit,<sup>72</sup> commercial practices themselves have begun to give rise to the more systematic and persistent—and therefore more threatening—disruptions of unconscionability and illegality.

Before delving into an examination of these new exceptions, a word about judicial nomenclature is warranted. Because the law of injunction of primary obligation bank guarantees has developed alongside the law of letter of credit injunctions, courts often cite the law of one as relevant to the disposition of disputes involving the other.<sup>73</sup> Not all courts, however, use the same terminology to refer to these functionally equivalent instruments. Within the United States, standby letters of credit are the primary obligation instruments used within the construction industry, and performance bonds are secondary obligation instruments. Outside the United States, a bank guarantee is the proper term for primary obligation instruments used in the construction industry.<sup>74</sup> While foreign jurisdictions generally adhere to the application of the independence principle to only primary obligation instruments, they do not always refer to such instruments as bank guarantees. As such, while the terminology in the cases is somewhat variable,<sup>75</sup> the nature of the instruments at issue is not.

#### A. THE RISE OF UNCONSCIONABILITY

##### 1. *Implicit Unconscionability*

As a basis for injunction, unconscionability appears to result from the confluence of two lines of jurisprudence. The first line, which paved the way for new exceptions to the independence principle by repudiating the exclusivity of the fraud exception, began in England, in 1984, with *Potton*

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72. See, e.g., Monroe Leigh, *Decision: Iranian Assets Control Regulations—Standby Letters of Credit—Blocking of Foreign Assets*, 78 AM. J. INT'L L. 224 (1984) (describing the unusual treatment of letters of credits issued for the benefit of Iranian business interests during the Iranian hostage crisis).

73. See, e.g., *Group Josi Re v. Walbrook Ins. Co.*, [1996] 1 W.L.R. 1152 (Eng.) (citing performance bond case law in a letter of credit case); *Olex Focas Pty Ltd. v. Skodaexport Co. Ltd.* [1998] 3 V.R. 380 (Austl.) (citing letter of credit law in a performance bond case).

74. *Barru*, *supra* note 11, at 53.

75. See, e.g., *Kvaerner Sing. Ltd. v. UDL Shipbuilding Pte Ltd.*, [1993] 3 S.L.R. 350 (Sing.) (involving a bank guarantee); *Potton Homes v. Coleman Contractors*, [1984] 28 Build L.R. 19 (involving a performance bond); *Royal Design Studio Pte Ltd. v. Chang Dev. Pte Ltd.*, [1990] 1 S.L.R. 1116 (Sing.) (involving a performance bond); *Bocotra Constr. Pte Ltd. v. Attorney Gen. (No. 2)*, [1995] 2 S.L.R. 733 (Sing.) (involving a letter of guarantee); *Dauphin Offshore Eng'g & Trading Pte Ltd. v. Private Office of HRH Sheikh Sultan bin Kalifa bin Azyed al Nahyan*, [2000] 1 S.L.R. 657 (Sing.) (involving a bank guarantee).

*Homes v. Coleman Contractors*,<sup>76</sup> and migrated to Singapore with the decisions in *Royal Design Studio Pte Ltd. v. Chang Development Pte Ltd.*<sup>77</sup> and *Kvaerner Singapore Ltd. v. UDL Shipbuilding (Singapore) Pte Ltd.*<sup>78</sup> Singapore is a former British colony that inherited the English common law system,<sup>79</sup> and although the decisions of the English courts are no longer binding upon the Singapore courts,<sup>80</sup> the Singapore courts' adoption and elaboration of the *Potton Homes* approach indicates that English jurisprudence is still influential as chronicled by Hang Yen Low's comprehensive study of Singapore's, Australia's, and Malaysia's confrontations with unconscionability.<sup>81</sup> From Singapore, unconscionability has migrated to Australia and Malaysia, and its existence appears to have been acknowledged in Hong Kong. The second line of cases, which originated with the 1995 decision by the Singapore Court of Appeals in *Bocotra Construction Pte Ltd. v. Attorney General (No. 2)*,<sup>82</sup> explicitly established unconscionability, in addition to fraud, as a basis for injunctions against bank guarantees.<sup>83</sup>

In *Potton Homes*, the decision from which the earlier line developed, a manufacturer of prefabricated housing units entered into a series of contracts with a buyer to build and ship a certain number of such units to Libya.<sup>84</sup> The buyer, who was also the beneficiary of a primary obligation performance bond established by the manufacturer,<sup>85</sup> fell behind on its payments for the units,<sup>86</sup> after which a dispute between the buyer and the manufacturer arose out of the buyer's allegations that some of the units were defective.<sup>87</sup> The buyer made demand under the performance bond,<sup>88</sup> and the manufacturer sought both payment of sums due on the underlying contract and an injunction to prohibit the buyer from obtaining payment under the performance bond.<sup>89</sup> The trial judge issued an interim injunc-

76. [1984] 28 Build L.R. 19 (Eng.).

77. [1990] 1 S.L.R. 1116 (Sing.).

78. [1993] 3 S.L.R. 350 (Sing.).

79. Walter Woon, *The Applicability of English Law in Singapore*, in THE SINGAPORE LEGAL SYSTEM 230, 230-48 (Kevin Y. L. Tan ed., 2d ed. 1999).

80. *Id.*

81. *Id.* at 238-42 (detailing the basis and degree of the continued influence of English common law in Singapore); see Hang Yen Low, *Unconscionability as a Ground for Withholding Payment in Demand Guarantees: Should the Exception Be Extended to Letters of Credit?*, 1 MALAYSIAN L.J. ARTICLES 183 (2008) (chronicling case interpretations consistent with this article).

82. [1995] 2 S.L.R. 733 (Sing.).

83. See *infra* notes 114-203 and accompanying text.

84. *Potton Homes v. Coleman Contractors*, [1984] 28 Build L.R. 19, ¶ 1 (Eng.).

85. *Id.* ¶ 3, 27.

86. *Id.* ¶ 2.

87. *Id.* ¶ 3.

88. *Id.*

89. *Potton Homes*, [1984] 28 Build L.R. ¶ 2-3.

tion,<sup>90</sup> but declined to permanently enjoin the buyers from obtaining payment under the bond,<sup>91</sup> and instead allowed the funds from the bond to be paid into an account controlled by the lawyers for both parties, pending the outcome of litigation to resolve the parties' competing claims.<sup>92</sup> The appellate court confirmed the lower court's denial of a permanent injunction, holding that, because the underlying contract had not somehow been rendered void, thereby removing all basis for even the existence of the bond, the court could "see no grounds for saying that the [buyers] should not be entitled to obtain their money in accordance with the intention of the parties as expressed in their [underlying] agreement."<sup>93</sup>

The significance of *Potton Homes*, therefore, rests not upon the outcome, but upon dictum that proved inspirational to other courts confronting the exclusivity of fraud as a basis for enjoining letters of credit, bank guarantees, and primary obligation performance bonds. In the part of the opinion dealing with the nature of the manufacturer's rights, vis-à-vis those of the buyer of the housing units, the court 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 to prevent a call upon the bond by the mere assertion that the bond is to be treated as cash in hand.<sup>94</sup>

While falling short of establishing a specific nonfraud basis, the court opened the possibility that grounds other than fraud could suffice.

The Singapore courts extended the possibility opened by *Potton Homes* with *Royal Design*.<sup>95</sup> In this case, a dispute arose out of a contract between a builder and a buyer for the building of a series of terrace houses

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90. *Id.* ¶ 3.

91. *Id.* ¶ 4.

92. *Id.* ¶ 7.

93. *Id.* ¶ 25.

94. *Potton Homes*, [1984] 28 Build L.R. at 18 (emphasis added).

95. [1990] 1 S.L.R. 1116 (Sing.).

for the buyer.<sup>96</sup> At some point, the parties severed their relationship and the buyer, who was the beneficiary of a primary obligation performance bond, sought payment under the bond.<sup>97</sup> The plaintiff-builder sought and received an interim injunction, restraining the defendant-buyer from “calling on and/or receiving payment . . . under the performance bond.”<sup>98</sup> The buyer opposed and sought dissolution of the injunction on the grounds that the builder had failed to timely complete construction,<sup>99</sup> but the builder maintained its entitlement to the injunction on the grounds that, if delay had occurred, it was due to the buyer’s failure to make periodic payments to the builder, thus denying the builder sufficient funding to build on schedule.<sup>100</sup> The court, relying on *Potton Homes*, maintained the injunction on the ground that the buyer should not, by its own behavior in breach of the payment schedule provisions of the underlying contract, be able to contrive a situation entitling it to draw under the terms of the performance bond.<sup>101</sup> The court explained that because the injunction interfered with only the *right* of the beneficiary to seek payment, but did not interfere with the *obligation* of the issuer to pay, and because the beneficiary’s right was contingent upon default by the builder, the injunction affected only the underlying contract, not the bond.<sup>102</sup> Therefore, because the bond was not at issue, the fact that it was a primary obligation bond and the functional equivalent of a letter of credit was irrelevant.<sup>103</sup> Thus, the rules relating to letters of credit did not apply,<sup>104</sup> and inquiry into the underlying contract was permissible.<sup>105</sup> Although the court did not explicitly ground its restraint of the bene-

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96. *Id.* at 1118.

97. *Id.* at 1119-20.

98. *Id.* at 1117.

99. *Id.* at 1119.

100. *Royal Design*, [1990] 1 S.L.R. at 1119.

101. *Id.* at 1124 (quoting *Potton Homes v. Coleman Contractors*, [1984] 28 Build L.R. 19) (Eng.).

If the contractor were unable to perform because the employer failed to provide the finance, it would seem wrong to me if the court was not entitled to have regard to the terms of the underlying contract and could be prevented from considering the question whether or not to restrain the employer by the mere assertion that a performance bond is like a letter of credit.

*Id.*

102. *Id.* at 1125.

103. *Id.*

104. *Id.*

105. *Royal Design*, [1990] 1 S.L.R. at 1124.

fiary on unconscionability, subsequent cases have recognized unconscionability as the conceptual foundation of *Royal Design*.<sup>106</sup>

Both *Potton Homes* and *Royal Design* involved injunctions against beneficiaries exercising their rights to seek payment, not against the obligations of banks to pay<sup>107</sup> and in both cases, the courts appear to have confined their remarks about the fraud-only rule to cases in which restraint was sought against the beneficiary.<sup>108</sup> In two subsequent cases, however, the Singapore courts widened the ambit of this developing exception to include issuers, as well as beneficiaries.<sup>109</sup>

The first of these two cases was *Kvaerner Singapore Pte Ltd. v. UDL Shipbuilding (Singapore) Pte Ltd.*,<sup>110</sup> in which the court inched closer to including issuers in the developing, but as yet unnamed exception to the independence principle. In this case, a seller of shipboard equipment entered into a contract with a shipbuilder to deliver and install certain equipment on a vessel the shipbuilder was constructing.<sup>111</sup> As part of the agreement, the seller was required to establish a bank-issued primary obligation<sup>112</sup> performance guarantee to protect the shipbuilder against the seller's

106. See *GHL Pte Ltd. v. Unitrack Bldg. Constr. Pte Ltd. & Anor*, [1999] 4 S.L.R. 604, 613 (Sing.) (“*Royal Design Studio* was decided on the ground of unconscionability, although the word ‘unconscionability’ was not expressly used there . . .”).

107. See *Potton Homes*, [1984] 28 Build L.R. ¶ 3; *Royal Design*, [1999] 1 SLR at 1117.

108. See *Potton Homes*, [1984] 28 Build L.R. at 26, 28-29; *Royal Design*, [1999] 1 S.L.R. at 1125.

109. See *Bocotra Constr. Pte Ltd. v. Attorney Gen. (No. 2)*, [1995] 2 S.L.R. 733, 744 (Sing.) (“[T]here is no distinction between the principles to be applied in cases dealing with attempts to restrain banks from making payment or those dealing with restraint of callers from calling for payment.”); *Kvaerner Singapore Pte Ltd. v. UDL Shipbuilding (Singapore) Pte Ltd.*, [1993] 3 S.L.R. 350, 353 (observing that the limitation of injunctions to issuers is “not an immutable principle”). This position appears to be consistent with the prevailing English view. See, e.g., *Grp. Josi Re v. Walbrook*, [1996] 1 All E.R. 791, ¶ 24.

[I]t is argued . . . that the case is altogether different, and the rule [regarding injunctions against issuer banks] . . . does not apply, when an injunction is sought not against the bank but against the beneficiary of a letter of credit. In my opinion that cannot be right. The 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.

*Id.*; see also *Bolivinter Oil SA v. Chase Manhattan Bank*, [1984] 1 All E.R. 351, 352 (Eng.); *Intraco Ltd. v. Notis Shipping Corp.*, [1981] 2 Lloyd’s Rep. 256, 257. But see *Themehelp Ltd. v. West*, [1995] 4 All E.R. 215 (Sing.) (expressing a contrary view, albeit in *dictum*).

110. [1993] 3 S.L.R. 350.

111. *Id.* at 352.

112. *Id.*

By the performance guarantee the bank undertook ‘unconditionally and irrevocably to pay . . . on . . . written demand . . . in case that the seller has failed or refused to fulfil

failure to deliver and install the equipment, and the shipbuilder was to establish a letter of credit to protect the seller against the shipbuilder's failure to pay for the equipment.<sup>113</sup> The seller established the guarantee, but the shipbuilder either failed or refused to establish the letter of credit,<sup>114</sup> prompting the seller to declare the contract discharged.<sup>115</sup> The shipbuilder nevertheless sought payment under the guarantee,<sup>116</sup> whereupon the seller sought and received an injunction.<sup>117</sup> Although it was not clear from the reported decision whether the injunction was formally against the issuer or the beneficiary, the court characterized its action as an interlocutory injunction in which "[t]he effect of such injunction would restrain the bank from making payment."<sup>118</sup>

In addition to expanding the class of parties subject to non-fraud injunctions, *Kvaerner* also incrementally advanced the cause of unconscionability. Fraud was neither alleged nor proved; but in its rationale, the court invoked *Potton Homes* and explicitly jettisoned the fraud-only rule while implicitly grounding its ruling on unconscionability, stating that the fraud-only rule "has no application where the injunction is sought against a party to the underlying contract who seeks to take advantage of the performance guarantee where by his own volition he fails to perform a condition precedent."<sup>119</sup> However, out of an apparent abundance of caution, the court also alluded to the fraud standard, stating that:

In circumstances where it can be said that the buyer had no honest belief that the seller has failed or refused to perform his obligation, a demand by the [shipbuilders] in my view is a dishonest act which would justify a restraint order. On the facts of the case a demand made by the buyer was utterly lacking in bona fides.<sup>120</sup>

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[sic] his obligations under the contract notwithstanding any objection by the seller the amount of the letter of guarantee or any part thereof . . . .

*Id.*

113. *Id.*

114. *Kvaerner Singapore*, [1993] 3 S.L.R. at 352.

115. *Id.*

116. *Id.*

117. *Id.*

118. *Id.*

119. *Kvaerner Singapore*, [1993] 3 S.L.R. at 352.

120. *Id.* at 354. See also *Dauphin Offshore Eng'g & Trading Pte Ltd. v. Private Office of HRH Sheikh Sultan bin Kalifa bin Azyed al Nahyan*, [2000] 1 S.L.R. 657 (Sing.) ("[I]n calling on the guarantee, fraud [means] a lack of bona fides on the part of [the beneficiary] that it was entitled to call on the guarantee.").

Although the court did not explicitly use the word “unconscionability,” *Kvaerner*, like *Royal Design*, is recognized as being qualitatively based in part on unconscionability.<sup>121</sup>

## 2. *Explicit Unconscionability*

### a. *Singapore*

The next case to broaden the class of parties subject to injunction, *Bocotra Construction Pte Ltd. v. Attorney General (No. 2)*,<sup>122</sup> was also the first in a sequence of cases that accomplished the transition from the implicit unconscionability of *Royal Design* and *Kvaerner* to explicit unconscionability but, as with the development of implicit unconscionability, the transition was incremental and a bit erratic. *Bocotra* involved a dispute arising out of a construction contract entered into between the Director General of Public Works (DGPW) and Bocotra Construction.<sup>123</sup> At issue was the enjoynability of DGPW’s right to draw under what was characterized as a primary obligation bank letter of guarantee.<sup>124</sup> The DGPW sought to obtain payment under the letter of guarantee, because Bocotra Construction had failed to timely complete a public works project,<sup>125</sup> and Bocotra Construction sought to have the government enjoined.<sup>126</sup> After a lengthy review of the jurisprudential authorities on the circumstances under which an injunction might properly be issued, the court stated that “[i]n our opinion, whether there is fraud or unconscionability is the sole consideration in applications for injunctions restraining payment or calls on bonds to be granted.”<sup>127</sup>

The proper interpretation of this statement was not immediately appreciated, because, in 1999, the High Court<sup>128</sup> in *New Civilbuild Pte Ltd. v. Guobena Sdn Bhd*,<sup>129</sup> opined that *Bocotra Construction* did not establish

121. See *GHL Pte Ltd. v. Unitrack Bldg. Constr. Pte Ltd.*, [1999] 4 S.L.R. 604, 613 (Sing.) (“*Kvaerner Singapore* was decided partly on the ground of unconscionability and did not strictly follow the ‘fraud’ exception laid down in the English cases.”).

122. [1995] 2 S.L.R. 733 (Sing.).

123. *Id.* at 746.

124. *Id.* at 741 (“The guarantee does not require the bank to enquire about the due performance of the [underlying construction] contract.”).

125. *Bocotra Constr. Pte Ltd. v. Attorney Gen.*, [1995] 2 S.L.R. 170, 175.

126. *Bocotra (No.2)*, [1995] 2 S.L.R. at 736.

127. *Id.* at 746.

128. See Tzi Yong Sam Sim, *A Guide to the Singapore Legal System & Legal Research*, HAUSER GLOBAL LAW SCHOOL PROGRAM, (Feb. 2007), [http://www.nyulawglobal.org/globallex/Singapore.htm#\\_The\\_Court\\_System](http://www.nyulawglobal.org/globallex/Singapore.htm#_The_Court_System) (last visited Sept. 27, 2009) (describing the Singaporean judicial system, in which the High Court functions as an intermediate appellate court, superior to a district court but subordinate to the Court of Appeals).

129. [1999] 1 S.L.R. 374 (Sing.).

unconscionability as a separate ground from fraud, as a basis for enjoining the beneficiary of a bank letter of guarantee, finding instead that while unconscionability should act as an *moral* restraint upon a beneficiary, it did not affect their *legal* right to obtain payment.<sup>130</sup> This decision stood in contrast to a series of decisions that had taken the opposite view.<sup>131</sup>

This split of opinion among the lower courts as to the separateness of unconscionability as a ground for an injunction was quickly resolved by the Court of Appeal. In *Dauphin Offshore Engineering & Trading Pte Ltd. v. Private Office of HRH Sheikh Sultan bin Kalifa bin Azyed al Nahyan*,<sup>132</sup> a dispute arose between Dauphin, a yacht builder, and Sheikh Sultan, the yacht purchaser.<sup>133</sup> As part of the underlying contract of sale, the Sheikh furnished a standby letter of credit in favor of Dauphin, to secure payment of the purchase price installments,<sup>134</sup> and Dauphin furnished an irrevocable confirmed bank guarantee in favor of the Sheikh, to protect the Sheikh against loss of any paid installments in the event Dauphin failed to build the yacht as agreed.<sup>135</sup> The Sheikh refused to pay the second installment and sought payment under the guarantee,<sup>136</sup> contending that Dauphin had breached the contract by deviating from the agreed upon construction standards.<sup>137</sup> Dauphin obtained an *ex parte* injunction from the High Court restraining the Sheikh from demanding payment,<sup>138</sup> whereupon the Sheikh sought and received dissolution of the injunction.<sup>139</sup> Dauphin appealed the dissolution of the injunction on the grounds of fraud and unconscionability.<sup>140</sup> The High Court judge dissolved the injunction, relying on his earlier decision in *New Civilbuild*,<sup>141</sup> held that only a showing of fraud would pre-

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130. *Id.* at 375.

131. *See* Raymond Constr. Pte Ltd. v. Lowe Yang Tong (S 1715/95, 11 July 1996) (unreported) (acknowledging the separateness of unconscionability); Min Thai Holdings Pte Ltd v. Sunlabel Pte Ltd & Anor, [1999] 2 S.L.R. 368, 375 (Sing.) (holding it unconscionable for the beneficiary to seek payment under a performance guarantee); Sin Kian Contractor Pte Ltd. v. Lian Kik Hong, (S 460/99, 31 July 1999) (unreported) (acknowledging the viability of unconscionability, alone, as a sufficient ground to restrain payment under a performance bond).

132. [2000] 1 S.L.R. 657.

133. *Id.* at 659-61.

134. *Id.* at 660.

135. *Id.*

136. *Id.* at 660-61.

137. *Dauphin Offshore Eng'g & Trading Pte Ltd.*, [2000] 1 S.L.R. at 660-61.

138. *Id.*

139. *Id.*

140. *Id.* at 662.

141. *Id.* at 667.

The judge below in the present action (as he did in *New Civilbuild* . . . where he thought that the Court of Appeal in *Bocotra* did not intend to create "unconscionability" as a separate ground of relief) thought that this court in *Bocotra* had used

vent the Sheikh from being able to obtain payment under the guarantee, and further concluded that, despite Dauphin's contention to the contrary, "unconscionability" was not a distinct and separate ground from fraud [upon] which [the court could] restrain a beneficiary from [seeking payment under such guarantees]."<sup>142</sup> However, the Court of Appeals in *Dauphin* found that, in fact, unconscionable activity by a party to the underlying contract could be sufficient grounds to enjoin payment.<sup>143</sup> In support of this, the court cited a line of earlier High Court cases,<sup>144</sup> and its own 1999 decision in *GHL Pte Ltd. v. Unitrack Building Construction Pte Ltd.*,<sup>145</sup> wherein it explained *Bocotra* to mean that:

[T]he concept of "unconscionability" was adopted after deliberation, and was not inadvertently inserted as a result of a slip; nor was it intended to be used synonymously or interchangeably with "fraud." There is nothing in that judgment which can be said to indicate or suggest that the court did not decide that "unconscionability" alone is not a separate ground as distinct from fraud. We accept that to that extent, *Bocotra* is a departure, and if we may respectfully say so, a conscious departure, from the English position.<sup>146</sup>

The Court of Appeals in *Dauphin* went further, and stated that the *Bocotra* court "was clearly conscious that fraud as a ground was quite distinct from that where you had to examine the circumstances surrounding the underlying contract."<sup>147</sup> A fairly steady stream of cases followed *Dauphin*, on this point.<sup>148</sup> Although the *Dauphin* court commented on the required degree of unconscionability, stating that "what must be shown is a strong prima facie

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the two terms "fraud" and "unconscionability" interchangeably.

*Dauphin Offshore Eng'g & Trading Pte Ltd.*, [2000] 1 S.L.R. at 667.

142. *Id.* at 662.

143. *Id.* at 672.

144. *See* Raymond Constr. Pte Ltd. v. Lowe Yang Tong & Anor, (S 1715/95, 11 July 1996) (unreported) (acknowledging the separateness of unconscionability); Min Thai Holdings Pte Ltd. v. Sunlabel Pte Ltd., [1999] 2 S.L.R. 368; Sin Kian Contractor Pte Ltd v. Lian Kik Hong, (S 460/99, 31 July 1999) (unreported) (acknowledging the viability of unconscionability, alone, as a sufficient ground to restrain payment under a performance bond).

145. [1999] 4 S.L.R. 604.

146. *Id.* at 610.

147. *Id.* at 667.

148. *See, e.g.*, Newtech Eng'g Constr. Pte Ltd. v. BKB Eng'g Constr. Pte Ltd., [2003] 4 S.L.R. 73 (affirming the *Dauphin Offshore* approach); Anwar Siraj v. Teo Hee Lai Building Constr. Pte Ltd., [2003] 1 S.L.R. 394; Samwoh Asphalt Premix Pte Ltd. v Sum Cheong Piling Private Ltd., [2002] 1 SLR 1 (confirming the separate availability of unconscionability).

case of unconscionability,<sup>149</sup> it made no attempt to define unconscionability, stating, instead that “[w]hat kind of situation would constitute unconscionability would have to depend on the facts of each case . . . . There is no pre-determined categorisation.”<sup>150</sup>

Nine months after *Dauphin*, in *Eltraco International Pte Ltd. v. CGH Development Pte Ltd.*,<sup>151</sup> the Singapore Court of Appeal again had occasion to confront the scope of the unconscionability exception when it overruled a lower court’s denial of an injunction, holding that because the beneficiary sought to draw more than the court thought it entitled to draw, the beneficiary had acted sufficiently unconscionably.<sup>152</sup> The court continued the case-by-case approach articulated in *Dauphin*, stating that “[i]n determining whether a call on a bond is unconscionable, the entire picture must be viewed, taking into account all the relevant factors,”<sup>153</sup> and added that while unconscionability would always involve unfairness, not every instance of unfairness would rise to the level of unconscionability.<sup>154</sup>

#### b. Australia

Unconscionability appears to have developed independently in Australia. Its availability originated with *Hortico (Australia) Pty. Ltd. v. Energy Equipment Co. (Australia) Pty. Ltd.*,<sup>155</sup> where a state court in New South Wales, in dictum, recognized the possibility of unconscionability, *at common law*, as a basis of intervention, stating that “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 [the] exercise of the discretionary power.”<sup>156</sup>

After the decision in *Hortico*, the notion of unconscionability as an exception to the independence principle in Australia appears to have lain fallow until eleven years later, when the Victoria State Supreme Court, with its 1996 decision in *Olex Focas Pty. Ltd. v. Skodaexport Co. Ltd.*,<sup>157</sup> definitively embraced unconscionability, although the basis of its receptivity was very different from that of the *Hortico* court. In *Olex Focas*, the plaintiff entered into a contract with Skodaexport, the lead contractor for the con-

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149. *Dauphin Offshore*, [2000] 1 S.L.R. at 672.

150. *Id.* at 668.

151. [2000] 4 S.L.R. 290.

152. *Id.* at 301.

153. *Id.* at 299.

154. *Id.* at 299.

155. (1985) 1 NSWLR 545.

156. *Id.* at 554.

157. No. 6282, 1996 VIC LEXIS 1245 (Vict. Sup. Ct. Aug. 28, 1996).

struction of an oil pipeline in India, for the Indian Oil Corporation Ltd.<sup>158</sup> Olex Focas was to provide communication and power cables and telecommunication equipment in connection with the pipeline.<sup>159</sup> As part of the contract, Skodaexport was to pay Olex Focas two “mobilization” advances—one within thirty days of the signing of the contract, and the other as soon as Olex Focas was fully ready to commence performance.<sup>160</sup> Olex Focas provided primary obligation bank guarantees to Skodaexport<sup>161</sup> to protect it against loss of the advances, in the event Olex Focas failed to commence work.<sup>162</sup> Disputes arose between the parties, and Skodaexport sought payment under the guarantees.<sup>163</sup> Olex Focas sought, among other relief, to enjoin both Skodaexport from obtaining payment, and the bank-guarantor from making payment.<sup>164</sup>

The court analyzed the propriety of such an injunction under both the common law and Australian statutory law, and declined to recognize the availability of unconscionability-based injunctions at common law, finding that, even though *Hortico* had raised the possibility of such injunctions, “[if unconscionability] were a ground, even allowing for the considerable growth in importance of unconscionability as a sword and a shield in Australian jurisprudence of late one would expect it to have been mentioned in the cases much earlier.”<sup>165</sup> In a comment reminiscent of the reluctance of the pre-*Dauphin* Singapore courts to fully embrace unconscionability as separate from fraud, the court did not completely close the door on unconscionability, at common law, but appeared ready to consider it only in cases where it became synonymous with fraud,<sup>166</sup> observing that it would not

158. *Id.* at \*4-\*5.

159. *Id.*

160. *Id.* at \*6.

161. *Id.* at \*19-\*20, \*48-\*49. In *Olex Focas*, the issuer undertook: to pay the buyer at sight forthwith on first demand and in writing without protest or demur or proof or satisfaction and without reference to the seller any and all amounts demanded from us . . . [and that the] bank guarantees of the types I am considering in this case are not guarantees as in the law of principal and surety but are really bonds . . . [and] [w]hilst there are differences, it has, in appropriate cases, been stated that a performance bond issued by a bank or a bank guarantee is analogous to a confirmed irrevocable letter of credit . . .

*Id.*

162. *Id.* at \*4-\*5.

163. *Olex Focas*, 1996 VIC LEXIS 1245 at \*30-\*32.

164. *Id.* at \*2.

165. *Id.* at \*60-\*61.

166. See Jeffrey J. Browne, *The Fraud Exception to Standby Letters of Credit in Australia: Does it Embrace Statutory Unconscionability?*, 11 BOND L. REV. 98, 115-16 (1998) (adopting a stance akin to the Singapore judiciary’s early uncertainty over whether fraud and unconscionability were distinct grounds for injunction, arguing that, at least in

“treat gross unconscionability falling short of actual fraud as a ground for an injunction.”<sup>167</sup> From a comparative perspective, the courts in Singapore had also spoken in terms of gross unconscionability, but did not specify that it be coextensive with fraud.

The *Olex Focas* court reached the opposite result, however, using a statutory approach based on Section 51AA of Australia’s Trade Practices Act,<sup>168</sup> which provides that “[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.” Under this provision, the court found that the defendant’s attempt to obtain payment under the guarantees securing the defendant against loss of the mobilization advances was unconscionable because most of the advances had been repaid, but the defendant had nevertheless sought payment for the full amount of the advances.<sup>169</sup> In arriving at its decision, the court acknowledged that it was at odds with the common law, observing that “[t]he 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.”<sup>170</sup>

This much criticized decision<sup>171</sup> calls attention to the fact that Section 51AA does not, itself, define unconscionable conduct, but requires, instead, that the court incorporate the common law definition, as that definition is found in the “unwritten law, from time to time, of the States and Territories.”<sup>172</sup> Thus, the unconscionability standard becomes something of a moving target.<sup>173</sup> In fact, the court seems to have considered no less than six

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Australia, the fraud exception to the independence principle encompasses unconscionability and that the behavior characterized by the court as unconscionable was “actual fraud and that, with respect, this was the way in which *Olex Focas* should have been decided.”) (footnote omitted).

167. *Olex Focas*, 1996 VIC LEXIS1245 at \*59.

168. *Trade Practices Act 1974*, Section 51AA (Austl.), available at <http://www.chartermerc.com.au/pdf/TradePractices%20act%201974.pdf>.

169. *Olex Focas*, 1996 VIC LEXIS1245 at \*68-69, \*73-74.

170. *Id.* at \*70.

171. See, e.g., Robert Baxt, *A Bombshell on Unconscionable Conduct*, 25 AUSTL. BUS. L. REV. 227 (1997); Ross P. Buckley, *Unconscionability Amok, or Two Readily Distinguishable Cases?*, 26 AUSTL. BUS. L. REV. 323, 326 (1998); Ben Zillman, *A Further Erosion Into Bank Guarantees?*, 13 BLDG & CONSTR. L. 354, 357 (1997).

172. *Trade Practices Act 1974*, Section 51AA(1), available at <http://www.chartermerc.com.au/pdf/TradePractices%20act%201974.pdf>. See also *Clough Eng’g Ltd. v. Oil & Natural Gas Corp.*, [2008] FCAFC 136, ¶ 131 (equating the “unwritten law,” as that term is used in Section 51AA(1), with the common law of Australia).

173. See Liam Brown, *The Impact of Section 51AC of the Trade Practices Act 1974 (Cth) on Commercial Certainty*, [2004] MELBOURNE UNIV. L. REV. 20, at n. 75-81 and accompanying text (describing the spread of opinions among courts and commentators as to the ambit of Section 51AA unconscionability); 13(8) *Documentary Credit World* (Letter of Credit Survey, Inc.) 31 (Sept. 2009) (quoting Professor James E. Byrne as considering the

different sources<sup>174</sup> before crafting its own definition—“according to ordinary human standards, quite against conscience”<sup>175</sup>—a definition so free of measurable criteria as to invite litigation. Although the Trade Practices Commission had issued guidelines indicating that it viewed § 51AA as importing the *equitable doctrine* of unconscionability into the statute<sup>176</sup>—which requires a showing that the stronger party in a transaction has exploited its knowledge of some special disability of the weaker party<sup>177</sup>—this did not seem to shape the court’s inquiry, as the dispute in *Olex Focas* was between two large corporations and no special disability was noted.

This free range approach to the definition of unconscionability has already led to troublesome developments. In *Boral Formwork & Scaffolding Pty. Ltd. v. Action Makers Ltd.*,<sup>178</sup> a 2003 decision from the Equity Division of the Supreme Court of New South Wales, an application for an *ex parte* injunction to restrain an Australian bank from paying on a documentary letter of credit was before the court.<sup>179</sup> The customer, Boral, sought the injunction on the grounds of unconscionability, citing two supporting factors: (1) the beneficiary, Action Makers, was not entitled to the full amount of the underlying contract because it had, allegedly, shipped defective goods, which Boral had gone to considerable expense to have repaired;<sup>180</sup> and, (2) the beneficiary was about to go into bankruptcy, and the receivers for the beneficiary acknowledged that if the issuer paid the letter of credit, Boral would be relegated to the status of unsecured creditor with respect to its defective goods claim and there would likely be no money to pay unsecured creditors.<sup>181</sup> The court, citing *Olex Focas*, acknowledged the availability of unconscionability-based injunctions under § 51AA,<sup>182</sup> and issued a temporary injunction, holding that making demand on the letter of credit (when the impending bankruptcy of the beneficiary would render Boral’s later claim on the underlying contract worthless) presented “a serious question to

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concept of unconscionability, in the context of letter of credit injunctions, as having “no limit or bounds”).

174. *Olex Focas*, 1996 VIC LEXIS 1245 at \*64-\*67 (referring to the OXFORD ENGLISH DICTIONARY, 2d ed., Vol. 35.5 of the LAWS OF AUSTL.; *Commonwealth v. Verwayen*, [1990] 170 C.L.R. 394; *Logue v. Shoalhaven Shire Council*, [1979] 1 NSWLR 537; *Stern v McArthur*, [1988] 165 C.L.R. 489; ANNOTATED TRADE PRACTICES ACT, 17th ed.).

175. *Olex Focas*, 1996 VIC LEXIS 1245 at \*69.

176. Trade Practices Comm’n, Draft Guideline on Unconscionable Conduct Under Part IV of the Trade Practices Act of 1974.

177. See, e.g., [2009] *Anthony v. Vaclav*, 2009 Vict. Sup. Ct. 347, ¶¶ 71-73 (setting forth Australia’s unconscionability doctrine).

178. [2003] NSWSC 557.

179. *Id.* ¶ 1.

180. *Id.* ¶¶ 5, 11.

181. *Id.* ¶ 13.

182. *Id.* ¶¶ 9, 13, 14.

be tried about whether the making of demand for the full invoice value constitutes unconscionable conduct.”<sup>183</sup> The court added that its ruling was based on the “pressing urgency” of the situation, and limited the duration of the injunction to the time necessary for it to become better informed as to the law on letter of credit injunctions.<sup>184</sup> Essentially, the court’s definition of unconscionability was compounded of a substantively deficient demand by the beneficiary, the court’s sense of urgency because the letter of credit was on the verge of being paid, and the court’s sense that it was not well versed in the relevant law.

The difficulty posed by this ruling is twofold. First, the independence principle was cast aside against a background of unremarkable facts. *Boral*, like all corporate applicants, either was or should have been aware that letters of credit offer greater protection to beneficiaries (because beneficiaries have greater opportunities to game the system by submitting formally correct but substantively deficient demands for payment); that letters of credit impose a pay-now-argue-later scheme with respect to disputes arising out of the underlying contract; and that beneficiaries sometimes become insolvent, making the argue-later part of the proposition valueless. The possibility that a letter of credit might be improvidently paid is not a matter of pressing urgency—it is part and parcel of the fundamental risk profile of letters of credit. The factors used to justify this ruling are simply part of the typical risks managed by every letter of credit and are factored into the decision to enter into the transaction. The net effect of the *Boral* court’s approach violates the basic premise of letters of credit by shifting the consequences of an applicant’s poor risk-appraisal skills onto the beneficiary.

The second difficulty with this case is that it illustrates the hazard posed by such a malleable definition of unconscionability. Because the *Olex Focas* court, which the *Boral* court cited with approval,<sup>185</sup> left the definition of unconscionability so unconstrained,<sup>186</sup> the inquiry in *Boral* was effortlessly shifted away from rule-based criteria designed to protect the independence principle, toward a fact-based measurement of how much discomfort the judge could tolerate.

In 2008, in its decision in *Clough Engineering Ltd. v. Oil & Natural Gas Corp.*,<sup>187</sup> the Full Court of the Federal Court of Australia took up the cause of unconscionability, stating that in addition to common law fraud, unconscionability, by way of § 51AA, was available as a ground for injunction,<sup>188</sup> although it also found that the behavior of the party sought to be

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183. *Boral*, [2003] NSWSC 557 ¶ 11.

184. *Id.* ¶¶ 14-15.

185. *Id.* ¶ 9.

186. *See supra* notes 171-77 and accompanying text.

187. [2008] FCAFC 136.

188. *Id.* ¶ 77.

restrained was not unconscionable.<sup>189</sup> The plaintiff, a construction company, sought to enjoin its customer from drawing under bank guarantees the plaintiff had provided to protect the customer against the plaintiff's failure to perform as agreed under the construction contract.<sup>190</sup> The customer had sought payment under the guarantees, alleging that Clough Engineering had breached the construction contract.<sup>191</sup> Clough, in turn, alleged that its breaches were a result of earlier breaches by its customer,<sup>192</sup> and that seeking payment under the guarantees, under such circumstances, was unconscionable.<sup>193</sup> The court continued the expansive definition of unconscionability, and stated,

under the unwritten law, which is the common law of Australia, unconscionable conduct will be such conduct as would support the grant of relief on principles set out in specific equitable doctrines. Equity does not provide a remedy in respect of conduct in trade or commerce which is, in the opinion of a judge, unfair.<sup>194</sup>

Because the availability of unconscionability-based injunctions under Section 51AA of the Trade Practices Act now seems firmly established in Australia, the challenge for the Australian courts is to set forth the definition of unconscionability that is least threatening to the independence principle. Interestingly, the history of Section 51AA itself reveals a pattern of caution motivated by a fear of the very developments represented by *Olex Focas* and *Clough Engineering*.<sup>195</sup> At the time Section 51AA was adopted, one legislator viewed the provision as not creating a new avenue for the challenge of commercial practices—beyond what already existed under the equitable principle of unconscionability then extant in Australian law—but as providing statutory remedies to victims of unconscionable behavior, and serving an educative and deterrent function.<sup>196</sup> In any event, the Australian experience is interesting in that it rejects common law as the *basis* for relief, but uses a statute to incorporate common law definitions of the basis for relief.

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189. *Id.* ¶ 138.

190. *Id.* ¶ 1.

191. *Id.* ¶ 12.

192. [2008] FCAFC 136, ¶ 2.

193. *Id.* at 13.

194. *Id.* ¶¶ 130-31.

195. See Browne, *supra* note 166, at 109-15 (chronicling the history of the sixteen attempts to statutorily inject the concept of unconscionability into Australia's commercial law).

196. *Id.* at 110 (quoting the Second Reading Speech of Mr. Duffy).

c. *Malaysia, England, and Hong Kong*

The experience in Malaysia has been inconsistent. Some lower courts have adopted unconscionability, while others have rejected it. In those courts that have allowed unconscionability, their rationale has generally emerged from fact patterns in which the beneficiary sought payment because of shortcomings in the customer's performance, shortcomings that were due, at least in part, to failures by the beneficiary to do the things it was required to do in order for the customer to be in a position to perform.<sup>197</sup> In those courts that have rejected or at least declined to use unconscionability, their reasons vary.<sup>198</sup> In *LEC Contractors (M) Sdn Bhd v. Castle Inn Sdn Bhd*,<sup>199</sup> for example, the court of appeals declined to embrace unconscionability, although its approach appears to be based more on an assertion that neither bad faith nor unconscionability rises to the level of fraud than on an outright rejection of unconscionability as an independent ground. While this decision was considered by some to have closed the door on unconscionability because it issued from the court of appeals,<sup>200</sup> its failure to clearly reject unconscionability—along with its failure to take notice of earlier decisions in which the exception had been allowed—casts doubt on its effect and has left it open to criticism.<sup>201</sup> Nine years later, however, in *Pasukhas Constuctions v. MTM Millenium Holdings*,<sup>202</sup> unconscionability was rejected by the High Court.<sup>203</sup>

While the fate of the unconscionability exception may still be an open question in Malaysia, it is interesting to note that, as is the case with its Australian counterpart, the definition of unconscionability remains in a state of flux. In *Transfield Projects (M) Sdn Bhd v. Malaysian Airlines Systems*

197. See, e.g., *Radio & Gen. Trading Co. v. Freytag*, [1998] 1 MALAY. L.J. 346 (holding, on the basis of *Potton Homes*, that it was “unconscionable on the part of the defendant in this case to call on the performance bond.”); *Bains Harding (Malaysia) v. Arab-Malaysia Merch. Bank*, [1996] 1 MALAY. L.J. 425 (granting an injunction on the grounds of fraud and unconscionability, specifically grounding its action on *Bocotra*).

198. See, e.g., *Esso Petroleum Malaysia Inc. v. Kago Petroleum*, [1995] 1 J.L.J. 149 (Supreme Court's opinion articulating on a fraud-only standard for performance bond injunctions as being consistent with the balance of convenience test which is equivalent to the traditional four factor test underpinning all injunction cases in the United States); *LEC Contractors v. Castle Inn*, [2000] 3 MALAY. L.J. 339 (Court of Appeals' opinion articulating on a fraud-only standard, but rejecting both unconscionability and the balance of convenience test); *Transfield Projects v. Malaysian Airlines Sys.*, [2000] 7 MALAY. L.J. 583 (High Court's opinion on declining to use unconscionability, but the actual basis was unclear—either lack of fraud or lack of significant issue to warrant injunction).

199. [2000] 3 MALAY. L.J. 339.

200. See Hang Yen Low, *supra* note 81, at 194-95.

201. *Id.* at 195.

202. [2009] 8 MALAY. L.J. 1.

203. *Id.* at ¶ 15.

*Bhd*,<sup>204</sup> for instance, the High Court declined to enjoin payment on a performance bond on the grounds of unconscionability, although the court did state, in dictum, that unconscionable was synonymous with inequitable,<sup>205</sup> mirroring the stance of the Australian Federal Court.<sup>206</sup> However, in *Radio General Trading Co. v. Wayss & Freytag*,<sup>207</sup> another High Court decision, the court appeared to consider unconscionable and inequitable to be distinct.<sup>208</sup>

Although *Potton Homes* is an English case, unconscionability does not yet seem to have found its footing in English law. Despite an early prediction that it would not,<sup>209</sup> English common law appears primed to admit unconscionability. In *TTI Team Telecom International Ltd. v. Hutchinson 3G UK Ltd.*,<sup>210</sup> the customer sought an injunction against the beneficiary's attempt to obtain payment under what was referred to as "an advance payment bond,"<sup>211</sup> which, by its terms, was the functional equivalent of a standby letter of credit,<sup>212</sup> and which the court eventually characterized as such.<sup>213</sup> The court summarized its understanding of the state of English law as permitting restraint of the beneficiary of a primary obligation instrument for, among other things, "a breach of faith by the beneficiary in threatening a call [on the bond]."<sup>214</sup> In a list of examples of what it considered to be a breach of faith, the court included "a threatened call by the beneficiary for an unconscionable ulterior motive . . . ."<sup>215</sup> Even though the injunction was denied,<sup>216</sup> the perception that unconscionability is available in England now

204. [2000] 7 MALAY. L.J. 583.

205. *Id.* at 598 ("What is clear is the only ground that has been forwarded by the plaintiffs in seeking the injunction is that it is unconscionable, or in other words it is inequitable.").

206. See *Clough Eng'g Ltd.*, [2008] F.C.A.F.C. 136, ¶ 130-31.

207. [1998] MALAY. L.J. 346.

208. *Id.* at 357.

209. See Peter S. O'Driscoll, *Performance Bonds, Bankers' Guarantees, and the Mareva Injunction*, 7 NW. J. INT'L L. & BUS. 380 (1985-1986).

Despite language in *Potton Homes* . . . which might indicate that the [English] Court of Appeal was taking a more flexible line toward the fraud exception in performance bond cases, two of the more recent unreported cases, *Dodsall PVT Ltd. v. Kingpull Ltd.* and *Esal (Commodities) Ltd. v. Oriental Credit Ltd.* indicate that, for the moment, the Court of Appeal remains wedded to the stricter principles of [the fraud-only rule].

*Id.* at 395-96 (footnotes omitted).

210. [2003] 1 All E.R. (Comm) 914.

211. *Id.* ¶ 5.

212. *Id.* ¶ 20.

213. *Id.* ¶ 29.

214. *Id.* ¶ 46.

215. [2003] 1 All E.R. (Comm) 914 ¶ 46.

216. *Id.* ¶ 97.

seems fairly certain. Perhaps the most interesting aspect of the decision was that the court considered unconscionability as having originated in the dictum of *Potton Homes*, as extended by the bad faith standard articulated by the Singapore courts in *Kvaerner*.<sup>217</sup> As of this writing, the dictum in *TTI* does not appear to have formed the basis of a clear incorporation of unconscionability into English law.

In Hong Kong, the unconscionability standard has surfaced, albeit subtly. In 1999, in *Sumitomo Bank Ltd v. Xin Hua Estate Ltd.*,<sup>218</sup> in an application for a summary judgment, one of the parties asserted that unconscionable conduct was on equal footing as fraud, in the context of a letter of credit injunction. The court did not discount this assertion, opting instead to deny the motion for summary judgment, and sending the matter for full trial.

## B. ILLEGALITY

In addition to fraud and unconscionability, illegality is also evolving into an independent non-fraud exception to the independence principle.<sup>219</sup> And, just as the fraud and unconscionability exceptions evolved through “degrees of fraud” and “degrees of unconscionability” phases, respectively, the illegality exception appears to be undergoing a similar evolution. The illegality exception presently encompasses illegality in the sense of fraudulent activity<sup>220</sup> as well as in the sense of the integrity of corporate financial statements,<sup>221</sup> and, in terms of its theoretical foundations, it has been justified where a letter of credit was used “to carry out an illegal transaction,”<sup>222</sup>

217. *Id.* ¶ 41.

218. No. HCCL256/98 (H.K. Spec. Admin. Reg. C.F.I. May 7, 2009).

219. *See Deutsche Rückversicherung A.G. v. Walbrook Insr. Co. Ltd.*, [1995] 1 W.L.R. 1017; *Group Josi Re v. Walbrook Insr. Co. Ltd.*, [1996] 1 W.L.R. 1152 (enunciating an illegality exception to payment of letters of credit in conjunction with reinsurance contracts); *Mahonia Ltd. v. JP Morgan Chase Bank*, [2003] E.W.H.C. 1927 (Comm) (denying a motion for summary judgment by invoking an illegality exception to payment of a letter of credit involved in a three swap financing transaction); *Mahonia Ltd. v. JP Morgan Chase Bank*, [2004] E.W.H.C. 1938 (Comm) (declaring no evidence of illegality present, however, clearly affirming the lower court’s formulation of the illegality exception to payment of letters of credit).

220. *See Jason Chuah, Documentary Credits and Illegality in the Underlying Transaction*, 9(6) J. INT’L. MAR. L. 518 (2003), reprinted in Westminster Research, <http://www.wmin.ac.uk/westminsterresearch> (last visited March 8, 2010).

221. *Id.* at 518-19.

222. *Group Josi Re*, [1996] 1 W.L.R. 1152, 1164. *See also Chuah, supra* note 220, at 520.

[I]f the reinsurance contracts are illegal, and if the letters of credit are being used as a means of paying sums due under those contracts, and if all that is clearly established, would the court restrain the bank from making payment or the benefi-

or was in contravention of “public policy”<sup>223</sup> or “morality.”<sup>224</sup> Courts also examine letters of credit in terms of whether they are “exchange contracts”<sup>225</sup> under the International Monetary Fund Agreement,<sup>226</sup> and therefore possibly illegal under the domestic law of a party to the Agreement, but we leave this issue for more appropriate treatment within the context of international law.<sup>227</sup>

English jurisprudence appears to be the seedbed for development of the illegality exception. In *Deutsche Rückversicherung A.G. v. Walbrook Insurance Co.; Group Josi Re v. Walbrook Insurance Co.*,<sup>228</sup> Group Josi, a reinsurer, sought to prevent Walbrook Insurance Company from seeking payment on a letter of credit established to cover loss reserves.<sup>229</sup> Group Josi characterized the letter of credit as illegal and unenforceable since Walbrook’s insurance contracts were not authorized under the Insurance

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ciary from demanding it? In my judgment the court would do so. That would not be because the letter of credit contracts were themselves illegal, but because they were being used to carry out an illegal transaction.

Group Josi Re, [1996] 1 W.L.R. 1152, 1164.

223. *Id.* at 519.

224. *Id.*

225. *See generally* Banco do Brasil v. A. C. Israel Commodity, 190 N.E.2d 235 (N.Y. 1963) (holding that, while Article VIII(2)(b) of the IMF Agreement contained no provisions for imposing damages where it found a letter of credit to be an illegal exchange contract, it could refuse enforcement); J. Zeevi & Sons, Ltd. v. Grindlay’s Bank (Uganda) Ltd., 333 N.E.2d 168, *cert. denied*, 423 U.S. 866 (1975) (refusing to hold a letter of credit to be an exchange contract under the facts of the case, but did not preclude such a determination under Article VIII(2)(b) of the International Monetary Fund Agreement); United City Merchs. (Invs.) Ltd. v. Royal Bank of Canada, [1982] 2 W.L.R. 1039 (recognizing that “the plaintiff not only had the difficult task of enjoining honor of a letter of credit, but also had to overcome the larger and potentially more troublesome conflict between international law and international business;” holding that a letter of credit correct on its face constitutes an “exchange contract” violative of Peru’s currency laws, and is thus unenforceable by the English courts.); *see also* Kalson, *supra* note 71 (discussing in general terms the judicial approach to implementing the Bretton Woods Agreement).

226. Articles of Agreement of the International Monetary Fund art. VIII, sec. 2(b), Jul. 22, 1944, 59 Stat. 512 (1945), 2 U.N.T.S. 29. This agreement is popularly referred to as the Bretton Woods Agreement.

227. Although English and U.S. letter of credit law have similarly evolved, the application of Article VIII(2)(b) of the IMF agreement by U.S. courts has been more gradual. *See* Kalson, *supra* note 71, at 1075-76, 1078-79 (“Given the twofold purpose of the Agreement, the furtherance of both international trade and international monetary cooperation, a court faced with a dispute under its terms should attempt to balance both concerns.”) It is also predicted that U.S. courts will eventually follow *United City Merchants* if confronted with similar facts, and speculating on the ability of U.S. courts to “walk the tightrope between international law and international business as deftly as did their British counterparts.” *Id.*)

228. [1996] 1 W.L.R. 1152.

229. *See* Chuah, *supra* note 220, at 519.

Companies Act of 1982.<sup>230</sup> The court ultimately found that statute inapplicable and the contracts, therefore, legal but not without first contemplating the issue of illegality as a defense to paying a letter of credit,<sup>231</sup> observing that “there must be cases when illegality can affect a letter of credit.”<sup>232</sup> The court founded its willingness to entertain a non-fraud exception to the independence principle on *United City Merchants (Investments) Ltd. v. Royal Bank of Canada*,<sup>233</sup> which opened the door to non-fraud exceptions.<sup>234</sup> Reminiscent of the degrees-of-fraud analysis, the court noted that the illegality cannot be insignificant, but that it must be integral to the contract.<sup>235</sup> Referred to as the main case dealing with letters of credit and illegality,<sup>236</sup> *Group Josi* is “important in offering guidance on the extent to which illegality might be compared to fraud as an exception to the principle of autonomy.”<sup>237</sup> In other words, there must be an illegality of such significance that for public policy and morality reasons, the letter of credit should not be paid in derogation of the independence principle.<sup>238</sup>

The *Group Josi* court’s connection of illegality in the underlying contract to the letter of credit was through the mechanism of payment, observing that “[p]ayment is, after all, virtually always an integral part of commercial or financial transactions.”<sup>239</sup> The use of a feature of the underlying contract, like payment, as the connection point could turn out to be a rather unconstrained approach. For example, applying this standard to sales of goods cases would dramatically undercut the independence principle because the goods are, after all, virtually always an integral part of an underlying sale of a goods contract, so any time non-conforming goods were

230. *Id.* at 520.

231. *See* Group Josi Re, [1996] 1W.L.R. 1152 n.218, at ¶¶ 1,51-52,72.

232. *See* Chuah, *supra* note 220, at 520.

233. 1 A.C. 168 [1983].

234. *See* Chuah, *supra* note 220, at 519.

[F]raud by the beneficiary was *only one* ‘established exception’ to the principle that the bank’s duty was to pay against documents which on their face conformed with the requirements of the letter of credit and without reference to any challenges to those documents arising from disputes between the applicant and the beneficiary.

*Id.* (emphasis added).

235. *Id.* at 520 (inviting comparisons to traditional fraud-by-degrees analysis originating with “egregious” fraud).

236. *Id.* at 519.

237. *Id.* (recognizing the lack of English case law treating illegality as a defense to payment of a letter of credit and the significance of establishing and clarifying another exception to the independence principle besides fraud).

238. *Id.* (reverting to a degrees analysis).

239. *See* Chuah, *supra* note 220, at 520 (linking the purpose of the letter of credit to illegal activity).

“used to carry out a transaction” there would be sufficient reason for not paying a letter of credit. In both *Group Josi* and another English case, *Mahonia Ltd. v. J.P. Morgan Chase Bank*<sup>240</sup> (discussed below), the courts have clearly expanded the illegality rationales for injunctive relief in ways that undermine the independence principle, and in *Mahonia Limited v. JP Morgan Chase Bank*,<sup>241</sup> the court continues the degrees-of-illegality analysis.

On paper, Mahonia was an energy venture company created by J.P. Morgan Bank, but in reality it was a tax shelter.<sup>242</sup> It engaged in end-of-the-year, prepaid sales of oil or gas where customers, such as Enron, received actual delivery in the following year so that such customers were able to decrease taxable income and defer taxes.<sup>243</sup> Enron comprised more than fifty percent of Mahonia’s sales but, as Enron’s financial health deteriorated, Mahonia became Enron’s lender by buying even more undelivered goods.<sup>244</sup> With Enron’s demise, it owed Mahonia billions and due to this perceived risk Enron had taken out “insurance” on the resulting bad sales, one of which was for \$650 million in 1999.<sup>245</sup> The insurers refused to pay alleging fraud in the underlying arrangements.<sup>246</sup> Morgan claimed that the insurance was unconditional.<sup>247</sup>

In the *Mahonia* 2003 summary judgment denial,<sup>248</sup> the parties, Chase, Mahonia, and Enron, entered a three swap transaction whereby \$350 million would be available to Enron for six months. The transactions were characterized by the bank issuing a letter of credit as a “cosmetic scheme” for Enron to avoid debt entries in its accounts. Through Chase, Mahonia loaned to Enron; and when Enron defaulted, Mahonia made demand for 165 million under a letter of credit to West LB. The bank refused payment since the letter of credit was integral to a scheme where there were violations of GAAP and U.S. securities laws and thus “tainted by illegality” that encompassed a violation of public policy and morality.<sup>249</sup>

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240. See *Mahonia Ltd. v. J.P. Morgan Chase Bank*, [2003] EWHC 1927; [2004] EWHC 1938 n.174.

241. [2003] EWHC 1927; [2004] EWHC 1938.

242. Andrew Beattie, *What was the Mahonia company and why did it become the subject of a lawsuit?*, <http://www.investopedia.com/ask/answers/09/mahonia-enron-jp-morgan> (last visited Feb. 17, 2010).

243. *Id.*

244. *Id.*

245. *Id.*

246. *Id.*

247. Beattie, *supra* note 242.

248. See *Mahonia*, [2003] EWHC 1927.

249. See Chuah, *supra* note 220, at 518-20 (“the separate nature of the letter of credit could not be used to trump the public policy that the beneficiary should not benefit from his illegality.”); *Mahonia*, [2003] EWHC 1927 at ¶12, [2003] 2 LLR 911, at 915.

Squarely at issue in this case was whether the independence principle requires the bank to pay regardless of illegality under United States law. Judge Colman refused to grant summary judgment in favor of Mahonia, thereby recognizing the illegality defense to payment since the swaps and the letter of credit had an illegal purpose. “[B]oth the swaps and the letter of credit were entered into for the purpose of providing the structure on which Enron’s misleading accounts were to be founded.”<sup>250</sup> As one commentator has stated, “[T]his is yet another case in very recent times permitting the derogation from the principle of autonomy in documentary credit. It is on the whole a moral decision but moral decisions often may not always sit well with the paradigms of commercial certainty.”<sup>251</sup>

In the 2004 *Mahonia* appeal, the court’s discussion of illegality as a defense to payment of a letter of credit followed the rationale previously set forth by Judge Colman in his 2003 decision denying summary judgment for Mahonia. The appellate court elaborated on “the taint of illegality” as follows:

With this reservation, I would have accepted the arguments of West as to the unenforceability of the L/C had West been able to make good Mahonia’s complicity in an illegal scheme unlawfully to account for the Three Swaps. For the reasons essentially set out by Colman J in July 2003 and those set out in West’s closing submissions, I would not have held that the “autonomy” of letters of credit required a different conclusion. If the L/C had played a part in an overall scheme of the magnitude alleged, to deliberately mislead by wrongful accounting, contrary to section 10(b) of the Exchange Act 1934, and Chase and Mahonia had been complicit therein, public policy would, in my view have required the court not to lend its aid to the enforcement of the L/C which shared the same unlawful purpose as the Three Swaps, which came into existence solely by virtue of that purpose and which was, in any event so closely connected with them as to be tainted by that purpose.<sup>252</sup>

The court found that Mahonia could obtain payment under the letter of credit since Chase and Mahonia were not aware that Enron’s accounting

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250. Chuah, *supra* note 220, at 519 (linking the letter of credit as an instrumentality of Enron’s faulty accounting practices); *Mahonia*, [2003] EWHC 1927 at 12, [2003] LLR 1927 at 915.

251. Chuah, *supra* note 220, at 519 (recognizing that morality may not be the best guide for establishing efficient commercial practice when subsequent litigation is available).

252. See *Mahonia*, [2004] EWHC 1938, ¶ 432.

was illegal and that there was no conspiracy between Mahonia and Enron, thus no illegality affected the underlying transaction or the L/C. There must be “clear evidence of illegality,”<sup>253</sup> and not be “relatively trivial.”<sup>254</sup>

While both the degree of illegality and the locus of illegality dimensions of this exception pose problems for the independence principle, it seems that the latter dimension is more problematic. The requirement that the degree of illegality be significant would appear to be inevitable, so if the exception must persist, a significance requirement would seem to be the better approach to the degree aspect. Judicial receptivity to the idea of allowing illegalities in the underlying contract to flow into the letter of credit contract between the issuer and the beneficiary, however, echoes the analogous and most troubling dimension in the evolution of the fraud exception. As one noted authority has observed, “[u]nprincipled inquiry into the underlying transaction . . . derails the effort to limit the fraud exception and destroys the independent obligation.”<sup>255</sup> The simple fabrication of a conduit from the underlying contract to the letter of credit would not seem to be a sufficiently “principled” mechanism by which to allow illegality to flow into and threaten the letter of credit itself. Section § 5-109 of the UCC requires a demonstration that “honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant,”<sup>256</sup> as a predicate to allowing fraud problems connected to the underlying contract to flow into the letter of credit. A similar approach with illegality would simultaneously take the significance dimension into account and interpose a tested control principle between illegality in the underlying contract and the letter of credit.

## V. CONCLUSION

Unconscionability and illegality damage the independence principle, in particular, and commercial certainty, in general, by elevating fairness-based judgments about the risk-allocation choices of the parties to the underlying contract above the certainty-dependent environment that underpins international transactions.<sup>257</sup> Both exceptions are still in their formative stages. In the United States, it took approximately sixty years of experience

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253. See Chuah, *supra* note 220, at 521 (acknowledging inherent difficulties of establishing illegality if “under some arcane foreign law”).

254. *Id.* (expressing concern over the existence of merely illegal technicalities and that evaluating triviality may pose difficult problems of perspective when viewed under different countries’ laws and courts, an issue of “international judicial comity”).

255. See Dolan, *supra* note 22, at 481.

256. U.C.C. § 5-109 (1995).

257. See Dolan, *supra* note 22, at 481 (leveling a similar criticism at the fairness basis underlying the fraud exception to the independence principle).

with two different statutory approaches<sup>258</sup> to bring the required level of predictability to the fraud exception.<sup>259</sup> If that piece of legal history offers any clear lesson, it is that statutory inoculation against uncoordinated, multijurisdictional developments in the courts alone is the better approach.<sup>260</sup> Consequently, until unconscionability and illegality are either statutorily clarified, or their form and effects evolve into sufficient transnational clarity, the particulars of each may turn out to be less significant than the pall of uncertainty their existence alone casts over the balance of expectations upon which transactions are based. Their emergence illustrates the growing vulnerability of letters of credit and bank guarantees to moral judgments and the equities of the underlying contract, and signals some level of judicial dissatisfaction with the independence principle and the fact that it does nothing to ameliorate the buyer's remorse experienced by a party dissatisfied with his original risk-allocation choice.

In addition to concerns common to unconscionability and illegality, each offers its own individualized threats. For instance, the scope of the illegality exception seems plagued with a sensitivity to changes in economic and political climates.<sup>261</sup>

With respect to unconscionability—which is probably here to stay,<sup>262</sup> albeit with some skepticism as to its eventual universality<sup>263</sup>—its mere

258. Compare U.C.C. § 5-114 (1952) (*fraud in the transaction* approach), with U.C.C. § 5-109 (1995) (*material fraud* approach).

259. See James G. Barnes & James E. Byrne, *Letters of Credit*, in 2008 ANNUAL SURVEY OF LETTER OF CREDIT LAW & PRACTICE 21, 25 (James E. Byrne & Christopher Byrnes eds. 2008) (“The notion prevalent decades ago that U.S. courts were promiscuous in interfering with payment under U.S. bank LCs has been reversed.”).

260. *Id.*

United States courts applying U.S. law continue to be uniquely advantaged in having a comprehensive codification of the LC fraud exception, and are well positioned to cooperate as a safe haven for banks worldwide that distrust the fraud exception as it is now being applied in other countries in the context of resisting . . . claims for reimbursement.

*Id.*

261. See, e.g., Daniel C. K. Chow, *Limiting Erie in a New Age of International Law: Toward a Federal Common Law of International Choice of Law*, 74 IOWA L. REV. 165, 183-89 (1988) (examining the connection between changes in political climates and the vigor with which currency restriction laws are used as the basis of the illegality exception); David Litvack, Note: *Losing Control: Why IMF Article VIII(2)(B) May Nullify the Enforceability of Financing Contracts when Spiraling Oil Prices Prompt the Use of Exchange Controls*, 13 FORDHAM J. CORP. & FIN. L. 805, 806 (2008) (noting the connection between the increases in oil prices and increases in the frequency with which currency controls are asserted as a contract defense).

262. See ROBIN BURNETT & VIVIENNE BATH, *LAW OF INTERNATIONAL BUSINESS IN AUSTRALIA* 252-53 (4th ed. 2009).

presence is a damaging complication,<sup>264</sup> and it may pave the way for more damage in the form of additional bases for injunctions.<sup>265</sup> So far, the courts involved seem content to take a case by case approach,<sup>266</sup> which, while judicially convenient, does little to serve the need for transactional certainty. Unlike fraud, which is premised on an intent to deceive, unconscionability is not so straightforward. While fraud is unconscionable, the reverse is not always true. As the Australian court in *Olex Focas* observed, the ethical dimensions of judging unconscionability are significant.<sup>267</sup> Because ethical standards have cultural underpinnings,<sup>268</sup> and because international transac-

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It seems likely that unconscionable conduct will continue to be a popular ground for attacking letters of credit, both as a ground in its own right and as an alternative to a claim of fraud, although the results in these cases suggest that a plaintiff arguing unconscionability may also find it difficult to persuade the court to act in its favour.

*Id.* See also Matthew Bisley & James Mok, *Unconscionable Demands Under Letters of Credit, Performance Bonds and Bank Guarantees*, 16 J. BANKING & FIN. L. PRAC. 197 (2005) (predicting a proliferation of unconscionability cases).

263. See JAMES O'DONOVAN, *LENDER LIABILITY* 356 (English ed. 2005) (stating, with respect to unconscionability as an exception to the independence principle, that "this exception is unlikely to take root in English law because it lacks the statutory foundation and framework which exists in Australia.").

264. See XIANG GAO, *THE FRAUD RULE IN THE LAW OF LETTERS OF CREDIT: A COMPARATIVE STUDY* 96 (2002). Gao asserts that the rise of unconscionability represents an undesirable development in the law of letters of credit, because it appears to have created another basis for the interference with the payment of letters of credit and independent guarantees at least in Australia: statutory unconscionable conduct, which may severely affect the commercial utility of letters of credit . . . .

*Id.*

265. *Id.* at 96. Gao states that the *Olex Focas* decision may have opened (at least in Australia) a "Pandora's box" and [lead] to more "exceptions" to the letter of credit payment system. For example, other sections of the *Trade Practices Act*, such as s 52, dealing with misleading and deceptive conduct, and s 53 dealing with false or misleading representations, may also be applied in future to letters of credit and independent guarantees. If this happens, the commercial utility of letters of credit and independent guarantees will be seriously eroded.

*Id.*

266. See BURNETT & BATH, *supra* note 262, at 252-53 (describing numerous situations in which unconscionability has been advanced, successfully and unsuccessfully). See also *Eltraco Int'l Pte Ltd. v. CGH Dev. Pte Ltd*, [2000] 4 S.L.R. 290, ¶ 28 (acknowledging that in its decision in *Dauphin Offshore* that it considered unconscionability to be indefinable).

267. No. 6282, 1996 VIC LEXIS 1245 (Vict. Sup. Ct. Aug. 28, 1996), at \*59-60.

268. See generally Mark S. Blodgett, Christian DeLaunay, Kuo-Ting Hung, *Source of Business Ethics Convergence: A Review of Global Corporate Websites*, 2(1) J. Know-

tions, by their very nature, span cultures, a consensus on the conceptual infrastructure of the unconscionability exception may never develop on its own. It may fall victim to the parochial I'll-know-it-when-I-see-it type of analysis famously applied to pornography, by Justice Potter Stewart, in *Jacobellis v. Ohio*,<sup>269</sup> and remain a permanently destabilizing force. As such, the appealing idea advanced by one commentator that unconscionability is really just a broadening of the fraud exception<sup>270</sup> may turn out to be just wishful thinking. At this point, the only common denominator appears to be the unentitled beneficiary attempting to exploit his natural advantage in the pay-now-argue-later scheme.

The possibility that disavowal of the fraud-only standard might open the door to a proliferation of standards harkens back to the confusing pre-UCC days where, even though fraud was the only basis for injunction, there were multiple standards of fraud.<sup>271</sup> As such, it represents a step in the wrong direction. *Potton Homes* opened the door, but established few limitations, leaving the question to be answered on an *ad hoc* basis. *Bocotra Construction* inserted unconscionability into the blank left open by *Potton Homes*. Its reference to failure of consideration and avoidance of the contract is perhaps illustrative of an intention to limit non-fraud based injunctions to traditional contract defenses, but this point is not definitively made. And, even if traditional contract defenses are later held to define the scope of these new exceptions, the number of factual permutations that this array of defenses permit deals a blow to commercial certainty.<sup>272</sup>

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ledge Globalization 79 (2009) (discussing and examining the culture basis of ethical systems).

269. 378 U.S. 184, 197 (1964) (Stewart, J., concurring) (stating, with respect to pornography that "I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it . . .").

270. See Browne, *supra* note 166, at 114.

271. See Symons, Jr., *supra* note 12, at 339-40 (describing the multiple pre-U.C.C. standards of fraud, and the difficulty they caused).

272. See, e.g., *Bolivinter Oil SA v. Chase Manhattan Bank & Ors*, [1984] 1 All E.R. 351. This court characterizes the need for certainty by stating that:

obtaining an injunction restraining the bank from honouring that undertaking, [] will undermine what is the banks' 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.*

*Id.* (emphasis added).

Because unconscionability has not yet arrived in the United States,<sup>273</sup> there may be little motivation for domestic courts and legislatures to become involved with it, although expanding the ambit of UCC § 5-109 to include both illegality and unconscionability, in a fashion analogous to the way it treats fraud, would be a logical place for legislatures to start. Failing that, perhaps the prospect of having to face this new exception as a *fait accompli* will provoke the domestic legal community to sponsor an international effort to develop a treaty-based approach.

At a minimum, these developments represent the beginnings of a significant shift in the common law of letters of credit and bank guarantees, and their relatively rapid spread from jurisdiction to jurisdiction is disturbing. Our antipathy toward the expansion of fairness at the expense of certainty is driven by the fact that the certainty-dependent ecology of international transactions is best served by fewer, more well-defined exceptions to the independence principle. Henry Harfield, a noted early commentator declared,

I view with alarm, that borders on panic, the possibility that judges may apply in letter-of-credit cases the principles of equity and compassion that are currently used to make bad law in hard cases arising in other areas . . . . I fear that the sacred cow of equity may trample the tender vines of letter-of-credit law.<sup>274</sup>

Unfortunately, Harfield's fears have proved prescient. As these exceptions evolve and spread, one would hope the debate between fairness and certainty will favor certainty. Otherwise, the independence principle will eventually become the *interdependence* principle.

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273. *Contra* Aicher, et al., *supra* note 12, at 909 (citing *Gillman v. Chase Manhattan Bank, N.A.*, 534 N.E.2d 824, 828 (N.Y. 1988)) (“[U]nconscionability can operate to justify dishonor [of a letter of credit] in some circumstances.”). The *Gillman* case, however, did not deal with the use of unconscionability as a defense to payment under a letter of credit. The letter of credit involved in *Gillman* had been paid without objection by any party. *Gillman*, 534 N.E.2d at 828. Unconscionability arose exclusively in connection with the terms of the contract of reimbursement between the issuer and the applicant. *Gillman*, 534 N.E.2d at 828-30.

274. Henry Harfield, *Code, Customs and Conscience in Letter-of-Credit Law*, 4 U.C.C. L.J. 7, 9-11 (1971).