Unconscionable Conduct in Commercial Transactions

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Global Perspectives and Applications

By

Garth Wooler

Cambridge Scholars Publishing

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This book first published 2018

Cambridge Scholars Publishing

Lady Stephenson Library, Newcastle upon Tyne, NE6 2PA, UK

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

ISBN (10): 1-5275-1578-8
ISBN (13): 978-1-5275-1578-9

Perspective

I have not so much thought my way through life as done things and found out what it was and who I was after the doing.

—Ray Bradbury
Drunk, and in Charge of a Bicycle[1]

[1] Bradbury, R., *The Stories of Ray Bradbury* (Granada Publishing, Volume 2, 1981), 24.

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ABSTRACT

The independence of letters of credit and demand guarantees from the underlying contract of sale that gave rise to them is fundamental to the integrity of the market in which they operate and is the core of the economic certainty provided by the product. In the absence of material fraud, stakeholders expect the separation between the two to be maintained. However, the application by courts in three countries of the principles of unconscionable conduct to lift the veil of autonomy separating the two has given rise to some concern about the efficacy of the independent instrument product.

The use of unconscionability to ground injunctions preventing the benefit of an instrument from flowing to its beneficiary is perceived to increase uncertainty and transactional risk. This manuscript argues that this need not be the case–that a properly-formed category of independent instrument unconscionability that is tailored to the specific attributes of independent instruments will provide judicial stability and stakeholder assurance while reflecting contemporary market expectations of commercial behaviour.

The use of unconscionability as a basis to restrain a demand-right or payment obligation has struggled to achieve consistency within and across jurisdictions because, it is posited herein, the jurisprudential basis for the doctrine has not been appropriately developed with specific reference to the independent instruments to which it is being applied. The relationship between the characteristics of independent instruments and the elements for proving independent instrument unconscionability have not been clarified in the courts or the literature. The result is a mash of procedural and substantive unconscionability principles being applied to adjudicate allegations of unconscionable conduct.

This book is predicated on the proposition that independent instrument unconscionability is necessary, reasonable, and justifiable for protecting applicant parties from the economic distress caused by abusive demands for payment. It examines the law of unconscionable conduct (procedural and substantive), the development of independence in trade finance instruments, and analyses the case law in both Singapore and Australia where unconscionable conduct has been alleged. This aggregation and analysis is used to distil the elements of independent instrument unconscionability into the framework provided in Chapter Six.

ACKNOWLEDGEMENTS

First and foremost, my deepest gratitude goes to my academic advisor, colleague, and friend, Dr Alan Davidson. Without his deep insight and encyclopaedic knowledge of this area of law; his recommendations on content, style, and approach; his fearless editing skills; and his serene patience and endless good humour, this work would never have been written. To him I am deeply and eternally grateful. There are some gifts that can never be repaid, and this is one of them. A better friend a man could not have for such a journey.

To my partner throughout this journey, my adored Farah, I also pay deep tribute. Without her tireless support, endless encouragement, uncommon belief, and angelic fortitude given all the challenges that living with me brings, I know I would never have been able to complete this. She has always made me want to be a better person. I've tried.

This book is the end of a very long road for me that started at Coorparoo Adult Education Centre in 1984 when, as a 25 year-old, I thought I might give 'finishing high school' a shot. I've seen the inside of many, many classrooms since then. So, I'd like to also acknowledge all the teachers and lecturers and tutors and fellow students who taught me and learned with me, and ultimately taught *with* me over all these years. I wish I could tell them personally that they each helped me in their own way. The sound advice and generosity of spirit I have received from some of them remains a gift with me to this day.

Finally I would like to acknowledge my late father, Harry Wooler. His response to this work would be understated perhaps, probably not really understanding the accomplishment, but I am fairly certain he would see it as worthwhile and of value. I'd like to think he would be a little bit proud of it, too.

CHAPTER ONE

PROJECT SCOPE AND LEGAL FUNDAMENTALS

Section A. Legal Issue and Investigative Approaches

1.0. Research Question

Given the unique legal character of independent instruments, how would a category of unconscionable conduct specific to their use be framed in law?

2.0. Hypothesis

That, properly described under law, there exists a special category of independent instrument unconscionability which, with sufficient materiality, is sufficient to ground an injunction.

3.0. Rationale

Abusive demands on independent instruments[1] cannot be priced by the party carrying nearly all the downside risk to the primary underlying contract: the applicant account holder. An abusive demand cannot be presumed. The risk of an abusive demand cannot be offset nor insured against. The risk of an abusive demand will not generally be contractually offset under the (underlying) contract given the inequality of the parties' bargaining positions.

The *raison d'être* for the 'autonomy principle' rests with its contribution to the risk mitigation properties of the instrument. The application of any exception to that principle fundamentally contradicts the precepts of party autonomy[2] in international private commercial law.

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[1] See Usage, p.16.

[2] By "party autonomy" it is meant that the parties to a commercial contract have an arguable right to choose the rules that will determine the operation of the contract

In some jurisdictions, courts have allowed concepts of 'fair behaviour' to negatively impact the relative commercial certainty provided by the independence of Documentary Credits and Demand Guarantees.

The only relief typically available for unconscionable demands on independent instruments is the equitable remedy of injunction. Equity will not suffer a wrong without a remedy;[3] an abusive demand is not an event that a party can presume and is therefore a *wrong*. Under Australian statute, the doctrine of unconscionability in relation to independent instruments remains to be fully formed. In Singapore the courts' equitable jurisdiction provides the head of power to ground injunctions and enjoys much greater clarity.

The protection of the independence principle and the inherent risk-allocation value of independent instruments in the market is paramount. Inept application of the notion of unconscionability on the integrity of the independence principle can damage the reputation of the product and cause rational users to consider alternate products. The obligation on issuers to honour a complying presentation should never be tampered with; it is argued herein that *restraint must always lie against the beneficiary*.

Where *abusive* demands are enabled by the court and serious economic and possibly social harm results from such a demand, the danger to the product's reputation and use profile is arguably greater. Unconscionable conduct in relation to demands on independent instruments have not been comprehensively framed due to a paucity of explanation available on how the special character of independent instruments juxtaposes with the law of unconscionable conduct *as it exists and is developing*. Therefore, a state of dissonance exists in this area of law that requires address.

This book *inter alia* posits that pleadings of unconscionability with respect to demands on independent instruments require sufficient materiality to restrain a demand, i.e. egregious unconscionable conduct needs to be proven *prima facie* to ground an injunction. This does not include a requirement to demonstrate any moral obloquy.

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entered into, including apropos, the rules that allow the agreement to be set aside, i.e. party autonomy is the capacity of parties to a "business contract [being] free to choose the governing law" and rule sets for incorporation into the transaction. See: H Watt, '"Party Autonomy" In International Contracts: From The Makings Of A Myth To The Requirements Of Global Governance' (2010) (3 ERCL) *Columbia University Alliance Program Papers* at www.columbia.edu/.

[3] *Ashby v White* (1703) 92 ER 126 (*Ashby*): "*Ubi jus, ibi remedium*…If the plaintiff has a right, he must of necessity have a means to vindicate and maintain it, and a remedy if he is injured in the exercise or enjoyment of it".

The arguments made here also provide support for the proposition that to set aside the independence of demand guarantees, and their equivalents, a lesser degree of materiality should be required than for letters of credit. This is proposed subject to the condition that the obligation to honour held by the issuer is not interfered with; that only the demand-right held by the beneficiary is restrained.

It is the object of this research to demonstrate that the intersection of unconscionable conduct and the commercial law can be successfully managed within a clearly defined, inter-jurisdictionally acceptable nomothetic framework. It must be designed to provide guidance for circumscribing the range of behaviours allowed to negatively impact commercial undertakings and the elements that need to be considered to found a pleading of sufficiently egregious unconscionable conduct.

Section B. Research Contribution, Assumptions and Methodology

1.0. Contribution to the Body of Knowledge

This book contributes original research in the discipline of international letter of credit and demand guarantee law by:

1. Providing a complete analysis of the jurisprudence in every superior court case dealing with unconscionable conduct in relation to demands on letters of credit and demand guarantees in both Australia and Singapore;
2. Compilation and discussion of all major letter of credit and demand guarantee governing rules relating to the independence principle;
3. Providing a framework of elements for independent instrument unconscionability supported by law and analysis.

2.0. Caveat Regarding Reader's Prior Knowledge

This manuscript has been researched and written at a doctoral level. Given the character of this study of letters of credit and demand guarantees, it is presumed that the reader will have a complete knowledge of the principles of usage and the terminology of the discipline.

It is presumed that the reader will be familiar with the fundamental rule sets operational throughout the industry, and the major organisational stakeholders:

- Uniform Customs and Practice for Documentary Credits (currently UCP600)[4]
- Uniform Rules for Demand Guarantees (URDG758)
- International Standby Practices (ISP98)[5]
- International Standard Banking Practice (ISBP2013)[6]
- UNIDROIT Principles of International Commercial Contracts (PICC)[7]
- Principles of European Contract Law (PECL)[8]
- Convention on the International Sale of Goods (CISG)[9]
- United Nations Convention on Independent Guarantees and Standby Letters of Credit (UN-CIGSLC)[10]
- *Uniform Commercial Code* (USA) (UCC)[11]
- Trade Practices Act/Australian Consumer Law (AUS) (TPA/ACL)[12]
- The Rules Sets of the Supreme People's Court Concerning Hearing Letter of Credit Cases (SPC-LCC)[13]
- International Chamber of Commerce (ICC)
- Institute of International Banking Law and Practice (IIBLP)
- United Nations Commission on International Trade Law (UNCITRAL)

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[4] J Byrne (ed), *LC Rules & Laws: Critical Texts for Independent Undertakings* (Institute of International Banking Law & Practice, Inc., Sixth Edition, 2014), p.2.
[5] <https://iiblp.org/resources/isp98/>
[6] J Byrne (ed), *LC Rules & Laws: Critical Texts for Independent Undertakings* (Institute of International Banking Law & Practice, Inc., Sixth Edition, 2014), 103.
[7] <www.unidroit.org/english/principles/contracts/principles2004/integralversion principles2004-e.pdf>
[8] <http://www.jus.uio.no/lm/eu.contract.principles.parts.1.to.3.2002/>
[9] <http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG.html>
[10] <http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_credit.html>
[11] <https://www.law.cornell.edu/ucc>
[12] Trade Practices Act 1974 (Cth): <http://www.austlii.edu.au/au/legis/cth/num_act/tpa1974149/> and *Competition and Consumer Act 2010* (Cth), Schedule 2–The Australian Consumer Law: <http://www.austlii.edu.au/au/legis/cth/consol_act/caca2010265/sch2.html>
[13] Rules Concerning Jurisdiction Over Foreign-Related Civil and Commercial Cases (PRC), 2002; Rules of the Supreme People's Court Concerning Hearing Letter of Credit Cases (PRC), 2005; Independent Guarantee Provisions of the PRC Supreme People's Court (PRC) 2017: <http://www.asianlii.org/cn/legis/cen/laws/potspcosicttocodoloc1163/>

From this point, no footnote reference will be made with respect to any of the above except where specific sections/articles are addressed.

It is also presumed that the reader will be familiar with the various legal systems in which independent instrument law operates and the hierarchies of the court systems.

For more detailed explanations, the reader might refer generally to *Ellinger and Neo*,[14] or Vout's excellent tome on the laws of unconscionable conduct in Australia.[15] Many terms are extensively defined in the various international rule sets that frame documentary credit usage as the reader will be aware.

3.0. Methodology

The research will use material drawn from the case law and both academic and judicial commentary.

The theoretical research to describe this hypothesis will be doctrinal in nature, and therefore qualitative. The research will consider the black-letter law of the statute, case law and the rule sets on which international commercial law and independent instrument transactions are founded. Analysis will be conducted in context with the general principles of unconscionable conduct:

a. within equity broadly;
b. considering the general concepts of good faith;
c. as defined in statute proscribing Unconscionable Conduct; and
d. statutory interpretation.

The method for studying 'black-letter' law:

> focuses heavily if not exclusively, upon the law itself as an internal self-sustaining set of principles which can be accessed through reading court judgements and statutes with little or no reference to the world outside the law.[16]

[14] E P Ellinger and D Neo, The Law and Practice of Documentary Letters of Credit (Hart Publishing, 2010).

[15] P Vout (ed), *Unconscionable Conduct: The Laws of Australia* (Thomson Reuters, Second Edition, 2009).

[16] M McConville and W Chui (eds), *Research Methods For Law* (Edinburgh University Press, 2007), 4. See also E L Rubin, "Law and the Methodology of Law" (1997) *Wisconsin Law Review* 525.

The 'scientific method', described by Karl Popper as the 'hypothetico-deductive' method, has been employed in this manuscript.[17] Donley states:

> Deductive research begins with a theory…that leads to the development of a research question or hypothesis to be tested through data that is then collected and analysed…[The] theory generates hypotheses; hypotheses point to certain kinds of data required to test them; data is analysed to determine whether they support a hypothesis or not.[18]

This book commences with the hypothesis that a properly-framed category of independent instrument unconscionability can operate to provide injunctive relief against sufficiently material abusive demands while maintaining the integrity of the independence principle and the commercial value of independent instruments themselves. It then sets out to demonstrate that this is so with reference to an international body of law and opinion.

Section C. Terminology, Syntax and Vocabulary

1.0. Usage in This Document

Both letters of credit and demand guarantees are 'independent instruments' but the rights and obligations of each operate quite differently and have had their 'independence' treated differently by different courts.[19] Letters of credit are widely referred to as 'Documentary Credits',[20] although the latter term could include other independent instruments.

For most purposes the terms 'Demand Guarantee', 'Independent Guarantee', 'Bank Guarantee', 'Bank Bond', 'Demand Bond', 'Performance Bond', 'Financial Guarantee', and 'Standby Letter of Credit' are functionally identical and are often interchanged or used incorrectly.

Throughout this book these instruments are referred to jointly and severally as 'independent instruments' when being discussed in a general context. They will be referred to separately as 'letters of credit' and 'demand guarantees' when it is necessary to differentiate between them. 'Demand guarantee' will be used when referring to all similar instruments

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[17] K Popper, *The Logic of Scientific Discovery* (Routledge, Second Edition, 1992).
[18] A Donley, *Research Methods* (Publ: Facts On File, 2012), 9.
[19] For example, see JBE Properties Pte Ltd v Gammon Pte Ltd [2010] SGCA 46 [10] (JBE$^{(No.2)}$).
[20] For example, UCP600 does not refer to 'Letters of Credit'; it refers to these instruments as 'Documentary Credits'.

unless discussing a specific instrument related to a specific case, such as a 'performance guarantee'. Original terms will be used in all extracts.

Where the analysis is dealing with specific aspects of unconscionability that only affect demand guarantees, as opposed to letters of credit, notice will be given in the footnotes.

For the purposes of this book the term "abusive demand" is a generic which refers to a demand for payment on an independent instrument or similar bank instrument that is *prima facie* fraudulent, unconscionable, oppressive[21] or illegal.[22]

2.0. Independent Instrument Naming Conventions

The word "guarantee" is widely used for an extensive array of instruments and other fiscal relationships. This book does not attempt to formulate any kind of meaningful taxonomy to classify them all. The word now has the nature of a generic. In documentary credit law, 'Guarantee' is used to describe both the obligation *and* the instrument.

'Guarantee' is also used in the moniker of both dependent *and* independent bank obligations. The terms 'unconditional' and 'independent' are also interchanged when they mean quite separate things.[23]

US law prohibits banks providing 'guarantees' (in the strict banking law sense) and therefore called their 'demand guarantee' equivalent instruments 'standby letters of credit'.[24] 'Guarantee' is occasionally used to describe instruments that are in essence a 'bond'. 'Guarantee' is also often modified by a descriptor relating to its function, such as 'Performance Guarantee' or 'Financial Guarantee'.

The Court has repeatedly stated that a Guarantee must be honoured "according to its terms",[25] meaning in part that it is irrelevant what the issuer or applicant *call* the instrument, its character will be drawn by the rights and obligations provided for in the 'conditions' of the instrument

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[21] GHL Pte Ltd v Unitrack Building Construction Pte Ltd [1999] 4 SLR 604 [20] (GHL).

[22] See generally: N Enonchong, 'The Problem of Abusive Calls on Demand Guarantees' (2007) *Lloyds Maritime and Commercial Law Quarterly* 83.

[23] See discussion p.29 under 'The Nomenclature of Independence'.

[24] E P Ellinger and D Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing, 2010), 5.
Chartered Electronics Industries Pte Ltd v Development Bank of Singapore [Unreported] Suit No 485/1990 [1999] 4 SLR 655, 668[38] (Chartered).

[25] Edward Owen Engineering Ltd v Barclays Bank International Ltd [1978] QB 159, 171-A (Edward Owen).

and, in the terms of the underlying contract when dependent, or otherwise lacking 'independence'. Regardless of the *name* given the instrument, if it is **not** independent it is not strictly a Demand Guarantee in its commonly-used sense.

Definition is also provided by the rules sets that govern independent instruments. For example, under UCP600, a 'Credit':

> is any arrangement, however named or described, that is irrevocable and thereby constitutes a definite undertaking of the issuing bank to honour a complying presentation.[26]

A 'Guarantee' under the URDG means:

> any signed undertaking, however named or described, providing for payment on presentation of a complying demand.[27]

The term 'letter of credit' has been defined as "a specialized commercial document arising from an agreement between a bank and its customer" and are "unique commercial instruments…governed by their own unique rules."[28] There are no contradictions inherent in these two definitions.

3.0. The 'Contractual' Nature of Independent Instruments

Courts often refer to independent instruments as 'contracts'. Strictly speaking, this is inaccurate. Both letters of credit and negotiable instruments such as cheques and Bills of Exchange are considered by some academics as "specialty contracts", as opposed to 'ordinary' contracts.[29]

Wunnicke refuses to take a position either way but points out that the hybrid nature of these instruments makes for controversy. Wunnicke lists five principles of common law contract that have been applied to letters of credit by US courts:

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[26] UCP600 [Article 2].
[27] URDG [Article 2].
[28] Western Surety Co v North Valley Bank 2005 Ohio 3453 (Ct. App.).
[29] G McLaughlin, 'Exploring Boundaries: A Legal and Structural Analysis of the Independence Principle of Letter of Credit Law' (2002) 119 *Banking Law Journal* 501, 501-503. For an analysis of the history of this term, see B Kozolchyk, 'The Legal Nature of the Irrevocable Letter of Credit' (1965) 14 *American Journal of Comparitive Law* 395, 412 [IV].

(1) Ambiguity is construed against the issuer;
(2) Terms should be interpreted in a manner that is "fair and customary and which prudent persons would enter into";
(3) The construction of terms should be interpreted to make the letter of credit operable if possible;
(4) Where a discrepancy exists, typed or handwritten provisions are to be preferred over those printed;
(5) Issuers of credits governed by UCC §5-102(a)(7) are subject to a duty of good faith.[30]

What can be said with certainty is that some elements of contract law apply to independent instruments, but not all. Consideration is not required, there is an absence of privity of contract, and the beneficiary incurs any obligations or rights under the terms of the instrument that would normally accrue under a common contract.[31]

None of the legislation or rule sets that govern independent instruments refer to such instruments as 'contracts', preferring such terms as "arrangement",[32] "binding undertaking",[33] and "definite undertaking".[34]

4.0. Referencing, Punctuation and Grammar

Due to the need to minimise word count, and the nature of legal references, an abbreviated form of AGLC referencing is used. Footnotes have been formatted to achieve minimum word count without sacrificing comprehensibility.

[30] B Wunnicke, D Wunnicke, and P Turner, *Standby and Commercial Letters of Credit* (Wiley Law Publications, Second Edition, 1996), 5-6.
[31] B Kozolchyk, 'The Legal Nature of the Irrevocable Letter of Credit' (1965) 14 *American Journal of Comparitive Law* 395, 400.
[32] UCP600 [Article 2].
[33] ISP98 §1.06(a).
[34] *Uniform Commercial Code Revised Chapter 5* (USA), §5-102(a)(10).

Section D. The Argument for Independent Instrument Unconscionability[35]

The purpose for this section is to address the reasoning upon which Chapter Six is premised. This author strongly supports the Courts' prohibition of unconscionable conduct in relation to abusive calls on independent instruments. The argument here contends that the application of both statute and equity is valid, although its jurisprudential foundations have arguably not been sufficiently well reasoned in the courts or in the literature to date.

Despite extensive research, almost no discussion exists in the literature with respect to the rights' relationships in independent instruments. Kozolchyk in 1965 stated in relation to the study of commercial letters of credit:

> Discussions of the nature of legal institutions are infrequent in contemporary legal literature. Pragmatic inquiries into the use and application of legal institutions, as well as their casuistic evaluation, seem to have displaced their analytic treatment.[36]

The focus of almost all extant research is either on practice matters or examines defences to the *status quo*. Very little of the obiter or literature discusses unconscionability with respect to the rights and powers being affected.

It is proposed here that the reluctance within the industry to accept a lower standard of fraud might reflect this lack of intellectual debate among scholars. It might to some extent be simply reactionary and an adherence to the *status quo*.

All law should develop and adjust to meet the demands of the market as they arise. The refusal to allow for a lesser standard of fraud can, it is posited, only serve to make demand guarantees less attractive to those called upon to provide them.

It is posited in this book that the right to make a demand against an independent instrument–which is referred to herein as the "demand-right"–

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[35] The expression "Unconscionability Exception" is a bespoke term in the documentary credit/demand guarantee paradigm that refers to the application of principles and law related to unconscionable conduct as an exception to the autonomy of letters of credit and demand guarantees.

[36] B Kozolchyk, 'The Legal Nature of the Irrevocable Letter of Credit' (1965) 14 *American Journal of Comparitive Law* 395, 395. This remains the only extant work that thoroughly describes the rights and obligations of commercial letters of credit.

arises in the underlying contract, and not in the instrument itself. The reasoning in support of this postulation follows.

The obligation undertaken by the issuer is unilateral, i.e. there is an absence of 'legal relations' (privity) between the issuer and the beneficiary. The issuance of an independent instrument does not compel the beneficiary to meet any obligation or undertake any action with regard to the instrument.

The obligation to honour a complying presentation does give rise to a right to sue for unlawful dishonour.[37] It provides the beneficiary with the *liberty* to make a presentation, but the beneficiary has no *obligation* to do so. There is no demand-right in the instrument itself because this right is founded on the express and implied obligations inherent in the underlying contract.

This position is given strong support by analogy to the fraud exception, which is universally recognised by the courts in the major independent instrument user jurisdictions. The fraud exception allows the issuer to refuse to honour. The fraudulent conduct is completely removed from the instrument itself–it reflects a deliberate abrogation of the contractual commitments (express and implied) in the underlying contract. Where challenged, fraud allows the court to restrain the beneficiary's right to make a demand.[38]

If the demand-right can be denied or restrained for fraud in the underlying contract, it follows that the demand-right arises pursuant to the proper performance of the beneficiary's contractual obligations. It cannot exist anywhere else–the fraudulent conduct does not, in fact *can* not, occur in relation to the obligation to honour. The instrument does not bestow upon the beneficiary any rights except the right to sue for wrongful dishonour. There is nothing therefore in the instrument upon which to found the restraint–here it's proposed to be founded upon the breach in the underlying contract.

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[37] M Andrews, 'Hohfeld's Cube' (1982-83) 16(3) *Akron Law Review* 471: This follows Hohfeldian logic that an duty/obligation undertaken by one person generally gives rise to a right in another person.

[38] In *Olex Focas Pty Ltd v Skodaexport Company Ltd* [1998] 3 VR 380, 406 (*Olex*$^{(No.1)}$) it appears that both the beneficiary and the issuer were subject to injunctions. The Court in *Boral Formwork and Scaffolding v Action Makers Ltd* [2003] NSWSC 713 [22] (*Boral*$^{(No.2)}$) [91-92] only restrained the beneficiary. *Board Solutions Australia Pty Ltd v Westpac Banking* [2009] VSC 474 [5] saw both the beneficiary *and* the issuer restrained. It is argued here that Courts which restrain the issuer's obligation to pay unnecessarily breach the independence of the instrument and provide fodder for the argument against the use of unconscionable conduct as grounds for an injunction.

That the demand-right is a *substantive* right that arises in the underlying contract was also recognised by the Court of Appeal in *Mount Sophia*:

> [A] finding of unconscionability is a conclusion applied to conduct which the court finds to be so lacking in *bona fides* such that **an injunction restraining the beneficiary's substantive rights** is warranted.[39]

It is arguable whether independent instrument fraud is unlike fraud in the common law in that an allegation of independent instrument fraud can be proved without proving the necessary intention.[40] Gao provides a thorough analysis of the different schools of thought on this, in addition to a study of the materiality of fraud.[41]

The standard of fraud that must demonstrated requires balance. As Gao notes:

> If the standard of fraud for the application of the fraud rule is set too low…it may lead to abuse of the rule by the applicant. Temptation to abuse always exists.[42]

The materiality may be important because 'extent' may be the only meaningful differentiation between independent instrument fraud and independent instrument unconscionability if an absence of intent is not fatal to an allegation of fraud.

Independent instrument unconscionability might be seen as a part of a broad law of fraud in equity. In *Dynamics Corp* it was re-stated:

> Fraud has a broader meaning in equity [than at law] and **intention to defraud or to misrepresent is not a necessary element**.[43]

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[39] *BS Mount Sophia Pte Ltd v Join-Aim Pte Ltd* [2012] SGCA 28 [45] (*Mount Sophia*). Emphasis added. See discussion with respect to lifting the veil of autonomy and the parties restrained at p.137.

[40] E P Ellinger and D Neo, *The Law and Practice of Documentary Letters of Credit* (Hart Publishing, 2010), 142, points out that "A potential problem concerns the degree of knowledge of fraud that is required of the beneficiary before he is infected by the fraud exception…actual knowledge rather than constructive knowledge."

[41] X Gao, The Fraud Rule in the Law of Letters of Credit (Kluwer Law, 2002), 67-73.

[42] X Gao, The Fraud Rule in the Law of Letters of Credit (Kluwer Law, 2002), 76-77.

[43] *Dynamics Corp of America v Citizens & Southern Bank* 356 F.Supp.991 (N.D.Ga 1973), 998-999. Emphasis added.

Typically independent instrument matters in common law jurisdictions alleging fraud are seeking injunctions to restrain the benefit of the instrument. The court will therefore be operating within its equitable jurisdiction and therefore it may consider fraud in equity, and unconscionable conduct. However, it is only with the greatest difficulty that the *material* difference between independent instrument fraud and unconscionable conduct can be made out by the court.[44]

There is little discussion of these matters anywhere in the literature and the overall impression is that the refusal to countenance independent instrument unconscionability is somewhat reactionary.

It has not been settled why a demand-right exists in the contract only for the purposes of setting it aside for fraud, and not for any other purpose. If the demand-right exists in the contract, as this author postulates, then it must also be susceptible to other remedies, such as those for acting unconscionably or (in civil law jurisdictions) failing to act in good faith.[45]

The courts in Singapore, Australia, and Malaysia have recognised this, albeit without explaining the doctrinal underpinnings for it as detailed in Chapter Six.

It is acknowledged here that this view is contrary to independent instrument law and practice to date. However this book maintains that the law is–and must be–a living, evolving entity. A failure to grow and adapt is ultimately self-destructive and the accommodation of unconscionability and good faith is necessary to meet the changing demands of the market.

It is also argued herein that the reason the courts in many jurisdictions have failed to allow bad faith and unconscionability as a means to restrain the demand-right is that it has not been argued within a logical framework.

Finally, it is argued in this book that the term "unconscionability exception" is a misnomer where the restraint is laid against the demand-right, as opposed to the honour-obligation. Restraining the demand-right, it is posited herein, *reinforces* the independence of the instrument by refusing to interdict the legal obligation of the issuer to honour a complying presentation.

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[44] *Westdeutsche Landesbank v Islington* [1996] AC 669: "A person who takes property by means of fraud will have dealt unconscionably with it". Cited in A Hudson, *Equity and Trusts* (E-Books Corporation, 8th ed, 2015) [Part 4.12.1.1].

[45] For a detailed discussion on contractual good faith, see G Kuehne, 'Implied Obligations of Good Faith and Reasonableness in the Performance of Contracts' (2006) 33 *University of Western Australia Law Review* 63, 65.

Some courts have failed to recognise the difference, and some have gone so far as to say that they are one and the same thing.[46] With respect, this book will argue that this position fails to properly recognise the right which is being restrained and is not sustainable.

Only where the obligation to *honour* is restrained does the court reach through the veil of autonomy and interfere with the independence of the undertaking–the abusive behaviour is generally within the underlying contract to which the issuer has no privity. This, in addition to the court's reluctance to undermine the integrity of the instrument itself, must ultimately make the instrument more attractive to rational users.

While fundamental to the overall argument in this book, the jurisprudential basis for unconscionability as grounds to restrain the demand-right is only a relatively small part. The courts in Singapore, Australia and Malaysia have determined that unconscionability can in appropriate cases be thus applied. It is the the lack of a complete portrait of the character of this doctrine that this manuscript seeks to address. The courts in those jurisdictions have applied unconscionability, and other jurisdictions have considered it. None have satisfactorily described it in any manner that comprises a fully-formed doctrine.

Section E. Chapter Summary

Chapter Two analyses and explains the independence principle–one the fundamental pillars of independent instrument law. Chapter Three examines the law of unconscionable conduct in equity and statute. From these, in conjunction with the independent instrument unconscionability case analyses in Chapters Four and Five, the necessary characteristics of 'independent instrument unconscionable conduct' can be extrapolated and framed in law in Chapter Six.

Chapter Six consolidates the academic and the judicial analyses on the subject provided in Chapters Two through Five to propose a complete description of the Doctrine of Independent Instrument Unconscionability.

[46] See discussion p.137.

CHAPTER TWO

THE INDEPENDENCE PRINCIPLE: CONTEXT, EXCEPTIONS, CASE LAW AND LEGAL ANALYSIS

Section A. The Independence Principle

1.0. The Independence Principle in Context

This chapter analyses and explains the terminology and application of the doctrine of independence. This process begins with study of the independence principle, its historical context and economic effect, and its character and scope in light of the extant academic analysis and judicial pronouncements.

A complete table of rules pertaining to independence is provided on page 30.

The 'risk allocation' purpose for independence is discussed in conjunction with a brief examination of the two other 'exceptions' to independence, fraud and illegality, for purposes of context and completeness.

In conjunction with the studies on unconscionable conduct provided in Chapters Three, Four and Five, the scope of the doctrine of independence and its legal enforceability are examined in the face of abusive demands.

1.1 Origins and Development of Independence

The law of independent instruments evolved from the *lex mercatoria* or 'merchant law' which developed over centuries to facilitate international trade and to regulate cross-border disputes between traders.[47] With its foundations based in ancient Rome, where *ius gentium* "regulated

[47] G McLaughlin, 'Exploring Boundaries: A Legal and Structural Analysis of the Independence Principle of Letter of Credit Law' (2002) 119 *Banking Law Journal* 501, 553.

the economic relations between foreigners and Roman citizens", *lex mercatoria* evolved over centuries and has proven itself remarkably robust. Traces of an ancient *lex mercatoria* have been identified in the middle east.[48]

Much trade law was developed in England during its ascendency as a world trading power in the mid-eighteenth century. London was for a time the world's largest commercial and naval centre; its law literally "ruled the seas".[49] Major clearing banks emerged in London,[50] and the first global trading house, the East India Company, was quartered there during the three hundred years it dominated global naval trade.[51] Relatively large private organisations such as Lloyds of London also emerged in the United Kingdom to finance and insure cargo and ships, which fuelled economic growth and trade:[52]

> With innovative responses from financial intermediaries and cooperation between the Treasury and the Bank of England a wider and deeper capital market developed in London to service the financial needs of agriculture, internal trade, and commerce overseas alongside the provision of credit and loans for the state.[53]

The *lex mercatoria* continues to develop internationally to address ongoing developments in trade, finance and technology. Contemporary examples of user-defined trade law include the various rule sets governing independent instrument usage developed by such organisations as the ICC.[54]

However, trade rules *per se* are constrained as to enforcement. They rely on domestic law and judicial systems to decide and enforce dispute settlements. Corte notes:

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[48] A Rodriguez, 'Lex Mercatoria' (2002) 2(2) *Retsvidenskabeligt Tidsskrift* 46, 46.
[49] Reference to the British national air, "Rule, Britannia!".
[50] E P Ellinger, *Ellinger's Modern Banking Law* (Oxford Press, Fifth Edition, 2011), 5[2(i)].
[51] E Erikson, *Between Monopoly and Free Trade: The East India Company, 1600-1757* (Princeton University Press, 2014), 31: "The period in which the English East India Company grew and expanded [stretched] roughly from 1500 to somewhere between 1750 and 1800."
[52] B Allen, 'Lloyd's of London' (1980) 22(5) *Education+Training* 152, 152.
[53] L Neal (ed), The Cambridge History of Capitalism: From Ancient Origins to 1848 (Cambridge University Press, 2014), Chapter 12; O'Brien, P., The Formation of States and Transitions to Modern Economies, 367.
[54] See Chapter One, Section C, §2.0. above.

> [T]he classical theory of the *lex mercatoria* as an autonomous system of law finds its own limits at the enforcement stage…(it) depend(s) upon national law, because at the moment of truth, legitimate enforcement remains a monopoly of the governments of nation states.[55]

Enforcement aside, there has always been a demand for safe and reliable methods of monetary transfer. Bills of exchange and letters of credit arose early to deal with this,[56] and demand guarantees were developed more recently to address new market needs.[57] The associated usage rules were developed and refined over relatively long periods of time, including how these instruments would interface with other elements of the transaction to which they relate.

As a means to deal with fraud in arm's-length transactions, financial instruments assuring payment were separated in principle from the contracts of sale; the principal was fundamentally reliant on honest brokers to make payment to a named beneficiary strictly on the basis of agreed-to documents. The system also relied on a strong, impartial judicial environment capable of enforcing contractual agreements.

Merchants developed the independence principle and it has merged with the growing body of recognised rules comprising modern *lex mercatoria* through mention in multiple rule sets and court opinions. Carr explains:

> Although UCP600 is not law, and cannot of itself mandate the independence of a letter of credit absent law, with regard to independence it does reflect the law merchant. Under modern commercial law, virtually all legal systems give effect to the independent character of the letter of credit.[58]

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[55] C Corte, 'Lex Mercatoria, International Arbitration and Independent Guarantees' (2015) 3(4) *Transnational Legal Theory* 345, 347.

[56] J Bentley (ed), The Cambridge World History: The Construction of a Global World (Cambridge University Press, 2015), Chapter Six, F. Trivellato, The Organisation of Trade In Europe and Asia, 1400-1800, 176.

[57] *Trafalgar House Construction v General Surety and Guarantee Co* [1996] 1 AC 199, 206, per Lord Jauncey of Tullichettle who also observed: "In recent years there has come into existence a creature described as an 'on demand bond' in terms which the creditor is entitled to be paid merely on making a demand for the amount of the bond."

[58] J Byrne, *UCP600–An Analytical Commentary* (IIBLP, 2010), 296.

Ultimately various trading instruments such as Bills of Exchange (which are also independent[59]), in company with their associated usage rules, became so widely used that codification became essential.[60]

The 'independence' of letters of credit and demand guarantees "is a cardinal principle in letter of credit law"[61] but needs to be avoided for the court to ensure the benefit does not flow to satisfy an abusive demand. Courts globally have contributed to the general understanding of the scope of the independence principle and in particular, framed the circumstances where the principle can be avoided. With respect to the integrity of the independence principle, the court ought to restrain the beneficiary from making a demand and not interfere with the bank's obligation to pay.[62] This is partly to maintain market confidence in the instruments themselves and partly for public policy reasons.

Ortego states that "[t]he rule of the independence of a letter of credit from the underlying transaction is based on two public policy considerations":

> First, given that in the absence of privity, issuers have no control over the formation or content of the underlying contract, and therefore have no cause to assume any liability for its performance.
> Second, that the value of documentary credits to trade facilitation would be degraded if issuers were required to "look beyond the credit's specific terms to [any] underlying contractual controversy".[63]

Reliance on these public policy positions underpins the fortitude of the independence principle. The independence principle also has a very practical effect–it "gives the letter of credit its unique qualities as a swift,

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[59] I Carr, *International Trade Law* (Routledge-Cavendish, Fourth Edition, 2010), 464: "The bill of exchange is an autonomous contract and is not affected by breach in the underlying contract."

[60] Bills of Exchange Act 1882 (UK); Bills of Exchange Act 1909 (Cth); *Uniform Commercial Code* (USA), §3-302.

[61] *Boral Formwork and Scaffolding v Action Makers Ltd* [2003] NSWSC 713 [22] (*Boral*$^{(No.2)}$): "an essential characteristic of a letter of credit that it is an autonomous contract". Also B Wunnicke, D Wunnicke, and P Turner, *Standby and Commercial Letters of Credit* (Wiley Law Publications, Second Edition, 1996), 20.

[62] See discussion with respect to lifting the veil of autonomy and the parties restrained at p.137.

[63] J Ortego and E Krinick, 'Letters of Credit: Benefits and Drawbacks of the Independence Principle' (1998) 115 *Banking Law Journal* 487, 488. Research reveals no evidence to support this contention.