BEYOND FRAUD: RETHINKING THE AUTONOMY OF LETTERS OF CREDIT IN CANADA

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1. EXECUTIVE SUMMARY

Are there limits to the autonomy principle? Can a beneficiary agree to conditions to obtain an autonomous letter of credit and then rely on autonomy to avoid those very conditions?

In Canada, until recently, the answer to the second question would appear to have been "yes". The only recognised remedy for an allegedly improper call was against the issuing bank in cases of clear fraud communicated to the issuing bank before payment. In view of the recent Saskatchewan Court of Appeal decision in *Veolia Water Technologies Inc v K+S Potash Canada General Partnership*,[2] there may now be room for an injunction against a beneficiary to prevent it from violating an express condition agreed between the beneficiary and the customer.

A survey of recent case law in England, Australia, Singapore and Malaysia shows that courts in those jurisdictions have taken this step and permitted such injunctions. Whether based upon notions of "unconscionability", as in Singapore and Malaysia, unnamed equity principles, as in England, or possibly a duty of honest performance in Canada as advocated for here, beneficiaries may not agree to conditions to obtain autonomous standby letters of credit, and then rely upon autonomy to shield themselves from the consequences of non-performance.

2. INTRODUCTION

Standby letters of credit play a significant role in the Canadian construction industry[3] and remain the predominant form of security on international

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[2] 2019 SKCA 25.

[3] Graham, GB and Geva, B, "Standby Credits in Canada" (1984) 9:2 *Canadian Business Law Journal* 180 at 184.

construction projects.[4] Briefly, commercial letters of credit facilitate payment for shipped materials while standby letters of credit guarantee performance. In essence, the standby letter of credit secures performance of a contractor's non-monetary obligations, like a performance bond, but without the options open to a surety on default.[5] Known as "standby letters of credit" in North and South America, these instruments are known as "bank guarantees" throughout Europe, Asia and Oceania. A further distinction may be made between "documentary" and "clean" letters of credit, with the former requiring production of some sort of documentation as a precondition to payment, and the latter requiring no more than a letter of demand.[6]

The essential characteristic of letters of credit, indeed much of their commercial value, is their autonomy from the underlying contract. This was explained by the Supreme Court of Canada in *Angelica-Whitewear Ltd v Bank of Nova Scotia*[7] as follows:

> "The fundamental principle governing documentary letters of credit and the characteristic which gives them their international commercial utility and efficacy is that the obligation of the issuing bank to honour a draft on a credit when it is accompanied by documents which appear on their face to be in accordance with the terms and conditions of the credit is independent of the performance of the underlying contract for which the credit was issued. Disputes between the parties to the underlying contract concerning its performance cannot as a general rule justify a refusal by an issuing bank to honour a draft which is accompanied by apparently conforming documents. This principle is referred to as the autonomy of documentary credits."

The obvious problem with the autonomy or independence principle is exposure to abuse. This is succinctly described by Alter and Houston:[8]

> "It should be apparent by this point that letters of credit are susceptible to abuse. Because letters of credit may be payable on first demand (and even where they require documentary production, the review of that documentation is only as to form) it is possible for a beneficiary (the project owner) to make premature, unfair, or bad faith claims on a letter of credit, which the issuer bank would be otherwise generally obligated to honour, resulting in the applicant (the Contractor) being required to repay the bank for a claim that ought not to have been made in the first place."

[4] Alter, MR and Houston, IJ, "Securing Payment and Performance on International Projects" 2009 *J Can C Construction Law* 83 at 87.

[5] Graham, GB and Geva, B, "Standby Credits in Canada" (1984) 9:2 *Canadian Business Law Journal* 180 at 184.

[6] Alter, MR and Houston, IJ, "Securing Payment and Performance on International Projects" 2009 *J Can C Construction Law* 83 at 88.

[7] [1987] 1 SCR 59.

[8] Alter, MR and Houston, IJ, "Securing Payment and Performance on International Projects" 2009 *J Can C Construction Law* 83 at 92.

3. THE FRAUD EXCEPTION IN CANADA

To date, in Canada, the only established exception to the autonomy of a letter of credit is clear and communicated fraud. An issuer is not obliged to honour a beneficiary's draft if it is made aware of fraud by the beneficiary before payment of the draft, or injunction of payment by a court of competent jurisdiction obtained on the same grounds.[9]

The law on interlocutory injunctions generally in Canada is governed by the 1994 Supreme Court of Canada decision in *RJR-MacDonald Inc v Canada (Attorney General).*[10] In that case, the Supreme Court adopted the following test:

> "First, a preliminary assessment must be made of the merits of the case to ensure that there is a serious question to be tried. Secondly, it must be determined whether the applicant would suffer irreparable harm if the application were refused. Finally, an assessment must be made as to which of the parties would suffer greater harm from the granting or refusal of the remedy pending a decision on the merits."

In the case of injunctions against a draw on a letter of credit in Canada, the first arm of the test is much more stringent, requiring a *prima facie* case of fraud, rather than the standard "serious issue to be tried".[11]

Once satisfied that the application is neither vexatious nor frivolous, the motions judge then proceeds to consider the second and third arms of the test, even if it appears at the interlocutory stage that the plaintiff is unlikely to succeed at trial. A prolonged examination of the merits is generally neither necessary nor desirable.

The "irreparable harm" arm of the test relates to the nature of the harm suffered rather than its magnitude. It is a harm which cannot be quantified in monetary terms or otherwise cured.[12]

The final "balance of convenience" arm of the test then requires the moving party to show that it would suffer greater harm from the refusal of the remedy than the respondent would from the granting of the remedy, pending a decision on the merits.[13] The factors considered are indeterminate and vary from case to case.[14] As the Saskatchewan Court of Appeal noted in *Potash Corp of Saskatchewan Inc v Mosaic Potash Esterhazy Ltd Partnership,*[15] "the balance of convenience analysis is exactly what its name suggests — a balance. On one arm of the scale lies the irreparable harm which might result if the injunction is denied and on the other arm lies the

[9] *Ibid.*

[10] [1994] 1 SCR 311.

[11] *Angelica-Whitewear Ltd v Bank of Nova Scotia* [1987] 1 SCR 59.

[12] *Ibid.*

[13] Perell, PM and Morden, JW, *The Law of Civil Procedure in Ontario,* (3rd Edition) (Toronto: LexisNexis, 2017) at §3.42.

[14] *Ibid.*

[15] 2011 SKCA 120 at paragraph 105.

irreparable harm, if any, to the other side if the injunction is granted and it carries the day".

The question this paper seeks to answer is whether a strong *prima facie* case of fraud must also be proven when a party seeks to enjoin not the issuer of the letter of credit from honouring the draft, but the beneficiary from wrongful draws on letters of credit. Traditionally, in Canada, courts have refused to distinguish between issuers and beneficiaries in such cases. In the authors' view, it is time for a change in Canada. We argue that where the underlying contract requires conditions precedent to be met before a beneficiary may draw on the letter of credit, a court ought to be able to restrain the beneficiary from drawing on the letter if those conditions remain unfulfilled.

As recently stated by the Chief Justice of Saskatchewan in *Veolia Water Technologies Inc v K+S Potash Canada General Partnership*,[16] there is neither "legal [n]or commercial logic in allowing a beneficiary to clearly agree to the conditions on which it can have resort to a letter of credit and to then permit the beneficiary to immediately avoid those very same conditions by invoking the autonomy principle". This marks a shift in judicial attitudes in such cases in Canada.

4. ENJOINING THE BENEFICIARY

4.1 The traditional view

Prior to *Veolia*,[17] there was very little Canadian case law discussing enjoining a beneficiary instead of an issuing bank.

In *Aspen Planers Ltd v Commerce Masonry and Forming Ltd*,[18] the plaintiff brought an application for an interim injunction restraining both the contractor from making further drawings under the letters of credit and restraining the bank from paying such draws. The court held that the plaintiff could not enjoin the beneficiary contractor because, in the circumstances, that would amount to freezing a potential asset of the contractor as security to satisfy a potential judgment. The court held that while it had much sympathy for the plaintiff who saw the possibility of obtaining an enforceable judgment disappearing, that was the risk the plaintiff took when it arranged the letter of credit with the bank.

In *Cineplex Odeon Corp v 100 Bloor West General Partner Inc*,[19] the court similarly dismissed an application to enjoin the beneficiary on the basis that the only admitted exception to the autonomy principle in relation to letters of credit was fraud, and that that test had not been made out.

[16] 2019 SKCA 25.
[17] 2019 SKCA 25.
[18] 1979 CarswellOnt 157 (HC).
[19] 1993 CarswellOnt 2358 (Gen Div).

The leading text in Canada on commercial letters of credit suggests that beneficiaries should not be enjoined in situations where the bank itself could not be enjoined, since to permit an injunction to issue against presentation of documents under a letter of credit, when such an injunction would not be proper to restrain payment by the issuer, would be tantamount to allowing a party to accomplish indirectly what it cannot do directly.[20]

At the time that statement was made it was in line with the traditional law in the UK, where appellate authority treated applications to restrain beneficiaries from drawing upon letters of credit exactly as they treated applications to restrain issuers from paying on such letters.[21]

The only earlier Canadian case in which a beneficiary was successfully enjoined is *1061590 Ontario Ltd v Ontario Jockey Club*.[22] In that case, a seller moved for an interim injunction restraining the purchaser from calling on a letter of credit securing certain deposits pending a motion for summary judgment to determine whether the purchaser had complied with the terms of the agreement of purchase and sale. The underlying agreement gave the purchaser the right to terminate the agreement and provided that the letter of credit would be returned to the purchaser upon termination. The purchaser purported to terminate the agreement and the seller disputed the propriety of the termination, keeping the letter of credit. The court allowed the injunction, finding it appropriate in the circumstances. Justice Feldman held that on an interim basis, the *status quo* ought to be maintained pending resolution of the dispute as to the compliance with the agreement in order to allow the agreement to be able to be carried out depending on the result of the dispute.

4.2 The changing test in the UK and Australia

Recent case law out of the UK and Australia suggests that the law in those jurisdictions is moving incrementally to a point where "the autonomy principle applies only as between the beneficiary and the issuer; as between the applicant and the beneficiary, the autonomy principle may be displaced, and the beneficiary's right to the proceeds of the credit may be impaired by the terms of the agreement in accordance with which a credit is established."[23]

[20] Lazar Sarna, *Letters of Credit: The Law and Current Practice*, 3rd Edition (Toronto: Carswell, 2015) at page 8–10.

[21] *Hamzeh Malas and Sons v British Imex Industries Ltd* (CA) [1958] 2 QB 127, *Deutsche Rückversicherung AG v Walbrook Insurance Co Ltd* (QBD) [1995] 1 Lloyd's Rep 153; [1995] 1 WLR 1017, 1027, 1030, aff'd *Group Josi Reassurance Co SA v Walbrook Insurance Co Ltd* (CA) [1996] 1 Lloyd's Rep 345; [1996] 1 WLR 1152.

[22] 1994 CarswellOnt 4552 (Gen Div).

[23] Quoting from Crawford, B, *The Law of Banking and Payment in Canada, Vol 2* (Toronto: Canada Law Book, 2018) at section 13.30.30(1)(b).

4.2.1 Sirius International Insurance Company v FAI General Insurance Ltd

In *Sirius International Insurance Company v FAI General Insurance Ltd*,[24] the Court of Appeal of England and Wales considered whether the autonomy of a letter of credit was undermined where a party had expressly agreed not to draw down on the letter of credit unless certain conditions were met, and then failed to meet those conditions. The Court of Appeal confirmed the principle of autonomy, but noted that there was no authority extending the autonomy principle for the benefit of the beneficiary of a letter of credit so as to entitle it as against the seller to draw the letter of credit when it was expressly not entitled to do so.

In *Sirius*, the relevant underlying agreement was not the commercial transaction that the letter of credit was intended to support, but a related agreement regulating as between the parties the terms upon which the letter of credit was established. The terms included express contractual restrictions on the circumstances in which Sirius was entitled to draw on the letter of credit. Although those restrictions were not terms of the letter of credit, and although the bank would have been obliged and entitled to honour a request to pay which fulfilled its terms, that did not mean that, as between themselves and FAI, Sirius was entitled to draw on the letter of credit if the express conditions of this underlying agreement were not fulfilled.

While the Court of Appeal's decision was overturned in the House of Lords, the House of Lords did not take issue with the principles enunciated by the Court of Appeal respecting the enforceability of agreements underlying autonomous letters of credit.[25] Indeed, the House of Lords' analysis of the conditions in the underlying agreement implicitly acknowledged that contractual conditions precedent may limit the autonomy of a letter of credit *vis-à-vis* the beneficiary.

4.2.2 Simon Carves Ltd v Ensus UK Ltd

In 2011, the Technology and Construction Court of England and Wales in *Simon Carves*[26] cited and relied upon the Court of Appeal decision in *Sirius* and provided further guidance with respect to the distinction between enjoining issuers and enjoining beneficiaries.

In *Simon Carves*, a contractor had provided an on-demand performance bond pursuant to a stipulated price construction contract that included express conditions to a valid call upon the bond. The contract provided that the bond would become null and void when the owner issued a certificate

[24] (CA) [2003] EWCA Civ 470; [2003] 1 WLR 2214.

[25] *Sirius International Insurance Company v FAI General Insurance Ltd* (HL) [2004] UKHL 54; [2004] 1 WLR 3251; [2005] 1 All ER 191.

[26] *Simon Carves Ltd v Ensus UK Ltd* (QBD (TCC)) [2011] EWHC 657 (TCC); [2011] BLR 340; 135 Con LR 96.

of acceptance. After completion of the work, the owner issued a defect notice and requested remedial work, but the certificate of acceptance was eventually issued five months later "subject to outstanding defects being rectified". The parties disagreed about who was responsible for the defects. Between issue of the acceptance certificate and the expiry of the bond, the owner commenced remedial work, estimated to cost about £10 million, which it would claim from the bond. The contractor argued that since the certificate of acceptance had been issued and there had been no claim as defined by the contract, the bond was null and void. The contractor's injunction was granted on the basis that it had an arguable case that the bond had become null and void.

The court in *Simon Carves* concluded:

> "33. In my judgement one can draw from the authorities the following:
>
> (a) Unless material fraud is established at a final trial or there is clear evidence of fraud at the without notice or interim injunction stage, the court will not act to prevent a bank from paying out on an on-demand bond provided that the conditions of the bond itself have been complied with (such as formal notice in writing). However, fraud is not the only ground upon which a call on the bond can be restrained by injunction.
> (b) The same applies in relation to a beneficiary seeking payment under the bond.
> (c) There is no legal authority which permits the beneficiary to make a call on the bond when it is expressly disentitled from doing so.
> (d) In principle, if the underlying contract, in relation to which the bond has been provided by way of security, clearly and expressly prevents the beneficiary party to the contract from making a demand under the bond, it can be restrained by the court from making a demand under the bond.
> (e) The court when considering the case at a final trial will be able to determine finally what the underlying contract provides by way of restriction on the beneficiary party in calling on the bond. The position is necessarily different at the without notice or interim injunction stage because the court can only very rarely form a final view as to what the contract means. However, given the importance of bonds and letters of credit in the commercial world, it would be necessary at this early stage for the court to be satisfied on the arguments and evidence put before it that the party seeking an injunction against the beneficiary had a strong case. It cannot be expected that the court at that stage will make in effect what is a final ruling."

4.2.3 Doosan Babcock Ltd

The decision in *Sirius* was followed in *Doosan Babcock Ltd (formerly Doosan Babcock Energy Ltd) v Comercializadora de Equipos y Materiales Mabe Limitada (previously known as Mabe Chile Limitada)*.[27]

In *Doosan*, the claimant agreed to supply two boilers for a power plant in Brazil. The performance guarantee in relation to each unit expired either

[27] (QBD (TCC)) [2013] EWHC 3201 (TCC).

on the issue of a taking-over certificate for that unit or, under the letters of guarantee, 31 December 2013, whichever was earlier.

The claimant had requested taking-over certificates to be issued in July 2013 after the boilers were put into use by the defendant, but the defendant refused to issue them, relying on a provision in the contract that it said allowed it to withhold the certificates where the unit had been used only as a temporary measure. The claimant then sought an injunction to prevent the defendant from making a call on the performance guarantees. The court held that the claimant had made out its case for interim relief: there was a strong case that the defendant's failure to issue the certificates was a breach of contract and that it was seeking to take advantage of its own breach of contract to derive a benefit, namely the continuing existence of the performance guarantees.

In following *Sirius*, the court accepted that that decision had extended the law, but that it had done so adopting a principled and incremental approach that did not undermine the general principles applicable to interim injunctions to restrain a party making a call on a bond or letter of credit.

4.2.4 Simic v New South Wales Land and Housing Corporation

The principles outlined by the Australian High Court in 2016, in *Simic v New South Wales Land and Housing Corporation*,[28] are consistent with those laid out by the Court of Appeal of England and Wales in *Sirius*.

In *Simic*, the Australian High Court addressed the obligations of an issuing bank to pay upon presentation of an on-demand performance bond (the conceptual equivalent for our purposes of an autonomous letter of credit), despite a patent defect in the performance bond's terms (the named beneficiary was not a legal entity). The *Simic* court, relying upon the presumed intentions of the parties, rectified the bond to comply with the underlying commercial agreement. Consistent with courts in Canada and the UK, the Australian High Court began by confirming that the principle of autonomy requires that a letter of credit be treated as independent of the underlying commercial contract.[29] The court, however, went on to explain that a *beneficiary's* right to draw is not unlimited:[30]

> "The autonomy principle requires that the obligations of the issuing or accepting bank under the bond not be read as qualified by reference to the terms of the underlying contract. That said, it does not prevent a party to a contract who procures the issue of a performance bond claiming as against the beneficiary that the beneficiary's action in calling upon the bond is fraudulent or unconscionable or in breach of a contractual promise not to do so unless certain conditions are satisfied. However, this is not such a case. The primary question in this case concerns

[28] [2016] HCA 47.
[29] *Simic*, at paragraph 6.
[30] *Ibid*, paragraph 8.

> the obligation of the issuing bank to pay on demand of a party claiming to be the beneficiary which, due to error on the part of the requesting party, is not the beneficiary named in the bond."

Thus, in Australia, a beneficiary's right to draw upon an autonomous letter of credit depends upon the draw being: (1) not fraudulent; (2) not unconscionable; and (3) not in breach of contractual conditions precedent.

4.3 Treatment in the US

Similar to Canada and the UK, letter of credit law in the US is premised on the principle that the letter of credit is independent of the underlying contract and that the commercial viability of letters of credit depends on their ability to provide an assurance of payment.[31]

In the US, the law governing letters of credit is governed by the Uniform Commercial Code and state Commercial Codes. Section 5109 of the California Commercial Code, for example, provides as follows with respect to injunctions to restrain draws against letters of credit (emphasis added):

> "(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 honour 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.
>
> (b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation *or grant similar relief against the issuer or other persons* only if the court finds that:
>
> (1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;
>
> (2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;

[31] *Trans Meridian Trading Inc v Empresa Nacional de Comercializacion de Consumos*, 829 F.2d 949 (1987), *Agnew v Federal Deposit Ins Corp*, 548 F.Supp 1234, 1238 (ND Cal 1982).

(3) all of the conditions to entitle a person to the relief under the law of this state have been met; and
(4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under paragraph (1) of subdivision (a)."

Section 5-109 of the Uniform Commercial Code is identical. As can be seen from the italicised part of the quote, a court can enjoin not only the bank, but also "any other person". That has been held by Californian courts to include a right to enjoin a beneficiary,[32] and courts have generally held that the same test applies to both types of injunctions.[33]

Commentary on the corresponding section of the UCC is to similar effect (emphasis added):[34]

> "Whenever the issuer could be enjoined from honoring the letter of credit, the beneficiary, instead, may be enjoined from drawing on the letter of credit. *Conversely, a beneficiary will not be enjoined from making demands under a letter of credit unless the situation is such that the issuer would be enjoined from honoring drafts drawn under the letter of credit.*"

There are two scenarios in which Californian courts have held that the test for enjoining beneficiaries might be different:

In *Steinmeyer v Warner Consol Corp*,[35] the California Court of Appeal upheld an injunction prohibiting the beneficiary from presenting a statement of default to a bank that was necessary to obtain payment of a letter of credit given as part of a complex transaction for the purchase of the entire capital stock of a corporation. The agreement between the parties contained an undertaking by the defendant to indemnify the plaintiff against any undisclosed liabilities of the corporation, and both the agreement and the note permitted the plaintiff to offset any loss, liability or damage suffered by or in connection with the provisions of the agreement. The plaintiff alleged that several liabilities affecting the value of the stock were not disclosed on the corporation's financial statement.

The court concluded that "as between Steinmeyer and Warner the letter of credit cannot be construed in isolation from the underlying agreement and the promissory note." The court viewed the beneficiary's seeking payment on the letter of credit as nothing more than a violation of the covenant of good faith and fair dealing implied in every contract.

In *Mitsui Mfrs Bank v Texas Commerce Bank-Fort Worth*,[36] the court reversed an order denying a preliminary injunction against the beneficiary of a letter of credit. In *Mitsui*, a specific condition for demanding payment on

[32] *Acosta Inc v Kerdman Enterprises GP* 2008 WL 11336210, United States District Court, CD California.

[33] *Ibid, Ground Air Transfer Inc v Westates Airlines Inc* 899 F.2d 1269 (1st Cir 1990), *In re Barton Chemical Corp* 156 BR 562 (1993).

[34] Anderson, L, *Uniform Commercial Code* section 5-114:51, (3d Edition) (Thomson Reuters: 1994). See also Uniform Commercial Code § 5-109.

[35] 42 Cal App 3d 515; 116 Cal Rptr 57 (1974).

[36] 159 Cal App 3d 1051; 206 Cal Rptr 218 (1984), as summarised in *Trans Meridian Trading Inc v Empresa Nacional de Comercializacion de Consumos* 829 F.2d 949 (1987).

the letter of credit was that the beneficiary present a "beneficiary's signed statement stating that Craigmuir Ltd has failed to meet its obligations to pay the face amount of loans drawn by themselves on beneficiary ... in connection with drilling of oil wells." Because the letter of credit made a specific reference to the underlying contract in establishing a condition for honouring a demand for payment, it was proper for the court to look at the underlying contract. The court found that the beneficiary knew the loans were not used for drilling oil wells, and therefore could not truthfully have made such a statement.

Steinmeyer and *Mitsui* are outliers in California. In fact, it has been held that "given California's seemingly strong policy honouring letters of credit, it would be illogical to thwart it so easily by enjoining the beneficiary, not the issuer".[37]

Steinmeyer has been treated inconsistently in other jurisdictions. For example, the US Court of Appeals for the Ninth Circuit, applying Nevada law, relied on *Steinmeyer* to enjoin a beneficiary from drawing on a letter of credit in *Hubbard Business Plaza v Lincoln Liberty Life Ins Co.*[38] There, the court enjoined a beneficiary from collecting on the letter of credit where a draw would have circumvented the court's decision to invalidate a liquidated damages clause in the contract as a penalty. Without the injunction, the plaintiff would have been forced to relitigate to recover the penalty after payment on the letter of credit was made.

Other decisions, however, have refused to follow *Steinmeyer*. The US Court of Appeal, in *Ground Air Transfer Inc v Westates Airlines Inc*,[39] held as follows:

> "We do not believe the California Supreme Court would follow *Steinmeyer* insofar as it significantly weakens the principle of 'independence' of the letter of credit. In particular, we do not believe the California Supreme Court would permit an injunction where other states (applying the traditional 'fraud' exception) would not do so. After all, California's state legislature has altered the UCC to make it more difficult in California than elsewhere to enjoin an issuer's payment of a letter of credit; to make it significantly *easier* than elsewhere to enjoin a call by a beneficiary would undercut that underlying legislative policy."

The law in the US therefore seems to be in line with that of Canada and the UK in that there is a general reluctance to deviate from the principle of independence of the letter of credit, though cases like *Steinmeyer* suggest that at least some courts have accepted that there might be room for an exception for the same reasoning later adopted in cases like *Simon Carves*.

[37] *Trans Meridian Trading Inc v Empresa Nacional de Comercializacion de Consumos* 829 F.2d 949 (1987). See also *Export-Import Bank of the US v United California Discount Corp* 738 F.Supp 2d 1047.

[38] 844 F.2d 792 (1988).

[39] 899 F.2d 1269 (1st Cir1990).

4.4 Singapore and the unconscionability exception

Singapore courts have taken the position that there is no difference in the principles applicable where an injunction is sought against a beneficiary instead of a bank.[40] Nevertheless, it is settled law in Singapore that unconscionability, as distinct from fraud, is a ground upon which a court may grant an injunction restraining a beneficiary of an on-demand guarantee from drawing on the guarantee.[41] In so finding, the Singapore Court of Appeal distinguished performance bonds, even on demand performance bonds, from letters of credit:

> "18. It is settled law that unconscionability, as distinct from fraud, is a ground upon which the court can grant an injunction restraining a beneficiary of a performance bond from calling on the bond (see, e.g., the decisions of this court in *Bocotra Construction Pte Ltd and Others v Attorney-General* [1995] 2 SLR(R) 262 ('*Bocotra*') and *JBE*). In so far as the *rationale* for adopting unconscionability as a relevant ground is concerned, the following observations by this court in *JBE* (at paragraphs 10 to 13) bear repeating:
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> 10. The Singapore courts' rationale in applying unconscionability as a separate and independent ground for restraining a call on a performance bond (especially one given by the Contractor-obligor in a building contract) is that a performance bond serves a different function from a letter of credit. The latter performs the role of payment by the obligor for goods shipped to it by the beneficiary (typically via sea or air from another country), and 'has been the life blood of commerce in international trade for hundreds of years' (see [*Chartered Electronics Industries Pte Ltd v Development Bank of Singapore* [1992] 2 SLR(R) 20 ('*Chartered Electronics*')] at paragraph 36). Interfering with payment under a letter of credit is tantamount to interfering with the *primary* obligation of the obligor to make payment under its contract with the beneficiary. Hence, payment under a letter of credit should not be disrupted or restrained by the court in the absence of fraud. In contrast, a performance bond is merely security for the *secondary* obligation of the obligor to pay damages *if* it breaches its primary contractual obligations to the beneficiary. A performance bond is not the lifeblood of commerce, whether generally or in the context of the construction industry specifically. Thus, a less stringent standard (as compared to the standard applicable *vis-à-vis* letters of credit) can justifiably be adopted for determining whether a call on a performance bond should be restrained. We should also add that where the wording of a performance bond is ambiguous, the court would be entitled to interpret the performance bond as being conditioned upon facts rather than upon documents or upon a mere demand, contrary to the *dictum* of Staughton LJ in *I E Contractors Ltd v Lloyds Bank plc and Rafidain Bank* [1990] 2 Lloyd's Rep 496 at 500.
> 11. Even where a performance bond is expressed to be payable 'on first demand without proof or conditions' (as in *Edward Owen Engineering* ([1978] 1 QB 159 at 170)), which, strictly speaking, means the paying bank is contractually

[40] Ellinger and Neo, *The Law and Practice of Documentary Letters of Credit* (Oxford: Hart Publishing, 2010) at 161, *Bocotra Construction Pte Ltd v Attorney General (No 2)* [1995] 2 SLR 733.

[41] *BS Mount Sophia Pte Ltd v Join-Aim Pte Ltd* [2012] SGCA 28, *JBE Properties Pte Ltd v Gammon Pte Ltd* [2011] 2 SLR 47 (CA), *Bocotra Construction Pte Ltd v Attorney General (No 2)* [1995] 2 SLR 733.

> obliged to pay the beneficiary once it makes a call on the performance bond, there is no reason why fraud (which is often difficult to prove) should be the sole ground for restraining the beneficiary from receiving payment. To adopt such a position is to 'apply a standard of proof which will virtually assure the beneficiary [of] ... immediate payment ... and ... does nothing more than to transfer the security from the [paying bank] ... to the beneficiary' (see *Chartered Electronics* at paragraph 37). This may in turn cause undue hardship to the obligor in many cases."

The performance bond payable "on first demand without proof or conditions" described above more closely resembles an on-demand letter of credit used in the Canadian construction industry than does the letter of credit described in the same paragraph as an instrument that "performs the role of payment by the obligor for goods shipped to it by the beneficiary (typically via sea or air from another country)". The Singaporean law on on-demand performance bonds may therefore provide a useful analogue to our discussion of letters of credit in the construction industry, specifically.

If unconscionability is a ground for injunctive relief, the obvious question is what constitutes unconscionable conduct. The term is generally understood to describe some "unsatisfactory conduct tainted by bad faith" and also incorporates an element of "unfairness".[42] The court in *BS Mount Sophia* found the elements of unconscionability to be fairly uncontroversial, having been variously stated to include elements of abuse, unfairness and dishonesty.[43]

In *Dauphin Offshore Engineering and Trading Pte Ltd v The Private Office of HRH Sheikh Sultan bin Khalifa bin Zayed Al Nahyan,*[44] the Court of Appeal held that it was not possible to define "unconscionability" other than to give some very broad indications such as lack of bona fides. According to the court, "what kind of situations would constitute unconscionability would have to depend on the facts of each case. This is a question which the court has to consider on each occasion where its jurisdiction is invoked. There is no predetermined categorisation".

A review of Singapore case law on point summarised the situations in which courts have found unconscionability as follows:[45]

> "The courts in applying this concept to on-demand guarantees have not made reference to its meaning in equity jurisprudence but have stated that they are exercising an equitable jurisdiction. However, the case law provides ample illustrations of the factual circumstances upon which courts have applied unconscionability in

[42] *BS Mount Sophia Pte Ltd v Join-Aim Pte Ltd* [2012] 3 SLR 352 at paragraphs 36 and 37, as summarised in (2015) 16 *SAL Ann Rev* 172.

[43] *BS Mount Sophia Pte Ltd v Join-Aim Pte Ltd* [2012] 3 SLR 352, citing *GHL Pte Ltd v Unitrack Building Construction Pte Ltd* [1999] 3 SLR(R) 44 ("*GHL*") and *Dauphin Offshore Engineering and Trading Pte Ltd v The Private Office of HRH Sheikh Sultan bin Khalifa bin Zayed Al Nahyan* [2000] 1 SLR(R) 117.

[44] [2000] 1 SLR(R) 117.

[45] Thanuja Rodrigo, "Unconscionable Demands under on-Demand Guarantees: A Case of Wrongful Exploitation" (2012) 33 *Adelaide Law Review* 481 at 494.

> the context of on-demand guarantees. For example, a demand under a guarantee stemming from non-delivery of goods due to natural disasters, despite a force majeure clause in the underlying contract, amounts to unconscionable conduct (*Min Thai* case); in light of the revision of the value of the contract demand under the performance guarantee for the *full amount* amounts to unconscionable conduct (*GHL* case); and *prima facie* gross exaggeration of the costs of rectification in support of the beneficiary's call under the guarantee amounts to unconscionable conduct (*JBE Properties*). The judicial pronouncements *in Dauphin Offshore, Eltraco International and Mount Sophia* provide some guidance in understanding the defining elements of unconscionable conduct in the on-demand guarantee context. These cases indicate that in the on-demand guarantee context unconscionability is just one type of unfairness. The courts have uniformly suggested that a beneficiary's conduct, in calling under the guarantee, that is so reprehensible or lacking in good faith constitutes unconscionable conduct on their part and that the existence of unconscionability depends largely on the facts of each case. This is essentially what Leong JA in *Mount Sophia* referred to as 'the entire chronology of the case, viewed in relation to all the relevant factors (set in their context)', that established a strong prima facie case of unconscionability on the part of the beneficiary calling under the on-demand guarantee."

Unconscionability in this sense shares many features with the honest performance principles established by the Supreme Court of Canada in *Bhasin*, as discussed below.

It has been held in Singapore that parties can contract out of unconscionability as a grounds for injunctive relief. In *CKR Contract Services Pte Ltd v Asplenium Land Pte Ltd*,[46] the contract provided that the contractor was not entitled to restrain the employer from making any call or demand on the performance bond on any ground, except in the case of fraud. The Court of Appeal reversed a High Court decision which had held the clause to be void on grounds on public policy instead finding the clause to be enforceable. It has been suggested therefore that while the doctrine of unconscionability remains law in Singapore, its significance may diminish as more owners will insist on such an "opt out" clause in their contracts.[47]

4.5 Malaysia

The approach in Malaysia mirrors that of Singapore.[48] The leading case on the issue of unconscionability in the context of bank guarantees and performance bonds remains the 2010 decision of the Federal Court, Malaysia's highest court, in *Sumatec Engineering & Construction Sdn Bhd v*

[46] [2015] 3 SLR 1041 (CA).

[47] Fong Chow, K and Chuen Fye Chan, P, "Building and Construction Law", 2015 *SAL Ann Rev* 168 (2015) at 7.16.

[48] With the exception that they do not seem to follow the finding by the Singapore courts that there is no difference in the principles applicable where an injunction is sought against a beneficiary instead of against the bank: see *Sumatec Engineering & Construction Sdn Bhd v Malaysian Refining Company Sdn Bhd* [2012] 2 MLRA 289.

Malaysian Refining Company Sdn Bhd.[49] In *Sumatec*, the court held that the law had progressed to allow restraint of payment not only in cases of fraud, but also in cases of unconscionability. The court's analysis of the principles governing unconscionability can be summarised as follows:[50]

"(a) Whether or not 'unconscionability' has been made out is largely dependent on the facts or each case.
(b) The 'unconscionable' category extends to all cases where unfair advantage has been gained by an unconscientious use of power by a stronger party against a weaker.
(c) The court looks to the conduct of the party attempting to enforce, or retain benefit of, a dealing with a person under a special disability in circumstances where it is not consistent with equity or good conscience that he should do so.
(d) The concept of unconscionability involves unfairness, as distinct from dishonesty or fraud, or conduct so reprehensible or lacking in good faith that a court of conscience would either restrain the party or refuse to assist the party.
(e) It is not possible to define 'unconscionability' other than to give some very broad indications such as lack of bona fides.
(f) There is no simple formula that would enable the court to ascertain whether a party had acted unconscionably in making a call on an on-demand performance bond or bank guarantee.
(g) A higher degree of strictness applies. An applicant must establish a clear case of fraud or unconscionability in the interlocutory proceedings. Mere allegations are insufficient".

The court held that (emphasis in the original):

> "*As in the case of fraud, to establish 'unconscionability' there must be placed before the court manifest or strong evidence of some degree in respect of the alleged unconscionable conduct complained of, not a bare assertion.* Hence, the respondent has to *satisfy the threshold of a seriously arguable case that the only realistic inference is the existence of 'unconscionability' which would basically mean establishing a strong prima facie* case. In other words, the respondent has to place sufficient evidence before the court so as to enable the court to be satisfied, not necessarily beyond reasonable doubt, that a case of 'unconscionability' being committed by the beneficiary (the appellant) has been established to an extent sufficient for the court to be minded to order injunction sought. This additional ground of 'unconscionability' *should only be allowed with circumspect where events or conduct are of such degree such as to prick the conscience of a reasonable and sensible man.*"

Having held that unconscionability could result in injunctive relief, however, the Federal Court found that there was no unconscionable conduct in the case before it. The appellant had relied on the following circumstances to show unconscionability:

"7. ...
(a) there was an agreement in principle reached by the parties for the bank guarantee to be reduced. This was in tandem with the reduction in the scope of works from that originally contracted for between MRC and Sumatec. It referred to the minutes of the meeting between the parties held on 29 October 2009 stating that:

[49] [2012] 2 MLRA 289.
[50] Paraphrased from paragraph 17 of the decision.

Liability, Warranty and Performance Bond: MRC confirmed that Sumatec could reduce the value of their performance bond in line with a value to be proposed by MRC.
The original contract sum was RM47,846,688. This was reduced to a sum of approximately RM13m.

(b) A provisional acceptance certificate had been issued to MRC for works performed to completion by Sumatec up to 31 May 2009. The certificate certified that the works completed up to 31 May 2009 by Sumatec was in the main accepted as satisfactory to MRC;
(c) MRC had no claims for any LAD for any delay and neither had MRC raised any other complaints/disputes, if at all Sumatec was in default;
(d) there was a one year gap between the date when the completed works was provisionally accepted and the date of the demand of the bank guarantee without any explanation by MRC;
(e) there is clear evidence of a reduction of Sumatec's scope of works under the contract to a region of about RM13m only. Accordingly, the demand on the bank guarantee for RM4,535,255.67 was equivalent to 40% of the value of the actual total contract sum. This amount was wholly disproportionate bearing in mind that the bank guarantee specifically sets the limit of the guaranteed sum at 10% of the contract sum; and
(f) from the minutes of the meeting between the parties, it is evident that the parties had agreed in principle to reduce the value of the bank guarantee to reflect the reduction of Sumatec's scope of works and the reduction in the contract value. Notwithstanding the same, MRC proceeded to make a call on the bank guarantee.

8. MRC on the other had contended that the bank guarantee was unconditional in nature and on-demand in character and thus cannot be restrained from being called and for payment to be made out to it by BIMB."

The Federal Court agreed with the Court of Appeal that this was not enough:

"43. In this appeal, Sumatec raised several incidences of the alleged unconscionable conduct on the part of MRC as particularised earlier in this judgment. These are factual matters which have been carefully evaluated and answered below in the Court of Appeal (see paragraphs 32 to 38 of the Court of Appeal judgment). The learned judges rightly concluded based on the materials before them, that unconscionability had not been proven to maintain the injunction granted below. We defer to these findings of facts by the Court of Appeal. We cannot find any reasons to justify an interference with the appellate judges' exercise of their discretion to set aside the injunction. It is unnecessary for us to add, minus or expand on the reasons given by the Court of Appeal to its negative finding of unconscionability on the part of MRC. We also agree with the Court of Appeal that the balance of convenience favoured refusal of the injunction."

Following the decision in *Sumatec*, the High Court in *Ranhill E&C Sdn Bhd v Thyssenkrupp Industries (M) Sdn Bhd and Another*,[51] held that in circumstances where a bank guarantee was about to expire, with the plaintiff expressing in strong language that it would not extend the guarantee, a beneficiary could not be said to have proceeded surreptitiously in making the call on the guarantee, nor could it be said that there was something

[51] [2016] 4 MLRH 151.

sinister or suspicious in its conduct in doing so. It was more of a case where negotiations between the parties had reached an impasse.

Case law in Malaysia highlights the extensive and varied circumstances in which the unconscionability exception has been relied upon to restrain a call by a beneficiary, including:

- demands after completion of the contract;[52]
- demands on the bond by the owner where the owner owes the contractor money under the contract;[53]
- demands in the face of ongoing negotiations;[54] and
- cases in which there simply was no breach by the contractor.[55]

Interestingly, this is perhaps the most extensive use of the exception anywhere.

4.6 Canada – *Veolia*

As mentioned above, prior to the recent Saskatchewan Court of Appeal decision in *Veolia*, there was no Canadian case law discussing the possibility of enjoining a beneficiary and, if that possibility existed, the test on such an application. Commentary was divided on the issue. The leading Canadian text in Canada on letters of credit suggested that beneficiaries should not be enjoined in situations where the bank itself could not be enjoined,[56] while a leading Canadian text on banking law, relying on *Sirius* and *Simon Carves*, proposed that "where the underlying contract that provides for the performance bond or demand guaranty expressly limits the beneficiary's rights, or prohibits a demand for payment except on specific terms which are shown not to have been satisfied, the court may enjoin premature demand and payment".[57]

In *Veolia Water Technologies Inc v K+S Potash Canada General Partnership*,[58] the Saskatchewan Court of Appeal became the first Canadian court to address this issue in some detail.

In *Veolia*, KSPC entered into a contract with Veolia whereby Veolia agreed to design, supply and commission the evaporation, clarification and

[52] *PJD Construction Sdn Bhd v IResidence Construction Sdn Bhd and Another* [2014] 1 LNS 1563 (HC), *Fulloop Sdn Bhd v Crest Builder Sdn Bhd and Anoher* [2014] 10 MLJ 192 (HC), *Humboldt Wedag GmbH and Another v Perak-Hanjoongs Simen Sdn Bhd* [2015] 4 CLJ 774 (HC).

[53] *PJD Construction Sdn Bhd v IResidence Construction Sdn Bhd and Another* [2014] 1 LNS 1563 (HC), *Humboldt Wedag GmbH and Another v Perak-Hanjoongs Simen Sdn Bhd* [2015] 4 CLJ 774 (HC).

[54] *Petrodar Operating Co Ltd v Nam Fatt Corp Bhd and Another* [2012] 5 MLJ 445 (CA).

[55] *Malaysian Reinsurance Bhd v Syarikat Weifong Industries Sdn Bhd* [2015] 1 MLJ 137 (CA). See Baskaran, T, "Performance Bonds: The Unconscionable Conduct Exception in Malaysia" (2016) 11(4) *Construction Law International* 21.

[56] Sarna, L, *Letters of Credit: The Law and Current Practice*, (3rd Edition) (Toronto: Carswell, 2015) at page 8–10.

[57] Crawford, B, *The Law of Banking and Payment in Canada, Vol 2* (Toronto: Thomson Reuters, 2018) at page 13–123.

[58] 2019 SKCA 25.

crystallisation system for KSPC's potash mine near Bethune, Saskatchewan. Veolia provided KSPC with two irrevocable standby letters of credit for which KSPC was the beneficiary. The first letter of credit [Letter of Credit No 1] arose out of the Contract. Sections 12(a) and (e) of the contract read as follows (emphasis added):[59]

> "(a) At the written request of the Owner from time to time, *the Contractor shall furnish to the Owner one or more irrevocable stand-by Letters of Credit* (each a 'Letter of Credit') in increments of US$100,000.00 up to an aggregate value of 25% of the Equipment Supply Price (as such Equipment Supply Price may be amended in accordance with the Contract including by the Owner exercising its purchase options set out in sections 6 and 10 of this Schedule). *Each such Letter of Credit shall be in the form attached as the Letter of Credit Schedule and issued by a financial institution acceptable to the Owner securing the Contractor's obligations under this Contract* including, without limitation, the obligation to deliver the Equipment contemplated by the Contract Documents. For purposes of this section 12, the Société Générale shall be deemed to be a financial institution acceptable to the Owner. At the Owner's request and expense, the Contractor shall arrange for any such Letter of Credit to be confirmed by a financial institution designated by the Owner.
>
> [...]
>
> (e) Without limiting the rights and remedies of the Owner, the Owner may draw upon the Letters of Credit if the Contractor defaults in any of its obligations under this Contract and fails to remedy the default within any applicable cure period provided for in the Contract including, without limitation, the obligation to make the deliveries contemplated by and in accordance with the dates specified in the Contract Documents. If any Letters of Credit will expire before the expiry of any such cure period, then the Owner may draw upon the Letters of Credit prior to their expiry without waiting for the expiry of any applicable cure period."

Letter of Credit No 1 itself provided that:[60]

> "We SOCIÉTÉ GÉNÉRALE hereby authorize you to draw on us in respect of irrevocable standby letter of credit No 02502-1087236PEE ('Credit'), for the account of the applicant up to an aggregate amount of [US$14,600,000] available by your drafts at sight, accompanied by your signed certificate stating that:
>
> We are entitled to draw on this Credit under the Design Supply and Commissioning Contract dated 11 December 2012 issued to the Contractor (HPD Project Number 530021#0##)."

The second letter of credit came into being after a steel frame supporting a large crystallizer vessel collapsed, for which KSPC believed Veolia was responsible.

The parties entered into an amended reservation of rights agreement after the collapse which provided, in part, as follows (emphasis added):[61]

> "(b) Subject to section 6(c) below and without limiting the rights and remedies of KSPC, KSPC may draw upon the Letter of Credit for any losses, costs or damages which are recoverable under the Contract, that are suffered or incurred by

[59] *Ibid*, paragraph 8.
[60] *Ibid*, paragraph 9.
[61] *Ibid*, paragraph 10.

> KSPC as a result of, or arising out of the Incident or any related impacts of the Incident and exceed the insurance proceeds received or reasonably expected to be received by KSPC pursuant to the Builder's Risk Policy, if KSPC determines, acting reasonably and in good faith, that the cause of the Incident is attributable to Veolia or its Personnel, in whole or in part, and such losses, damages or costs are not covered under the Builder's Risk Policy.
>
> [...]
>
> (e) KSPC may also draw upon the Letter of Credit for the full amount then available if, within thirty days after KSPC's written request from time to time, Veolia does not extend the Letter of Credit for a further one year beyond its then current expiry."

Letter of Credit No 2 itself provided that KSPC, as the beneficiary, could call on Société Générale when the following conditions were met:

> "We SOCIETE GENERALE hereby authorize you to draw on us in respect of irrevocable standby letter of credit No 02502-1148368PEE ('Credit'), for the account of the applicant up to an aggregate amount of USD 15,000,000.00 (Fifteen Million United States dollars) available by your drafts at sight, accompanied by your signed certificate stating that:
>
> We are entitled to draw on this Credit under the Reservation of Rights Agreement between K+S Potash Canada GP, Veolia Water Solutions & Technologies North America, Inc and Veolia Water Solutions & Technologies SA dated 20 December 2016.
>
> [...]
>
> This Credit is issued in with the Reservation of Rights Agreement between the Beneficiary, the applicant and Veolia Water Solutions & Technologies SA dated 20 December 2016.
>
> We irrevocably agree with you that all drafts drawn under, and in compliance with the terms of this Credit will be duly honored, if presented at the counters of SOCIETE GENERALE — GTPS/GPS/OPE/TRA/GAR — Immeuble Cristallia — 189, rue d'Aubervilliers — 75886 Paris Cedex 18 (France) at or before 5.00 pm (ET) on 30 June 2018."

KSPC made a demand on Letter of Credit No 1 and gave notice to Veolia that it intended to make a demand on Letter of Credit No 2. Veolia alleged that KSPC had not satisfied the conditions necessary for it to make draws on either Letter of Credit No 1 or Letter of Credit No 2 and sought an interlocutory injunction to prevent KSPC from drawing on the letters of credit until a court or arbitral tribunal had determined whether KSPC had a right to do so.

With regard to Letter of Credit No 1, Veolia argued that it was plain and evident on the record that express conditions precedent to KSPC's right to draw had not occurred. KSPC had neither given notice of default nor permitted Veolia an opportunity to remedy as required by the contract, mirroring the circumstances in *Simon Carves*. A draw on the letter of credit in these circumstances could not be said to be honest or in good faith, and this was a serious issue to be tried.

With regard to Letter of Credit No 2, Veolia argued that the Reservation of Rights Agreement was incorporated by express reference into a change order, which stipulated the conditions upon which KSPC could draw down upon the letter of credit:

> "KSPC further agrees that [...] (b) it will not draw upon the Letter of Credit to recover amounts paid to Veolia under this Change Order, until such time as final determination of responsibility for the costs under this Change Order has been made pursuant to section 9 of the Reservation of Rights Agreement."

Veolia argued that the agreement expressly limited the extent of any potential draw upon Letter of Credit No 2 to costs and damages for which Veolia was legally responsible, and because no determination of legal responsibility had been made, and no assessment of damages recoverable under the contract had occurred, the contractual conditions precedent to a good faith draw upon Letter of Credit No 2 had not been met, just as they were not met in *Sirius*.

The Court of Appeal reviewed the international law on enjoining beneficiaries from drawing on letters of credit and held as follows:

> "There appears to be merit, as per Chief Justice French in *Simic* and the more recent English cases, in allowing an applicant to enjoin a beneficiary from drawing on a letter of credit in circumstances where the draw would be a violation of an express agreement between the beneficiary and the applicant, at least when the conditions limiting the beneficiary's right to draw on the letter of credit are distinct from its obligations with respect to the performance of the substance of the underlying contract. Simply put, I do not see the legal or commercial logic in allowing a beneficiary to clearly agree to the conditions on which it can have resort to a letter of credit and to then permit the beneficiary to immediately avoid those very same conditions by invoking the autonomy principle. However, given the importance of letters of credit in the commercial world, and the weight of the English authorities, it would seem an applicant should be obliged to establish a strong *prima facie* case that the beneficiary is expressly disentitled from making a draw before an injunction will issue."

The court seems to have agreed that the policy considerations related to enjoining beneficiaries have shifted toward a greater focus on fairness. In the end, however, the court found that it did not have to decide whether it should adopt the approach in *Sirius*, *Simic* and *Simon Carves*, because even if that approach had been adopted, Veolia had not established a strong *prima facie* case that KSPC was contractually prevented from making the draws in question.

5. A LIMITED EXCEPTION TO THE AUTONOMY PRINCIPLE IN CANADA

Courts throughout the Commonwealth have begun to extend circumstances in which beneficiaries can be restrained from drawing on demand instruments beyond instances of fraud. In the UK, while courts have not expressly created a second exception beyond the fraud exception, courts have nevertheless come to the conclusion that when considering the contractual relationship between parties, courts can restrain parties who are about to commit or are committing a breach of contract to prevent that occurring.

In Singapore and Malaysia, it is settled law that unconscionability, in addition to fraud, is a ground upon which a court may grant an injunction restraining a beneficiary of an on-demand guarantee from drawing on the guarantee.

In Australia, courts have expressly created further exceptions to the effect that a beneficiary's right to draw upon an autonomous letter of credit depends upon the draw being: (1) not fraudulent; (2) not unconscionable; and (3) not in breach of contractual conditions precedent.

To date, in Canada, the fraud exception remains the exclusive avenue for restraining draws on standby letters of credit or performance guarantees by either issuer or beneficiary. However, in the authors' view, the sanctity of the autonomy principle as it relates to issuers must now be balanced against the organising principle of good faith that govern the contractual relationship between parties.

The Court of Appeal in *Veolia* considered the impact of the Supreme Court of Canada decision *Bhasin v Hrynew*,[62] in which the court recognised an organising principle of good faith in the law of contract, which was seen as a requirement of justice from which more specific legal doctrines may be derived. Justice Cromwell, for the court, recognised a new common law duty of honest performance as a specific manifestation of the principle of good faith, a duty which requires parties to be honest with each other in the performance of their contractual obligations.

The Saskatchewan Court of Appeal in *Veolia* denied that *Bhasin* played any role in the case before it, holding that the principle of good faith could not be relied on to prevent KSPC from drawing on the letters of credit until all of the disputes about its entitlements to make such draws had been resolved by a court or an arbitral tribunal. That, according to the court, was "simply a bridge too far" and would have turned good faith into "a kind of generic cure-all", which was not how the Supreme Court intended *Bhasin* to be applied.

While *Bhasin* certainly ought not to be used as a kind of generic cure-all for impugned calls on letters of credit, *Bhasin* does provide a coherent framework for extending the categories of exceptions to the autonomy principle as it relates to beneficiaries, beyond the singular fraud exception. As explained by Justice Cromwell in *Bhasin*, an organising principle "is not a free-standing rule, but rather a standard that underpins and is manifested in more specific legal doctrines and may be given different weight in different situations".[63]

Indeed, the *Veolia* court alluded to this notion in its reasons, when it acknowledged that beneficiaries must not be allowed to agree to conditions on which they can have resort to a letter of credit and then be permitted to immediately avoid those very same conditions by invoking the autonomy

[62] 2014 SCC 71.

[63] *Bhasin*, at paragraph 64.

principle. In other words, beneficiaries must be acting honestly and in good faith. The exercise of contractual rights and freedoms must be done in a way that is consistent with the spirit and intent of the parties' agreement.

This is essentially an argument in favour of equity, and indeed the trajectory of cases reviewed above suggest that contemporary public policy is trending further toward a greater balance between notions of fairness and equity and strict legal rights.

Thus, the addition of the "unconscionable" exception to the autonomy principle *vis-à-vis* beneficiaries and letters of credit is, in the authors' view, exactly the type of specific existing legal doctrine that the court in *Bhasin* envisioned. Indeed, the Supreme Court in *Bhasin* held that "considerations of good faith are apparent in doctrines that expressly consider the fairness of contractual bargains, such as unconscionability. This doctrine is based on considerations of fairness and preventing one contracting party from taking undue advantage of the other."[64]

Whether the argument is based on "unconscionability" as defined in Singapore and Malaysia, unnamed equity principles, as in England, or on an organising principle of good faith, if the parties' duty of honest performance in *Bhasin* is to mean anything, beneficiaries must not be allowed to agree to strict conditions, knowing they remain immune under the protection of a letter of credit's autonomy.

Commentators in Canada and in the US have expressed dismay at what they view as an unreasonable expansion of the exceptions, warning that a "disavowal of the fraud-only standard might open the door to a proliferation of standards" harkening back to pre-UCC days.[65] Others worry that "that the sacred cow of equity may trample the tender vines of letter of credit law".[66]

The traditional view holds that expanding opportunities to restrain calls on standby letters of credit will ultimately undermine the utility and use of letters of credit in international commerce. The primary arguments against expanding the exceptions in the case of beneficiaries can be summarised as follows:

(a) The expansion would undermine the autonomy of letters of credit by allowing a plaintiff to accomplish indirectly what it cannot do directly.
(b) The expansion would introduce uncertainty and lack of confidence in the operation of letter of credit transactions, and the perceived lack of reliability would in turn chill commerce and international trade.

[64] *Bhasin*, at paragraph 43.

[65] Johns, RJ and Blodgett, MS, "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" (2011) 31 *N ILL U L Rev* 297 at 336.

[66] Harfield, H, *Code, Customs and Conscience in Letter-of-Credit Law*, quoted *ibid.*

(c) The expansion would undermine freedom of contract, as parties consciously agreed to allow beneficiaries to obtain payment before and independent of resolution of disputes arising out of the underlying contract.

The conception that restraining a beneficiary outside of the fraud exception is to somehow allow the plaintiff to accomplish indirectly what it cannot do directly is misleading. It is time for courts to recognise that the risk of opportunism exists on both sides. The legal relationship between the beneficiary and the bank and the beneficiary and the customer are based upon very different contracts. A beneficiary's entitlement to draw is governed by the underlying contract. When a beneficiary makes a draw on a letter of credit before it is entitled to do so under the underlying contract, relying on the autonomy of the bank, it too is doing indirectly what it cannot do directly. This is simply a matter of competing policy interests: commercial certainty and confidence in letters of credit versus principles of good faith and certainty in contracting.

Holding a beneficiary to the terms of its contract should not undermine commercial confidence in the operation of letter of credit transactions. On the other hand, the risk that beneficiaries can hide behind the shield of autonomy enjoyed by banks does, in fact, undermine the parties' confidence in the terms of their own contract. Clear conditions precedent to a draw become meaningless in these circumstances.

Principles of good faith, recognised in Canada as being an organising principle of contract law, require that parties not take undue advantage of each other, simply because there is an opportunity to do so. Enforcing these good faith principles by preventing beneficiaries from drawing on letters of credit when they have no contractual entitlement should, in fact, promote certainty and confidence in parties' transactions, not undermine it.

Importantly, expanding the exception beyond the fraud exception should not be unlimited in Canada. We recognise and understand the concern of critics that these developments threaten freedom of contract insofar as parties have expressly agreed to allow beneficiaries to obtain payment before, and independent of, the resolution of disputes arising from the underlying contracts.[67] Indeed, this concern is not without justification. For example, in the Malaysian context, the unconscionability exception has been used by courts to enjoin owners where contractor plaintiffs simply satisfied the court that it had genuine claims for set-off.[68] The mere existence of a *bona fide* dispute, however, should not be enough.

[67] Johns, RJ and Blodgett, MS, "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" (2011) 31 *N ILL U L Rev* 297.

[68] See supra, 3.2.1; *PJD Construction Sdn Bhd v IResidence Construction Sdn Bhd and Another* [2014] 1 LNS 1563 (HC), *Humboldt Wedag GmbH and Another v Perak-Hanjoongs Simen Sdn Bhd* [2015] 4 CLJ 774 (HC).

Interestingly, in Singapore, the concern appears to have been sufficient among owners so as to precipitate the introduction of a new clause into building contracts requiring contractors to agree to waive their right to plead the "unconscionability" exception in the event the owner moves to draw down on a bank guarantee. In *CKR Contract Services Pte Ltd v Asplenium Land Pte Ltd*,[69] the Court of Appeal of Singapore overturned a High Court decision and upheld a contractual provision that provided as follows:

> "In keeping with the intent that the performance bond is provided by [the Contractor] in lieu of a cash deposit, [the Contractor] agrees that except in the case of fraud, [the Contractor] shall not for any reason whatsoever be entitled to enjoin or restrain:
>
> (a) [the employer] from making any call or demand on the performance bond or receiving any cash proceeds under the performance bond; or
>
> (b) [the bank] under the performance bond from paying any cash proceeds under the performance bond
>
> on any ground including the ground of unconscionability".[70]

The exception advocated for here is not as wide as the "unconscionability" exception now adopted in Malaysia (and perhaps Singapore), but something much narrower and focused on the parties' duties of honest performance. The mere existence of even a genuine dispute between the parties arising out of the underlying contract is not sufficient. However, where parties have agreed to clear conditions precedent to an owner's right to draw on a letter of credit or on-demand performance guarantee, those conditions must be enforceable to be meaningful. Therefore, where a plaintiff satisfies a court that it has a strong *prima facie* case that a beneficiary has not met conditions precedent to a draw under the underlying contract, courts must be permitted to restrain beneficiaries.

As between plaintiffs and beneficiaries, the recognition of this "condition precedent" or "entitlement" exception, will reinforce parties' confidence in their commercial transactions and provide necessary commercial certainty that both sides will be held to the bargain they made.

Similarly, courts ought to have the latitude to restrain beneficiaries clearly acting in bad faith or dishonestly. While it is impossible to give a clear definition of what this may look like, the experience in Canada following *Bhasin* has not been the flood gate of bad faith cases that critics feared. We should trust our courts to call bad faith out when they see it.

[69] [2015] SGCA 24.

[70] In *Bhasin*, the Supreme Court of Canada held that "[b]ecause the duty of honesty in contractual performance is a general doctrine of contract law that applies to all contracts, like unconscionability, the parties are not free to exclude it" (paragraph 75). It is submitted, therefore, that CKR Contract Services would be decided differently in Canada.