THE FRAUD EXCEPTION TO STANDBY LETTERS OF CREDIT IN AUSTRALIA: DOES IT EMBRACE STATUTORY UNCONSCIONABILITY?

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Introduction

The *standby* letter of credit is a relatively new creature to international commercial transactions. However, for a long time, banks have engaged in *commercial* letter of credit transactions in connection with international trade. This is reflected in the case law the United States and the United Kingdom whose courts have long had to resolve disputes on letter of credit matters. Nevertheless, in recent years, letters of credit have become the most common method of payment in international, as well as domestic, commercial transactions.[1]

One principle that is clear from overseas cases is that the autonomy of letters of credit (from interference by courts) has traditionally been respected in order to maintain their utility in the context of international trade and commerce. However, recent cases in Australia have indicated that this may no longer be the case.

This article attempts to demonstrate the difference between commercial and standby letters of credit and explain the importance of the autonomy principle to their effectiveness. Fraud, the traditional exception to the autonomy of letters of credit, will be explained as it has been interpreted and applied in the courts of the United States, the United Kingdom and Canada.

The Victorian case of *Olex Focas Pty Ltd v Skodaexport Co Ltd*[2] (hereinafter *Olex Focas*) will then be critically examined to demonstrate the way in which the autonomy of standby letters of credit in Australia may be jeopardised and address whether the fraud exception to standby letters of credit has been extended in Australia to embrace statutory unconscionability. In outlining how *Olex Focas* was decided, under the unconscionability provision in the *Trade Practices Act* 1974 (Cth) (s 51AA), the traditional circumstances in which the equitable principle of unconscionability has developed will be discussed.

Finally, in circumstances in which the fraud exception in Australia *does* embrace statutory unconscionability, it will be argued that this is an undesirable

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1 Gabriel H, 'The Revision of the Uniform Commercial Code in the United States and Its Implication For Australia' (1998) 24 (2) *Monash University Law Review* 291 at 313.

2 (1996) 134 FLR 331.

course for courts to pursue, that cases which have strayed down this path can be distinguished, and that the High Court needs to demonstrate less readiness to encroach on this area of commerce, and needs to utilise a more narrow application of s 51AA.

Standby Letters of Credit Explained

The use of credits from commercial sale (commercial letters of credit), where they serve to reduce risk of nonpayment of the purchase price under a contract for the sale of goods have been extended to nonsale settings, where they serve to reduce risk of nonperformance under a contract that calls for performance. Generally, credits in the nonsale setting have come to be known as standby credits.[3]

There are several significant differences between commercial and standby credits. Firstly, commercial credits involve the payment of money under a contract of sale. Such credits become payable upon presentation of documents by the seller-beneficiary that show he has taken affirmative steps to comply with the sales agreement. In the standby case, the credit is payable upon certification of a party's nonperformance of the agreement.[4]

The first difference in the two credit types is critical. It demonstrates the relative ease of drafting a commercial credit in a way that no payment will be made without performance. It also demonstrates the difficulty of drafting a standby credit in a way that no payment will be made when there has been performance.[5]

The second difference is that the commercial credit issuer expects to pay the seller's drafts. However, the issuer of the standby credit usually does not expect to pay; the presentation of drafts or demands under a standby credit is an indication that something has gone wrong. Because the standby credit operates when the parties to the underlying contract are not in harmony, the standby credit issuer can be virtually certain that its customer does not want to see the beneficiary paid. The uncertainties against which the issuing bank must protect itself are very different; in the standby case, the issuer seeks reimbursement from a failing customer; in the other, from an account party that is healthy. In addition, the chances that the customer wants the issuer to dishonour the draft are much greater in standby cases. In standby cases, the account party usually disputes the assertion that it did not perform.[6]

Any party issuing a standby credit must understand the nature of the customer's undertaking and must evaluate its risks. For all practical purposes, a bank that issues a standby credit is making a loan to its customer, and may not be able to

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3 Dolan JF, *The Law of Letters of Credit*, (2nd ed), Warren, Gorham and Lamont Inc, Boston, USA (1991) 1-15.
4 Ibid.
5 Ibid.
6 Ibid at 1-16.

determine whether that loan is bankable without understanding the performance called for by the customer's contract with the beneficiary.[7]

As one author has remarked, in the context of international trade and commerce, the banker's documentary letter of credit has 'evolved into an extremely useful device for facilitating…' these types of 'complex international business transactions.'[8] Two basic contractual relationships exist in an international standby letter of credit transaction:

1. the underlying contract for services to which only the buyer and seller are parties; and

2. the contract between the seller (or account party) and the issuing bank under which the latter agrees to issue the credit and, either itself or through a correspondent bank, to notify the buyer (or beneficiary) and to make payments to, or to the order of, the buyer against presentation of stipulated documents; the seller agrees to reimburse the issuing bank for payments made under the credit.[9]

There are almost no limits to the variety of transactions that the standby credit can serve. In principle, standby credits can be used in any contract where the performance by one party is executory. There are some industries and transactions, however, where standby credits arise with frequency, such as real estate development, leases, securities and the sale of goods.[10]

The Autonomy Principle

The autonomy principle presupposes that the letter of credit transaction remains autonomous from the sales contract between the account party and the beneficiary. In other words, the two basic contractual relationships illustrated above are considered independent of each other. This separation of services and documents is considered crucial to the continued utility of letters of credit and is the principal basis upon which banks enter into such transactions. In effect, the autonomy principle is at the core of letters of credit.[11]

An express term is usually included in international letter of credit instruments, which incorporates the Uniform Customs and Practices for Documentary Credits (UCP).[12] The UCP consists of a set of rules issued by the International Chamber of Commerce (ICC) and adhered to by banks in 165 countries.[13] The

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7 Ibid at 1-17.
8 Fellinger GA, 'Letters of Credit: The Autonomy Principle and the Fraud Exception' (April 1990) *Journal of Banking and Finance – Law and Practice* 1 at 4.
9 Ibid at 5.
10 See above n 3 at 1-22 – 1-33.
11 See above n 8 at 7.
12 The most recent version was adopted by the ICC Executive Board in April 1993. That version was first published as ICC Publication No 500 in May 1993 and became effective January 1, 1994. It is also referred to as 'UCP 500'.
13 Graham GB and Geva B, 'Standby Credits in Canada' (1984) *Canadian Business Law Journal* 180 at 186.

autonomy principle is embodied in UCP Articles 3, 4 and 14 which state generally that, credits are by their nature transactions separate from their underlying transactions and that payment by the issuer is to be based solely on a determination of the conformity of the documents presented to the requirements of the credit.

These articles are basically a codification of the judgment in *Sztejn v J Henry Schroder Banking Corporation*[14] of Justice Shientag. *Sztejn* is generally considered to be the landmark case in the United States in relation to fraud in letters of credit. The English courts,[15] the Supreme Court of Canada[16] and the Supreme Courts of Victoria[17] and New South Wales[18] have also recognised and applied the principle.

While the courts recognise that several sets of circumstances will interfere with the autonomy principle, circumstances involving fraud and the application of the fraud exception to the autonomy principle remain the most notorious.

The Fraud Exception

As we have seen, the letter of credit is a device which provides certainty of payment for the beneficiary. However, the increased certainty for the beneficiary amounts to an increased risk of loss for the account party. Consequently, the balance of risk is tipped heavily in favour of the beneficiary. Nevertheless, whilst the autonomy principle achieves the desired commercial result in the majority of cases, and the account party is willing to expose itself to the risk of loss for the eventual gains effected by a successful deal, the principle gives rise to inequitable results in one recurring situation - when the transaction is denigrated by fraud. The fraud exception relies on the maxim: *ex turpi causa non oritur actio*.[19]

In such circumstances the autonomy principle may operate unjustly. For instance,

> …in cases of beneficiary fraud in which an action by the account party on the underlying contract would be ineffectual, the rule of independent contracts would operate to unjustly enrich an unscrupulous beneficiary.[20]

In these types of cases, the courts have attempted to strike a balance between the commercial utility of letters of credit (and the autonomy principle) against the

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14 31 NY Supp 2d 631 (Supreme Court, 1941).
15 See for example, *United City Merchants (Investments) Ltd v The Royal Bank of Canada* [1983] 1 AC 168.
16 See for example, *Bank of Nova Scotia v Angelica-Whitewear* (1987) 36 DLR (4th) 161 (SC).
17 See above n 2.
18 See for example, *Contronic Distributors Pty Ltd (Receiver and Manager Appointed) v Bank of New South Wales* [1984] 3 NSWLR 110.
19 *United City Merchants Investments Ltd v The Royal Bank of Canada* [1979] 1 Lloyd's Rep 267 (QB) at 278 per Mocatta J. The literal meaning is that 'no action arises out of a dishonourable cause'.
20 'Letters of credit: Injunction as a Remedy for Fraud in UCC Section 5-114' (1979) 63 *Minnesota Law Review* 487 at 490.

desire to prevent the inequitable results which may result from fraudulent misrepresentations in individual cases. This balancing of risk between the parties has been achieved through the fraud exception. However, case law remains 'somewhat unsatisfactory if not wholly inconsistent'[21] on application of the fraud exception.

The fraud exception was enunciated by Justice Batt in *Olex Focas* in the Supreme Court of Victoria. His Honour stated:

> Now in Victoria, as in England, that law is clear. The principle is clearly established that payment by a bank and a demand therefor by a beneficiary under an unconditional performance bond or guarantee, as under a confirmed irrevocable letter of credit, will not be restrained except in a clear case of fraud, of which the bank is clearly aware at the time of, probably, the proposed payment, or in the case of forgery of documents (which is probably applicable only to letters of credit) or, perhaps, in the case illegality of the underlying contract...[22]

However, this statement does not provide a lucid illustration of the principle, partly due to Justice Batt's adoption of the words 'probably' and 'perhaps' and also because it does not appear to accord accurately with the relevant authorities it purports to incorporate. It is beneficial to understand the way in which the fraud exception has been applied in overseas jurisdictions, where litigation in this area has been more frequent than in Australian courts.

The US Position

Similar provisions to the UCP articles appear in the Uniform Commercial Code (UCC)[23] in the United States which embodies the major corpus of American commercial law. Like the UCP, the UCC is a set of standard terms which only applies if incorporated by reference into a documentary credit.[24] Recently, the UCC has undergone a major revision. The content of the revised UCC articles in relation to letters of credit will be considered below.

Prior to the introduction of the UCC, there were several examples of buyers using letters of credit who sought the aid of courts to prevent payment to sellers whose documents allegedly did not comply with the letter of credit or whose merchandise allegedly failed to meet the standards called for by the underlying contract of sale.[25] Even though the majority of these cases deal with the commercial letter of credit, the autonomy principle and the application of the fraud exception apply equally to the standby credit.

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21 See above n 8 at 6.
22 See above n 2 at 348.
23 The American Law Institute, *Uniform Commercial Code* 1995.
24 Revised UCC Article 5-116 now expressly acknowledges that if a letter of credit incorporates the UCP, then the UCP will be binding and preempts the UCC.
25 Symons EL, 'Letters of Credit: Fraud, Good Faith and the Basis for Injunctive Relief' (1980) 54 *Tulane Law Review* 338 at 358.

In a major case in the United States, *Maurice O'Meara Co v National Park Bank*,[26] the New York Court of Appeal rejected the attempt to invoke the fraud exception. The *O'Meara* case involved the shipment of paper of a particular quality. The defendant bank refused to honour the plaintiff against the letter of credit because there had '…arisen a reasonable doubt regarding the quality of the newsprint paper.'[27] A majority of the court stated:

> The bank was concerned only in the drafts and the documents accompanying them…If the drafts when presented were accompanied by the proper documents, then it was absolutely bound to make payment under the letter of credit, irrespective of whether it knew, or had reason to believe, that the paper was not of the tensile strength contracted for.[28]

The statement illustrates that the majority opinion in *O'Meara* believed that in no circumstances could an issuing bank inquire as to fraud except on the face of the complying documents. In other words, the issuing bank can only assess the genuineness of the documents themselves to determine fraud. It is outside the bank's liability and concern to determine matters of extrinsic evidence indicating fraudulent statements within correct documents.

However, Justice Cardozo's dissenting judgment in that case implied that if the seller presenting the drafts for payment had perpetuated the fraud, the issuing bank may be entitled to refuse payment if the documentary fraud was discovered before payment was due. Justice Cardozo stated that the bank,

> …acts not merely on the credit of its customer, but upon the credit also of the merchandise which is tendered as security.[29]

In *Sztejn*, Justice Shientag, agreeing with numerous authorities, stated that it would be an unfortunate interference with business transactions if banks were required or allowed to become involved in disputes between the parties regarding the quality of the merchandise. Moreover, while the exception to the autonomy principle in *Sztejn* is the 'fraud as represented in the documents' exception, it seems clear that, as a matter of evidence, Justice Shientag looked to the performance rendered on the underlying sales contract in order to make his determination on the issue of documentary fraud.

In *Intraworld Industries Inc v Girard Trust Bank*,[30] a standby letter of credit case, the court held that:

> The circumstances which will justify an injunction against honour must be narrowly limited to situations of fraud in which the wrongdoing of the beneficiary has so vitiated the entire transaction that the legitimate

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26 146 NE 636 (NYCA 1925).
27 Ibid at 639.
28 Ibid.
29 Ibid at 641.
30 336 A (2d) 316 (SC Pa, 1975).

> purposes of the independence of the issuer's obligation would no longer be served.[31]

However, in *New York Life Insurance Co v Hartford National Bank and Trust Co*,[32] the court declared that the issuing bank's examination must be limited to an examination of whether the documents complied on their face with the letter of credit.[33] This would appear to comply with the reasoning of the majority opinion in *O'Meara*.

In *FDIC v Bank of San Francisco*[34] the court held that, for the purposes of interpreting the relevant article in the UCC, 'fraud in the transaction'[35] means fraud in the presentation of the documents required by the letter, rather than fraud in the underlying commercial transaction.[36]

On the side of Justice Cardozo's dissenting opinion in *O'Meara*, and the court in *Intraworld Industries*, lies the case of *Rockwell International Systems Inc v Citibank, NA*.[37] Here the court stated that,

> …the logic of the fraud exception necessarily entails looking beyond the supporting documents…to the circumstances surrounding the transaction…[38]

Other courts in the United States have employed different tactics to attack the autonomy of letters of credit in order to produce just results. One such tactic has been to interpret the wording of the letter of credit instrument to declare that it incorporated the underlying sales contract. In *Shaffer v Brooklyn Park Garden Apartments*,[39] the court used,

> …the language 'loans which are payable' to incorporate the underlying loan contract into the standby letter of credit contract.[40]

Similarly, in *NMC Enterprises Inc v Columbia Broadcasting Systems*,[41] the court referred to specific terms included in the documents tendered under the letter of credit in declaring that the underlying sales contract was thereby incorporated into the credit contract.[42]

In *NMC Enterprises*, the drafters of the credit cleverly incorporated the underlying transaction, not by mere reference to it, but by requiring the

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31 Ibid at 324-325.
32 378 A (2d) 562 (SC Conn, 1977).
33 Ibid at 567.
34 817 F 2d 1935 (9th Circuit, 1987).
35 The American Law Institute, *Uniform Commercial Code* 1972, Article 5-114(2).
36 See above n 8 at 14.
37 719 F 2d 583 (2nd Circuit, 1983).
38 Ibid at 589.
39 250 NW 2d 172 (SC Minn, 1977).
40 Ibid at 505.
41 14 UCC Rep Serv 1427 (SC NY, 1974).
42 See above n 8 at 15.

beneficiary to assert that the account party was liable under the contract between the account party and the beneficiary.[43]

From an analysis of these cases, it seems clear that the courts of the United States now extend the fraud exception to the underlying commercial transaction, as opposed to restricting it to fraud in the complying documents. In one author's view, 'these decisions imperil the credit as a commercial device'[44] and have 'rendered fraud claims…surrogates for breach of contract claims.'[45]

Recent revisions to the UCC have gone some way towards clarifying the fraud exception in relation to letters of credit in the United States.[46] These revisions were undertaken in an effort to respond to changes in the commercial practices involving letters of credit and a significant increase in litigation.[47]

The contentious issue of the fraud exception to the autonomy of letters of credit is dealt with in Article 5-109. An applicant under Article 5-109 can seek to enjoin the issuer from honouring a credit only if the presentation 'would facilitate a material fraud by the beneficiary on the issuer or applicant'. Therefore the standard for injunctive relief remains consistent with the previous Article 5, as well as the case law. In other words, the standard remains high, as the phrase 'material fraud' makes clear.[48]

In addition, Article 5-109 establishes certain factors which the court must consider in order to determine whether to enjoin the issuer from honouring the draft. These factors include the effect of an injunction on the beneficiary, the prohibition of an injunction by another law, and the availability of a remedy for fraud or forgery against the responsible party.

The UK Position

In the United Kingdom, fraud has never been found to exist, pursuant to the standard applied, on the facts of the cases. In *RD Harbottle v National Westminster Bank*,[49] Justice Kerr stated that banker's irrevocable obligations are the '…life blood of international commerce…'[50] and, that a buyer must establish a '…clear case of fraud of which the bank has notice'[51] in order to justify injunctive dishonour. This viewpoint is the common thread in all cases dealing with the fraud exception to letters of credit transactions. It illustrates the

43 See above n 3 at 7-65.
44 Ibid at 7-69.
45 *Phillip Bros Inc v Oil Country Specialists Ltd* 9 UCC Rep Serv 2d at 201 per Callaghan J.
46 The relevant section of the UCC dealing with letters of credit is Article 5 which was approved in its amended form in August 1995 and is presently being widely adopted by the states.
47 See above n 1 at 313.
48 McLaughlin G and Hull B, 'International Developments United States' (September 1995) 6 *Journal of Banking and Finance Law and Practice* 234 at 234.
49 [1977] 2 All ER 862.
50 Ibid at 870.
51 Ibid.

hesitation with which courts, especially in the United Kingdom, will interfere with letters of credit.

In *Edward Owen Engineering Ltd v Barclays Bank International Ltd*,[52] the court supported a narrow application of the fraud exception thereby asserting the ascendancy of the autonomy principle. The court unanimously accepted that,

> …it is certainly not enough to allege fraud; it must be 'established', and in such circumstances I should say very clearly established.[53]

It would appear that the major hurdle to overcome in the English courts with regard to the alleged fraud is one of proof. However, the cases dealing with standby credits indicate that fraud sufficient to invoke the exception may not have to revert directly back to documents but may simply the demand made under the instrument.[54]

In *Edward Owen*, after quoting from *Sztejn*, Lord Denning MR stated:

> That case shows that there is this exception to the strict rule; the bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances when there is no right to payment.[55]

Therefore, in the United Kingdom the fraud exception applies to both fraud in the documents and fraud in the underlying contract, however only in circumstances in which the beneficiary has knowledge at the time of the presentation.

The Canadian Position

In Canada, the fraud exception to the autonomy of standby credits has also recognised by their courts. Initially the assumption made by the courts in Canada in several cases[56] was that the appropriate test was that established in *Edward Owen* of clearly established fraud. However, more recently Canadian courts have adopted the less stringent test of a 'strong prima facie case'[57] of fraud on application for an injunction. In *CDN Research*, Justice Galligan considered the balance of convenience in granting or refusing an injunction. The court felt that the defendant bank's potential harm of reputational damage in international banking circles was outweighed by the potential harm of the plaintiff being defrauded without any realistic hope of redress.

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52 [1978] 1 All ER 976.
53 Ibid at 984 per Lord Denning MR, Browne and Geoffrey Lane LJJ.
54 See above n 8 at 18.
55 See above n 52 at 982.
56 See for example, *Lumcorp Ltd v Canadian Imperial Bank of Commerce* [1977] Que SC 993.
57 *CDN Research and Developments Ltd v Bank of Nova Scotia* (1980) 18 CPC 62 (Ont HC) per Galligan J.

In *Rosen v Pullen*,[58] the court stated that where the plaintiff is able to establish that the defendant called up the letter of credit in circumstances where it had not been entitled to do so, a prima facie case of fraud has been made out. In such circumstances, the bank will be entitled to withhold payment on an interlocutory injunction. In weighing up the balance, the court found that the defendant would face less risk of harm if the injunction were granted than the plaintiff would if it was denied.

In *Bank of Nova Scotia v Angelica-Whitewear*,[59] the court held that the fraud exception applies:

> …to what amounts in the particular circumstances of a case, to a fraudulent demand for payment, and it has been said that the exception should not be confined, as possibly suggested in *United City Merchants*,[60] to fraud in the tendered documents.[61]

In *Angelica-Whitewear*, a unanimous court presented a comprehensive judgment setting out the Canadian position on the fraud exception. The judgment began by affirming the fraud exception as part of Canadian law[62] and went on to state:

> …the fraud exception to the autonomy of documentary letters of credit should not be confined to cases of fraud in the tendered documents but should include fraud in the underlying transaction of such character as to make the demand for payment under the credit a fraudulent one.[63]

In Canadian courts, the exception extends, as in the United States, to any act of the beneficiary the effect of which would permit such beneficiary to obtain the benefit of the credit as a result of fraud.[64]

It is clear from these cases that differences in particular viewpoints regarding the various fraud exception issues reflect the tension between two principal policy considerations:

> …the importance to international commerce of maintaining the principle of the autonomy of documentary credits and the limited role of an issuing bank in the application of that principle; and the importance of discouraging or suppressing fraud in letter of credit transactions.[65]

This policy tension was recognised in Australia by Justice Batt in his widely criticised judgment in *Olex Focas*. However, the reason that this judgment has caused such concern is due to his Honour's finding that the unconscionability

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58 (1981) 126 DLR (3d) 62 (Ont. HC) at 69.
59 See above n 16.
60 See above n 15.
61 See above n 16 at 175.
62 Ibid.
63 Ibid at 176.
64 Ibid at 177.
65 Ibid at 168.

provision in the *Trade Practices Act* was able to be utilised to attack the autonomy principle.

Olex Focas v Skodaexport

The case involved a situation where Olex Focas agreed to undertake the supply and installation of telecommunications, telesupervisory and instrumentation systems work for Skodaexport, the defendant (a Czech company), on a pipeline that was being built in India. To insure Skodaexport's position in relation to the contractual work, Olex Focas provided certain guarantees through an Australian bank. One such guarantee was given to secure mobilisation advances/securement advances. They were not to secure performance of the work.[66]

A dispute arose about whether the work done by Olex Focas fulfilled the obligations despite certain delays. Skodaexport denied that it did. It then demanded that, unless Olex Focas agreed to reduce its claim for work done, Skodaexport would make a demand on the Bank to pay amounts due under the guarantees that were provided.[67] The plaintiffs alleged that this threat was either fraudulent or a breach of the unconscionable conduct provisions of the *Trade Practices Act*[68] and sought injunctions.[69]

In making his decision, Justice Batt considered whether the relief should be granted either on the basis of fraud (for which he denied relief) or on the basis of unconscionability in s 51AA of the Act. His Honour noted that the Act itself contained no definitions of the word 'unconscionable'.[70] His Honour then turned to *The Oxford English Dictionary*, second edition, which gives as a second meaning of the word 'unconscionable' the following: 'showing no regard for conscience; not in accordance with what is right or reasonable.'[71] Justice Batt then considered a number of High Court decisions in which the word 'unconscionable' had been considered.[72]

In Justice Batt's examination of the mobilisation advances/securement advances he felt that the parties were acting unreasonably. He noted that by relying on its rights, Skodaexport was acting unreasonably when assessed against 'ordinary human standards'[73] – its action was 'quite against conscience'[74] or 'unconscionable'.[75] By calling on more money than was needed to protect itself

66 See above n 2 at 331.
67 Ibid at 331-332.
68 Ibid at 344-345.
69 Ibid at 343-344.
70 Ibid at 355-356.
71 Ibid at 356.
72 Ibid at 356-357.
73 Ibid at 358.
74 Ibid.
75 Ibid.

Skodaexport was abusing its position in the context of the Act and therefore an injunction was warranted.[76]

On appeal from this case, the Court of Appeal in Victoria in an unreported judgment has refused to grant a further injunction.[77]

Unconscionability under the Trade Practices Act – s 51AA

The *Trade Practices Act* 1974 (Cth), at s 51AA states:

> A corporation must not, in trade or commerce, engage in conduct that is unconscionable within the meaning of the unwritten law, from time to time, of the States and Territories.

At the time of its introduction, much opposition to s 51AA was based on the significant erosion of certainty within commercial dealings which opponents foresaw would result from it.[78]

The inclusion of the prohibition on unconscionable conduct was first considered by the Swanson Committee in 1976.[79] The Committee was strongly against the introduction of a general prohibition against 'unfair' conduct, as it believed that it could 'under Australian conditions lead to a considerable degree of uncertainty in commercial transactions.' The Committee recommended a prohibition focused on unconscionable 'conduct' rather than contract, and recommended 'fairly detailed legislative guidance' within the provision itself. While sweeping amendments were made to the Act subsequent to the Swanson Committee's Review, no provision dealing with unconscionability was inserted at that time.[80]

The amendments to the *Trade Practices Act* were proposed in 1984. The list of criteria in the draft Bill was fairly similar to that contained in the *Contracts Review Act* 1980 (NSW). Interestingly at the time of the enactment of that legislation, the perceived benefits of a detailed list were many. The issue of providing detailed guidance for a judiciary which had traditionally shown a degree of reluctance to interpret a vague prohibition in a broad manner was also an issue.[81]

Subsequent reviews of the *Trade Practices Act* by the House of Representatives Standing Committee on Legal and Constitutional Affairs (the Griffiths Committee) and the Senate Standing Committee on Legal and Constitutional

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76 Ibid.
77 Baxt R, 'Unconscionable Conduct Under the Trade Practices Act' (1997) 71 ALJ 432 at 435.
78 Healey D, 'Unconscionable Conduct in Commercial Dealings' (1993) 1 TPLJ 169 at 169.
79 Trade Practices Review Committee, *Report to the Minister for Business and Consumer Affairs*, 20 August 1976.
80 See above n 79 at 170.
81 Ibid at 170; see Woods G and Stein P, *Harsh and Unconscionable Contracts of Work in NSW*, The Law Book Co, Sydney (1972) 2ff.

Affairs (the Cooney Committee) expressed reservation at the prospect of the extension of the unconscionability provisions to commercial transactions. Both cited the need for certainty in commercial transactions as the critical factor in any consideration of this issue. The Cooney Committee actually recommended the repeal of the provision in its entirety.[82]

Amendment to the *Trade Practices Act* in 1992 saw the extension of provisions relating to unconscionability to commercial transactions. The amendment was introduced despite continuing opposition to its inclusion in the Act from a variety of quarters, and various recommendations to the contrary.[83]

Amendment to the *Trade Practices Act* in 1992 was by way of the introduction of a new Part IVA, entitled 'Unconscionable Conduct' which contains s 51AA.

The Second Reading Speech to the amendment for s 51AA stated the following:

> All transactions covered by the new provision are already covered by the equitable doctrine. The advantages of prohibiting in the Act what is already addressed by equity lie in the availability of remedies under the Act…and the educative and deterrent effect of a legislative provision.[84]

Reference is there made to the equitable unconscionability cases of *Blomley v Ryan*[85] and *Commercial Bank of Australia v Amadio*.[86] There is, however, a marked lack of instances where the doctrine of equitable unconscionability has been applied in commercial situations.[87]

The Explanatory Memorandum to the s 51AA amendment states:

> The phrase 'the unwritten law, from time to time, of the States and Territories' denotes the non-statutory law (ie the law which is not contained in statutes, instruments under statutes or prerogative instruments) as developed by the courts of common law and equity. Because of the position of the High Court of Australia as the ultimate appellate court for all States and Territories, the 'unwritten law' of the States and Territories is the same. If a court in a State or Territory were thought to deviate from the principles recognised by the High Court, another court exercising its jurisdiction in relation to s 51AA would not be bound to follow that deviation, unless it was satisfied that to do so was consistent (or at least not inconsistent) with the law as recognised by the High Court from time to time.

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82 Ibid at 171.
83 Ibid at 169.
84 Mr Duffy (Member for Holt – Attorney General) *Trade Practices Amendment Bill 1992* (Cth) - *Second Reading Speech*, in the House of Representatives, 3rd November 1992.
85 (1956) 99 CLR 362.
86 (1983) 151 CLR 447.
87 See above n 79 at 178-179.

The Second Reading Speech and the Explanatory Memorandum both emphasise that the equitable principles of unconscionable conduct do not embrace conduct which is merely unfair or unreasonable or which amounts to a hard bargain.[88]

The Trade Practices Commission released a *Draft Guideline on Unconscionable Conduct* in March 1993.[89] It was there stated that the words 'within the meaning of the unwritten law' in s 51AA confined the operation of unconscionability for the purposes of s 51AA to equitable unconscionability, and did not encompass areas such as fraud, breach of fiduciary duty, and undue influence. This was important in focusing the development of the provision purely on the equitable doctrine of unconscionability.

The Trade Practices Commission *Guideline* reinforced the equitable view that to constitute unconscionability, the stronger party must have known of a 'special disability' and have taken advantage of it before the provision would apply.

As to the nature of the necessary 'special disability', the Trade Practices Commission stated that this could include, inter alia, a consideration of:

- the special commercial needs of the particular trade involved;
- the reasonableness of the conduct in terms of the relationship of the parties;
- the setting, purpose and effect of the contract.

Justice Batt in *Olex Focas* appears to have taken these considerations into account in making his decision and will be discussed below. Prior to *Olex Focas* such a finding of unconscionability in commercial transactions had not been made in Australia, although it had been considered.[90]

The *Guideline* also recognised that competition is a ruthless and difficult process in which competitors may be hurt, and that unconscionable conduct will always be harder to prove in commercial settings than in consumer transactions because hard bargaining is a characteristic of commerce.[91]

As mentioned above, opponents of the extension of statutory unconscionability to commercial situations feared that an explosion of case law and a subsequent erosion of certainty in commercial contracts would result. *Olex Focas* may indicate a crystallisation of these fears and appears to signify a detour from the law relating to equitable unconscionability in commercial transactions. Prior to

88 See above n 79 at 179.
89 Trade Practices Commission, *Draft Guideline on Unconscionable Conduct under Part IVA of the Trade Practices Act 1974*.
90 See *Hortico (Aust) Pty Ltd v Energy Equipment Co (Aust) Pty Ltd* [1985] 1 NSWLR 545.
91 See above n 79 at 181.

Olex Focas, equity has, in general, been reluctant to intervene in circumstances where business people merely fail to protect their own best interests.

In order to understand how *Olex Focas* represents such a significant extension to the application of s 51AA, and consequently a significant detour from the traditional principles relating to unconscionability at equity, the development of that principle will be discussed below.

The Equitable Doctrine of Unconscionability

The doctrine of unconscionability was considered in some detail by the High Court of Australia in the important case of *Amadio*,[92] which affirmed the continuing operation of the doctrine in Australia and clarified the principles relating to its operation. As mentioned above, the general category of unconscionability at equity involves a position of special disability followed by the unconscientious taking advantage of the weaker party 'whose will is so overborne…that it is not independent and voluntary…'[93] or where the weaker party '…is unable to make a worthwhile judgment as to what is in his best interest.'[94] Once the special disability and the taking of advantage have been established, the onus is cast on the party seeking to uphold the transaction to show that it is fair, just and reasonable.

The general category of unconscionable conduct recognised by equity has been considered on many occasions by the High Court. It is usually considered in circumstances where one party is placed at a serious disadvantage to another whether by reason of poverty or need of any kind, sickness, age, sex, infirmity of body or mind, drunkenness, illiteracy, lack of education, lack of assistance or explanation where assistance or explanation is necessary.[95]

Importantly, in *Tri-Global (Aust) Pty Ltd v Colonial Mutual Life Assurance Society Ltd*[96] it was appreciated by Justice Spender in the Federal Court that unconscionability goes to the formation and not to the termination of a contract.[97]

In *Louth v Diprose*,[98] the court cited with approval the words of Justice Salmond in *Brusewitz v Brown*:[99]

> The law in general leaves every man at liberty to make such bargains as he pleases and to dispose of his own property as he chooses. However improvident, unreasonable, or unjust such bargains or disposition may be,

92 See above n 87.
93 Ibid at 461 per Mason J.
94 Ibid.
95 See above n 86 at 405 per Fullagar J.
96 (1992) ATPR 41-174.
97 Ibid at 40,382 per Spender J.
98 (1992) 175 CLR 621.
99 [1923] NZLR 1106.

> they are binding on every party to them unless he can prove affirmatively the existence of one of the recognised invalidating circumstances.[100]

In the course of his decision in *Louth v Diprose*, Justice Toohey outlined the place of equitable unconscionability as a doctrine developed by the courts in the following way:

> Although the concept of unconscionability has been expressed in fairly wide terms, the courts are exercising an equitable jurisdiction according to recognised principles. They are not armed with a general power to set aside bargains simply because, in the eyes of the judges, they appear to be unfair, harsh or unconscionable. This is in contrast to some legislation which permits the courts to exercise a broad discretion to control harsh, oppressive, unconscionable or unjust contracts.[101]

Prior to the decision in *Olex Focas* there was little evidence of the application of the equitable doctrine of unconscionability to true commercial situations.[102]

Implications of the decision in *Olex Focas*

It has been submitted that the scenarios which were foreseen to be affected by s 51AA were situations in which pressure was imposed on parties who were at a special disadvantage vis-à-vis the other - the classic application of the unconscionability doctrine in equity. However, the case of *Olex Focas* involved two large corporations. On the one hand, Olex Focas Pty Ltd, a wholly owned subsidiary of Pacific Dunlop, and on the other, Skodaexport Co Ltd, a similarly large corporation. Therefore it is immediately apparent from the judgment of Justice Batt that his Honour's application of the unconscionability doctrine did not rely upon traditional grounds of the identification of a special disadvantage. Indeed, it would be difficult to attribute any of the recognised circumstances of a special disadvantage to a large corporation such as Olex Focas and no such evidence was tendered.[103]

Following the decision of Justice Batt, the implications for banks providing guarantees in such situations cannot be underestimated. It would appear that banks should not act simply because facially complying documents permit them to do so.[104]

In general, courts have refused to intervene in such commercial transactions. However, legislative inclusion of the words 'in trade or commerce' in s 51AA,

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100 Ibid at 1109.
101 See above n 99 at 654.
102 See Baxt R and Mahemoff J, 'Unconscionable Conduct Under the Trade Practices Act – An Unfair Response by the Government: A Preliminary View' (1998) 26 *ABLR* 5 at 11.
103 Ibid at 15.
104 Baxt R, 'Are Bank Guarantees Safe from the Unconscionable Conduct Provisions of the Trade Practices Act?' (April 1997) *The Australian Banker* 62 at 63.

appear to have provided the motive for judicial extension beyond it's intended boundaries.[105]

If the decision in *Olex Focas* is good law, then the unconscionable conduct provisions of the Act will become a powerful weapon for those parties seeking to set aside contracts and commercial relationships that they have freely entered into merely because it may be convenient for them to do so.[106]

It is submitted that s 51AA should be considerably cut back from the interpretation is was given in *Olex Focas*. Without such a reading down of the provision, s 51AA of the Act may be used to flagrantly undermine commercial relationships and change some of the fundamental concepts of the law of contract.[107] If *Olex Focas* were to be followed, it seems likely that the utility of the standby credit would no longer be served, particularly in circumstances in which overseas courts have already advanced significant inroads into the autonomy principle through common law and equitable means.

Could *Olex Focas* have been decided differently?

The outcome of *Olex Focas* appears to be a good one for the simple reason that Skodaexport was allegedly threatening to exercise the mobilisation advances/securement advances in circumstances which would have been unfair, although they were legally entitled to do so due to the loose wording of the document. The terms of the procurement/mobilisation advance bank guarantee were that:

> We Hongkong Bank of Australia Ltd…do hereby irrevocably undertake to pay the buyer at sight forthwith on first demand and in writing without protest or demur or proof or satisfaction and without reference to the seller any and all amounts demanded from us by the buyer with reference to this undertaking…[108]

By phrasing the standby credit in this way, Skodaexport was well within its rights to make a claim under the credit. On one view, this closed the door for Justice Batt to consider common law fraud and instead his Honour's decision depended upon an extension of the interpretation of s 51AA of the *Trade Practices Act* so as to reach a just outcome. According to Justice Batt:

> I consider that the plaintiffs are entitled to relief under the statute with respect to this class of guarantee. The effect of the statute, applying as it does to international trade and commerce, is to work a substantial inroad into the well established common law autonomy of letters of credit and performance bonds and other bank guarantees. I must apply the Act as I understand it.[109]

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105 See above n 103 at 15.
106 See above n 105 at 63.
107 See above n 78 at 433.
108 See above n 2 at 340.
109 Ibid at 358.

It is submitted that this was not the best course for the Supreme Court of Victoria to take. In circumstances such as the one in *Olex Focas*, it appears that the case could have been decided according to the ordinary principle of fraud at law.

The leading case in Australia dealing with fraud in letters of credit is the decision of the New South Wales Supreme Court in *Inflatable Toy Co Pty Ltd v State Bank of New South Wales*.[110] In that case Justice Young canvassed the relevant overseas authorities and principally went on to state that the judgment of Justice Shientag in *Sztejn* was 'accepted as being the law in Australia in this court…'[111] Whilst it is true that on the facts of the case in *Inflatable Toy Company* Justice Young did not feel it necessary to decide the issue of whether the fraud exception extends to the underlying contract,[112] his Honour demonstrated a notable degree of flexibility in determining what the fraud exception does cover:

> It is not merely a mechanical exercise of seeing whether the words in the documents are completely true or completely untrue to the knowledge of the seller; the question is really one of considering whether in all the circumstances the uttering of the documents involves actual fraud.[113]

In addition, Justice Young again left open the possibility that unconscionable conduct may be used as an exception to the autonomy of letters of credit.[114] This suggestion was first countenanced by his Honour in the earlier case of *Hortico (Aust) Pty Ltd v Energy Equipment Co (Aust) Pty Ltd*.[115] In that case it was stated:

> It does not seem to me that anything short of actual fraud would warrant this Court in intervening, though it may be that in some cases (not this one), the unconscionable conduct may be so gross as to lead to exercise of the discretionary power.[116]

This obiter dictum was considered by Justice Batt in *Olex Focas* but it did not find his support. Instead his Honour held that gross unconscionability falling short of actual fraud was not a ground for an injunction in such a case.[117]

Regardless of these observations in relation to unconscionable conduct, the facts in *Olex Focas* would appear to provide a strong argument in favour of a positive finding of the fraud exception to the autonomy of letters of credit. In other words, by Skodaexport claiming under a bank guarantee for sums already

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110 (1994) 34 NSWLR 243.
111 Ibid at 249. Therefore, that the bank should be permitted to refuse payment where there was fraud of which it had notice before being presented with the drafts of documents for payment.
112 Ibid at 251.
113 Ibid.
114 Ibid.
115 See above n 91.
116 Ibid at 554.
117 See above n 2 at 333.

received, it was acting with an intentional or reckless disregard of the truth.[118] It is submitted that in all the circumstances, the uttering of the documents by Skodaexport constituted actual fraud and that, with respect, this was the way in which *Olex Focas* should have been decided.[119]

By deciding the case on a broad interpretation of s 51AA, his Honour would appear to have provided the impetus for courts to interfere in any circumstances in which a dictionary definition, or personal interpretation, of the word 'unconscionability' accorded with the facts of a given case.

If there is anything positive to come out of the judgment in *Olex Focas*, it is the suggestion that it can be very readily distinguished on its own special facts. In addition, the Victorian Court of Appeal has refused to grant interlocutory injunctions pending the appeal from the judgment of Justice Batt in this matter. It is interesting to note that Charles JA expressed some 'concerns' with his judgment in so far as it undermined commercial letters of credit and guarantees.[120]

For the sake of completeness, the comments of the Federal Court in *Pritchard v Racecage*[121] should also be observed as this case has been recognised by some commentators[122] as demonstrating a further willingness on the part of the judiciary to extend the ambit s 51AA. In that case the Full Court, on appeal, held that:

> It cannot…be said that the argument in favour of a wide construction of s 51AA is untenable or doomed to failure.[123]

Whilst this statement does not go as far as to suggest that s 51AA *should* be given a broad interpretation, such an argument is obviously open to conjecture. Regrettably the court in *Pritchard v Racecage* declined to restrict s 51AA to a narrow equitable cause of action. Nevertheless, that case did not involve a letter of credit transaction.

Conclusion

It is clear from the decision in *Olex Focas* that Justice Batt found that the fraud exception to the autonomy of standby credits did embrace statutory unconscionability, under the broad interpretation of the unconscionability provision in s 51AA.[124] What is not clear is whether this decision will be

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118 The test for common law fraud established in *Derry v Peek* (1889) 14 App Cas 337.

119 See also Buckley R, 'Unconscionability Amok, or Two Readily Distinguishable Cases?' (1998) 26 *ABLR* 323 at 327.

120 See above n 105 at 63.

121 [1997] 27 FCA (4 February 1997).

122 See for example Baxt R, 'Unconscionability Taken One Step Too Far?' (1997) 25 *ABLR* 301.

123 See above n 122 per Branson J.

124 The reference made by Batt J of his 'very heavy commitments at the moment' (at 333) and his statement that 'I could have wished for longer time to consider my decision' (at 333) perhaps shed some light on the questionable application of the fraud exception in this case.

followed in subsequent Australian cases. For the reasons expressed above, it appears that s 51AA was not intended to be used in such circumstances. Traditionally the party caught in the middle of letter of credit disputes about the underlying contract is the issuing bank. The obligations of an issuer bank in such a situation remains unclear. It also remains unclear whether such credits will maintain their utility in the marketplace, or will gradually become unacceptable. It is hoped that in the future, a greater understanding by the judiciary of the utility of standby credits will facilitate a narrower application of the fraud exception.