INDICA TRADERS (PVT) LTD.•
v.
SEOUL LANKA CONSTRUCTION (PVT) LTD.
AND OTHERS

COURT OF APPEAL.
S. N. SILVA, J. (PRESIDENT C/A)
RANARAJA, J.
C. A. NO. 916/93 WITH
C.A L.A. NO. 277/93
MAY 31, JULY 14 AND AUGUST 15, 1994.

Contract – Construction contract – Termination – Advance payment guarantee – Performance bond – Burden of proof – Injunctive relief – Fraud.

Held:

Where the plaintiff (construction company) based his cause of action upon an alleged wrongful and illegal termination of a construction contract, the burden is on the plaintiff to satisfy *prima facie* that there has been a wrongful termination of the contract as pleaded by him which would disentitle the 1st defendant (owner) from making recoveries on the guarantee and performance bond.

The proper approach of a court to a consideration of an *ex parte* application for an interim injunction restraining a bank from paying under an irrevocable letter of

credit (LC), a performance bond or guarantee should be to ask whether there is any challenge to the validity of the letter, bond or guarantee itself. If there is not or if the challenge is not substantial, *prima facie* no injunction should be granted and the bank should be left free to honour its contracted obligation although restrictions may well be imposed on the freedom of the beneficiary to deal with the money after he has received it. The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which may thereafter be made will clearly be fraudulent. But the evidence must be clear, both (1) as to the fact of fraud and (2) as to the bank's knowledge. It would certainly not normally be sufficient that this rests on the uncorroborated statement of the customer, for irreparable damage can be done to a bank's credit in the relatively brief time which must elapse between the granting of such an injunction and an application by the bank to have it discharged.

Business transactions between a bank and a beneficiary, constituted in the nature of a performance bond, a performance guarantee, letter of guarantee or irrevocable letter of credit, whereby the bank is obliged to pay money to a beneficiary, are not tripartite transactions between the bank (surety) the beneficiary (creditor) and the party at whose instance the bond, guarantee or letter is issued (the principal debtor) but, simply transactions between the bank and the beneficiary. A bank thereby guarantees to the beneficiary payment of money and is obliged to honour that guarantee according to its terms. Any dispute that may arise between the beneficiary (creditor) and the party at whose instance the guarantee or letter is given (the principal debtor), on the underlying contact, cannot be urged to restrain the bank from honouring the guarantee or letter according to its terms.

In the case the plaintiff made no challenge to the validity of the letter of guarantee and bond put in suit. The letter of guarantee is unconditional and payable on demand. The allegation of fraud rests on the uncorroborated statement of the plaintiff and appears to be an afterthought put in solely for the purpose of supporting the application for an injunction.

A default or a violation of a contract or even receipt of an overpayment does not constitute fraud. The fraudulent conduct on the part of the beneficiary must be such as would strike at the very root of the transaction and vitiate the bond, guarantee or letter.

Cases referred to:

1. *Edward Owen Engineering Ltd. v. Barclays International Ltd.* (1978) 1 All ER 976, 983.

2. *Bolivinter Oil SA v. Chase Manhattan Bank and Others* (1984) 1 All ER 351, 352.

APPLICATION for revision of the order of the District Judge of Colombo.

Romesh de Silva, PC. with *Palitha Kumarasinghe* for petitioner.
E. D. Wickramanayake with *Nigel Hatch* for respondents.

Cur adv vult.

October 07, 1994.

S. N. SILVA, J.

The 1st Defendant has filed an appeal and an application in revision from the order dated 8.11.1993. It was agreed by counsel that both matters could be heard and determined in one proceedings. By that order learned District Judge granted to the Plaintiff-Respondent interim injunctions as prayed for in prayer (f), (g) and (h) of the prayer to the plaint. The injunctions restrain the 1st Defendant:

(1) from receiving payment in a sum of Rs. 2,000,000/- on the advance payment guarantee (A5 (a)) issued by the 2nd Defendant Bank and restrains the Bank from making payment on that guarantee to the 1st Defendant;

(2) from receiving payment in a sum of Rs. 500,000/- on the Performance Bond A5(b) from the 3rd Defendant and restrains the 3rd Defendant from making payment on that bond to the 1st Defendant.

The facts relevant to this action are briefly as follows:

The Plaintiff being a construction company entered into a contract with the 1st Defendant for the construction of a multi-storeyed shopping and residential complex at No. 280, Main Street, Colombo 11. The full contract sum is Rs. 20,000,000/- and the relevant documents relating to that contract have been produced (A3 to A4 (c)). Pursuant to the contract the 1st Defendant made an advance payment of Rs. 4,000,000/- to the Plaintiff. One condition of that advance payment is that it should be covered by guarantee for Rs. 4,000,000/-. It appears that later the 1st Defendant agreed to accept a guarantee for Rs. 2,000,000/- with a personal guarantee of the Managing Director of the Plaintiff for the balance Rs. 2,000,000/-

(A6). Document A5 (A) is the guarantee furnished from the People's Bank in compliance with this condition in the contract. The guarantee is valid from 25.1.1993 to 27.7.1995. The Performance Bond A5(b) was also given by the 3rd Defendant as surety to the Plaintiff's due performance of all terms and conditions under the agreement.

It is the Plaintiff's case that on 16.8.1993 the 1st Defendant unilaterally and wrongfully terminated the contract and took over the work-site for the work to be completed by the 1st Defendant directly. It is pleaded by the Plaintiff that the termination is contrary to the contract, illegal and of no force in law (Paragraphs 14 and 15 of the plaint). The main relief in the plaint is for a declaration that the termination is unlawful and void. The Plaintiff has also pleaded that the advance payment of Rs. 4,000,000/- was recovered on the bills that were submitted and that no amount was due from the Plaintiff to the 1st Defendant on account of the advance payment that was made. On that basis a declaration is sought that the 1st Defendant is not entitled to recover money on the guarantee. The Plaintiff has made a claim for Rs. 5,853,973.42 for damages arising upon wrongful termination of the contract. In view of these claims for damages the Plaintiff has sought a declaration that no amount is due upon the Performance bond referred above.

The 1st Defendant has denied that the contract was wrongfully terminated on 16.8.1993 as pleaded by the Plaintiff. It is the 1st Defendant's case that the Plaintiff could not carry out the work on the contract in due time and that the work done was delayed and defective in certain respects. That the Plaintiff indicated that it would not be possible to conclude the contract and requested termination which request was granted by the 1st Defendant on 24.8.1993. Thereafter the 1st Defendant carried out the work on its own using some material and equipment made available by the Plaintiff. The 1st Defendant has adduced evidence of payments amounting to Rs. 9,060,000/- and has pleaded that the actual cost of the work done by the Plaintiff amounts to only Rs. 6,707,067/-. On that basis the 1st Defendant has claimed a sum of Rs. 2,674,639/- as damages. It is pleaded that the guarantee is payable on demand and in any event in view of the sum due from the Plaintiff the 1st defendant is

entitled to recover money on the guarantee and the bond. Accordingly the 1st Defendant had passed a resolution (B9(a)) on 14.9.1994 to demand payment on the Bank guarantee.

The 2nd Defendant bank has in the objections filed in the District Court (c) admitted that the guarantee had been issued and that it is operative. The bank has pleaded that it is liable to make payment on the guarantee upon the demand that was made, and that no payment was made in view of the enjoining order issued by Court. The 3rd Defendant has not filed any objections to the interim injunctions that were sought.

The two main matters that come up for consideration in this appeal are as follows:

(1) The termination of the contract for construction entered into between the Plaintiff and the 1st Defendant; whether it was wrongfully terminated by the 1st Defendant on 16.8.1993, as pleaded by the Plaintiff or whether it was terminated at the instance of the Plaintiff on 24.8.1993 as pleaded by the 1st Defendant;

(2) Whether the advance payment guarantee is payable on demand without any further proof, as pleaded by the 1st Defendant or whether the claim on this guarantee has been made without any basis and fraudulantly as pleaded by the Plaintiff.

As regards the 1st matter relating to the termination of the contract, it is to be noted that the Plaintiff has based his cause of action upon the alleged wrongful and illegal termination of the contract on 16.8.1993 by the 1st Defendant. Therefore, the burden is on the Plaintiff to satisfy *prima facie* that there has been a wrongful termination of the contract as pleaded by him which would disentitle the 1st Defendant from making recoveries on the guarantee and the Performance Bond. The Plaintiff has failed to adduce any documentary evidence which supports its claim of a termination on 16.8.1993. In fact the 1st Defendant has submitted that the first instance in which such an allegation of a wrongful termination on 16.8.1993 was made, was in the plaint filed in the District Court. On

the other hand the 1st Defendant has relied on several documents, the genuineness of which is not disputed to support its case that the contract was continued up to 24.8.1993, on which day there was a mutual termination. Document B5(f) (1D4(f)) filed in the District Court) dated 20.8.1993 is an acknowledgement of a payment of Rs. 50,000/- made by the 1st Defendant to the Plaintiff. This document is hand-written and signed by the Managing Director of the Plaintiff Company. I am inclined to agree with the submission of learned President's Counsel for the 1st Defendant that this document cuts across the case of the Plaintiff that the contract was unilaterally and wrongfully terminated by the 1st Defendant on 16.8.1993. It is inconceivable that the 1st Defendant having terminated the contract unilaterally on 16.8.1993 would have paid the Plaintiff a sum of Rs. 50,000./- on 20.8.1993. The document clearly states that the sum of money is payment for construction of "Indica Traders" at 280, Main Street, Pettah. This establishes, *prima facie*, that the contract was in progress as at 20.8.1993. The case of the 1st Defendant of a mutual termination on 24.8.1993 is supported by documents A8(a), A8(c) and A8(d) dated 24.8.1993 and 25.8.1993. Document A8(a) signed by both parties states that the contract was terminated on 24.8.1993 and that the Plaintiff has handed over a concrete mixer and a vibrator to the 1st Defendant which would be returned to the Plaintiff on 2.8.1993. Similarly A8(b) refers to a number of other items used for the laying of the concrete slab, that were handed over to the 1st Defendant by the Plaintiff on 24.8.1993. A8(c) gives a list of items of steel rods taken over by the 1st Defendant from the Plaintiff on 25.8.1993. A8(d) is a letter that certain other items necessary for construction work were taken over by the 1st Defendant on 25.8.1993 and would be returned to the Plaintiff within a week by the 1st Defendant. Document B4 is evidence of the fact that the concrete mixer and the vibrator retained by the 1st Defendant according to A8(a) were returned to the Plaintiff on 1.9.1993. These documents establish *prima facie* that there was a mutual termination of the contract on 24.8.1994 and that the Plaintiff in fact made material and equipment available to the 1st Defendant to carry out the work immediately outstanding which involved the laying of the concrete slab on the 3rd floor.

The case for the Plaintiff is that there was a unilateral termination by the 1st Defendant on 16-8-1993 and a final bill (A9) bearing the same date was submitted by the Plaintiff. The 1st Defendant has denied the receipt of the final bill A9. On the other hand, the 1st Defendant relies on documents A14 and A14(a) dated 23-8-1993 sent by the Plaintiff to the 2nd and 3rd Defendants where it is specifically stated that the final bill is "now under preparation". This admission of the Plaintiff cuts across the claim in the plaint that the final bill was submitted on 16-8-1993. Furthermore, these letters clearly state that the Plaintiff is negotiating with the 1st Defendant "for a mutual termination of the contract". In these circumstances I have to hold that *prima facie* there was no unilateral termination of the contract by the 1st Defendant on 16-9-1993 as pleaded by the Plaintiff. On the contrary, *prima facie* evidence is that there was a mutual termination of the contract on 24-8-1993 in the circumstances pleaded by the 1st Defendant in its statement of objections. The learned District Judge in his order has not considered the contents of the documents referred to and has failed to consider the salient question whether the Plaintiff has established that he has a *prima facie* sustainable case on the cause of action pleaded in the plaint. In view of the finding stated above that the Plaintiff has failed to establish such a *prima facie* sustainable case; the application for interim injunctions should fail in limine. However, in view of the findings of the learned Judge on the second matter, referred above, I will briefly examine the evidence with regard to the matter of the advance payment guarantee A5(a).

I have set out above the circumstances in which the guarantee was issued by the 2nd Defendant Bank. The case of the Plaintiff is two-fold:

(1) that the guarantee is conditional and takes effects only upon proof that there was a breach of the contract by the 1st Defendant;

(2) that the claim made by the 1st Defendant on the guarantee is fraudulent, in that the mobilization advance in respect of which the guarantee was furnished has been fully recovered as against the bills submitted by the Plaintiff.

The 1st Defendant contends that the guarantee is payable on demand without proof of any breach of the contract by the Plaintiff. On the second matter it is contended that payments have not been made in relation to any specific bills that were submitted and that there is no question of the mobilization advance having been set-off on the previous bills that were submitted.

Learned District Judge has relied mainly on the first matter referred above to grant the injunctions as sought by the Plaintiff.

The letter of guarantee A5(a) is *ex facie* payable on demand, It does not state that the payment thereon is conditional upon a proof of a breach of the contract by the Plaintiff. Learned District Judge has relied on letter dated 3-8-1993 (A7) which purports to amend the original letter of guarantee in support of his finding. It is agreed by parties that the amendment A7 was in fact sent by the Bank. The Plaintiff has not claimed that the amendment was made at its instance. On the contrary, in paragraph 19 of the plaint it is pleaded that the amendment purports to enable the payment of the claims made by the 1st Defendant directly to the Headquarters Branch of the 2nd Defendant. That is clearly stated in A7. However, learned District Judge has relied on the words "In breach of the contract for construction of building for Indica Traders (Pvt.) Ltd. by Seoul Lanka Constructions (Pvt.) Ltd. all claims under the guarantee will be ..." appearing in the sentence included by the amendment. It has been held that these words introduced a condition to the guarantee that payment will be made only upon a breach of the contract.

On the other hand, the 1st Defendant submits that the amendment was merely introduced to designate the branch to which payment will be made since the 1st Defendant had pledged the letter of guarantee to that branch of the Bank to raise funds for the construction. On a consideration of the documents A5 (a) and A7 it is clear that the amendment is not intended to introduce a new condition to the original letter and that it is merely intended to designate the branch to which payment will be made. The Plaintiff itself understood the amendment as such, as disclosed in paragraph 19 of the plaint. The Bank could not have introduced a new condition on its own without the consent of the 1st Defendant in whose favour the guarantee

payable on demand (which was operative) had been issued. Certainly, such a condition would not have been introduced without the knowledge of the Plaintiff. On the other hand, the Bank in its objections filed in the District Court (c) has taken up the position that the guarantee was payable on demand. In these circumstances, the learned District Judge's finding, made on the premise that the amendment renders the guarantee to be conditional, is unsupportable. Therefore the case had to be considered on the basis that the document put in suit is an unconditional guarantee payable on demand. In any event relief is sought in the plaint only in respect of the original letter of guarantee and not the letter as amended.

The claim of the Plaintiff that the advance payment was recovered on earlier bills that were submitted is also not supported on any documentary evidence. If this claim is true the Plaintiff would have stated this matter in letters dated 23-8-1993, sent to the 2nd and 3rd Defendants [A14 and A14(a)]. On the other hand, the submission of the 1st Defendant that payments were not made on the basis of any bills submitted and in the form of advances in approximate amounts (round figures) is clearly borne out on the schedule of payments made from 11-3-1993 onwards. There have been eight payments in all and none of them have been for any specific amounts, clearly supporting the claim of the 1st Defendant that payments were not made against any bills submitted. Therefore, the claim of the Plaintiff that the advance payment has been set-off against previous bills submitted is not supported.

The foregoing analysis reveals that the Plaintiff has failed to establish a *prima facie* sustainable case on any of the matters that are in dispute between the parties. On the contrary, on all disputed matters the *prima facie* finding has to be in favour of the position taken by the 1st Defendant.

Learned President's Counsel for the 1st Defendant urged forcefully that a letter of guarantee payable on demand issued by a Bank should be treated as a "sacrosanct document" and be strictly honoured. He submitted that the transaction was entered into in the faith, that the letter of guarantee represents money and the very basis of the transaction would be eroded if the contracting party at whose instance the guarantee was issued is able to obtain injunctive relief

from Court restraining the Bank from honouring the guarantee. Counsel for the plaintiff submitted that a contract of guarantee is a tripartite agreement which contemplates, the principal debtor, the creditor and the surety and should be strictly construed.

In the case of *Edward Owen Engineering Ltd. v. Barclays International Ltd.* [1] Lord Denning examined the nature of the business transaction called a performance guarantee or a performance bond issued by a bank and the legal implications of such transaction. In that case too a contracting party who caused a bank to issue a performance guarantee sought to restrain the bank by injunction from making payment on that guarantee. On the facts, the contracting party to whom payment was to be ultimately made (a Libiyan customer of the Plaintiff) was in default on the main contract but it was held that an injunction could not issue to restrain payment on the guarantee on that basis. Lord Denning, on an examination of parallel transactions opined as follows at p983;

> "So, as one takes instance after instance, these performance guarantees are virtually promissory notes payable on demand. So long as the Libiyan customers make an honest demand, the banks are bound to pay and the banks will rarely, if ever, be in a position to know whether the demand is honest or not. At any rate they will not be able to prove it to be dishonest. So they will have to pay.
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> All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand if so stipulated, without proof or conditions. The only exception is when there is a clear fraud of which the bank has notice."

The law on this aspect was laid as settled in the brief but cogent judgment of Sir John Donaldson MR in *Bolivinter Oil SA v. Chase Manhattan Bank and others.* [2] The proper approach of a Court to a

consideration of an *ex parte* application for an interim injunction restraining a bank from paying under an irrevocable letter of credit, a performance bond or guarantee was stated as follows:

> "The unique value of such a letter, bond or guarantee is that the beneficiary can be completely satisfied that, whatever disputes may thereafter arise between him and the bank's customer in relation to the performance or indeed existence of the underlying contract, the bank is personally undertaking to pay him provided that the specified conditions are met. In requesting his bank to issue such a letter, bond or guarantee, the customer is seeking to take advantage of this unique characteristic. If, save in the most exceptional cases, he is to be allowed to derogate from the bank's personal and irrevocable undertaking, given be it again noted at his request, by obtaining an injunction restraining the bank from honouring that undertaking, he will undermine what is the bank's greatest asset, however large and rich it may be, namely its reputation for financial and contractual probity. Furthermore, if this happens at all frequently, the value of all irrevocable letters of credit and performance bonds and guarantees will be undermined.
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> Judges who are asked, often at short notice and *ex parte*, to issue an injunction restraining payment by a bank under an irrevocable letter of credit or performance bond or guarantee should ask whether there is any challenge to the validity of the letter, bond or guarantee itself. If there is not or if the challenge is not substantial, *prima facie* no injunction should be granted and the bank should be left free to honour its contractual obligation, although restrictions may well be imposed on the freedom of the beneficiary to deal with the money after he has received it. The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which may thereafter be made will clearly be fraudulent. But the evidence must be clear, both as to the fact of fraud and as to the bank's knowledge. It would certainly not normally be sufficient that this rests on the uncorroborated statement of the customer, for irreparable damage can be done to a bank's credit in the

relatively brief time which must elapse between the granting of such an injunction and an application by the bank to have it discharged."

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

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

(i) the fact of fraud and,

(ii) the knowledge of the bank as to the facts constituting the fraud.

When the principles as stated above are applied to the facts of this case it is seen that the Plaintiff has made no challenge to the validity of the letter of guarantee and bond put in suit. The letter of guarantee is unconditional and is payable on demand. The allegation of fraud rests on the uncorroborated statement of the Plaintiff. It appears to have been put in as an afterthought solely for the purpose of supporting the application for an injunction. It is significant that letters 'A14' and 'A14(a)' dated 23-8-1993 sent by the Plaintiff to the 2nd and 3rd Defendants do not contain any allegation of fraud. They only state that the 1st Defendant is "violating/defaulting the contract". As noted above disputes, on the underlying contract are irrelevant to the question whether the bank should make payment on the bond, guarantee or letter to the beneficiary. In any event, a default or a violation of a contract or even the receipt of an over payment do not constitute fraud. Fraud as contemplated in the exception stated above carries a far more serious connotation. It is such fraudulent conduct on the part of the beneficiary as would strike at the very root of the transaction and vitiate the bond, guarantee or letter. The allegation of the Plaintiff taken as its highest falls far short of this requirement.

The Plaintiff has failed to establish a *prima facie* sustainable case on its claim that payment should not be paid on the letter of guarantee and bond put in suit. He has also failed to establish a *prima facie* sustainable case on the cause of action pleaded in the plaint. In the result there is no basis to grant the injunctions that were sought. Accordingly, I allow the application and set aside the order dated 8-11-1993 of the learned District Judge and make order dismissing the application for interim injunctions. The Plaintiff will pay the costs of the 1st and 2nd Defendants at the inquiry in the District Court and pay a sum of Rs. 7,500/- as costs of these proceedings to the 1st Defendant.

DR. RANARAJA, J. – I agree.

Application allowed and application for interim injunction dismissed.