IN THE SUPREME COURT OF THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

Lanka Milk Foods (CWE) Limited,
Welisara,
Ragama.

Plaintiff

SC Appeal No. SC/CHC/16/2007
CHC Case No. HC (Civil) 157/2001 (1)

Vs,

Seylan Bank Limited,
No. 33, Sri Baron Jayatilaka Mawatha,
Colombo 01.

Presently at:
"Ceylinco-Seylan Towers",
No. 90, Galle Road,
Colombo 03.

Defendant

-And Now-

Seylan Bank Limited,
No. 33, Sri Baron Jayatilaka Mawatha,
Colombo 01.

Presently at:
"Ceylinco-Seylan Towers",
No. 90, Galle Road,
Colombo 03.

<u>Defendant-Appellant</u>

Vs,

Lanka Milk Foods (CWE) Limited,
Welisara,
Ragama.

<u>Plaintiff-Respondent</u>

Before: **Justice S. Thurairaja, PC**
Justice A.L. Shiran Gooneratne
Justice Mahinda Samayawardhena

Counsel: Dr. Romesh de Silva, PC with Shanaka Coorey instructed by De Livera Associates **for the Defendant-Appellant.**

Nihal Fernando, PC with Harshula Seneviratne instructed by Hemanthi Bulatwatte **for the Plaintiff-Respondent.**

Argued on: 25/11/2024

Decided on: 19/03/2025

A.L. Shiran Gooneratne J.

[1] By Plaint dated 26/11/1992, the Plaintiff-Respondent (hereinafter sometimes referred to as 'the Plaintiff') filed this action CHC No. HC (Civil) 157/01 (1) against the Defendant-Appellant (hereinafter referred to as 'the Defendant Bank') for the recovery of money due on Performance Bond/Guarantee No. 001/LG/90/253 dated 15/10/1990 [marked P6], and Performance Bond/Guarantee No. 001/LG/91/027 dated 07/02/1991 [marked P9], as the first and second causes of action, against the Defendant Bank, in a sum of US$ 72,730.23 and US$ 56,733.25 respectively, together with legal interest until the date of payment in full.

[2] The Plaintiff also prayed that, in the event of any inability to recover the decreed sum of US dollars, the sum to be recovered in Sri Lankan Rupees may be equivalent to the sum of US dollars and interest thereon at the date of payment.

[3] In paragraph 5 of the Plaint, the Plaintiff stated, that in or about July 1991, the business of The Bank of Credit and Commerce International (overseas) Limited (hereinafter referred to as the "BCCI") was suspended by the Central Bank of Sri Lanka and the Defendant Bank upon being appointed and/or upon being given the power to do so by the Central Bank of Sri Lanka, managed and/or administered and/or carried on the business of BCCI in Sri Lanka.

[4] In paragraph 6 of the plaint, the Plaintiff stated, that acting under the Gazette Extraordinary No. 694/17 dated 28/12/1991, the President under Section 5 of the Public Security Ordinance, and under the Gazette Extraordinary No. 695/11 dated 01/01/1992, by the powers vested in it by Emergency (Banking Special Provisions) Regulations No. 2 of 1991, the Monetary Board of the Central Bank of Sri Lanka, vested the business of the said BCCI in Sri Lanka in the Defendant Bank with effect from 1st January 1992.

[5] In Paragraph 8 of the Plaint, the Plaintiff stated, that the Defendant has acted and/or taken the benefit of the said Order made by the President marked P1, and the said Regulations marked P4 and is therefore estopped from denying same.

[6] In paragraph 09 of the Plaint, the Plaintiff, for a first cause of action on Performance Bond/Guarantee No. 001/LG/90/253 dated 15/10/1990, for the recovery of a sum of US$ 72,730.30 together with legal interest, [marked P6], stated that the Plaintiff entered into a contract with Won Ji Industrial Company Limited of Seoul, South Korea, (hereinafter referred to as 'the Contractor'), for the purchase by the Plaintiff of 150 metric tons of Triple Laminate Foil to be supplied by the Contractor.

[7] A Condition of the said Contract marked P5, was that the Contractor shall furnish a Performance Bond for US$ 72,730,23 [United States dollars, Seventy-two thousand seven-hundred and thirty and cents twenty-three only] (10% of the total value of the contracted amount) for the due and punctual performance and fulfilment of the contract above referred to and the contractor has requested to furnish the requisite Performance Bond and whereas, Bank of Credit & Commerce International (overseas) Limited has agreed to do so.

[8] In paragraph 11 of the plaint, the Plaintiff stated, that BCCI, at the request of the Contractor, issued Performance Bond or Guarantee No. 0001/LG/90/253 dated 15/10/1990, (P6) for US$ 72,730.23 in favor of the Plaintiff.

[9] In paragraph 20 of the Plaint, the Plaintiff, for a second cause of action on Performance Bond/Guarantee No. 001/LG/91/027 dated 07/02/1991 [marked P9], for the recovery of a sum of US$ 56,733.25, together with legal interest, stated that the Plaintiff entered into a Contract with the said Contractor, for the purchase by the Plaintiff of 105 metric tons of Triple Laminate Foil to be supplied by the Contractor.

[10] As in the 1st cause of action, a Condition of the said Contract marked P8, was that the Contractor shall furnish a Performance Bond for US$ 56,733.25 [United States dollars Fifty-six thousand seven hundred and thirty-three and cents twenty-five only], (10% of the total value of the contracted amount) for the due and punctual performance and fulfilment of the Contract above referred to and the Contractor has requested to furnish the requisite Performance Bond and whereas Bank of Credit & Commerce International (overseas) Limited has agreed to do so.

[11] In paragraphs 21 and 22 of the Plaint, the Plaintiff stated, that BCCI, at the request of the Contractor, issued Performance Bond or Guarantee No. 0001/LG/91/027 dated 07/02/1991 (marked P9) for US$ 56,733.25 in favor of the Plaintiff.

[12] The operative parts of P6 and P9, referred to above is as follows:

In P6:

"Whereas Won Ji Industrial Co. Ltd 550-1, Garibong Dong, Guro Ku. The 3rd Export-Industrial Zones, Seoul, Korea (hereinafter referred to as the "Contractor") have entered into a tender for the supply of 150 MT Triple Laminate Foil "Lakspray" "Vita Milk" and "Vita Spray" pack to be shipped on or before 31.05.1991 with the Lanka Milk Foods (CWE) Ltd. Welisara, Ragama (hereinafter referred to as the "Obligee")…"

"If the Contractor shall fail in the due and punctual performance and fulfillment of the contract above referred to and upon the said Obligee requesting to the said Bank of Credit & Commerce International (overseas) Ltd. Colombo a statement signed by a duly authorized signatory of the said Obligee that the said contractor has failed in the contractual obligations then and in that case to make payment to the said Obligee sum of US$ 72,730.23 (United States dollars seventy-two thousand seven hundred and thirty and cents twenty-three only) ---"

In P9:

"Whereas Won Ji Industrial Co. Ltd 550-1, Garibong Dong, Guro Ku. The Third Export-Industrial Zone, Seoul, Korea (hereinafter referred to as the "Contractor") have entered into a tender for the supply of 105 Metric Tonnes Triple Laminate Foil "Lakspray" "Vita Milk" Pack to be shipped on or before August 31 1991 with the Lanka Milk Foods (CWE) Ltd. Welisara, Ragama (hereinafter referred to as the "Obligee"…)

"If the Contractor shall fail in the due and punctual performance and fulfillment of the tender above referred to, and upon the said obligee requesting to the said Bank of Credit & Commerce International (overseas) Ltd. Colombo a statement signed by a duly authorized signatory of the said Obligee that the said contractor has failed in the contractual obligations then and in that case to make payment to the said Obligee sum of US$ 56,733.25 (United States dollars fifty-six thousand seven hundred and thirty-three and cents twenty-five only) ---"

[13] Paragraph 3 of the Performance Bonds marked P6 and P9 contained agreements and declarations, inter alia, which state that,

- In case of impossibility to perform in accordance with the obligations as stipulated in the said paragraph, then in such instance the said Bonds shall cease and the liability shall thereupon be extinguished.
- This bond will remain in force from October 15, 1990 to December 31, 1991,

  All claims under this Bond are payable in Colombo and must be made on or before 31st December 1991. (P6)
- This bond will remain in force from January 31, 1991 to January 1992, both days inclusive.

  All claims under this Bond are payable in Colombo and must be made on or before January 31, 1992. (P9).

[14] In paragraphs 13, 15 and paragraphs 24, 26 of the Plaint, for a first and second cause of action, respectively, the Plaintiff stated that, since the Contractor failed in the said contractual obligations, the Plaintiff by writing dated 18/12/1991, marked P7, addressed to the Defendant, demanded payment of the monies due under the aforesaid Performance Bonds, P6 and P9 from the Industrial Bank of Korea relying on the said Performance Bonds and the Counter Guarantee issued by the Industrial Bank of Korea to BCCI, in the same terms as the guarantors undertaking to the beneficiary.

[15] Claiming, in Paragraphs 19 and 30 of the Plaint, that the Defendant has made default in the payment of the aforesaid sums to the Plaintiff, though obliged to do so on demand, the Plaintiff has filed this action as aforesaid, for the recovery of the said sums together with legal interest.

[16] The Defendant filed Answer dated 02/07/1993 and stated *inter alia*, that the Plaint does not disclose a cause of action, alleged that the action is prescribed in law, denied any liability on the alleged transaction set out in the Plaint, and prayed for the dismissal of the Plaint.

[17] Having considered the pleadings, the evidence led in Court and the written submissions tendered by the respective parties, the learned Commercial High Court Judge, by Judgment dated 20/02/2007, held in favour of the Plaintiff and awarded the reliefs prayed for in the Plaint.

[18] Being aggrieved by the said Judgment of the Commercial High Court the Defendant-Appellant filed a Petition dated 29/03/2007 in this Court, whereby, *inter alia*, has sought the said Judgement dated 20/02/2007 delivered by the Commercial High Court be set aside.

[19] When this matter was taken up for hearing before this Court the learned President's Counsel for the Defendant-Appellant raised the following legal positions, which in his submission, would deprive the Plaintiff-Respondent to have and maintain this action;

a. in terms of the Regulations made by the President under section 5 of the Public Security Ordinance, can the Monetary Board of the Central Bank of Sri Lanka, acting under and in terms of the Emergency (Banking Special Provisions), Regulations No. 2 of 1991 (P4), vest the business of BCCI in Sri Lanka, in the Defendant Bank,

b. the relevant Bonds P6 and P9 are not 'On Demand' guarantee bonds but 'Conditional Bonds',

c. plaintiff has not taken steps against Wong Ji Industrial (the contractor) for its failure in the due and punctual performance and fulfilment of the contract,

d. no proper claim/call on P6 and P9 related to the supply of Triple Laminated Foil,

e. the Plaintiff's claim is excessive and thus unlawful.

[20] The legal position in paragraph (a) above, was raised for the first time in these proceedings by the learned President's Counsel for the Defendant Bank, as a preliminary objection to the maintainability of this action. The Court having decided that the said question makes out a 'pure question of law,' permitted the respective Counsel to address the Court on the said question of law.

Legal Validity of the Emergency (Banking Special Provisions) Regulations No. 2 of 1991.

[21] Section 2(1) of the Public Security Ordinance reads thus:

"Where, in view of the existence or imminence of a state of public emergency, the President is of opinion that it is expedient so to do in the interests of public security and the preservation of public order or for the maintenance of supplies and services essential to the life of the community, ----"

[22] This provision grants the President broad discretion in determining whether the implementation of a regulation is necessary. The expressions "in the interest of" and "Public Order" within the confines of emergency regulations have been given a wide connotation by this Court in the case of ***Yasapala v. Ranil Wickramasinghe and Others*** [1]. In this case, the Court held that a regulation may not have been directly designed to maintain public order, yet it may have been enacted "in the interest of public order." The Court was also of the view that "Public Order" was an expression of wide connotation and signifies the state of tranquility that prevails among members of a political society.

[1] S.C. Application 103 of 1980, S.C. Minutes of 8 .12 .80 .

[23] The Court also emphasized that the existence of such a state of emergency is not a justiciable matter that the courts be called upon to determine by applying an objective test. This principle was consistently upheld and more fully emphasized in ***Weerasinghe v. Samarasinghe***[2], ***Bank of Ceylon v. Bogala Graphite***[3], ***Janatha Finance and Investments Ltd. v. Liyanage and others***[4]**.**

[24] As established in the case of Yasapala, the President's belief in the necessity or expediency of an emergency regulation is deemed conclusive of its validity, as he is not bound as a matter of law to disclose the reasons for the proclamation. This principle aligns with the reasoning in ***Carltona Ltd. v Commissioners of Works***[5] (cited by Sharvananda J. in ***Yasapala v Wickramasinghe***[6]), where it was held:

"All that the Court can do is to see that the power which it is claimed to exercise is one which falls within the four corners of the power given by the legislature and to see that those powers are exercised in good faith. Apart from that, the Courts have no power at all to inquire into the reasonableness, the policy, the sense, or any other aspect of the transaction."

[25] This validation was reiterated in ***R v. Comptroller General of Patents***, ***ex. P. Bayer Products Ltd***[7], where it was held that if a regulation is good on its face, the necessity, or the expediency of making such regulation could not be canvassed in the courts.

However, it is pertinent to note that the finality clause under Section 8 of the Public Security Ordinance does not exempt emergency regulations from judicial review. This was stated in ***Siriwardena and others v. Liyanage and others***[8],

[26] In ***Edirisuriya v. Navaratnam and Others***[9] the Court was of the view that when the exercise of such power is challenged, it is open to the Court to examine whether the impugned power has been exercised as required by law in the circumstances under

[2] [1966] 68 NLR 361
[3] 77 NLR 385
[4] [1983] 2 SLR 111
[5] [1943] 2 All ER 560, 564.
[6] Supra (n1)
[7] [1941] 2 K.B. 306.
[8] [1983] 2 SLR 164
[9] [1985] 1SLR 100, 112

which alone such powers could have been exercised. *“**Once the existence of the facts and circumstances upon which a reasonable man could have so acted is established to the satisfaction of the Court**, the ‘Judicial intrusion’ should then come to a halt”* (emphasis is mine)

[27] The Gazette notification dated 28th December 1991 explains the background in which the control of BCCI bank was vested in the Defendant Bank and justifies the implementation of emergency financial regulations.

[28] Regulation 2 states, Where upon a report …. the Monetary Board of the Central Bank of Sri Lanka is satisfied that any licensed commercial bank incorporated outside Sri Lanka is unable to carry on business in Sri Lanka, or is unable to meet the demands of its depositors and other persons who have had transactions with such Licensed Commercial Bank (hereinafter referred to as the ‘Defaulting Bank’), and that its continuance in business is likely to involve **serious economic loss** to and to **adversely affect the Monetary and bank system of the national economy**, the board may notwithstanding the provisions of any other law to the contrary, by the Order published in the Gazette vest, the business, of such defaulting bank in another licensed commercial bank (hereinafter referred to as the ‘Acquiring Bank’) which consents to such vesting. (emphasis is mine)

[29] Therefore, with the justification provided in the said Gazette notification and the failure on the part of the Petitioners to substantiate any claim of *mala fides* or where the law is stretched beyond its legal confines, I am of the view that the impugned regulation remains valid within the framework of the Public Security Ordinance.

Acquiescence to the Gazette by the Defendant Bank

[30] The Gazette notification dated 28th December 1991 reads thus:

3 (1) No order under regulation 2 shall be made by the Board unless-

a) ----

b) the proposed acquiring bank agrees in writing to comply with all such terms and conditions as may be specified by the Board relating to the manner in which the existing assets of the defaulting Bank are to be used and the existing liabilities of the defaulting bank are to be met.

(2) Upon making of an order under regulation 2-

(a) the acquiring bank shall comply with such terms and conditions as may be specified by the Board under paragraph (1) of this regulation and such other direction as the Board may lawfully give.

[31] In terms of the above provisions, the Defendant Bank, by its conduct has unequivocally acquiesced to the vesting order and was in control of the financial affairs of BCCI, including its contractual obligations. Assuming authority in the banking business of BCCI, it benefited from the transfer of assets while also becoming responsible for its liabilities. The Defendant Bank did not challenge the validity of the vesting order at the time of its execution. It is observed that the objection to the validity of the vesting order is taken up for the first time when sued for default of its contractual obligations.

[32] Moreover, the principle of estoppel by conduct prevents a party from accepting the benefits of a legal order while simultaneously repudiating its obligations. I find that the Defendant Bank is estopped from denying its liabilities and shall be bound by its obligations arising out of the vesting order. By accepting the vesting order and acting upon it, the Defendant Bank is precluded from denying its liabilities arising from the said performance bonds.

Valid Authorization of Signatories

[33] In the proceedings before the Commercial High Court, the Plaintiff's position was that a demand had been made on the Performance Bonds (marked P6 and P9) through a document dated 18/12/1991 (marked P7). The demand stated that the Contractor had "failed in the due performance of their contract for the supply of 105

M/T and 150 M/T of Triple Laminate Foil to Lanka Milk Foods (CWE) Ltd." The demand was signed by authorised signatories, i.e. the Directors authorised by a Board resolution (marked P17) and the Finance Manager.

[34] In proceedings before the trial court, the position of the Defendant Bank was that the signatures placed in the demand marked P7, were not by authorised signatories and therefore had no legal validity in terms of the law. However, a Board resolution passed by the Plaintiff Company with the authorised signatures was tendered in evidence marked P17. It is noted that the Defendant Bank at no stage of the trial, contested the validity of the said Resolution marked P17.

[35] The said Resolution (P17), has authorised and mandated persons named therein, to act on instructions regarding any accounts or transactions of the Plaintiff Company. It provided that "one of the two signatories should be the Acting Finance Manager and only in his absence any two of the other persons" named are authorised to sign on behalf of the Plaintiff Company. It is in evidence that when P7 demand/call was made, the Defendant Bank never took up the position that the signatures placed were not by authorised signatories.

[36] Having considered the objections raised by the Defendant Bank and the facts and circumstances referred to above, the learned Judge of the Commercial High Court concluded that "the objection raised by the Defendant regarding the purported requirement of the demand having to be signed by an authorised signatory in my opinion, merits no consideration." I too see no reason to depart from that stand.

Quantifying damages

[37] During cross-examination, it was suggested to the Plaintiff's witness that "a claim on a Performance Bond, regardless of its value, is limited to the actual damages suffered." The Defendant's position was that the beneficiary had failed to quantify the damages incurred due to the Contractor's actions before lodging the claim. It was also the position of the Defendant, that if there were defects in the goods

supplied, the beneficiary should have availed himself to institute an action against the Contractor or referred the matter to Arbitration.

[38] Responding to the above, the Plaintiff's position was that due to the deficiency in delamination, the loss caused to the Plaintiff was around 17% of the contract value and that this action was filed to sue the banker on the Performance Bond and not on the contract entered with the Contractor.

The quantification of damages shall be discussed in detail in the latter part of this judgement.

Are the Performance Bonds 'On Demand' guarantee Bonds or 'Conditional Bonds'

[39] The learned President's Counsel for the Defendant Bank argued that if a Performance Bond is to be construed as an 'on demand' Bond, it requires extremely clear wording, and Performance Bonds P6 and P9 do not qualify as such. The Court's attention was drawn to the term:

"That the contractor has failed in the contractual obligations then and in that case to make payment to the oblige sum of …"

It was submitted that the phrase *"then and in that case"* makes the payment conditional, requiring the Plaintiff to first obtain an adjudication that Wong Ji Industrial (the contractor) is in breach of contract prior to seeking relief from the Defendant under the contested Bonds.

[40] Regarding P6 and P9, the learned President's Counsel for the Defendant Bank further submitted that no proper claim or call was made. He argued that P6 and P9 require the Plaintiff to make an independent claim through a statement that the Contractor is in breach. It was emphasized that the precise terms of the Bond must be strictly followed when making a claim or call under it.

In my view, this position raises two key questions.

- does the term "'and in that case' to make payment to the said Oblige sum of ----," make the underlying relationship between the Contractor and the Beneficiary conditional, thereby necessitating the institution of an action for breach of contract against the Contractor to prove the underlying liability before seeking relief from the Defendant Bank based on the Performance Bond?
- has the qualifying event been sufficiently identified?

[41] The Bonds in question marked P6 and P9, are termed as Performance Bonds. Whatever the terms used, 'Performance Bond,' Demand Bond,' 'Performance Guarantee' and 'Demand Guarantee' can be used interchangeably and are recognized in law as such. The said interchangeability was appreciated in ***Edward Owen Engineering Ltd. v. Barclays Bank International Ltd***[10]***,*** where Lord Denning MR began his judgment by stating:

"This case concerns a new business transaction called a performance guarantee or a performance bond."

[42] A Performance Bond generally takes the form of a demand guarantee, where liability is triggered by a demand in the form of a statement that the applicant is in breach of its obligations under the underlying relationship.

[43] As discussed earlier in this judgment, upon the beneficiary's assertion that the Contractor has failed in the due and punctual performance and fulfilment of the contract, the Defendant is obliged to make payment to the Obligee. On its proper construction, the Performance Bonds are payable on demand. As in P6 and P9, when the breach of contract by the Contractor and the payment obligation by the Obligee is expressed in plain terms, the banker 'must and should' pay on first demand.

[44] Where an instrument contains an undertaking to pay 'on demand' (with or without the words 'first' and/or 'written'); and does not contain clauses excluding or limiting the defences available to a surety; 'it will almost always be' construed as a demand

[10] [1978] QB 159, 164

guarantee. (***Howe Richardson Scale Co. Ltd. v. Polimex-Cekop and National Westminster Bank Ltd.*** [11]).

[45] In determining whether a guarantee is payable upon demand or requires proof of underlying liability factors such as the inclusion of a principal debtor clause may be used to interpret the instrument. Clauses that restrict or exclude defences available to the guarantor, or the use of phrases like "on demand," can aid interpretation but are not decisive on their own.

[46] As explained in Paget's Law of Banking[12], when interpreting guarantees, it is important to recognize that a demand guarantee will inevitably reference:

- the contractual performance it secures; and
- the conditions under which a demand can be made, namely the principal's default.

A simple promise to pay on demand, without any reference to the principal's obligations, would leave room for fraudulent claims. This is because the principal would have no basis to argue that the demand relates to an obligation not covered by the guarantee. In other words, the guarantee must still be tied to the underlying contract to provide clarity and protection against unjustified claims.

[47] As held in ***Siporex Trade SA V Banque Indosuez***[13] *"The whole commercial purpose of a performance bond is to provide a security which is to be readily, promptly, and assuredly realisable when the prescribed event occurs; a purpose reflected in the provision here that it should be payable 'on first demand.'"*

[48] In the present case, the beneficiary, when making the demand for payment, claimed that the Contractor had failed in the due performance of the contract. In my view, the words "the contractor has failed in the due and punctual performance and the fulfilment of the contract" on its true construction create no ambiguity to assert a

[11] [1978]1 Lloyds Rep 161
[12] John Odgers QC (ed), Paget's Law of Banking (15th edn, Butterworths Law 2018) ch 35, [35.8].
[13] [1986] 2 Lloyd's Rep 146, 158

claim to require the payment on demand specified in the guarantee, without any objection, contestation, or defense.

[49] It is also observed that the Defendant Bank never complained about the qualifying event for the recovery of the money due to the Beneficiary on non-compliance by the Contractor of the terms and conditions of the Performance Bonds or any discrepancy that would justify withholding or rejecting the demand.

[50] In ***Esal Commodities Ltd. And Reltor Ltd. V Oriental Credit Ltd and Wells Fargo Bank NA***[14] the words "*we undertake to pay the said amount on your written demand in the event that the supplier fails to execute the contract in perfect performance*" were construed not to require the beneficiary to prove a failure to perform.

'Autonomous nature' of a demand guarantee

[51] As pointed out earlier, the Defendant Bank submitted that the Plaintiff should limit itself to the actual loss and damages suffered as a result of the breach of contract therein, underlining the importance of the contractual relationship between the parties. When the Defendant asserts that the Plaintiff has not taken steps against the Contractor prior to seeking relief from the Defendant, it is in fact, questioning the 'autonomous nature' of a demand guarantee.

[52] The difference between a traditional guarantee (suretyship) and a demand guarantee lies in the nature of the liability. In a traditional guarantee, the surety's liability is secondary and dependent upon the principal debtor's default. The creditor must prove such default to enforce the surety's liability.

[53] In contrast, a demand guarantee creates a primary obligation for the issuer (the Defendant Bank in this case), which is triggered solely by a demand from the beneficiary, regardless of disputes between the beneficiary and the principal debtor. The demand guarantee operates autonomously from the underlying contract, meaning the guarantor is detached from disputes or claims arising from that contract.

[14] [1985] 2 Lloyd's Rep 546

[54] The principle of autonomy is reflected in Article 5(a) of the International Chamber of Commerce (ICC) Uniform Rules for Demand Guarantees (URDG), which states: *"A guarantee is by its nature independent of the underlying relationship and the application, and the guarantor is in no way concerned with or bound by such relationship. A reference in the guarantee to the underlying relationship for the purpose of identifying it does not change the independent nature of the guarantee. The undertaking of a guarantor to pay under the guarantee is not subject to claims or defenses arising from any relationship other than a relationship between the guarantor and the beneficiary."*

Paget's Law of banking[15], referring to a number of decided UK case laws observes that;

"It is hoped that the revised URDG are to be incorporated into more demand guarantee contracts worldwide."

[55] A Guarantor can challenge the validity of an instrument by asserting fraudulent conduct or misrepresentation by the beneficiary. In such instance the Guarantor may decline payment when a sufficient case of fraud is made out, entitling the Guarantor to refuse to honor the guarantee. However, in this case, no such allegation of fraud was pleaded or led in evidence by the Defendant Bank.

[56] However, if a Beneficiary claims more than they are entitled to under a demand guarantee, there is an implied obligation for them to repay the excess amount to the principal. This duty applies even if the principal has already reimbursed the bank. The repayment obligation arises once the overpayment amount is determined, either by agreement or a court ruling, and must be dealt with in a separate suit.

[57] Regarding the legal position on bank guarantees, the Plaintiff, in their written submissions to the Commercial High Court and this Court, cited several decided cases from the UK and Sri Lanka.

[15] Supra [n12] ch 35, [35.2].

In ***Edward Owen Engineering Ltd. v. Barclays Bank International Ltd***[16]**.**

It was held that *"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 honor 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 contractual obligation or not; nor with the question whether the supplier is in default or not. The banker 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"*

[58] In the words of Kerr J. in ***R. D. Harbottle (Mercantile) Ltd. v. National Westminster Bank***[17], cited with approval by Lord Denning MR. in the above-mentioned judgement, *"…the machinery and commitments of banks are on a different level. They must be allowed to be honored free from interference from courts. Otherwise, trust in international commerce could be irreparably damaged."*

[59] In ***Hydrabad Industries ltd. v Idac Trading (Pvt) Ltd and two others***[18] it was held that

"…A confirmed letter of credit constitutes a bargain between the banker and the vendor of goods, which imposes on the banker an absolute obligation to pay irrespective of any dispute which there may be between the parties on the question whether the goods are up to contract or not. An elaborate commercial system has been built up on the footing that bankers' confirmed credits are of that character, and it would be wrong for the court to interfere with that established practice. The system of financing these operations would break down completely if a dispute between the vendor and the purchaser were to have the effect of 'freezing' the sum in respect of which the letter of credit was opened. The court's jurisdiction to grant injunctions is wide, but this is not a case in which, in the exercise of the court's discretion, it ought to grant an injunction."

[16] [1978] 1 All ER 976
[17] [1977] All ER 862, 870
[18] [1995] 2 SLR 304

[60] The Appellate Courts in Sri Lanka, in various instances, have propounded Bonds and irrevocable letters of credit as 'the life blood of international trade.' In many instances, the trial court judges have been put on notice to be mindful not to intervene and/or disturb the banker's obligation to pay and that it should be left free to honor its contractual obligation.

In ***Telecommunication Consultants India Ltd. v. Pan Asia Bank Ltd***[19]**.**, TCIL, an Indian company, entered into a contract with Nipuna Teleconstructions (Pvt) Ltd. and obtained an Advance Payment Guarantee from Pan Asia Bank to secure the contract. When Nipuna failed to perform its contractual obligations, TCIL demanded payment under the guarantee. However, the bank delayed payment and allowed Nipuna to obtain an *ex-parte* injunction from the District Court, blocking payment for over two and a half years. Once the injunction lapsed, the bank still refused to honor the guarantee, pleading fraud on the part of the TCIL. The Supreme Court ruled in favor of TCIL, and held that banks must honor guarantees on demand, regardless of disputes between contracting parties, and that the only valid exception is proven fraud, which the bank failed to establish in this case.

Similarly, in ***Hemas Marketing (Pvt) Ltd. v. Chandrasiri and Others***[20], held that

"A guarantee is an accessory contract by which the promisor undertakes to be answerable to the promisee for the debt, default, or miscarriage of another person whose primary liability to the promisee must exist or be contemplated. Bank Guarantees were established as a universally acceptable means of payment equivalent to cash in trade and commerce, on the basis that the promise of the issuing bank to pay was wholly independent of the contract between the buyer and seller and the issuing bank would honour its obligations to pay regardless of the merits or demerits of the dispute between the buyer and the seller."

Indica Traders (Pvt) Ltd. v. Seoul Lanka Construction (Pvt) Ltd. and Others[21] reaffirmed that courts should not interfere with a bank's obligation to honor

---

[19] SC CHC 36/2006 decided on 24.11.2017

[20] [1994] 2 SLR 181

[21] [1994] 3 SLR 387

guarantees unless fraud is clearly established. The dispute in this case, arose from a construction contract where Indica Traders alleged that Seoul Lanka Construction wrongfully terminated the contract and sought to prevent the enforcement of an Advance Payment Guarantee and a Performance Bond. The Court held that bank guarantees are independent financial instruments, distinct from the underlying contractual disputes. In this case, the plaintiff's fraud allegations were uncorroborated and appeared to be an afterthought to justify the injunction. The court held that a contract violation or an overpayment does not constitute fraud unless it is so severe that it undermines the entire transaction.

[61] In the facts and circumstances of this case it is observed that;

I. the payment under the performance Bond/Guarantee was restrained by the Defendant Bank with no challenge to the validity of the Bond/Guarantee itself.

II. there was no condition precedent precluding or limiting the right to draw on the instrument that would restrain the beneficiary.

III. no knowledge of fraud to the notice of the Defendant Bank.

IV. although not incorporated into P6 and P9, the persuasive value of Article 2 of the ICC Uniform Rules for Demand Guarantee 1991 [revised in 2007 and 2010], calls for due compliance to recognise the autonomy of the Performance Guarantee from the underlying contractual relationship.

[62] In these circumstances, the question to be asked is why the Defendant Bank, prevented the beneficiary from drawing on the instrument in terms of the underlying contract when there was no substantial challenge to its validity. The Defendant Bank has failed to answer this question to the satisfaction of this Court. Therefore, the irresistible conclusion that this Court can come to is that by preventing the drawing on the said Performance Bonds, the Defendant Bank has defaulted in the discharge of its contractual obligations towards the beneficiary,

[63] International commerce attaches great significance to Bank Guarantees/Performance Bonds as pioneering financial instruments that bring greater stability and accountability to principals [exporters and importers alike] involved in international trade. Therefore, when an action is filed challenging the validity of such instrument, the courts should not interfere lightly with its due performance. Even in the first instance, where an *ex-parte* order is sought to restrain payment when "the beneficiary has on the face of it made a fraudulent demand, he must normally be given the opportunity to answer the allegation" (***Bolivinter Oil SA v. Chase Manhattan Bank***[22]).

[64] When fraud is affecting the validity of an instrument, the courts are compelled to act with caution not to permit deception or fraud by a party, which can cause irreparable reputational loss and/or damage to a guarantor. At the same time, unless the fraud exception applies, the courts should refrain from interfering or restraining a legitimate call/demand on a Guarantee.

[65] In the words of banker, M.C.V. Rajanathan,

"in exceptional circumstance, such as fraud, the Courts do intervene with an injunction or restraining order, --- any claim made by the beneficiary should be expeditiously settled and there should be no hesitation on the part of the bank in honoring the claim.---, whenever a claim is made on a Bank Guarantee within the expiry date, it is the obligation of the Banker to pay immediately on demand. All Banks generally issue unconditional guarantees, hence there is no excuse whatsoever for banker i.e., the guarantor to delay or refuse settlement. In other words, ***Bankers should understand their lips are sealed when a claim is made within the expiry****.*[23]*"* (emphasis is mine)

[66] For all the above reasons I am of the view that the Plaintiff has asserted its position taken in the Plaint dated 26/11/1992, in the evidence led before Court, to establish

---

[22] [1984] 1 Lloyd's Rep 251, 257

[23] Rajanathan M C V, Lending Against Collateral (Sarasavi Publishers) 231–233.

that the Plaintiff should be granted the reliefs as prayed for in the Plaint, in terms of prayers (a) (b) (c) and (d) as affirmed by the impugned Judgment dated 20/02/2007.

[67] In all the above circumstances, I answer all questions of law in favour of the Plaintiff and uphold and affirm the Judgement dated 20/02/2007 of the Commercial High Court. Accordingly, this Appeal is dismissed with costs fixed at Rs. 400,000/-

Judge of the Supreme Court

S. Thurairaja, PC, J.

I agree

Judge of the Supreme Court

Mahinda Samayawardhena J.

I agree

Judge of the Supreme Court