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A LEGAL PERSPECTIVE OF BANK GUARANTEE SYSTEM IN INDIA

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ABSTRACT

The study examines the nature and scope of bank guarantee system in India. The present study is concerned with the law relating to the bank guarantees particularly embodied in the Indian Contract Act 1872. The present paper also puts light on the economic functions and benefits of the bank guarantees. Besides that, this study also explains the various types of guarantees issued by the banks in India. This study is a doctrinal study. For this research, relevant statutory material has been examined. The decisions of the Supreme Court regarding bank guarantees had been consulted. The purpose of this study is to make systematic evaluation of law and judicial approach relating to bank guarantee system in India.

KEYWORDS

Nature and scope of Bank guarantee, Payment under bank guarantee, Safeguards taken by banks.

INTRODUCTION

A guarantee is a promise to answer for the payment of some debt, or the performance of some duty, in case of the failure of another party, who is in the first instance, liable to such payment or performance. 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 promise must exist or be contemplated.¹ Guarantee, is an undertaking to be collaterally responsible for the debt default or miscarriage of another. In a banking context it is an undertaking given by the guarantor to the banker accepting responsibility for the debt of the principal debtor if he defaults, the guarantor may or may not be a customer. A contract of guarantee is thus a secondary contract, the principal contract being between the creditor and the principal debtor themselves. If the promise or liability in the principal contract is not fulfilled or discharged only then the liability of the surety arises.

OBJECTIVES

The objectives of this study are

- to make systematic evaluation of law relating to bank guarantee system in India
- to make systematic evaluation of judicial approach relating to bank guarantee system in India
- to make systematic evaluation of policies relating to bank guarantee system in India

METHODOLOGY

The present study is a doctrinal study. In this study, relevant statutory material has been examined. The decisions of the Supreme Court regarding bank guarantee system published in various journals have been consulted. The various reporters, digests and manuals have also been consulted. The statutory material and the various decisions of the courts related to bank guarantee system from various reference and text books have been analysed.

DEFINITION

Section 126 of Indian Contract Act, 1872 defines a contract of guarantee as a contract to perform the promise, or discharge the liability, of a third person in case of his default. The section further provides that the person who gives the guarantee is called the "Surety", the person in respect of whose default the guarantee is given is called the "principal debtor", and the person to whom the guarantee is given is called "Creditor". A guarantee may either be oral or written. For example, A takes a loan from a bank. A promises to bank saying that if a does not repay the loan "then I will pay". In this case A is the principal debtor, who undertakes to repay the loan; B is the surety, whose liability is secondary because he promises to perform the same duty in case there is default on the part of A. The bank, in whose favour the promise has been made, is the Creditor. The object of a contract of guarantee is to provide additional security to the creditor in the form of a promise by the surety to fulfill a certain obligation, in case the principal debtor fails to do that.¹

In every contract of guarantee, there are three parties, the creditor, the principal debtor, and the surety. There are three parties in a contract of guarantee. Firstly, the principal debtor himself makes a promise in favour of the creditor to perform a promise, etc. Secondly, the surety undertakes to be liable toward the creditor if the principal debtor makes a default. Thirdly, an implied promise by the principal debtor in favour of the surety that in case the surety has to discharge the liability on default of the principal debtor, the principal debtor shall indemnify the surety for the same.²

¹ *Halsbury's Laws of England*, "Guarantee and Indemnity", 4th edn, reissue, vol.20, para 101

² Nagpur N.S. Bank V. Union of India A.I.R. 1981 A.P. 153 at 158

³ Suresh Narain V. Akhauri A.I.R. 1957 Pat. 256

⁴ According to section 140 of Indian Contract Act, 1872 after the Surety has made the payment or performed the duty on default of the principal debtor, he is conferred with the same rights which the creditor had against the principal debtor

⁵ According to section 141 of Indian Contract Act, 1872 'A surety is entitled to the benefit of every security which creditor has against the principal debtor at the time when the contract of surety ship is entered into, whether the surety knows of existence of such surety or not.

⁶ According to section 145 of Indian Contract Act, 1872 after making the payment to the creditor by the surety, he can recover the same from the principal debtor. Such a claim can be made by the surety only in respect of the sums he has rightfully paid under the Guarantee, but no sums which he has paid wrongfully.

The contract of guarantee is no doubt tripartite in nature but it is not necessary or essential that the principal debtor must expressly be a party to that document.³ In a contract of guarantee, the principal debtor may be a party to the contract of implication. Thus there is a possibility that a person may become a surety without the knowledge and consent of the principal debtor. In such a case, the rights of the surety are given in sections 140, 141 and 145 of Indian Contract Act, 1872 viz, the right of subrogation,⁴ right to securities with the creditor⁵ and the right of indemnity against the principal debtor⁶, respectively.

In English Law a guarantee is defined as "a promise to answer for the debt, default or miscarriage of another".⁷ It is a collateral engagement to be liable for the debt of another in case of his default. "Guarantees are usually taken to provide a second pocket to pay if the first should be empty."⁸

According to section 126 of Indian Contract Act, 1872 a Guarantee may be either oral or written. On this point the position in India is different from the England. According to English Law, for a valid contract of Guarantee, it is necessary that it should be in writing and signed by the party to be charged therewith.

ESSENTIAL FEATURES OF GUARANTEE

The essential features or elements of a valid contract of Guarantee are⁹

1. There must be a debt existing, which should be recoverable.
2. There must be three parties' i.e. principal debtor, creditor and surety.
3. The contract of Guarantee may be either oral or written.
4. There must be a distinct promise, oral or written, by the surety to pay the debt. In case of default, committed by the principal debtor.
5. There should be no misrepresentation or concealment of any material facts concerning the transaction.
6. Sometimes a contract of Guarantee is implied also from the Special Circumstances. For example the endorser of a bill of exchange is liable to pay the amount of the bill to the payee in case of the acceptor of the bill defaults to fulfill his promise.
7. The principal debtor must be primarily liable. Surety's Liability arises only in case of default of the principal debtor.
8. There should be some consideration. Benefit to the principal debtor is sufficient consideration.
9. The liability under Guarantee must be legally enforceable.
10. The Contract of Guarantee must have all the essentials of a valid contract.

In England there is no statutory law governing bank guarantees. Therefore, English courts are content by stating that the banks should be left free to perform their obligations under the agreements of bank guarantees, however in India Courts necessarily have to keep in view the provisions of the Indian Contract Act, 1872, applicable to the bank guarantees² those provisions have to be read into each contract of Bank Guarantee.¹⁰

By virtue of Section 126 of Indian Contract Act, 1872, every bank guarantee is a tripartite contract between banker, the beneficiary and the person at whose instance the bank issues the guarantee. Bank Guarantees are guarantee given by Suppliers/Contractor's Bank in favour of the Buyer/Principal:

- (i) towards earnest money deposit;
- (ii) as security against performance of the contract ;
- (iii) as security against initial and stage payment made by the Buyer to the Supplier;
- (iv) towards liquidated damages in exceptional cases of large value contracts;
- (v) towards guaranteeing specified operational parameters of the equipments;
- (vi) towards meeting warranty claims in respect of equipment ; or
- (vii) towards performance of maintenance during a specified period (usually one year) in respect of Civil Works Contracts.

Bank guarantees lead to invoking the payment only if there is default by the Supplier/Contractor. Bank Guarantees figure therefore as a contingent liability in the accounts of a bank which has furnished it and the Supplier / Contractor on whose behalf it has been furnished.

Bank Guarantees should be unconditional guarantees by the Bank to the beneficiary (Buyer/Principal) undertaking to pay the sum specified in the guarantee on demand and without demur. It is well established law that when a bank guarantee is given by a bank to the beneficiary, a contract comes into being between the bank and the beneficiary, independent of the main contract between the Buyer /Principal and the Supplier / Contractor. Thus, two contracts and three parties come into existence when a contract is entered into which provides for bank guarantees being furnished. A bank has to honour its undertaking when the guarantee is invoked, without reference to the party on whose behalf it has been issued, notwithstanding any disputes or disagreements that might have arisen in the mean time between the Buyer / Principal and the Supplier /Contractor.

The right of the beneficiary under a bank guarantee is governed by the bank guarantee itself and not by the terms and conditions of the original contract. The bank guarantee is a contract separate from the original contract. The bank guarantee is not a party to the original contract. The party at whose instance the bank guarantee is furnished pursuant to the original contract is not a party to the guarantee.

Whether it is a financial guarantee, a performance guarantee or a letter of credit established by a bank, it is a contract under section 126 of Contract Act 1872 to perform the promise or discharge the liability of a third person on that third person's default. In the case of non-performance or short performance of obligations by its constituents, the bank will be called upon to make good the monetary loss arising out of non-fulfillment of the guarantee obligations to the extent stipulated in the guarantee, to the beneficiary.

The operative clause in bank guarantees is reproduced below:

We, Bank, hereby agree and undertake that, if in your opinion, any default is made by (constituent) in performing any of the terms and conditions of order or if in your opinion, they have committed any breach of the contract or there is any demand by you against....(Constituent), then on notice by you, we shall, on demand and without demur and without reference to(Constituent). Immediately pay in any manner in which you may direct a sum of Rs.....or such portion thereof as may be demanded by you not exceeding the said sum and as you may from time to time require. Our liability to pay is not dependent or conditional on your proceedings againstand we shall be liable to pay the aforesaid amount as and when demanded by you merely on a claim being raised by you and even before any legal proceedings are taken against the constituent. Unless extended, this guarantee shall expire on Notwithstanding anything continued herein above our liability shall be limited to Rs.....

This clause gives unfitted rights to the beneficiary of the guarantee, and the bank has no option but to make the payment of the same on its being invoked. The courts have observed in numerous cases that the liability of the bank under the guarantee is absolute and they would not generally interfere with the contractual obligations of the banker by issuing any injunction against the payment when the guarantee is validity invoked. In enunciating the general principle of non-intervention by the courts in respect of the guarantees and letter of credit the courts intend that trade and commerce should function smoothly without interference from the judiciary. At the sometime, the courts expect businesses to honour their respective commitments and maintain business honesty.

In bank guarantee the bank binds itself to pay, unconditionally and unequivocally without protest or demur or performance by principal debtor. The bank that has issued the guarantee is not concerned with the relationship between the seller and the customer, nor with the question whether the seller performed its contractual obligation or not. The bank must be allowed to honour its commitments in a bank guarantee, otherwise, trust in international commerce will be irreparably damaged respectability and reliability of the assured mode of payment through bank guarantees is necessary for the growth and promotion of trade. In *Basant Rlymers Alwar Vs State Chemical and Pharmaceuticals Corporation of India*¹¹; it was held that banking system is the backbone of the economy and it is necessary that there should be confidence in the banking system itself. If the bank guarantees are not encashable just like a credit note or there is an impediment in encashing the bank guarantee then the whole foundation of the banking system will collapse and the people will lose faith in it. Bank guarantees

⁷ S.4 Statute of Frauds 1677, 29 Car, II, C3

⁸ Wood, *Law and Practice of International, Finance*, (1980) at 295

⁹ Section 126 of Indian Contract Act, 1872

¹⁰ *Nangia Construction India Pvt. Ltd. V. National Building Construction Corporation Ltd.* II (1990) B.C. 51:4 (1990) DLT 359

for purposes, should be taken to be a credit – note issued, and it should be encashable just like a credit not ordinarily, unless the intention of the parties is otherwise.

NO INJUNCTION OF RESTRAINING PAYMENT UNDER A BANK GUARANTEE

Where a bank gives a guarantee to pay on 'first demand' and 'without contestation and 'without reference to such party' or notwithstanding any disputes between the partiesthe guarantee bank is obliged to pay according to the contractual obligation, and the court will not give an injunction restraining the bank for payment.¹² Where the guarantee was enforceable on the importer's failure to take delivery of goods, but it was also provided that the decision of the beneficiary as to whether the importer failed to carry out their obligation shall be final and binding on the bank, was held that the bank could not be restrained from making payment under the guarantee on the Importer's plea that the goods contracted for were not offered for delivery.¹³ The fact that the guarantee issued by the bank is wider in terms, than that agreed between the bank and the debtor is also no reason to grant injunction restraining payment.¹⁴ Where however, there is no unconditional or irrevocable promise to pay in the guarantee in which it was only undertaken to indemnify the company from any loss or damage that was caused to it or was suffered by it by the act of the contractor, it was held that temporary injunction could be granted, restraining the company from realizing the bank guarantee, since the guarantee sought to be enforced amounted to a contract of indemnity and the beneficiary had to show the loss or damage caused to it.¹⁵

It is settled law that a contract of guarantee is a complete and separate contract by itself. The law regarding enforcement of an on demand bank guarantee is very clear. If the enforcement is in terms of the guarantee, then courts must not interfere with the enforcement of bank guarantee. The court can only interfere if the innovation of on demand guarantee in accordance with its terms by looking at terms of the underlying contract.¹⁶

³EXCEPTIONS

Payment under a bank guarantee may be refused or restrained:

1. Where the bank knows that the documents presented by the beneficiary for seeking enforcement are forged or fraudulent.¹⁷
2. Where a fraud by one of the parties to the underlying contract has been established and the bank has notice of the fraud.¹⁸
3. Where a case of apprehension of Irretrievable Injustice is made out.
4. Where the guarantee is conditional and the condition has not been complied with.¹⁹
5. Where the conditions necessary for invoking a conditional bank guarantee have not arisen.²⁰
6. Where the purpose for which a conditional guarantee was given has been accomplished.²¹
7. Where the period stipulated for innovation of the guarantee has expired.²²

In *BSES Ltd. (Now Reliance Energy Ltd) Vs Fanner India Ltd.*²³; it was held that as a general rule that a bank guarantee must be honoured in accordance with its terms there are however, two exceptions:

The first is when there is clear fraud of which the bank has notice and a fraud of the beneficiary from which it seeks the benefit. The fraud must be of an egregious nature as to vitiate the entire underlying transaction.⁴

The second exception to the general rule of non-intervention is when there are special equities in favour of injunction, such as when irretrievable injury or irretrievable injustice would occur if such an injunction were not granted.

LIMITATION PERIOD FOR CLAIMING AMOUNT UNDER BANK GUARANTEE

Under the Indian Limitation Act, 1963, the period for invoking the bank guarantee is 30 years if the beneficiary is government Department or Municipal Corporation and 3 years in all other cases.

Prior to the amendment made by the contract (Amendment) Act, 1996 in Section 28 of the Indian Contract Act, 1872, the bank guarantees used to have a clause that unless the claim under this bank guarantee is made within six months from the expiry of the bank guarantees, the liability of the bank will be extinguished under the guarantee. After the amendment, if a beneficiary of a bank guarantee invokes the bank guarantee with the claim period, for a default committed by the debtor during the validity period, then the bank will not make payment, the beneficiary may file suit against the bank within the period mentioned in the Limitation Act, 1963 and any clause restricting the bank's liability will be illegal and void ab initio. Therefore the bank should obtain the bank guarantee duly cancelled by the beneficiary or a certificate from the beneficiary that there is no claim under the guarantee. If the guarantee, duly cancelled or certificate is not obtained from the beneficiary, the bank should retain the security of the debtor and cash margin till the expiry of the limitation period under the Limitation Act, 1963.

SAFE GUARDS TAKEN BY BANKS

To reduce the risks to which the banks are exposed while furnishing bank guarantees on behalf of their clients, banks resort to the following to safeguard their interest.

(a) Limits

Banks lay down maximum monetary limits upto which they would furnish guarantees and open letters of credit at any point of time. The limits are fixed on the basis of the financial standing, extent to which the account has been maintained by customers satisfactorily, the volume of transactions, past track record of the client in-respect of such guarantees etc. The limits are reviewed and refixed periodically along with monetary limits for overdrafts, cash credits etc.

(b) Margins

Banks lay down maximum monetary limits upto which they would furnish guarantees and open letters of credit at any point of time. The limits are expired on the basis of the financial standing, extent of which the account has been maintained by the customers satisfactorily, the volume of transactions, past track record of the client in respect of such guarantee etc. The limits are reviewed and refixed periodically along with monetary limits for overdrafts, cash credits etc.

¹¹ *AIR* 1986 Raj. 1: 1985 Raj LW 231

¹² *Taxmaco Ltd. V. State Bank of India AIR* 1979 Cal. 44 ; approved in *Uttar Pradesh Co-op. Federation Ltd. V. Singh Consultants and Engrs Pvt. Ltd.* (1988) 1 SCC 174 ; *Tarapore & Co. V. V/o Tractoro Export Moscow* (1969) 2 SCR 960, *AIR* 1970SC 1981, *RD Harbottle (Mercantile) Ltd. V. National Westminster Bank Ltd.* (1977) 2 All ER 862, (1997) 3 WLR 752 *Edward Owen Engg Ltd. V. Barclays Bank Intl. Ltd.* (1978) 1 All ER 976, P 983 (1977) 3 WLR 764, p-773 (a bank must pay on demand), *Dena Bank V Fertilizer Corpn. of India Ltd.* *AIR* 1990 Pat 221, p-223.

¹³ *Allied Resins and Chemicals Ltd. V. Minerals and Metals Trading Corpn. of India Ltd.* *AIR* 1986 Cal. 346

¹⁴ *Hindustan Steel Workers Const. Ltd. V. GS Atwal & Co.(Enggs)Pvt. Ltd.* *AIR* 1996 SC131(1995) 6SCC 76.

¹⁵ *Kudremukh Iron Ore Co. Ltd. V. Korula Rubber Co. Pvt. Ltd.* *AIR* 1987 Kant 139, p-154.

¹⁶ *National Highway Authority of India V Ganga Enterprise AIR* 2003 SC 3823.

¹⁷ (1984) 1 All ER 351, *United City Merchants (Investments) Ltd. V. Royal Bank of Canada* (1982) 2 All ER 720, p-728 (for a discussion) ; *Federal Bank Ltd. v. VM.*

¹⁸ *Bolivinter Oil SA v chase Manhattan Bank* (1984) 1 All ER 351, P-352, (1984) 1 WLR 392

¹⁹ *Banwari Lal Radhe Mohan v. Punjab State Co-op Supply and Marketing Federation Ltd.* *AIR* 1982 Del 357 *Banerjee and Banerjee v Hindustan Steel Works Consm Ltd AIR* 1986 Cal 374

²⁰ *Basic Tele Services Ltd. v. Union of India AIR* 2000 Del 1 (bank Guarantee given to cover withdrawal of bid by a bidder during period of validity of bid could not be invoked where the bidder never withdraw the bid *Kirloskar Pnlumatic Co. Ltd. v. National Thermal Power Corpn Ltd.* *AIR* 1987 Bom. 308

²¹ *Larsen and Toubro Ltd. v. Maharashtra State Electricity Board AIR* 1996 SC, 334 (1995) 6 SCC 68.

²² *Makharia Bros v. State of Nagaland AIR* 1999 SC, 3466 (2000) 10 SCC 503.

²³ *A.I.R.* 2006 SC 1148; (2006) 130 Comp Cas 8 (SC).

The percentage of margin money could range from ten to fifty percent of the value of the guarantees. The margin money will be released once the bank guarantee has expired and is returned to the bank duly discharged.

(c) Counter Guarantee

In addition to fixing limits and taking 'margin money' as security, banks invariably obtain counter guarantees from the client's for equal value before furnishing bank guarantees on their behalf. This document provides the basis for the bank to debit the clients' accounts when it has to honour a bank guarantee invoked by the beneficiary, and to proceed legally against the client, if it is unable to fully reimburse itself of the amount from the client.

BANK GUARANTEE AND ARBITRATION CLAUSE

The enforcement of a bank guarantee cannot be made the subject-matter of arbitration proceeding²⁴ but where a bank found that there was a pending arbitration under which the liability of all the parties had to be ascertained. The Karnataka High Court upheld the decision of the bank to withhold payment.²⁵

ECONOMIC FUNCTION OF GUARANTEE

The function of a Contract of Guarantee is to enable a person to get a loan, or goods on credit or an employment. Some person comes forward and tells the lender, or the supplier or the employer that he (the person in need) may be trusted and in case of any default, "I undertake to be responsible".

BENEFITS OF BANK GUARANTEE

FOR GOVERNMENTS:

1. Increases the rate of private financing for key sectors such as infrastructure.
2. Provides access to capital markets as well as commercial banks.
3. Reduces cost of private financing to affordable levels.
4. Reduces government risk explore by passing commercial risk to the private sector.⁵

FOR PRIVATE SECTOR

1. Reduces risk of private transactions in emerging countries.
2. Mitigates risks that the private sector does not control.
3. Opens new markets.
4. Improves project sustainability.

DIFFERENCE BETWEEN A BANK GUARANTEE AND A USUAL GUARANTEE

Following are some points of difference between a bank guarantee and a usual guarantee

1. A usual guarantee is governed by section 126 of the Indian Contract Act, 1872. A bank guarantee is not directly governed by section 126 of the Indian Contract Act, 1872.
2. An ordinary guarantee is a tri-partite (3 parties) agreement involving the surety, the debtor and the creditor. But a bank guarantee is a contract involving two parties i.e. the bank and the beneficiary.
3. In an ordinary guarantee, the contract between the surety and the creditor arises as a subsidiary to the contract between the creditor and the principal debtor. The bank guarantee is independent of the main contract.
4. In an ordinary guarantee, the inter se disputes between the debtor and the creditor have a material effect upon the surety's liability. However, the bank guarantee is independent of the disputes, arising out of the contract.
5. An ordinary guarantee does not have any time limit before which the debt has to be claimed. Bank guarantees generally have a specific time within which they are functional.

CONCLUSION

Guarantee is an undertaking to be collaterally responsible for the debt, default or miscarriage of another. In banking context it is an undertaking given by the guarantor to the banker accepting responsibility for the debt of the principal debtor if he defaults. Bank guarantees should be unconditional guarantees by the bank to beneficiary undertaking to pay the sum specified in the guarantee on demand and without demur. In bank guarantee the bank binds itself to pay unconditionally and unequivocally without protest or demur or performance of the principal debtor. A bank guarantee is an independent and distinct contract between bank and the beneficiary, and is not qualified by the underline transaction and the primary contract between the people at whose instance the bank guarantee is given. When bank gives absolute and unconditional guarantee then the courts cannot issue an injunction restraining the bank for the payment. The main difference between the ordinary guarantee and the bank guarantee is that in ordinary guarantee the contract between the surety and the creditor arise as a subsidiary to the contract between the creditor and the principal debtor but the bank guarantee is an independent contract from the principal contract.

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²⁴ National Project Constrn. Corp. v.G. Ranjan, *AIR* 1985 Cal 23, U.C.O. V Hanuman Synthetics, *AIR* 1985 Cal 86, Scrap Mould will v. Metal Scrap Trade Corpn (1989) 2 Cal LOT 350, where the court cited United City Merchants (Investments) Ltd. v.I Royal Bank of Canada, (1982) 2 *All ER* 720; United Commercial Bank v. Hanuman Synthetics Ltd., *AIR* 1985 Cal. 96, Synthetic Foams Ltd. v. Simplex Concrete Pipes (India) P. Ltd., *AIR* 1988 Del 207; Hindustan Paper Corpn. V. Keneilhouse Angami, (1990) 1 Cal. LT 200. The court referred to Union of India v. Raman Iron Foundry, *AIR* 1974 SG 1265 ; Centex (India) Ltd. v. Vinmar Impex Inc. (1986) 4 SCC 136 ; *AIR* 1986 SC 1924.

²⁵ Kudremukh Iron Ore. Co. V. Karola Rubber Co. Ltd., *AIR* 1987 Kant 139.

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