BANK GUARANTEE WITH SPECIAL REFERENCE TO EXCEPTION III OF SECTION 28, INDIAN CONTRACT ACT, 1872

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Abstract

A guarantee is considered to be a major facilitator of trade and commerce. When such a function is paired with the reputation of financial institutions such as banks, the result is a tool which has been indisputably considered to be among the most important ones in the arsenal of the participants of trade commerce in the local, national and international markets without which the blood of economy, that is credit and capital, shall cease to flow as freely as it does now. As such the Banks have been granted certain privileges as an incentive for them to play their role in the flow of credit and capital. In this paper, the authors attempt to under that privilege under the statutory regime and the approach of the Courts.

Keywords: *Bank Guarantee, Fraud, National, International, Economy, Courts.*

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INTRODUCTION

"*Garantie*," which translates "*to protect something*" is the origin of the English word "guarantee". Guarantee is a type of contract under the Indian law and has been dealt under Section 126 of the Indian Contract Act, 1872. A contract of guarantee primarily serves the purpose of making it simpler for a person to obtain loan or make a transaction on credit. "*A contract of guarantee can be inferred to accommodate a second pocket if the first one fails.*"[1] In such contracts of guarantee, the party giving the guarantee is known as the surety, the party to whom it is provided is known as the creditor, and the party to whom it is directed is known as the principal debtor. It is crucial to keep in mind that such a promise may be offered orally or in writing at this point. Guarantee is of two types: *specific* and *continuing* guarantees. The specific guarantee, as its name suggests, is restricted to a specific event, whereas under the "continuing guarantee" numerous transactions are covered, as provided under Section 129 of the Indian Contract Act, 1872.

In this paper, the researchers will try to assess and comprehend the concept of bank guarantees and the issues concerning them. The researchers will put special efforts on Exception III of Section 28 under the Contract Act, 1872 that concerns the contracts of bank guarantee. The authors then try to analyse the clauses of exclusion in standard form of contract of guarantee by the bank and the relevance of Section 28 of the Indian Contract Act, 1872 with respect to bank guarantee.

BANK GURANTEE

Under a normal creditor-debtor relationship, there are two main parties,

[1] Philip R Wood, *Law, and Practice of International Finance* (Sweet & Maxwell 1980).

called by the role they play in the transaction – a creditor and a debtor. However, another party may be added to this relationship in order to protect the interests of the creditor – a guarantor. As such the contract of guarantee, which is a unique three-party contract, is where the last party assumes a secondary responsibility of paying the creditor in the event that debtor defaults.[2] Thus, "bank guarantee" is an agreement among three parties - they are "*the banker*, *the Creditor/ beneficiary*, and *the Debtor*" wherein "*the Bank*" performs the role of a surety in the transactions carried on between "*the Creditor*" and "*the Debtor*". This relationship is marked by a formal agreement entered into by a bank with the creditor and the debtor wherein the bank agrees that in case the debtor defaults, the bank would step into the shoes of the debtor and indemnify any loss incurred by the creditor. Since a bank guarantee shields the borrower by enabling the creditor to collect the loan and recover from any plausible loss without having deal with the drawn-out proceedings in the court of law, it is seen as a measure adopted by the markets to promote free trade.[3]

Typically, a bank guarantee stands distinct from the core contract as the banks are not inclined to involve themselves with any disagreements that the first two parties may develop under the core contract. Consequently, the feature entails that regardless of the disputes that the creditors and debtors may have developed under the core contract, the liability of the contracting bank as a surety shall persist. Bank guarantee comes in two broad categories: 1) *conditional bank guarantee* and 2) *unconditional bank guarantee*. Under the first type of bank guarantee the liability of a bank as a surety arises only when the conditions regulating the guarantee are met, whereas in the second type the

[2] Anirudh Wadhwa and Dinshah Fardunji Mulla, *Mulla on the Indian Contract Act* (15th edn, Lexis Nexis Butterworths Wadhwa 2016).

[3] Akshay Anurag, *Bank Guarantee and Judicial Intervention*, MANUPATRA, (2016).

bank is absolutely liable, and the assured amount is payable at the request of the creditor.

It may be safe to say that the intent behind the conception of the contract of the bank guarantee and addition of a third party to the relationship of a creditor and debtor was to facilitate a trust between said parties of the commercial transaction; and such trust would be cemented more so when the assurance comes from reputed institutions such as banks.[4] Commercial transactions are marked by their significant amount of moneys and volumes of goods are frequently traded, and the parties who get involved are typically unwilling to assume the danger in the absence of any guarantee from either party. As such bank guarantee has been utilized in situation such as these as a means of to develop mutual trust between the parties.

In *Pollen Dealcom Pvt. Ltd.* v. *Chambal Fert. & Chem. Ltd.*,[5] the Court ruled that a contract of bank guarantee has to be as a distinct legal obligation which is payable on demand. The Court further declared that this guarantee is appropriate method for use in commercial transactions as it is not really affected by the relationships between the parties. The court further held that, regardless of any current disagreements between the parties, the beneficiary is required to make the full payment under the contract of guarantee.

In *State Bank of India* v. *M.S.S. Karkhana Ltd.*[6], the court ruled that the contract of guarantee must be interpreted in accordance with its own terms and is entirely distinct from the main contract. The Judiciary, through a

[4] K G White, *Bankers Guarantees and the Problem of Unfair Calling*, 2 Journal of Maritime Law Commerce, 121 (1979).
[5] MANU/WB/0031/2010.
[6] (2006) 6 SCC 293.

number of precedents, has gradually established that in such contracts a banker and the debtor bear varied responsibilities. For the purpose of deciding matters involving bank guarantee in the future, the Hon'ble Supreme Court of India established the following guidelines in the case of *HSC Ltd.* v. *Tarapore*[7]:

> "A. *A bank guarantee is a stand-alone agreement and is not affected by the main transactions and consequently by the core agreement between the parties.*
>
> B. *If the guarantee given is unconditional, then the responsibility of the bank is not affected by any ongoing dispute between the rest of the parties and is therefore absolute in such a situation.*
>
> C. *The court further declared that, barring any instances of fraud or unfairness, it would not interfere with the regular operation of bank guarantee.*"

It was further noted in *M/S National Telecom of India* v. *Union of India and Ors*[8] that to be able to claim a guarantee, the beneficiary must prove some wrongdoing and or something similar to it in the specific transaction. It is clear that in their view on the concept of Bank Guarantee, the Courts in India have been inspired by and have adhered[9] to the views expressed in the UNCITRAL Convention of Independent Guarantee.[10]

BANK GUARANTEE IN LIGHT OF SECTION 28 OF THE

[7] (1996) 5 SCC 34.
[8] AIR 2001 Del 236.
[9] AIR 2000 Del 1.
[10] United Nations Convention on Independent Guarantee and Stand-By Letters of Credit (NY, 1995).

INDIAN CONTRACT ACT, 1872

This part discusses the effects of Section 28 under Indian Contract Act, 1872 on Bank guarantee and the approach of judiciary with special reference to the interpretation of the Courts of Exception III. First, the understanding of Section 28 by the Courts prior to the Amendment Act, 1997 which amended Section 28 is focused on. Second, the Amendment Act, 1997 has been discussed. This is then followed by the Amendment Act, 2013 and the circumstances leading towards the said amendment of the particular section have been touched upon. Finally, the concept of Bank Guarantee as it is interpreted in current scenario specifically with respect to Exception III has been covered.

BEFORE 1997 AMENDMENT

Surprisingly, before the amendment, a clause in a contract that stated that all rights and benefits would be forfeited if no action was taken within a certain time period would not break the law.[11] The types of agreements that were affected by Section 28 were the ones which stipulated that any lawsuits must be filed within a certain window of time and where the parties had given up the right to sue after such a time had passed.

When addressing the guarantee's limitation clause in the case of *St. of Maharashtra* v. *Dr. M.N. Kaul*[12], the Hon'ble Supreme Court concluded that the guarantor's liability must not extend beyond what is specified in the contract. The contention that the "*limitation clause*" incorporated in the guarantee agreement violated the terms of the Contract Act was consistently

[11] Law Commission of India, 97th Report.

[12] AIR 1967 SC 1634.

made by the parties. It was argued that agreements which set a shorter period of limitation than as required by the law under as the Limitation Act or any other law in force are in direct contravention under Section 28 of the Indian Contract Act, 1872 because such agreements prevent the exercise of the rights by the parties even when the limitation time were not yet expired. It was further argued that the parties involved in such agreements were incompetent to agree or enter into contracts that would modify their rights guaranteed by the statutes and laws in force. However, the Court held that these contracts must be distinguished from those that do not place a restriction on time by when a party may exercise their legal options, but instead call for a release of such rights if no action is taken or no claim is made within the allotted time. Bearing this difference in perspective, the Hon'ble High Court of Bombay upheld a standard clause relating to limiting the right to sue in the insurance policy on the grounds that said clause did not absolutely bar institution of suits but rather forfeited the said right of the assured in case the claimant before the Court was unable to be bring forth the claim under the policy after the period of three months since the claim was denied.[13]

The Supreme Court reaffirmed this view in the *Dr. M.N. Kaul* case.[14] The Hon'ble Judges emphasized that "*an effort must be made to execute the guarantee within the time frame agreed upon by the parties*" and that it would be unacceptable to disregard such a limit since it is a critical element of the contract between them. Similar clauses in the "bank guarantee" would come under the aforementioned rules and be treated at par to the rules that apply to the restriction clause in insurance policies. Even while the law gives the party a

[13] *Baroda Spg., & Weg.Co. Ltd.* v *Satyanarayan Marine and Fire Insurance Co.*, AIR 1914 Bom 225.
[14] *Supra note 12.*

right to a longer term of limitation, if said party agrees to a shorter period and limits his rights to enforce the said rights in the predetermined time limit, said party would be bound by that agreement. This viewpoint is also not in violation of the statute of limitations for the reason that the Limitation Act, 1963 requires that lawsuits be filed well inside the allotted time frame in order to make the claim easier to establish.

The "limiting clause" in a bank guarantee was something that the Hon'ble High Court of Kerala had to take into consideration in the *Kerala Electrical and Allied Engineering* case.[15] The Bank's main argument was that because the Plaintiff failed to file a lawsuit within six months of the guarantee's expiration date, he had forfeited his rights under the guarantee and so no claim could be made under it. The Hon'ble Judges upheld the limitation clause as valid and noted that Section 28 is not violated by a clause in a contract that states that a party's rights under the agreement will be released or forfeited if he fails to file a lawsuit within a certain amount of time on the grounds that the parties to the contract themselves agreed to release of said statutory right upon passing of decided time period. As a result, such an agreement would not be touched by Section 28 since there was no absolute bar on statutory right but rather a limit on it meaning thereby that an agreement that bars the right to sue itself will be prohibited under the Section.

THE AMENDMENT ACT 1997 AND AMENDMENT ACT, 2013

The Law Commission in its 97th Report while noting the difference between a right and a remedy observed that while a clause in a Contract which terminates one's own rights is valid, the clause that is in nature of

[15] AIR 1980 Ker 151.

prohibiting the remedies is not valid. The Commission suggested amending the Indian Contract Act, 1872 and more specifically Section 28 to make clauses in contracts which terminate rights arising from and pursuant to the contract upon the expiration of a certain period, and thereby limiting a statutory right to seek a remedy, void in order to address this issue.[16] On January 18, 1997, the Contract Act was amended to make such following provisions void: (a) "*limit the enforcement of rights under or pertaining to any contract*" and (b) "*annihilate the rights of the parties*". The Amendment paired elimination of rights and the elimination of remedies. The Amendment was however only temporary, and a fresh amendment was sought since under the said Amendment the freedom of Banks to determine the limits and extent of their liability in Bank Guarantees was seriously hampered; further under the said Amendment the Banks were expected to bear their obligations in form of "unsettled liabilities".

ANDHYARUJINA EXPERT COMMITTEE AND THE AMENDMENT ACT, 2013

As part of their regular business operations, bankers execute guarantees in favour of third parties on behalf of their clients. These are typically referred to as "bank guarantee." It is a well-established legal principle that the liability of the guarantor is secondary and arises solely in the event that the principal debtor defaults, and hence it is considered such a liability of the guarantor is considered as a mere extension of the principal debtor's primary liability. The surety holds a special privilege in the eyes of the law as its role helps maintain the flow of blood in the national and international commerce. Therefore, the Andhyarjiuna Expert Committee was of the

[16] Law Commission of India, 97th Report.

opinion that the surety has to be granted the option to relieve itself of its liability upon some previously agreed upon terms including specific commissions and omissions of the parties to the transaction.

By including numerous provisions in the contract of guarantee whereby the guarantor is allowed to waive off its statutory rights, the bank enhances its own position. After the aforementioned 1997 Amendment, banks were compelled to adhere to the limitation's periods outlined in the Limitation Act of 1963 in order to discharge their obligations under bank guarantee. These limitations periods were 3 years in case of parties who were private and 30 years in case of entities owned by Governments.

Since banks and financial institutions had expressed concerns, the Sh. T.R. Andhyarujina Expert Committee cited the Second Narasimham Committee Report which was established by the Union of India on February 15, 1999 and observed that:

"*With the aforesaid amendment in force, banks will have to carry their liabilities under the bank guarantee till 30 years. Unless, the original guarantee is received back from the beneficiary Government departments, the Banks will not be able to round off all their entries till the limitation period of 30 years.*"[17]

As a result, the Committee suggested giving the creditor a reasonable time frame of one year to exercise his guarantee rights following the occurrence of the particular event. Subsequently, in the 2013 Amendment Act, the Parliament amended Section 28 of the Indian Contract Act, 1872 to add Exception III.

[17] Committee on Banking Sector Reforms (Narasimham Committee II); *See also* W.P.(C) 7677/2019.

CURRENT SCENARIO

As things stand now, Exception III given in Section 28 expressly concerns with the rights that a creditor may exercise his rights granted in a contract of bank guarantee following the occurrence of particular incident. The ruling of the High Court of Delhi in the *Larsen & Tubro Limited* v. *Punjab National Bank and Ors*[18] upholds the aforementioned view. The Court relied upon the decision held in *Explore Computers Ltd.* v. *Cals Ltd and Anr*[19] and noted that there is a distinction between right to invoke a bank guarantee and a right of the party to seek remedy by instituting a suit upon the violation of said right to invoke the bank guarantee. The Court opined that Exception III did not touch upon the right of a party to invoke bank guarantee nor does it take away the right to remedy. In the Court's opinion, only the time given to enforce the right to seek remedy has been touched upon by the Exception III and which was further based on mutual consensus between the parties under the contract of the guarantee.

As a result, and there seems to be a lot of logic in it, it can be seen that both the Judiciary and the Legislature are of the opinion that it is permissible for any person entering into a contract of bank guarantee to give consent with respect to being held accountable only if the concerned party is notified of indemnification inside the specific time limit. This may be because after considerable time has passed it could give a wide range of allegations that cannot be verified in a Court of Law. The Courts have further observed that limiting the time a party has to file a lawsuit does not violate any legal provisions and is not against public policy. It is not in violation of either the Contract Act, 1872 or the Limitation Act, 1963.

[18] W.P.(C) 7677/2019.
[19] 2006 (90) DRJ 480.

BANK GUARANTEE AND FRAUD

The concept of general fraud which has been dealt under Section 17, Section 142 and Section 143 of the Indian Contract Act, 1872 and the concept of frauds in contracts of bank guarantee have minor differences. Under bank guarantee, the party to which the bank becomes liable to pay may defraud the bank into believing that it has fulfilled its contractual obligations necessary for the claim under the guarantee to arise in order to unjustly obtain the guaranteed sum, when in fact said party has not done so. In such cases, the party on behalf of which the bank stood as guarantor is supposed to file a suit praying that the guarantor bank be prohibited from making the payment in favour of the recipient party. However, the Courts in India have approached these allegations of fraud with great caution. In such suits where the party prays for injunction on the grounds of fraud, the burden of proof that the Courts demand is considerably higher.

In commercial transactions, a bank guarantee is frequently unconditional and payable upon demand by the beneficiary. According to Kerr J[20], these guarantees are typically issued based on the credibility and reputation of the recipient party. This, in theory and in practice, could be occasionally detrimental since misuse of such powers given to the beneficiary leaves the other party with no legal choice. As such, in unconditional bank guarantees the scope of exploitation of the banks issuing the guarantee becomes very real. In *Owen* v. *Barclays Bank*[21], the *locus classicus* on this topic, The Court laid down the law on bank frauds and has been the bedrock of the decisions of Courts since in cases of bank fraud and has even been incorporated in the legal frameworks of various countries. Here Lord Denning observed that,

[20] [1977] 2 All ER 862.

[21] [1977] 3 WLR 764.

"*unless there is a blatant case of fraud, the duty of the banks to pay is independent of any dispute between the parties*". This decision was reaffirmed in *Harbottle* v. *National Westminster Bank*,[22] wherein Kerr J., while signifying the importance of non-interference of Courts in matter of bank guarantees, held that bank guarantee is a tool that ensures the flow of credit and cash in international and national economy and as such it would be prudent upon the Courts to be cautious in passing interim orders to the effect of nullifying bank guarantee.

The approach was reaffirmed in *Howe* v. *Polimex* case,[23] where Court opined that solid evidence of commission of fraud is an absolute necessity before intervening in the case and decline to do so if the claims were not adequately supported by such evidence. In the *Chase Manhattan Bank*[24] case, Sir Donaldson MR expressed a similar opinion, saying that if banks are subjected to frequent injunctions without needing the party claiming relief to present solid evidence the very reputation of the banking system might come under jeopardy. He further observed that intervention of the Courts in these cases of economic nature and more particularly in cases involving bank guarantee, an unbearable burden would be put upon the banks and their reputation. Such burden upon the banks may inadvertently result in a blockage of flow of funds and thereby lead to collapse of the economy. Following this rule, the Courts have generally refrained from making interventions in cases of bank fraud unless the party alleging fraud has strong evidence to support its claim.

Given the nature and risks associated with these types of commercial

[22] *Supra note 20.*

[23] [1978] 1 Lloyd's Rep 161.

[24] [1984] 1 Lloyd's Rep 251.

transactions, the high standard of proof and evidence in such cases pertaining to fraud is reasonable and also serves as a deterrent for parties intending to institute frivolous suits before the court. In *Ms. Adhunik Power & Natural Resources Ltd.* v *Central Coalfields Ltd.*,[25] the court determined that the type of fraud that must be committed in order for the court to issue an injunction is one that taints the entire transaction and causes irreparable loss.

CONCLUDING REMARKS

The conclusion which can be drawn is that a contract of Bank Guarantee is a tripartite contract of guarantee among the beneficiary, the surety, and the creditor. It is a legal instrument used in business operations. This bank guarantee contract has been made an instrument of law to facilitate trade and business on a national and international scale. A bank guarantee is a contract which at its core provides the parties thereto with independence and autonomy to decide their own rights and obligations. The Judiciary in India has done a lot to advance the ideas of justice and equality. It bears the crucial responsibility to assess laws and deliver judgment keeping in mind various circumstances in order to settle the disputes. Even though this role of Judiciary is restricted in matters concerning disputes relating bank guarantee as such contracts are purely economical in nature, it has made every effort to settle the disputes that have come before it. Nevertheless, there is still a sharp division in the approach of the courts that one may find in cases involving fraud in bank guarantees. The current stance is that bank guarantees are not dependent on the core contracts; that there is an absolute obligation to pay, barring fraud or irreparable damage. Although it is

[25] (2017) MANU 112 JH.

claimed that factual analysis determines the majority of the characteristics of such claims, courts tend to interpret the law in a narrow way. Therefore, the best option for resolving this conflict is to devise a strategy that strikes a balance between safeguarding business interests and personal losses, thereby fostering increased trade and broadening the scope of the law.