Supreme Court of India
U.P. State Sugar Corporation vs M/S. Sumac International Ltd on 4 December, 1996
Author: M S Manohar
Bench: M.M. Punchhi, Sujata V. Manohar

PETITIONER:
U.P. STATE SUGAR CORPORATION

Vs.

RESPONDENT:
M/S. SUMAC INTERNATIONAL LTD.

DATE OF JUDGMENT: 04/12/1996

BENCH:
M.M. PUNCHHI, SUJATA V. MANOHAR

ACT:

HEADNOTE:

JUDGMENT:

THE 4TH DAY OF DECEMBER, 1996 Present:

Hon'ble Mr. Justice M.M. Punchhi Hon'ble Mrs. Justice Sujata V. Manohar Dushyant Dave, Sr. Adv., and Pradeep Misra, Adv. with him for the appellant V.C. Mahajan, Sr. Adv., Anil Dr. Sangal, Adv. with him for the Respondent J U D G M E N T The following Judgment of the Court was delivered:

J U D G M E N T Mrs. Sujata V. Manohar, J. Leave granted.

The appellant, U.P. State Sugar Corporation entered into an agreement dated 2nd of August, 1989 with the respondent, M/s Sumac International Pvt. Ltd. under which the respondent agreed to design, to prepare an engineering lay-out and to manufacture or procure and supply to the appellant the machinery and equipment for a complete sugar plant for extension and modernisation of the appellant's existing sugar plant at Rohana Kalan, District Muzaffarnagar, U.P. The respondent was required to set up a new plant of 2500 TCD at a new site or an adjoining site close to the existing sugar plant of the appellant. The total contract price was fixed under Clause 2.1 of the contract at Rs. 1780 lacs.

Under the terms of the agreement the respondent was required to set up the plant and make it ready for commercial production by 30th of November, 1990. The agreement stated that in this regard time was of the essence of the contract and if the respondent failed to do so the consequences were also spelt out in the contract. Under clause 3 of the contract a month-wise progressive delivery report was to be submitted by the respondent and a PERT/CPM chart had to be submitted and adhered to. Clause 4 which dealt with delivery required the respondent to complete all supplies by 15th of November, 1990 so that the plant could be commissioned by 30.11.1990. Under Clause 11.1 the respondent-seller was entitled to a reasonable extension of time as decided by the purchaser if the purchase order was expressly suspended for no fault of the seller.

Under Clause 15 the respondent-seller was required to furnish to the appellant five bank guarantees as specified therein. These were:

1. A bank guarantee for timely delivery of plant and machinery as provided in Clause 14.1 representing five percent of the contract price referred to in Clause 2.1. This was required to be furnished within 3-1/2 months of the signing of the agreement.

2. The seller was required to furnish a bank guarantee in respect of guaranteed performance of the plant and machinery for an amount representing 5% of the contract price. This guarantee was required to be furnished eight months before the scheduled date of commissioning mentioned in Clause 4.1 or within six months from the date of the signing of the agreement or after 2-1/2 months of the opening of the Letter of Credit whichever of these dates was earlier.

3. Three bank guarantees in respect of advance payments to be made by the appellant to the respondent under Clause 13.2(a) to 13.3(c) were required to be for Rs.89 lacs, Rs.178 lacs and Rs.89 lacs respectively, representing 5%, 10% and 5% of the contract price respectively.

Under Clause 13.2 on receipt of the first of these bank guarantees for Rs.89 lacs the first installment of advance would be paid within a week from the date of signing of the agreement. Or receipt of the second bank guarantee for Rs.178 lacs the second advance would be paid by the appellant to the respondent within 2-1/2 months of the signing of the agreement subject to the respondent furnishing various statements, certificates etc. as set out in that clause. The third bank guarantee for Rs.89 lacs was to be furnished against the advance to be paid by the appellant to the respondent within 3-1/2 months from the date of the signing of the agreement. These three bank guarantees are thus in respect of the advance payments required to be made by the appellant to the respondent.

Under Clause 15.5 all these bank guarantees are payable on demand. It is expressly provided that it shall not be open to the guarantor to know the reasons of or to investigate or to go into the merits of the demand invoking the bank guarantee or to question or challenge the demand or to require the proof of the liability of the seller before paying the amount demanded. It is further provided that the invocation of the bank guarantee shall be binding on the respondent and that the invocation of the bank guarantee would not be affected in any manner by reason of the fact that any dispute or disputes had been raised by the respondent with regard to its liability. Nor would it be affected by the fact that proceedings were pending before any Tribunal, Arbitrator or Court with regard thereto.

Accordingly, the respondent furnished, inter alia, four bank guarantees, one being a guarantee for due delivery and the other three being the bank guarantees in respect of advance payment of price. The total amount covered by the bank guarantees securing advance payments is Rs.3.56 crores, which amount was paid by the appellant to the respondent as advance.

The contract was not carried out within the time envisaged under the contract. Thereafter, at a meeting held on 1.10.1991 between the appellant and the respondent, the time for completion of this project was extended upto May 1992 and a detailed chart was drawn up for the completion of the project by that date. No further extension of time has been given by the appellant to the respondent thereafter. The respondent, however, did not complete the said project within the extended period.

By their letter dated 6th of September, 1995 the State of U.P. through the Special Secretary, Govt. of U.P. informed the Managing Director of the appellant that it had been decided to transfer the Rohana Kalan (Muzaffarnagar unit) of the appellant to the joint sector. As a result, the expansion project of this unit should be cancelled and appropriate action in accordance with law should be taken. Thereupon the appellant cancelled the agreement by its letter dated 7th of September, 1995 addressed to the respondent. The appellant claimed a refund of the advance payment of Rs. 3,14,78,093/- as unutilised and unadjusted amount of advance payment. The appellant, by its four letters all dated October 28, 1995 addressed to the respondent invoked the three bank guarantees in respect of advance payments after giving credit to the respondent for material worth Rs.42 lacs which had been supplied till then. The appellant also invoked the delivery guarantee for Rs.89 lacs. The bank guarantees so invoked are: Bank guarantee no.9/47 dated 10.8.89 for Rs. 89 lacs. In this bank guarantee credit for Rs.42 lacs has been given and the invocation of the bank guarantee is only for the balance sum of Rs.47 lacs. The second bank guarantee so invoked is no.9/64 dated 20.11.89 for Rs.178 lacs. The third bank guarantee is no.9/70 of 6.1.90 for Rs.89 lacs and the fourth, delivery guarantee is no.12/88 dated 13.11.1990 for Rs.89 lacs.

On 5.10.1995 the respondent filed a petition under Section 20 of the Arbitration Act for appointment of an arbitrator since the agreement between the parties provides for arbitration. The respondent also filed two applications for interim relief under Section 41(b) of the Arbitration Act seeking interim stay against encashment of bank guarantees. The Civil Judge, Senior Divisions, Muzaffarnagar before whom these applications were filed, dismissed these applications. In revision, however, these applications have been allowed by the High Court and an injunction has been granted restraining the appellant from enforcing these bank guarantees. Hence, the appellants has come by way of the present appeal.

These bank guarantees which are irrevocable in nature, in terms, provide that they are payable by the guarantor to the appellant on demand without demur. They further provide that the appellant shall be the sole judge of whether and to what extent the amount has become recoverable from the respondent or whether the respondent has committed any breach of the terms and conditions of the agreement. The bank guarantees further provide that the right of the purchaser to recover from the guarantor any amount shall not be affected or suspended by reason of any disputes that may have been raised by the respondent with regard to its liability or on the ground that proceedings are pending before any Tribunal, Arbitrator or Court with regard to such dispute. The guarantor shall

immediately pay the guaranteed amount to the appellant-purchasers on demand.

The law relating to invocation of such bank guarantees is by now well settled. When in the course of commercial dealings an unconditional bank guarantee is given or accepted, the beneficiary is entitled to realize such a bank guarantee in terms thereof irrespective of any pending disputes. The bank giving such a guarantee is bound to honour it as per its terms irrespective of any dispute raised by its customer. The very purpose of giving such a bank guarantee would otherwise be defeated. The courts should, therefore, be slow in granting an injunction to restrain the realization of such a bank guarantee. The courts have carved out only two exceptions. A fraud in connection with such a bank guarantee would vitiate the very foundation of such a bank guarantee. Hence if there is such a fraud of which the beneficiary seeks to take advantage, he can be restrained from doing so. The second exception relates to cases where allowing the encashment of an unconditional bank guarantee would result in irretrievable harm or injustice to one of the parties concerned. Since in most cases payment of money under such a bank guarantee would adversely affect the bank and its customer at whose instance the guarantee is given, the harm or injustice contemplated under this head must be of such an exceptional and irretrievable nature as would override the terms of the guarantee and the adverse effect of such an injunction on commercial dealings in the country. The two grounds are not necessarily connected, though both may co-exist in some cases. In the case of U.P. Cooperative Federation Ltd. v. Singh Consultants and Engineers (P) Ltd. (988 [1] SCC 174), which was the case of works contract where the performance guarantee given under the contract was sought to be invoked, this Court, after referring extensively to English and Indian cases on the subject, said that the guarantee must be honoured in accordance with its terms. The bank which gives the guarantee is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the suppler has performed his contractual obligation or not, nor with the question whether the supplier is in default or not. The bank must pay according to the tenor of its guarantee on demand without proof or condition. There are only two exceptions to this rule. The first exception is a case when there is a clear fraud of which the bank has notice. The fraud must be of an agregious nature such as to vitiate the entire underlying transaction. Explaining the kind of fraud that may absolve a bank from honouring its guarantee, this Court in the above case quoted with approval the observations of Sir John Donaldson, M.R. in Bolivinter Oil SA v. Chase Manhattan Bank NA (1984 [1] AER 351 at 352): "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 charged". This Court set aside an injunction granted by the High Court to restrain the realisation of the bank guarantee.

The same question came up for consideration before this Court in Svenska Handelsbanken v. M/s Indian Charge Chrome & Ors. (1994 [1] SCC 502). The Court once again reiterated that a confirmed bank guarantee/irrevocable letter of credit cannot be interfered with unless there is established fraud or irretrievable injustice involved in the case. Irretrievable injury has to be of the nature noticed in the case of Itek Corporation v. The First National Bank of Boston etc. (566 Fed Supp.

1210). On the question of fraud this Court confirmed the observations made in the case of U.P. Cooperative Federation Ltd. (supra) and stated that the fraud must be that of the beneficiary, and not the fraud of anyone else.

On the question of irretrievable injury which is the second exception to the rule against granting of injunctions when unconditional bank guarantees are sought to be realised the court said in the above case that the irretrievable injury must be of the kind which was the subject-matter of the decision in the Itek Corporation case (supra). In that case an exporter in the U.S.A. entered into an agreement with the Imperial Government of Iran and sought an order terminating its liability on stand by letters of credit issued by an American bank in favour of an Iranian Bank as part of the contract. The relief was sought on account of the situation created after the Iranian revolution when the American Government cancelled the export licences in relation to Iran and the Iranian Government had forcibly taken 52 American citizens as hostages. The U.S. Government had blocked all Iranian assets under the jurisdiction of United States and had cancelled the export contract. The court upheld the contention of the exporter that any claim for damages against the purchaser if decreed by the American Courts would not be executable in Iran under these circumstances and relisation of the bank guarantee/Letters of credit would cause irreparable harm to the plaintiff. This contention was upheld. To avail of this exception, therefore, exceptional circumstances which make it impossible for the guarantor to reimburse himself if the ultimately succeeds, will have to be decisively established. Clearly, a mere apprehension that the other party will not be able to pay, is not enough. In the Itek case (supra) there was a certainty on this issue. Secondly, there was good reason, in that case for the court to be prima facie satisfied that the guarantors i.e. the bank and its customer would be found entitled to receive the amount paid under the guarantee.

Our attention was invited to a number of decisions on this issue -- among them, to Larsen & Turbro Ltd. v. Maharashtra State Electricity Board & Ors. (1995 [6] SCC 58) and Hindustan Steel Workers Construction Ltd. v. G.S. Atwal & Co. (Engineers) Pvt. Ltd. (1995 [6] SCC 76) as also to National Thermal Power Corporation Ltd. v. Flowmore Pvt. Ltd. & Anr. (1995 [4] SCC 515). The latest decision is in the case of State of Maharashtra & Anr. v. M/s National Construction Company, Bombay & Anr. (JT 1996 [1] SC 156) where this Court has summed up the position by stating, "The rule is well established that a bank issuing a guarantee is not concerned with the underlying contract between the parties to the contract. The duty of the bank under a performance guarantee is created by the document itself. Once the documents are in order the bank giving the guarantee must honour the same and make payment ordinarily unless their is an allegation of fraud or the like. The courts will not interfere directly or indirectly to withhold payment, otherwise trust in commerce internal and international would be irreparably damaged. But that does not mean that the parties to the underlying contract cannot settle the disputes with respect to allegations of breach by resorting to litigation or arbitration as stipulated in the contract. The remedy arising ex-contractu is not barred and the cause of action for the same is independent of enforcement of the guarantee." The other recent decision is in Hindustan Steelworks Construction Ltd. v. Tarapore & Co. & Anr. (JT 1996 [6] SC 295).

Clearly, therefore, the existence of any dispute between the parties to the contract is not a ground for issuing an injunction to restrain the enforcement of bank guarantees. There must be a fraud in

connection with the bank guarantee. In the present case we fail to see any such fraud. The High Court seems to have come to the conclusion that the termination of the contract by the appellant and his claim that the time was of the essence of the contract, are not based on the terms of the contract and, therefore, there is a fraud in the invocation of the bank guarantee. This is an erroneous view. The disputes between the parties relating to the termination of the contract cannot make invocation of the bank guarantees fraudulent. The High Court has also refereed to the conduct of the appellant in invoking the bank guarantees on an earlier occasion on 12th of April, 1992 and subsequently withdrawing such invocation. The court has used this circumstance in aid of its view that the time was not of the essence of the contract. We fail to see how an earlier invocation of the bank guarantees and subsequent withdrawal of this invocation make the bank guarantees or their invocation tainted with fraud in any manner. Under the terms of the contract it is stipulated that the respondent is required to give unconditional bank guarantees against advance payments as also a similar bank guarantee for due delivery of the contracted plant within the stipulated period. In the absence of any fraud the appellant is entitled to realise the bank guarantees.

Before us, however, in the course of argument, learned advocate for the respondent urged for the first time that in this case there would be irretrievable injustice to the respondent if the bank guarantees are allowed to be realised because the appellant is a sick industrial company in respect of which a referee is pending before the Board for Industrial and Financial Reconstruction under The Sick Industrial Companies (Special Provisions) Act, 1985. The respondent contends that even if it succeeds before the Arbitrator it will not be able to realise its claim from the appellant. The mere fact that a reference under The Sick Industrial Companies (Special Provisions) Act, 1985 is pending before the Board, is, in our view, not sufficient to bring the case in the ambit of the "irretrievable injustice" exception. Under the scheme of the said Act the Board is required to make such inquiry as it may deem fit for determining whether any industrial company has become a sick industrial company. Under Section 16(4) where the Board deems it fit to make an inquiry or to cause and inquiry to be made in this connection, it may appoint one or more person to be special directors for safeguarding the financial and other interests of the company or in the public interest. Under Section 17 after making an inquiry, if the Board is satisfied that a company has become a sick industrial company, the Board may then decide, by an order in writing, whether it is practicable for the company to make its net worth exceed the accumulated losses within a reasonable time. If this is practicable, then the Board shall give such company the opportunity to make its net worth exceed the accumulated losses. Under sub-section (3) of Section 17 if the Board decides that this is not practicable within a reasonable time, it may adopt measures specified in Section 18 and provide for a scheme for appropriate measures in relation to that company. There can, therefore, be no presumption that the company will, in no circumstance, be able to discharge its obligations.

Under Section 22 on which the respondent relies, where in respect of an industrial company, an inquiry under Section 16 is pending, or any scheme under Section 17 is under preparation or a sanctioned scheme is under implementation or when an appeal under Section 25 is pending, then no proceedings for the winding up of the industrial company or for execution, distress or the like against any of the properties of the industrial company or the appointment of a receiver in respect thereof can be proceeded with; and no suit for the recovery of money or for the enforcement of any security against the industrial company shall lie or be proceeded with except with the consent of the

Board or, as the case may be, the Appellate Authority. The respondent contends that its right to realise its claim, if established, would be affected by reason of Section 22 of the said Act. There is no material before us to show that the appellant-company cannot make its net worth positive. No scheme has been framed under the said Act so far. Even under Section 22 there is no absolute bar against any suit for the recovery of money. The suit cannot be proceeded with except with the consent of the Board or the Appellate Authority. Therefore, in an appropriate case, the Board or the Appellate Authority is entitled to give its consent to such a claim being proceeded with. This is not a situation of the kind envisaged in the case of Itek Corporation (supra) where there was no possibility whatsoever of recovery of any amount from the purchaser. In the present case, there is a good possibility of such recovery. In any case, learned counsel for the appellant has, on instructions, very fairly stated that the appellant- company undertakes to earmark the amounts realised from the bank guarantees in question for the purpose of recovery of claims, if any, which the respondent may ultimately be found to be entitled to recover from the appellant. Any scheme which the Board may frame under the said Act will be subject to this undertaking given by the appellant to set apart the amounts realised under the bank guarantees in question for meeting any validly adjudicated claims of the respondent against the appellant under or arising from the said contract. If any scheme is required to be framed, the Board shall take into account this undertaking, while framing the scheme.

Both sides are agreed that for a speedy resolution of their disputes they are willing to refer all their disputes under or arising from the said contract to the sole arbitration of Justice R.M. Sahai (retd.), a retired Judge of this Court. We accordingly refer all disputes between the parties under or arising from the contract to the sole arbitration of Justice R.M. Sahai (retd.). The arbitrator may fix his remuneration in consultation with the parties. The parties shall obtain appropriate directions from the learned arbitrator in connection with the filing of claims, replies etc. in accordance with law. The petition filed by the respondent before the court of the Chief Judicial Magistrate/Civil Judge, Muzaffarnagar under Section 20 of the Arbitration Act is disposed of accordingly.

The appeal is allowed and the impugned judgment and order of the High Court is set aside and the injunction granted by the High Court is vacated. Parties will bear their own costs.