

# BANK GUARANTEE AND JUDICIAL INTERVENTION

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## ABSTRACT

Contract of guarantee is defined in India under the Section 126 of Indian contract act, 1872, According to which a contract to perform the promise or discharge the liability of third person in case of breach or default by that person. In bank guarantee the lending institution i.e., the bank acts as a surety for the creditor. Bank guarantee plays very vital role in expansion of Business helping Entrepreneurs to grow.

This paper mainly focuses on the concept of bank guarantee. During the course of analysis the paper, First defines Bank guarantee as according to the Indian contract Act, 1872 with some illustrations for better understanding. Second, the paper shows the usage as well as the relevance of this concept in the law of contract. Third, this paper explains the laws relating to Bank guarantee and intervention from judiciary for the encashment of money in Bank guarantee.

## INTRODUCTION

In the verge of globalisation and increase in the International trade as well as domestic trade there is need of some reliable source to protect and reduce the risks in the business transactions. In the contemporary business conditions the business transaction are done globally, parties being apart from each other, an innovative institution is needed so that it would serve the original purpose of guarantee that is providing security in payments or to our claims, so the concept of bank guarantee was introduced. Bank guarantee is considered as the "life-blood" for the purpose of trade both domestic as well as international<sup>1</sup>.

## DEFINITION AND MEANING

Contract of guarantee is defined in the section 126 of Indian contract Act, 1872 which defines it as a contract to perform promise or discharge the liability of the third person if he makes any default. The person who promises to perform or discharge the liability of the third person is called the "Surety". The person on for whom guarantee is given is called "Principal debtor" and the person to whom guarantee is given is called the "Creditor".

Illustrations: B requests A to sell and deliver to him goods on credit. A agrees to do so, provided C will guarantee the payment of the price of the goods. C promises to guarantee the payment in consideration of A's promise to deliver the goods. This is sufficient consideration for C's promise. Here, 'B' is the debtor, 'A' is the creditor and 'C' is the surety.

Bank guarantee is a tripartite agreement between banker, the beneficiary and the person or the creditor in which "Bank" becomes the surety for the transactions between the Debtor and Creditor. A bank guarantee is a written contract given by a bank on the behalf of a customer which undertakes to pay or discharge the liability of the debtor in case of any default. The concept of bank guarantee is Basically, introduced for the free flow of the trade as guarantee given by bank secures the Creditor from loss and also enables the creditor to claim the debt in case of any default without opting for the cumbersome process of litigation.

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<sup>1</sup> Avtar Singh, Contract and Specific Relief (Eastern Book Company, Lucknow, 2013)

### Illustrations:

Mr. 'A' leases his flat to Mr. 'B' for Rs. 100,000 per month. Mr. 'A' insists on a bank guarantee from Mr. 'B' 's bankers, the Bank of India for Rs.250,00,000 to compensate him in case Mr. 'B' refuse to hand over possession at the end of the lease period.

Here, 'B' is the principal debtor, The Bank of India is the surety and 'A' is the creditor.

For any default of 'B' Mr. 'A' can indemnified directly by the bank of India.

In the case Maharashtra SEB v official liquidator, Ernakulam (AIR 1982 SC 1497) the Supreme court said that the board has a right to enforce payments of the guarantee as money is payable on demand not on breach. Bank guarantee is also called as the "On Demand guarantees" or unconditional Performance of guarantee which means that under any case of dispute the bank is liable to pay without the need of creditor to prove any breach or loss occurred because of that breach. In case of any default by the debtor the creditor can ask for the performance and the bank is bound to indemnify the creditor without any proof of default means bank guarantee is "Absolute" and "Unconditional". This is necessary to save the creditor or debtor in case of advance, from the Very recently in the case of M/S Adani Agri Fresh Ltd V Mahaboob Sharif & Ors Supreme court said that the Bank guarantee is an unconditional one. The respondent, therefore cannot be allowed to raise any dispute and prevent the appellant from encashing the bank guarantee<sup>2</sup>. Also in the case of Ansal Engineering projects Ltd v Tehri Hydro Development Corporation Ltd ((1996) 5 SCC 450) that a bank guarantee is an independent and distinct contract between the Bank and the beneficiary and is not qualified by the underlying transaction. As the bank unconditionally and unequivocally promised to pay, on demand, the Court thus held that the liability of the bank was absolute and unconditional and could not be circumvented in any manner. Further in the case of Rawala construction co. v Union of India (ILR 1982 Delhi 44) Supreme Court laid down that the bank guarantee constitutes an agreement between bank and the government under which there is an absolute obligation of the bank to make payment to the government merely on the demand of the government. The bank is prohibited under the guarantee from raising any objection.

### NEED OF BANK GUARANTEE

The concept of bank guarantee is basically introduced to reduce the transaction risks. Bank guarantee enabled various new firms to set-up efficiently, now firms can start-up with small sum of money also. The Entrepreneurs who are starting their business don't have large sum for investment are benefited a lot as now they can raise their money in credit with the help bank as a Surety and the creditor also in the name bank can give loans without any risk as if the debtor can't be able to pay then they can be reimbursed by the Bank. Bank guarantee is one of the reliable source in trade and reduces the risk in business transactions. The Bank guarantee not only secures the seller rather it also secures the advances or the payment made by the buyer.

There are various types of Bank guarantee being used in different circumstances according to their relevance and needs:

1) Advance Payment Guarantee<sup>3</sup>: This type of guarantee is generally used in the business transactions including exports and imports but it is also extended to Domestic trade. This guarantee is exercised by the buyers of goods to secure the Advances made by them. Illustrations: 'A' orders machineries for his factory from 'B' the seller, Further 'B' wants some advances before the delivery of goods, advances made by 'A' but latter on the goods were not delivered and 'B' declared the agreement to be void, in these cases 'A' can recover his advanced money from the guaranteeing bank . As in the case of Meritz Fire & Marine Insurance Co Ltd v Jan De Nul NV,(137 Con LR 41) the Court of Appeal's decision reiterated that, in this case the advance payment guarantees paid can be

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<sup>2</sup>Available at: <http://www.indianlawcases.com/ILC-2015-SC-CIVIL-Dec-8> (Last modified on 21<sup>st</sup> May 2016)

<sup>3</sup> Available at : [www.nordea.ru](http://www.nordea.ru) (Last modified on 22<sup>nd</sup> May 2016)

recovered as it is the primary obligation of the guaranteeing bank is to pay upon the presentation of the correct documents.

2) The Payment Guarantees<sup>4</sup> : Payment guarantee is a kind of guarantee or promise given by the debtor or buyer that makes him bound for the payment. The extra benefit of "payment guarantee" is that it provides extra security as the guarantee is extended with some co-lateral securities also like property. Most often this type of guarantee is used by the lending Bank as a Indemnity. If the bank has paid to creditor on default made by the debtor then the bank can recover the sum from the co-lateral security granted by the debtor. This is an extra non-conditional guarantee to the exporters which enhances security in transaction.

Apart from these two, other bank guarantees like Bank Guarantee for Warranty Obligations, Attributes of Guarantees as Security are also available<sup>5</sup>.

Also JSW Energy's power plant deals with JSPL, Nimbus Communications dealings with the Board of Control for Cricket in India, manifests the need of Bank guarantee at present.<sup>6</sup>

### EXCEPTIONS

Although Bank guarantee is meant for the security of the creditor but there are some exceptions where the creditor can't exercise his right of encashment. The exceptions are:

1) Fraud:- An injunction against encashment of bank guarantee can be issued when there is clear fraud on the part of beneficiary, which the bank notices. The fraud must be as to vitiate the whole transaction. This principle was underlined in the case of *Sztejn v J. Henry Schroder Banking Corpn.*, ((1941) 3 HYS 2d631). The basic reason for the injunction in case of fraud is to protect the misuse of this credit system. This concept is the clear application of the maxim "ex turpi causa non obiter actio" which means that the "truth unravels all"<sup>7</sup> Also in the case of *Rigoss Exports International (P) Ltd. v Tartan Infomark Ltd* (AIR 2001 Delhi 285) it was held that since the bank guarantee is obtained by the fraud therefore they were vitiated and the beneficiary is not entitled to get claim the amount. Further it was also held that in such circumstances, the court can intervene, and prevent encashment of bank guarantee.

2) Irretrievable harm or injustice: There is another exception to the encashment of bank guarantee is irretrievable harm or injustice to one of the parties concerned as in most of the cases history shows that the encashment of money under bank guarantee adversely affects the bank as well as the customer on whose behalf guarantee is given, the harm or injustice contemplated under this head must be of such an exceptional and irretrievable nature has adverse effect on commercial transactions including national along with international trade.

### JUDICIAL INTERVENTION

As we have seen that the bank guarantees secures the third party as in case of default by the debtor all the liabilities of the debtor will be discharged by the Bank. But the liability of the bank is secondary which means that the Bank can only be held liable in the case of default of the Debtor, Bank can be held liable and can be exercised independently even if any disputes pending in the matter of transaction between Creditor and Debtor. Various recent judgements from Supreme court and High courts made circumstances vivid, where there is a need of Judicial Intervention.

The Supreme Court in the case of *Tarapore and Co. v VO Tractors Export*,( AIR 1970 SC 891) held that the contract created between the creditor and the bank is separate from the original contract

<sup>4</sup> Available at : [www.universalwealthcreation.com](http://www.universalwealthcreation.com) (Last modified on 22<sup>nd</sup> May 2016)

<sup>5</sup> Available at : <http://law-projects.blogspot.in/2013/04/contractual-obligation-in-bank-guarantee.html> (retrieved on 21st May 2016)

<sup>6</sup> Available at : <http://articles.economictimes.indiatimes.com/keyword/bank-guarantee> (Last modified on 21st May 2016)

<sup>7</sup> Avtar Singh, *Contract and Specific Relief* (Eastern Book Company, Lucknow, 2013)

between the buyer and the seller because of that bank's undertaking to the creditor is absolute and unconditional, so there is no need of any interventions from courts as interventions from court may destroy the very essence of Bank guarantee. Bank guarantee enables the individuals to recover their debts by avoiding the long strands of legal proceedings and if there will always be any judicial intervention then it will defeat its very purpose. Also, in the case of *United Commercial Bank v Bank of India*, (AIR 1981 SC 1426) the Supreme Court has ruled that Courts ought not to intervene in the of Bank Guarantee as more intervention may lead to delays and can affect the transaction procedure.

Moreover, there are some instances where the intervention becomes a necessity. As in the case of Fraud and Irretrievable harm or injustice as discussed above. The intervention is necessary otherwise, trust in international and domestic commerce would be vitiated.

### CONCLUSION

First the paper defines the concept of Bank Guarantee in accordance with the statutory provisions relating to the Bank guarantee. Bank guarantee is the undertaking by the bank that if there is a failure in the part of debtor or creditor, bank will indemnify the party who has suffered the loss. As we have seen Bank guarantee plays a significant role in business sector and also helps to flourish the national and international trade efficiently. It should be unconditional so that it can be claimed easily. This concept is introduced to save the parties from indulging into the long court proceeding for claiming their amounts. It also solves the complexities, as in case of breach, to get the judicial remedy first we have to determine the place where we can sue and so and forth. All these complexities are solved by Bank guarantee. A bank guarantee is formed with a contract between the Bank, creditor and debtor all these contracts are independent of each other. There should be no intervention from the courts for enforcing or for the invocation of bank guarantee but there are some instances like fraud and in case of irretrievable harm or injustice the courts must interfere so as to protect the interests of the parties. The parties must be allowed fulfil their obligation according to the terms of the contract and there should be minimum intervention from judiciary. As we know that the banking system is the backbone of the economy and If the bank guarantees are not encashable by the parties themselves without judicial intervention the whole foundation of the bank guarantee system will collapse and the people will lose faith in it with the course of time.