Bank Guarantee

Its origin lies in the documentary letters of credit. They are irrevocable in nature and are considered "the life-blood of international commerce" *Harbottle R.D. (Mercantile) Ltd* v *National Westminster Bank Ltd* 1978 QB 146

In *Centax (India) Ltd. v Vinmar Impex Inc.* the supreme court has stated that a bank guarantee attracts the same consideration as **a letter of credit.** It further added: "A letter of credit sometimes resembles and is analogous to a contract of guarantee. A bank guarantee is very much like a letter of credit. The courts will do their utmost to enforce it according to its terms." *(1986) 4 SCC 136*, AIR 1986 SC 1924.

In a bank guarantee a bank or a lending institution agrees to pay an amount specified in the guarantee to the guarantee holder if the person at whose instance the guarantee is given, commits a breach with respect to the underlying contract. It is a very important instrument used to ensure performance of contractual obligations in modern times.

Types- Unconditional and Conditional.

Unconditional bank guarantees are very strict in nature as the bank agrees to pay the amount specified in the guarantee agreement merely on demand without demur. In such a case "the liability of the bank is absolute and unequivocal." *Ansal Engineering Projects Ltd. v Tehri Hydro Development Corporation Ltd. and Ors.* (1996) 5 SCC 450.

Conditional Bank Guarantees are to be encashed in accordance with the terms laid down in the guarantee agreement with respect to their invocation. Those conditions must be strictly complied with.

Nature of the Bank Guarantees (Unconditional) – Independent and Autonomous:

The Supreme Court has stated that,, "It is settled law that bank guarantee is an independent and distinct contract between the bank and the beneficiary and is not qualified by the underlying transaction and the validity of the primary contract between the person at whose instance the bank guarantee was given and the beneficiary." *Ansal Engineering Projects Ltd. v Tehri Hydro Development Corporation Ltd. and Ors.* (1996) 5 SCC 450.

In a case before the Supreme Court, a bank undertook to pay to the SEB a sum not exceeding Rs 50,000 within 48 hours of demand. The guarantee was submitted on behalf of a supplier who had deposited with the bank sufficient securities. There was no condition to the bank's liability except demand by the Board. The Board demanded payment. The supplier was a company which went into liquidation. The liquidator sought to prevent the Board from realising the guarantee and the bank from paying it. No such relief was allowed as the Court held that the bank guarantee and the contract with respect to which the bank guarantee is given are "independent of each other." ***Maharashtra SEB* v *Official Liquidator*, (1982) 3 SCC 358: AIR 1982 SC 1497**.

HCCL v State of Bihar. (1999) 8 SCC 436, AIR 1999 SC 3710. Herein the bank guarantee was furnished to the Chief Engineer of a government project. The same was invoked by an Executive Engineer who was in charge of the project at the relevant time. The guarantee could not be realized because the demand was not made by the Chief Engineer. The definition of the term Chief Engineer in the main contract would have entitled the Executive Engineer also to invoke the guarantee in the said situation. The Court stated that since a bank guarantee is independent and autonomous of the main contract nothing can be imported from the main contract to interpret it.

Exceptions to Grant Injunction: The bank must honour the irrevocable commitment assumed by it "Otherwise, the very purpose of bank guarantees would be negatived and the fabric of trading operations would get jeopardised." (Bombay High Court)

There are 2 exceptions when enforcement of a bank guarantee can be stayed by the courts

These exceptions are: (1) Fraud and (2) Irretrievable harm or injustice. Thus stated the Supreme Court in *U.P. Coop Federation Ltd* v *Singh Consultants and Engineers (P) Ltd*. that, "An irrevocable commitment either in the form of confirmed bank guarantee or irrevocable letter of credit cannot be interfered with except in case of fraud or in case of question of apprehension of irretrievable injustice has been made out.

In *Bolivinter oil SA v. Chase Mannattan Bank & ors.* Sir John Donaldson M.R. observed that [1984] 1 All E.R. 35 1 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 hereafter 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. A bank acting on such a statement may cause irreparable damage to its credit*."

A fraud by the beneficiary would allow a bank to refuse encashment but the fraud must be of "egregious nature so as to vitiate the entire underlying transaction" and detectable by the bank with minimal investigation. If bank finds it difficult to reach upon a conclusion then the debtor must approach a court for injunction.

The test with respect to fraud is very vague, as the courts have laid down that the fraud must be of egregious nature.

An example of a fraud of this kind was before the Bombay High Court in *Dai-Ichi Karkaria (P) Ltd* v *Oil and Natural Gas Commission*. AIR 1992 Bom 309.

In reference to the meaning of **irretrievable injury**, the Supreme Court said that it must be of the kind which was the subject-matter of the decision in ***Itek Corpn* v *First National Bank of Boston*:** "To avail of the exception, therefore, exceptional circumstances which make it impossible for the guarantor to reimburse himself if he 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."

Even the winding up of the company on whose behalf the guarantee was submitted would not enable the bank to refuse payment. *MSEB v Official Liquidator, High Court of Ernakulam AIR 1982 SC 1497*. The courts below had held that the Board cannot invoke the guarantee and can claim the amount as a creditor in the winding up proceedings.

The SC set aside these orders and held the BG is independent of the underlying transactions. It is agreed that the liability of a surety is coextensive with that of the guarantor u/s 128 and according to S.134 a surety would be discharged if the principal is discharged "but a discharge a PD may secure by operation of law in bankruptcy does not absolve the surety of his liability."

The fact that the company which was invoking bank guarantee was likely to be declared a sick industrial undertaking was held to be not a situation of a special equity or irretrievable injustice so as to justify an injunction against encashment. The supreme court has stated that generally in such cases making payment would adversely affect the bank and the debtor both, but in order grant injunction 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."

In some cases the courts have stayed enforcement of BG on the ground that there was no contract entered into between the PD and the Beneficiary.

BTS v Union of India AIR 2000 Delhi 1.

The Bombay High Court too has restrained enforcement of a bank guarantee where the bidder had rightfully withdrew his bid before its acceptance since there was no contract which could be breached.

However in a decision a decade latter the same High Court refused to stay the enforcement of a bank guarantee where the validity of the main agreement was challenged. It did so in view of the autonomous nature of the bank guarantee and stated that "the bank issuing a guarantee is not concerned with the underlying contract between the parties to the contract. (MANU/MH/0099/1997 K. L. Steel

BTS v Union of India AIR 2000 Delhi 1. Stayed encashment of BG.