Jus Corpus Law Journal
Open Access Law Journal – Copyright © 2021 – ISSN 2582-7820
Editor-in-Chief – Prof. (Dr.) Rhishikesh Dave; Publisher – Ayush Pandey

Fraud in Bank Guarantee – Problems with the current Judicial Approach

Tridib Mandal[a]

[a]West Bengal National University of Juridical Sciences, Kolkata, India

Received 16 August 2021; *Accepted* 14 September 2021; *Published* 18 September 2021

The article analyses the current legal position of fraud in bank guarantees. The author has criticized the current judicial approach with respect to fraud in bank guarantees. The primary contention lies in the fact that the courts not only refuse to intervene in such cases unless prima facie evidence is adduced but also leave a major part of the allegations to depend on the knowledge of the bank about such fraud. Therefore, a dichotomy is observed between the approaches of the courts putting emphasis on factual analysis and propagating a restrictive approach when it comes to interpretation to such allegations of fraud. This can be solved by coming up with a middle ground approach balancing both aspects.

Keywords: *contract law, bank guarantee, fraud, guarantee.*

INTRODUCTION

Bank Guarantees, one of the most used financial instruments in commercial transactions, are a simple and efficient method of finalizing a transaction by gaining the trust of each other through financial surety. However, when one of the parties resort to fraudulent behavior with respect to such instruments, proving such fraud becomes difficult. The approach currently

followed by the courts has given rise to lots of controversies and difficulties for the party claiming relief.

In this article, the author will analyze the current approach of the judiciary in cases that includes proving fraud in a transaction involving Bank Guarantee. The author will criticize any inconsistency in such an approach and will try to suggest a better alternative approach balancing the interest of all the stakeholders involved.

WHAT IS A BANK GUARANTEE?

A guarantee is a special tripartite contract where a third party undertakes a secondary obligation to pay the creditor on the default of the debtor.[1] A bank guarantee, as the name suggests, is a guarantee given by the bank to the creditor/beneficiary at the request of the debtor/assuring party. Bank guarantees are generally independent of the main contract, mainly because the bank doesn't want to be involved in the disputes between the parties. So whatever be the dispute with the underlying contract, the bank's liability as a surety will persist. In these transactions, the party agreeing to provide a bank guarantee enters into a contract with a bank (issuing bank) that agrees to pay an amount on behalf of that party. This amount is received by the bank which the other recipient party has appointed on their behalf (negotiating bank). The negotiating bank, on receiving proper documents from the recipient party gives them the guarantee amount and then claims the same from the issuing bank.

In practice, there are two types of bank guarantees- conditional and unconditional bank guarantees. In an unconditional bank guarantee, the bank has an absolute liability to pay on demand by the beneficiary. However, in a conditional bank guarantee, the bank does not pay until and unless the condition governing such guarantee is satisfied.

The main objective of Bank Guarantees is to facilitate commercial transactions by giving the necessary assurance to build up trust between the principal parties.[2] In commercial

[1] Anirudh Wadhwa and Dinshah Fardunji Mulla, *Mulla on The Indian Contract Act* (15th edn, LexisNexis Butterworths Wadhwa 2016)
[2] K G White, 'Bankers Guarantees and the Problem of Unfair Calling' (1979) 2 Journal of Maritime Law & Commerce

transactions, there are often a huge amount of goods and money exchanged and the parties involved are generally not willing to bear the risk without any assurance from either side. This is where bank guarantees become useful as an instrument of assurance and trust between the parties.

FRAUD IN BANK GUARANTEE: AN ANALYSIS

The type of fraud that is alleged in transactions involving Bank Guarantees is a bit different from ordinary fraud as defined in sections 17, 142 & 143 of the Indian Contract Act, 1872. In bank guarantees, fraud is committed by the beneficiary/recipient party by producing false documents to ensure the negotiating bank that they have complied with the contractual obligations on their part which in reality they don't, and then take the guaranteed amount. During such a situation, the issuing party can file a suit in the court alleging fraud and thereby asking the court to grant an injunction against the issuing bank from paying any amount to the negotiating bank. However, the current judicial approach places a heavy burden on the party asking for an injunction based on an allegation of fraud in the invocation of a bank guarantee. The reasonability and justifiability of such an approach are further analyzed with the help of a few decided cases on this issue.

Bank guarantees in commercial transactions are often unconditional and are payable on the beneficiary's demand. As observed by Kerr J[3], these guarantees are mostly made relying on the beneficiary's reputation and credibility. This can sometimes be counterproductive due to abuse of such reliance placed on the beneficiary leaving the sellers with no proper recourse. This brings us to a very pertinent question about the effect of such abuse in the case of unconditional bank guarantees. The locus classicus on this issue, *Owen vs Barclays Bank*[4], laid down the rule with respect to frauds in bank guarantees which is still followed by many courts across the world. In this case, Lord Denning stated that the obligation of banks to pay doesn't depend on any dispute between the parties, until and unless there's a clear case of fraud. In the

[3] *Harbottle v National Westminster Bank* [1977] 2 AllER 862
[4] *Owen v Barclays Bank* [1977] 3 WLR 764

same year, the case of *Harbottle v National Westminster Bank* [5] echoed the ruling laid down in Barclay's Bank. Kerr J, in that case, pointed out that the non-interference of courts in matters involving an allegation of fraud in bank guarantee was important for preserving the *'life-blood of international commerce*'. The same principle was also reiterated in *Howe Richardson v Polimex-Cekop*[6], where the court once again asked for clear proof of fraud and decided not to interfere in such a matter unless the allegations are clearly proved. Therefore, it can be observed that the courts from the very inception started to develop an approach that promoted lesser interference of courts in cases involving bank guarantees in the commercial field for the sake of commercial efficacy.

NEED OF JUDICIAL INTERVENTION

The trend which developed from these initial landmark cases on bank guarantee fraud made it clear that unless there is prima facie evidence of fraud produced by the claimants, the courts will not go into deciding the fraudulent behaviour. This continuous reluctance of the courts to grant an injunction on invocation of bank guarantee by the beneficiary brings us to a pertinent question about the need for judicial intervention in disputes related to commercial transactions.

The question regarding whether the courts should consider the allegations of fraud more seriously or whether they should consider only strong established prima facie evidence of fraud in deciding the case is left in the dark by the judiciary, leading to a lot of debate. If we look at the cases from an individual claimant's perspective level, the losses faced by them on the court's refusal to grant injunction are massive. It can be argued that through greater judicial intervention, the courts prioritizing individual losses over commercial efficiency and independence, will protect innocent parties from unnecessary losses and will set a precedence that will act as deterrence for any party fraudulently invoking a bank guarantee in the future. Even if it hampers business for a bit, the fact that the courts are showing greater concern for granting relief to victims of fraud in commercial transactions will lead to the issuing or

[5] *Harbottle v National Westminster Bank* [1977] 2 All ER 862
[6] *Howe Richardson v Polimex-Cekop* [1978] 1 Lloyd's Rep 161

negotiating banks to be more careful while handing over the amount to such beneficiary. However, as held by Sir Donaldson MR in the case of *Bolivinter Oil S.A v Chase Manhattan Bank*[7], if rampant injunctions are put on banks without the claimant party being able to adduce any prima facie evidence of the alleged fraud, it might *'undermine the bank's greatest asset....its reputation for financial and contractual probity*'. Furthermore, due to the huge amount of time taken in by the courts in deciding a case, judicial intervention in cases of bank guarantee may put the bank out of business. As a result, the courts frequently going into such inquiry might put the bank out of business leading to an economic meltdown in the long run. Therefore, if we think in terms of the overall effects of such judicial intervention in a larger commercial efficacy context, the cons outweigh the pros. Thus, while focusing on saving individual transactions from fraud, banks all over the world might go out of business in the period between granting of injunction and banks applying for it to discharge, leading to greater damages.

PROVING FRAUD: BURDEN TOO HIGH?

Another issue that arises while discussing fraud and its implications in bank guarantees is of proving fraud in such transactions. As has been laid down through the decisions of various English courts, the burden is very high on the party alleging fraud and it must either be established beyond a reasonable doubt or there must be prima facie evidence of fraud. However, the courts have not laid down any rules for what is to be construed as prima facie evidence of fraud.

In the case of *United Trading Corp. S.A. vs Allied Arab Bank*[8], the court although not explicitly, gave a hint about what can be construed as an established proof of fraud. The judge laid down that if the only plausible inference from the documents available can be that of fraud, then the courts can consider it as prima facie evidence of truth. If the court is convinced from the evidence that inaction might lead to irreparable harm for the claimant party, then it will grant an injunction on the invoking of the bank guarantee by the beneficiary. The Indian Courts, in

[7] *Bolivinter Oil SA v Chase Manhattan Bank* [1984] 1 Lloyd's Rep 251
[8] *United Trading Corp SA v Allied Arab Bank* [1984] 7 WLUK 182

the case of *Ms. Adhunik Power & Natural vs Central Coalfields Limited*[9], have ruled that for the court to grant an injunction, the nature of fraud committed must be such that it vitiates the entire transaction and leads to irreparable loss.

According to me, the burden of proof in these type of cases is justified as well as reasonable keeping in mind the nature and risks involved in such commercial transactions. Such a high burden of proof acts as deterrence and prevents the alleging party from bringing frivolous claims in front of the court for getting unjustified injunction orders against the issuing bank.

KNOWLEDGE OF FRAUD

This is one aspect of cases involving Bank Guarantee where the entire fate of such frauds is left depending on the mere knowledge of the bank. The judicial trend for all these years has been to rely on the issuing bank's knowledge about the fraud of the beneficiary to decide on the merit of such allegation of fraud. The earliest case on this issue was *Guarantee Trust Co. Of New York vs Hanny*[10], where the court held that since there was no knowledge of fraud by the bank, there can't be any injunction passed against them. In another landmark American case on this issue named, *Sztejn vs J. Henry Schroder Banking Corp*[11], it was held that when the issuing bank becomes aware of any fraudulent behavior before any claim is made by the beneficiary, then the principle of independent nature of bank guarantee despite disputes between principles won't apply. In such cases, it was held, the bank can be restrained from giving the guaranteed amount and an injunction can be placed on the invocation of the bank guarantee. In the Indian case of *Federal Bank Ltd vs VM Jog Engineering*[12], the court held that if reasonable care is taken by the bank in deciding the credibility of such claim by the beneficiary and is satisfied with the same without any prima facie evidence of fraud, the bank cannot be restrained from issuing the bank guarantee.

[9] *Ms Adhunik Power & Natural v Central Coalfields Limited* (2017) MANU 112 JH
[10] *Guarantee Trust Co of New York v Hanny* (1915) 2 KB 536
[11] *Sztejn v J Henry Schroder Banking Corp* (1941) 31 NYS 2d 631
[12] *Federal Bank Ltd v VM Jog Engineering* (2000) MANU 626 SC

The problem, in my opinion, lies in the fact that the banks have been given excessive leeway by letting the claim of injunction depend upon their knowledge of fraud committed by the beneficiary. Although what amounts to reasonable care taken by the bank to examine the beneficiary's claim is a question of fact, the history of the hesitancy of the courts to interfere with such transactions often puts the issue of factual analysis of reasonable care in the dark. The Indian Courts have adopted the rulings of previous English courts, and have treated non-interference with bank guarantees until and unless there is clear proof of fraud or irreparable harm, as settled law. However, when it comes to proving fraud, the courts have always taken shelter under the shades of 'factual analysis' and later denied the same by giving the same old excuse of protecting commercial expediency.

CONCLUSION

The position that stands as of now is that bank guarantees are independent of any underlying contract and obligation to pay is absolute, except in cases of fraud or irreparable injury. However, even after a handful of cases on this issue, there still exists a rigid dichotomy between the approaches of the court. While most of the aspects of such allegations are said to depend on factual analysis, the courts on the other hand propagate a restrictive approach when it comes to interpretation. Therefore, the most viable recourse to solve this dichotomy can be coming up with an approach that balances between protecting commercial expediency and individual losses, in a way leading to the growth of commerce and expansion of the legal horizon.