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Analysing the obligation of a Guarantor under A Bank Guarantee

Ujjwal Raj^a

^aSymbiosis International University, Pune, India

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A bank is a monetary institute, whose primary function is to allow and enhance money deposits from the citizens, apart from this, this institution also helps people by issuing various loans. A bank is authorized by the government to carry out financial services for society. A bank is a trustworthy and reliable financial institution because the creditor is always sure that the bank is financially sound. Apart from this, the bank also offers various comfort to the customers in the form of various discounts on issuing cards and on opening a bank account. All these bank accounts are safe and here the customer is very much sure that the money is entrusted in the right set of an institution. A bank also issues a bank guarantee, this guarantee enables a company to buy products that it would not otherwise be able to, thus assisting business growth and encouraging economic development. A bank guarantee is a commitment made by a bank to a third party that it will incur payment risk on behalf of its clients. A bank guarantee is a promise made in a form of a contractual obligation. To shield the third party against monetary losses, such guarantees are commonly used in business and personal transactions.

Keywords: *bank guarantee, guarantor money deposits, contract.*

INTRODUCTION

The word guarantee has been derived from the French word “*garantie*” which means to safeguard something. In law, a guarantee is a form of contract as enshrined in section 126 of the Indian Contract ACT, 1872. The main objective of a contract of bank guarantee is to allow a

person to secure a loan easily, to get employment, or to buy goods on credit. A contract of guarantee can be inferred to accommodate a second pocket if the first one fails¹.

Section 126 of the Indian Contract Act, 1872 states that a contract of guarantee is an obligation to fulfill the promise, or realize the liability, of a third person, if, by any chance, he is in default. In such a contract, a person who gives the guarantee is called the surety, and the person in whose regard the guarantee is given is called the principal debtor and the person to whom this guarantee is given is called the creditor. It is important here to consider that such a guarantee may be given either orally or in written form. There are two types of guarantee-specific and continue. As the name suggests, the specific guarantee is limited to a specific event whereas as per section 129 of the Indian Contract Act, the continuing guarantee extends to a series of transactions.

MEANING OF A BANK GUARANTEE

A bank guarantee is a tri-legal arrangement between the banker, the beneficiary, and the individual or the creditor under which the "Bank" acts as a surety for the Debtor and Creditor's dealings. It is a written contract issued by a bank on behalf of a customer that commits the bank to discharge the debtor's debt in the event of his default. The notion of a bank guarantee was adopted to allow free flow of trade since a bank guarantee protects the borrower against loss and allows the creditor to claim the debt in the event of default without having to go through the time-consuming procedure of legal prosecution².

In the case of *Pollen Dealcom Private Limited v Chambal Fertilisers and Chemicals Ltd.*³, it was held by the court that the bank guarantee can also be defined as an independent legal responsibility that is payable when demanded. The court also stated that this guarantee is not affected by the relations between the parties and is an appropriate method of getting the amount in transactions that are commercial in nature. It was also held by the court that the full payment

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

² Akshay Anurag, 'Bank Guarantee and Judicial Intervention' (*Manupatra*, 9 November 2016) <<http://docs.manupatra.in/newslines/articles/Upload/1A60C2E6-874F-4655-8821-CA4915F9D4F6-%20banking.pdf>> accessed 01 September 2021

³ *Pollen Dealcom Pvt Ltd v Chambal Fertilisers & Chemicals Ltd* MANU/WB/0031/2010

must be made under the contract of guarantee by the beneficiary irrespective of the existing disputes among the parties.

It has been stated by the court that the contract of guarantee must be construed on its own term and is completely separate in the case of *SBI v Mula Sahakari Sakkar Karkhana Ltd*⁴. If for example, two contracts are there, then in such a case, the bank should only invoke one of them, this view has also been promoted in the case of *National Highway Authority of India v Jivanlal Joitram Patel*⁵. The various obligations of a bank and a guarantor in the contract of guarantee have been developed by the judiciary in several precedents with the passage of time. Let us discuss them in detail in the next topic.

Case Laws Pertaining to Bank Guarantee and the Role of Indian Judiciary

It is well established that a guarantee contract is a specific and distinct contract in itself. The law governing the execution of a bank guarantee on demand is very straightforward as the courts must not intervene with the compliance of a bank guarantee if the enforcement is based on the guarantee. By examining the terms of the contract, it is inferred that the Court can only intervene if the on-demand guarantee concept complies with its terms.

In several cases, the judiciary has stated that the bank's responsibility under the guarantee is absolute and that the institution of the judiciary will not necessarily intervene with the banker's contractual obligations by imposing an order against payment when the guarantee is lawfully applied. The courts thus intend to uphold that the economic activity should operate smoothly without interference from the judiciary. The presence of a conflict between the Contracting Parties is not a basis for imposing an injunction to prevent the Bank Guarantee from being enforced. However, this does not prohibit the parties to the underlying contract from resolving a dispute over a violation claim by resorting to a court as mentioned in the contract in the cases of fraud and injustice⁶.

⁴ *SBI v Mula Sahakari Sakkar Karkhana Ltd* (2006) 6 SCC 293

⁵ *National Highway Authority of India v Jivanlal Joitram Patel* AIR 2010 NOC 402 (Guj)

⁶ Sankalp Jain, 'Commercial Instruments: Bank Guarantee and Letter of Credit' (SSRN, 28 June 2014)

<https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2460246> accessed 24 September 2021

Some famous case-laws related to obligations under bank guarantee are as follows:-

1. In the case of *Maharashtra SEB v Official Liquidator*⁷, it was held by the court the board of the bank has a right to enforce payment based on the contract of guarantee, and in doing so, a bank can get itself out of the securities.
2. In yet another case of *Hindustan Steelworks Construction Ltd v Tarapore & Co*⁸, some pointers were laid down by the Supreme Court of India for deciding the future cases on bank guarantee, these pointers are as follows:-
 - A contract of bank guarantee is independent and a very distinct one, it doesn't get affected by the given transaction and it also doesn't get altered by the existing primary contract between the person on whose the guarantee is given and the surety.
 - If there is an unconditional guarantee of the given, then, in such a case, the obligation of the bank is absolute and doesn't get affected by any existing dispute between the parties.
 - It was also held by the court that it will not interfere in the daily function of bank guarantee until and unless some cases of fraud and injustice pop up.
3. It is also observed by the court in the case of *National Telecom of India v Union of India*⁹ that in order to claim a guarantee, the beneficiary has to establish some violation and its types in the given transaction. This view has been adopted from the UNCITRAL Convention of Independent Guarantee¹⁰ and has been further fostered in the case of *Basic Tele Services Ltd v Union of India*¹¹.
4. In many further cases, the court developed the jurisprudence related to fraudulent cases and went on to state that judicial intervention becomes imperative to curb injustice. This has been held in the case of *U.P. Coop Federation Ltd v Singh Consultants and Engineers (P) Ltd*¹², and also in the case of *Itek Corpn v First National Bank of Boston*¹³ among others.

⁷ *Maharashtra SEB v Official Liquidator* (1982) 2 SCC 358

⁸ *Hindustan Steelworks Construction Ltd v Tarapore & Co* (1996) 5 SCC 34

⁹ *National Telecom of India v Union of India* AIR 2001 Del 236

¹⁰ Lars Gordan, *Convention of Independent Guarantee* (1997)

¹¹ *Basic Tele Services Ltd v Union of India* AIR 2000 Del 1

¹² *UP Coop Federation Ltd v Singh Consultants and Engineers (P) Ltd* (1988) 1 SCC 174

5. In the case of *Llyods Steel Industries Ltd v Indian Oil Corpn Ltd*¹⁴, the court fostered the opinion that the guarantor's right should remain impaired against the principal debtor, it was further held that any clause is valid until and unless it doesn't affect the liability of the bank.
6. In the verdict of *New Bank of India v Sajitha Textiles*¹⁵, it has been stated by the court the maximum limit to enforce a contract of guarantee is three years. If the guarantee has a continuing nature, then in such a case, the limitation period is governed by section 55 of the Limitation Act, 1963. In yet another case of *ICICI Bank Ltd v Tata International Ltd*¹⁶, it has been fostered by the court that in the contract of guarantee where the limitation period is of 90 days and the 90th day falls on a public holiday, then in such a case, the contract can be enforced on 91st day.
7. In the case of *National Project Construction Corpn Ltd v G. Ranjan*¹⁷, the view of not subjecting the bank guarantee to arbitration clause has been promoted by the Karnataka High court.
8. In the case of *Hamzeh Malas and Sons v British Imex Industries Ltd*¹⁸, the English Court pronounced that sometimes the contract of bank guarantee resembles that of a letter of credit and but has to be considered after analyzing the facts of the case.
9. In a very recent case of April 2021, namely *Cochin Port Trust v Bank of India and Another*¹⁹, it has been held by the court that in order to claim a right under the contract of guarantee, the demand of the right should be moved within the validity period and not there-after.

PRESENT DAY REQUIREMENTS

¹³ *Itek Corp v First National Bank of Boston* 566 Federal Supp 1210

¹⁴ *Llyods Steel Industries Ltd v Indian Oil Corp Ltd* (AIR) 1999 Del 248

¹⁵ *New Bank of India v Sajitha Textiles* AIR 1997 Ker 201

¹⁶ *ICICI Bank Ltd v Tata International Ltd* (2008) 6 Mah LJ 446

¹⁷ *National Project Construction Corp Ltd v G Ranjan* AIR 1985 Cal 23

¹⁸ *Hamzeh Malas & Sons v British Imex Industries Ltd* (1958) 2 QB 127

¹⁹ *Cochin Port Trust v Bank of India & Anr* WP (C) No 22760/2019

I feel that the special provisions as enshrined in the Indian Contract Act, 1872 have become outdated with time mainly because such legislation was drafted considering the development level of the 19th century and 149 years hence, doesn't hold much relevance as the societies have become much more complex and advance. The legislation doesn't serve any good in matters related to bank guarantee mainly because it limits the power of the judiciary as discussed above and also doesn't specifically discusses the concept of bank guarantee in detail. This concept can only be inferred after analysing the sections so the need of the hour is to amend the law while considering the demand of the commercial world.

Even though we have other laws like the Limitation Act of 1963 and the Insolvency and Bankruptcy Code, 2016 in place, it is imperative to observe that such laws don't accommodate the obligation of the guarantor and hence the parliament should think of drafting a new set of laws for the banking sector. In my opinion, considering the immense changes the society have been through, there is a vital need to enact new legislation in place, such legislation should address the gaps which the Indian Contract Act, 1872 cannot accommodate and should adhere itself to the banking sector to deal with the concept of bank guarantee.

CONCLUSION

The conclusion of the above discussion can be summarized as stating that a bank guarantee is a legal document of commercial transactions and is mainly a contract between the beneficiary, surety, and the bank. This contract of bank guarantee is issued to promote trade and commerce in any legal form at a national and an international level. Such a contract is independent and autonomous in its own nature. The Indian judiciary has immensely served the notion of equality and justice. It has a major duty to comprehend the laws and decide the verdict in various cases to resolve the dispute. With matters related to the bank guarantee, even though its role is limited but this institution has tried its best to resolve the dispute between the parties, and in the process of doing so, it also laid various precedents to refer to in resolving future disputes. The author strongly holds the opinion that a new law should be framed to cover the loopholes of 149-year-old legislation related to contracts.