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Bank Guarantees: An effective tool to hedge contractual risk

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☞ INTRODUCTION

Indian economy is booming and business intelligence is essential to minimize contractual risks. Commercial prudence is necessary to optimize business results. An instrument, which is widely used to minimize the risk involved in commercial contracts is a guarantee. A guarantee is a commercial instrument which secures compliance of a contract, and indemnifies a contracting party against the defaults for (a) failure to perform the promised act; or (2) failure to repay the promised debt/consideration.

The business community relies heavily on banks/financial institutions for capital assistance to run their day-to-day operations. Further, due to globalization of business structures, companies want to have their presence in various parts of the world. But, it takes time to build credibility in the market. So, if a new company (domestic or foreign) is hired to execute a project by a domestic company, it is quite common in India that a bank guarantee is provided in case the hired company fails to fulfill the contractual obligations. The role of banks in such situations is to act like an anchor and build trust among the contracting parties by securing performance and hedging payment risk.

This newsletter highlights the features, types, and the legal position regarding invocation of bank guarantees in India.

1. Law on guarantees

The law on guarantees is covered in the Indian Contract Act, 1872 (**"Contract Act"**). The relevant section[1] of the Contract Act, which defines 'contract of guarantee', 'surety', 'principal-debtor' and 'creditor' is described below:

"A contract of guarantee is a contract to perform the promise, or discharge the liability, of a third person in case of his default. The person who gives the guarantee is called the 'surety', the person in respect of whose default the guarantee is given is called the 'principal-debtor' and the person to whom the guarantee is given is called the 'creditor'. A guarantee can be either oral or written".

This section defines a contract of guarantee in which the promisor promises to perform the promise of a third person, or to discharge the liability of a third person, in the case of the latter's default. Therefore, a guarantee is an undertaking to indemnify, if some other person does not fulfill his promise. Like other contracts, it is necessary for a contract of guarantee that there should be concurrence of the parties to the contract. But this does not mean that the surety should undertake its obligation at the request of the principal-debtor and an implied request will be sufficient to satisfy the concurrence of the parties.[2]

The term liability which is one of the important aspects of a contract of guarantee is also covered in section 126 of the Contract Act. Clearly, the draftsmen intended that the liability must be enforceable at law. If the liability does not exist, there cannot be a contract of guarantee. For example, it has been held by the Bombay High Court that a surety is not liable on a guarantee for the payment of a debt which is barred by the law of limitation.[3] The liability of the guarantor presupposes the existence of a

[1] Section 126 of the Contract Act.

[2] Jagannath Baksh Singh v Chandra Bhukan Singh AIR 1937 Oudh 19 p.20.

[3] Manju Mahadev vs. Shivappa, I.L.R 42 Bom.444.

separate liability of the principal-debtor and his liability is, thus, secondary which comes into existence only on default of the principal-debtor. Thus, even where the surety becomes insolvent before default is made by the principal-debtor, the surety's liability to the creditor is absolute and is not discharged by the insolvency. The surety is contractually bound to fulfill its irrevocable obligation as a guarantor. Further, under the contract of guarantee, surety cannot be made liable for an amount more than that specified under the underlying contract.

2. Nature and types of bank guarantees

A bank guarantee is a contractual undertaking by a bank, to pay a specified sum in the event of any default in performance by the principal-debtor under the contract with the creditor. In contrast to a contract of guarantee, a bank guarantee is ordinarily a bipartite contract between the issuing bank and the beneficiary. Bank guarantees can be broadly classified into two categories (i) unconditional and (ii) conditional.

2.1 Unconditional bank guarantee

Unconditional bank guarantees are absolute and encashable on the very demand of the beneficiary. Under such bank guarantees, the beneficiary is not required to prove any breach under the underlying contract and is the sole judge or arbiter as to whether there is any breach of underlying or primary contract on the part of the other party. Therefore, the principal elements of an unconditional guarantee are: (1) an unconditional promise of payment by the guarantor; (2) guarantor is bound immediately upon the principal defaulting or failing to perform his contract; (3) demand is made in the manner provided for in the guarantee; and (4) the creditor is not required to prove any breach or loss to the bank.

The Supreme Court (**"SC"**) has held in *Ansal Engineering Projects Limited vs. Tehri Hydro Development Corporation Limited*[4] that the bank is under no obligation to find out whether any default is committed or whether any amount is due by the person at whose instance the guarantee was issued. The amount of liability undertaken by the banks unconditionally and irrevocably is absolute and unequivocal.

Briefly, the facts of the case are that in March 1991, Ansal Engineering Projects Limited (**"Petitioner"**) had entered into contract with Tehri Hydro Development Corporation Limited (**"Respondent"**) to construct 108 residential quarters at Tehri. The construction was to be completed within the stipulated time period but was not completed and the Respondent terminated the contract. The Petitioner availed of the remedy under section 11 of the Arbitration and Conciliation Act 1996 for appointment of an arbitrator for reference of the dispute in terms of the contract. Pending consideration thereof, the Petitioner filed an application for injunction to restrain the Respondent from invoking the bank guarantee.

The SC held that the bank had irrevocably promised and undertaken to pay the Respondent without any demur or damage irrespective of any dispute or disputes raised under the contract in any proceedings before any court. The court further emphasized that unless fraud or special equity is pleaded and prima facie established, the Respondent cannot be restrained from encashing the bank guarantee as the bank guarantee is an independent and a distinct contract between the bank and the beneficiary and the plea of injunction by the Petitioner was rejected.

2.2 Conditional bank guarantee

According to Black's Law Dictionary, a conditional guarantee is one which depends upon some extraneous event, beyond the mere default of the principal. In other words, it is one which is not immediately enforceable against the guarantor upon default of the principal but one in which the creditor must take some action in order that the liability arise.

The principal elements of a conditional guarantee, therefore, are: (1) payment depends upon other factors than the mere default of principal; (2) guarantee is not immediately enforceable; (3) creditor has to exhaust proper legal remedies against the principal; and (4) creditor is required to prove breach of terms of the contract or loss occurring from the breach or both. An example of a conditional

[4] (1996) 5 SCC450/*JT 1996 (7) SC 336*.

guarantee would be a guarantee that would only be valid upon the presentation of a legally enforceable award or judgment. This means that a security would only be encashed after the parties had gone through arbitration or litigation. Therefore, conditional bank guarantees are subject to specified conditions and are enforceable on the proof of breach of the primary underlying contract. The bank is liable to pay when the conditions in the guarantee instrument are fulfilled, but only after the bank is entitled to make an independent investigation of the underlying conditions prior to payment. For this reason, conditional bank guarantees are rarely accepted by banks because the bank would have to decide on the merits of the claim of the beneficiary.

To determine whether a bank guarantee is conditional or unconditional, the terms of the contract of guarantee are to be scanned minutely.

3. Invocation of a bank guarantee and fraud

A bank guarantee is a commercial document and it is invoked in a commercial manner. A bank guarantee can be made subject to specified conditions and such conditions act as a guiding principle for the bank when the bank guarantee is invoked. Invocation of a bank guarantee is dependent on the terms agreed at the time of issuing of bank guarantee.

Once the terms for invocation specified in the bank guarantee are met, the right to invocation gets triggered and, in such a situation, the guarantor bank must honour the invocation. There is no obligation on the bank to go into the merits of the dispute between the parties and to determine which party is at fault.

However, the SC has held that in the case of *U.P Co-operative Federation Limited vs. Singh Consultant and Engineers (P) Limited*[5] the courts can pass an order, restraining encashment of a bank guarantee in two exceptional circumstances, (i) where there is fraud of an egregious nature which would vitiate the very foundation of such a bank guarantee and the beneficiaries seek to take advantage of the situation; and (ii) when encashment of an unconditional bank guarantee is allowed, it would result in irretrievable harm or injustice to one of the parties concerned. In the instance case the U.P Co-operative Federation Limited **("Appellant")** entered into a contract with Singh Consultant and Engineers (P) Limited **("Respondent")** for supply and installation of vanaspati manufacturing plant. The Respondent furnished two bank guarantees as security for money advanced by the Appellant for undertaking the work. The Respondent failed to complete the work within the stipulated time and the Appellant invoked the two guarantees. Meanwhile, the Respondent filed the petition for an order restraining the Appellant from realizing the bank guarantees. The petition was dismissed. The SC held that an irrevocable commitment in the form of a bank guarantee cannot be interfered with as there was no question of fraud or irretrievable justice involved.

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Though the bank guarantees are independent of the underlying contract but, if they include a condition or a clause that they cannot be invoked prior to the decision of the judicial forum, then encashment of bank guarantee becomes subordinate to the specified condition. Hence, it is important that the terms of the bank guarantee are properly scrutinized since conditions specified in the bank guarantee can sometimes paralyze the independent nature of a bank guarantee.

☞ CONCLUSION

Clearly, bank guarantees can be an effective tool for performance of contractual obligations and provide a surety of fulfillment of the obligations by the other. Simultaneously, it is pertinent to remember that at times parties at fault may encash the guarantees and enrich themselves unjustly as the courts refrain from granting injunctions to prevent encashment. Due care must be exercised while drafting bank guarantees which must be unconditional and enforceable at the time of invocation without the need of any extraneous proof.

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[5] (1988) 1 SCR 1124.

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