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INTERNATIONAL JOURNAL  
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# **BANK GUARANTEES: RECENT DEVELOPMENT** **& JUDICIAL INTERPRETATION**

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## **Introduction**

Guarantee, as the very name suggests, is the assurance given by one person for another. With the advent of time, the needs and aspirations of business have shown an increasing trend and so have the risks associated alongside. Be it a harsh reality, but today, money decides the extent of growth of an individual or a business. Resources however are limited at the same time. The question lies as to whether the meagre means of the people of India should act as a hurdle in its prospect of development and expansion.

Owing to the same deficiency, in the olden days, India experienced a comparatively slow rate of growth. As regards innovation and determination, we have stood supreme but the economic power to set those thoughts in the right direction is where we've lacked. As the need to expand grew, so came a way out of this defect. There was a constant wave of uncertainties pertaining to whether the sum expected to be received in future was secure or not. However, with the concept of Bank Guarantees coming into the picture, this faded away.

A Contract of Guarantee in general shifts the liability to the guarantor in case, the person for whom the guarantee is being taken, fails to do what he was required to or simply, acts in default. This assists both the person whose guarantee is being taken and the person in receipt of such a guarantee. The former's ability to "*buy now, pay later*" is similarly put to use while the latter finds a sense of security of not having to suffer any loss/damage in future. When the Bank acts as a guarantor to aid its customers in availing credit elsewhere, the same is referred to as Bank Guarantee. The Judiciary has over time, given it a distinct interpretation. We will be dealing with the concept of Bank Guarantees in detail, laying weight on its judicial interpretation and the recent developments that have taken place in this regard.

## **Research Questions/Research Objectives**

1. To understand the concept of Bank Guarantees and analyze related provisions of the Indian Contract Act, 1872
2. To know about the recent developments that have taken place in this regard
3. To bring about the judicial interpretation with respect to Bank Guarantees

## Meaning And Definition

According to Section 126 of the Indian Contract Act, 1872 – ‘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 may be either oral or written.’<sup>1</sup>

Hence, Bank Guarantees are dealt with in Section 126 of the Indian Contract Act, 1872. Put simply, it may be defined as an arrangement/contract whereby the bank promises to fulfil the contractual obligations of some third party in case of his/her default. It is a three-party agreement between the promisor/principal debtor, promisee/creditor/beneficiary and the bank/surety. All three contracts are independent of each other.

When the promisor fails to perform his/her promise or the debtor fails to pay back the loan as required, the Bank does the same on his behalf.

**Illustration:** Mr. ‘A’ of India wishes to procure expensive machinery worth INR 12,00,000 from Mr. ‘B’ of Russia. Mr ‘B’ insists that a bank guarantee be given in respect of the same. XYZ Pvt. Ltd., the bankers of Mr. ‘A’ provide a guarantee in writing to indemnify Mr. B in case of his default to do so.

Here, Mr. ‘A’ is the principal debtor, Mr. ‘B’ the creditor and XYZ Pvt. Ltd., the surety.

If default occurs on part of Mr. ‘A’, Mr. ‘B’ can directly ask XYZ Pvt. Ltd. to indemnify the same.

## Need For Bank Guarantees

With the modernization and up-gradation of India, ideals of globalization and innovation came up, which furthered the need for finance. Now is the era of startups and entrepreneurship wherein mass investment is required. However, the immediate capacity to pay is what hinders the growth of the business industry. In the majority of these cases, it is expected that the amount falling short of, shall be earned/procured in the near future. Bank Guarantees, by minimizing transaction risks, removes these hindrances.

New firms/businessmen have insufficient means to further their prospects. Also, raising loans becomes difficult consequently. Such persons can avail of credit facilities by using Bank Guarantees as a tool of security. Creditors, on receipt of such guarantee, advance the money as they find Bank Guarantees as a reliable source of securing their transaction. From the point of view of creditors, they have a sense of security that in case the promisor fails to perform his/her contractual obligations, they will be reimbursed for the same.

Henceforth, Bank Guarantees not only ease things for the principal debtor but also provide security to the Creditors.

## Recent Developments

The outbreak of COVID-19 was an unforeseen and exceptional challenge, one which India had not witnessed. In a setting of uncertainties and chaos, the business world was adversely affected. Further, the Judiciary was not taking its usual course of action. Bank Guarantees was another aspect that went through disorderly interpretation when a whole lot of contracts came to a standstill, with their future ambiguous. However, the Government of India vide order dated 13<sup>th</sup> May 2020,

<sup>1</sup>Indian Contract Act, 1872, § 126, No. 9, Imperial Legislative Council, 1872 (India).

declared the ongoing pandemic as force majeure. Doing so raised the question as to whether Covid-19 be used as a pretext to bank guarantees.

The Delhi High Court and the Bombay High Court had differing opinions on this subject matter. In *Haliburton Offshore Services Inc. vs Vedanta Ltd. &Anr.*<sup>2</sup>, the Delhi High Court observed that the defendant was wanting the invocation of Bank Guarantees despite the outbreak of Covid-19 which had prevented the plaintiff from discharging his contractual obligations. It provided relief to the plaintiff and held that the lockdown having affected the plaintiff's ability to discharge obligations, was a state of distinct circumstances, and hence, granted an injunction restraining the invocation of bank guarantees.

In contrast to this, the Bombay High Court, in *Standard Retail Pvt. Ltd. vs M/s G.S. Global Corp. &Ors.*<sup>3</sup>, wherein as against the demand for bank guarantees by a South Korean company, that had exported steel to an Indian party, the Indian party sought an injunction to restrain encashment of bank guarantee by reason of lockdown restrictions, held that the defence of force majeure cannot be applied in the given situation and allowed the invocation of bank guarantees.

Thus, we saw a disagreeing take on the matter by two different Courts. The decision of the Supreme Court is still awaited, which will show us a way out without any shadow of reasonable doubt. The Insolvency and Bankruptcy Code, 2016 was well touched upon consequently. As a matter of fact, Non-performance guarantees cannot be revoked during the moratorium period, as has been upheld in *GAIL (India) Ltd. vs Rajeev Manaadiar*<sup>4</sup>. However, ambiguity arose when an inconsistent judgement was given in *ICICI Bank Ltd. vs Vista Steel Pvt. Ltd.*<sup>5</sup>, whereby bank guarantees were stayed on the ground of the moratorium period being in operation.

We can find, through recent developments that the law pertaining to Bank Guarantees is still to undergo many changes.

## Judicial Interpretation

The Judiciary has over time, held the opinion that its intervention in the execution of Bank Guarantees would be unfair to the very resolution of the law. These guarantees can be invoked as and when the Principal Debtor defaults on his/her promise without the Court, having to enforce the same. This saves both money and time that goes into litigation. Further, it has been found that the contract between the Bank and the Creditor is one independent of the original contract. Hence, in case the party for whom a guarantee has been taken fails to discharge his/her obligations, the Bank's liability arises. This liability is unqualified and absolute. Hence, regardless of any enduring dispute between the Principal Debtor and the Creditor, the Bank cannot escape its legal responsibility.

In *Tarapore and Co. vs M/s V/O Tractors Export*<sup>6</sup>, the Court held that Bank Guarantees are independent of the original contract. Hence, they are absolute in nature. It reinstated the purpose of this tool as being to avoid legal proceedings. Overall, the invocation of Bank Guarantees has been unconditional. However, as an ever-growing judicial system, the Court has laid down certain exceptions, when such guarantees can be revoked.

In view of the same, we find that the Courts in India have treated Bank Guarantees as a contract distinct from the original one, and established that the same can be invoked on the fulfilment of required conditions (Conditional) or on-demand (Unconditional), as the case may be, without

<sup>2</sup>*Haliburton Offshore Services Inc. vs Vedanta Ltd &Anr.*, 2020 SCC OnLine Del 542.

<sup>3</sup>*Standard Retail Pvt. Ltd. vs M/s G.S. Global Corp. &Ors.*, 2020 SCC OnLine Bom 704.

<sup>4</sup>*GAIL (India) Ltd. vs Rajeev Manaadiar*, 2018 SCC OnLine NCLAT 374.

<sup>5</sup>*ICICI Bank Ltd. vs Vista Steel Pvt. Ltd.*, 2018 SCC OnLine NCLAT 230.

<sup>6</sup>*Tarapore and Co. vs M/s V/O Tractors Export*, AIR 1970 SC 891.

regard to the contract between the Principal Debtor and the Creditor. The Banks, if not protected by the special exceptions, are bound to be liable undeniably.

## **Analysis And Conclusion**

Bank Guarantees, a means of ensuring security in business transactions, serve various purposes for us. Be it the real-estate industry, or the setting up of tech giants, little would have been possible but for the aid of such guarantees. Foreign Bank Guarantees, Deferred Bank Guarantees, EMDs, Advance Payment Guarantees and Performance Bank Guarantees – these guarantees exist as a whole sphere. An added advantage to this arrangement is the absence of the need for the Judiciary to undertake enforcement since it is an independent contract between the Bank and the Beneficiary. No matter what the state of affairs persists between the original parties to contract, it has no bearing on this relationship.

However, the Judiciary realizes that this should not be taken as an opportunity and in lieu of the same, has considered exceptions for granting injunctions restraining Bank Guarantees. As held by the Supreme Court in *U.P. State Sugar Corporation v. Sumac International Ltd.*<sup>7</sup>, when there exists fraud on part of the beneficiary of such a nature as to “vitiating the entire underlying transaction”, an injunction can be granted in order to restrain such guarantee of the Bank. In furtherance of the view as per Section 17 of the Indian Contract Act, 1872, fraud should be seen not only as one being committed while entering into the contract but thereafter as well. Moreover, where the Court believes that enforcement of the Bank Guarantee would cause irreparable injustice to either of the parties, causing severe consequences for the nation as a whole. [REDACTED]

Henceforth, I believe that Bank Guarantees are the fillers to the voids surfacing in the trade and commerce of India. The only thing to be given due regard is the misuse of the elimination of the judicial mechanism in general. In consideration of the same, have the exceptions been listed out, as and when the need arose. However, I believe that there should be a regulatory mechanism, thus removing the ‘absolute’ nature of such guarantees. A Quasi-judicial body in respect of the same is what can be worked upon. The law pertaining to Bank Guarantees is still in the process of evolution and defining some vibrant scope for the same should be thought upon by competent persons.

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<sup>7</sup>*U.P. State Sugar Corporation v. Sumac International Ltd.*, (1997) 1 SCC 568.

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