Enforcement of Bank Guarantee: Limits of Court's Interference

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< EXECUTIVE SUMMARY >

◆A Bank Guarantee is an act of trust to facilitate the fine flow of trade and commerce in Internal and International trade or business. A Bank Guarantee is a commercial document and stands the test of time to ensure a workable guarantee in the performance of a contract. A Bank Guarantee even though, having its genesis in the primary contract between the parties, is nevertheless autonomous and independent.

Author, while analysing the concept of Bank Guarantee as evolved out from the Indian Contact Act, 1872 and various judicial pronouncements, has summarised the sanctity of its enforcement. The Scope and Limits of judicial interference have also been delineated in this Article.

While performing the auditing and consultancy job, in corporate houses, whether public or private, a Chartered Accountant, quite often, has to address the issue of Bank Guarantee and its enforcement. The provision of a Bank Guarantee has sood the test of time to ensure a workable Guarantee in the performance of a contract. For a better understanding, we may deal with the issue , first in `concept' and then in `practice'.

A Bank Guarantee is an act of trust with full faith to facilitate the fine flow of trade and commerce in Internal or International trade or business. It is a common practice in the business world that the other party (contractor or supplier) is required to furnish a Bank Guarantee of a specified amount to ensure performance Guarantee of the awarded contract. Such Guarantees even though, having their genesis in the primary contract between the parties, are nevertheless autonomous and independent contract, and the Bank which gives a performance Guarantee must honour that Guarantee according to the terms and conditions of the Bank Guarantee itself.

A Bank Guarantee is a contract between the issuing Bank and the beneficiary in whose favour the Guarantee has been furnished. Though the Bank Guarantee may have been issued by the Banker at the instance of his client, as far as the Bank Guarantee is concerned, it is a contract between the Banker and the Beneficiary in whose favour the Bank Guarantee has been issued. The party at whose instance the Guarantee has been furnished is, in a way, a stranger to the said contract of Bank Guarantee. The person in whose favour the Bank Guarantee has been issued has a right to ask the Bank to fulfil its obligation in terms of the Bank Guarantee. If the

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terms of the Bank Guarantee entitle a party to ask for the payment of money from the Bank then this right cannot be interfered with merely for the reason that there exists a dispute between the party and the client at whose instance the Bank Guarantee has been issued.

A Bank Guarantee is a commercial document and may be invoked in a commercial manner. A Bank Guarantee has many similarities to a Letter of Credit and stands on a similar footing to a Letter of Credit. Both constitute life blood of Internal and International Commerce. They are independent of underlying contract and is autonomous.

In the State of Maharashtra –vs- National Construction Company, 1996(1) J.T. (S.C.) 156, the Supreme Court has very rightly held; "The rule is well established that a Bank issuing a Guarantee is not concerned with the underlying contract between the parties to the contract. The duty of the Bank under a performance Guarantee is created by the document itself. Once the document are in order, the Bank giving the Guarantee must honour the same and make the payment. Ordinarily, unless there is an allegation of fraud or the like, the Court will not interfere directly or indirectly, to withhold payment, otherwise, trust in commerce, Internal and International, would be irreparably damaged".

In National Thermal Power Corporation Ltd. –vs-.- Flowmore Pvt. Ltd., AIR 1996 SC 445, the Supreme Court has categorically held that in a Bank Guarantee which is payable on demand, implies that the Bank is liable to pay as and when a demand is made upon the Bank by the Beneficiary. The Bank is not concerned with any dispute between the Beneficiary and the person at whose instance the Bank has issued the Bank Guarantee. In this context we may quote Lord Denning M.R. in Edward Own Engineering Ltd. –vs- Barclay's Bank International Ltd. (1978) 1 All. E.R. 976 wherein he observed: "A Bank which gives a performance Guarantee must honour that Guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier is in default or not. The Bank must pay according to its Guarantees, on demand, if so stipulated, without proof or conditions. The only exception is when there is a clear fraud of which the Bank has notice".

STATUTORY PROVISIONS:

Section 126 of the Indian Contract Act, 1872 provides "Contract of Guarantee", "surety", "principal debtor and creditor" – A "contract of Guarantee" is a contract to perform that promise, or discharge the liability of a third person in case of his default. The person who keeps 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."

And Section 127 provides for "Consideration for Guarantee – Any thing done, or any promise made for the benefit of the principal debtor may be a sufficient consideration to the surety for giving the Guarantee."

So, a Contract of Guarantee is a Tripartite Agreement which contemplates the Principal Debtor, the Creditor or Beneficiary and the Surety. A Contract of Guarantee may be said to be an Accessory Contract i.e., a contract of accessory nature, being always ancillary and subsidiary to some other contract or liability on which it is founded and without the support of which it must fail. By this Contract, the Promisor undertakes to be the answerable person, whose primary liability to the Promisee must exist or be contemplated.

But it is not necessary or a Sine qua non, that the principal debtor must expressly be a party to the document or Guarantee, as it is adequate, if the principal debtor is a party by implication. A careful reading of Section 126 and 127 of the Contract Act would clearly indicate that the primary idea of a suretyship is an undertaking to indemnify the debtor in case he does not fulfil his promise, the contract of Guarantee, being thus, a contract to indemnify.

Let us analyse the whole phenomenon. First, there is a contract between the principal debtor and the creditor, which is the base of the entire transaction. Then there is a contract between the Bank or the Guarantor and the Creditor by which the former Guarantee, the performance of the Contract to the Creditor. This, however, is not enough to constitute a Contract as one of Guarantee, because, so far one essential element, that there exist a further contract, by which the principal debtor asks the guarantor to act as such, is missing, though such a request may not always be expressed and may be implied. A Guarantee is a Contract to indemnify upon a contingency i.e., the failure of the principal debtor to perform the contract as per the terms and conditions of the Contract.

ENFORCEMENT OF BANK GUARANTEE:

The proposition of law in respect of the encashment of a Bank Guarantee is well established. There are two types of Performance Guarantees. The first one is absolute and is encashable on the very demand of the beneficiary and the demand according to the terms of the Guarantee is conclusive. In such types of Guarantees the Beneficiary 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 and as to how much amount is due to the former.

The other type is where the Guarantee is not encashable without proof of breach of underlying contract. However, in both types of Guarantees, the Bank issuing the performance Guarantee is not concerned with the underlying contract. The duties in such Guarantees are created by the document itself which in other words is independent and autonomous and is not concerned with the underlying contract unless the Guarantee itself says that it will be enforceable on the proof of breach of the primary underlying contract. The aforesaid approach has been confirmed by the Supreme Court in Hindustan Steel Workers Constn. Ltd. –vs- G.S. Atwal & Co. (Engineers) Pvt. Ltd., AIR 1996 SC 131 wherein the Apex Court observed : "where a Bank unconditionally agreed to pay to party to whom Guarantee was given to pay on demand sums specified therein and amount specified was to be paid without demur and without requiring the beneficiary to invoke legal remedy and there was a specific provision that beneficiary was to be sole judge as to whether party furnishing Guarantee has committed breach of contract and as to what extent of loss and damages and decision of the beneficiary as to amount was final and binding, the order of Court restraining beneficiary from enforcing Guarantee till disposal of proceedings pending before Arbitrator as to disputes between beneficiary and party furnishing Guarantee is illegal and without jurisdiction".

The principle is that commercial trading must go on the solemn Guarantee either by the letter of credit or by Bank Guarantee irrespective of any dispute between contacting parties whether or not the goods or services are up to contract".

In United Commercial Bank –vs- Bank of India AIR 1981 SC 1426 the Supreme Court has enunciated only one exception in the following words : "Except possibly in clear cases of fraud of which the Banks have notice, the Courts will leave the merchants to settle their dispute under the contract by litigating or arbitration as available to them or stipulated in the contract". In Larsen & Toubro Ltd. –vs- Maharashtra State Electricity Board, AIR 1996 SC 334, the Supreme Court, while confirming the same approach, has observed that injunction against enforcement of Bank Guarantee can be granted by a Court only the event of fraud of irretrievable injustice.

SICK INDUSTRIAL COMPANIES ACT, 1985:

When the principal debtor is declared as sick industry under the provisions of Sick Industrial Companies (Special Provisions) Act, 1985, the encashment of Bank Guarantee can be made in compliance with the provisions of the Act.

In Allahabad Bank, Katni –vs- M.P. Electricity Board, Rampur AIR 1996 M.P.1, an objection was raised on behalf of the Bank that if the amount cannot be recovered directly from the Company, the same cannot be recovered indirectly from the Bank. Setting aside this contention the High Court came to the conclusion : "Where a Guarantee being irrevocable was given for the performance of the contract in relation to an industry, even if the industry was declared sick under the sick industrial Companies (Special Provisions) Act, 1985 legal proceedings for encashment of Guarantees against the Bank, standing as surety for the industry would not be barred by the Act as no order passed under Act had been challenged nor is the recovery contrary to any scheme framed under the Act. The recovery proceedings are not execution proceedings against the Sick Industry.

In this case reliance was placed on UP Co-operative Federation Ltd. –vs- Singh Consultant & Engineers Pvt. Ltd. (1988) 1 SCC 174 wherein it is held : "The commitments of Banks must be honoured free from interference by the Courts and irrevocable commitments either in the form of confirmed Bank Guarantee or irrevocable letter of credit cannot be interfered with. In order to restrain operation either of irrevocable letter of credit or of Bank Guarantee there should be serious disputes and there should be good prima facie case of fraud and special equities in the form of preventing irretrievable injustice between the parties".

However, these observations of Madhya Pradesh Pradesh High Court may be analysed in the light of 1993 Amendment of Sec. 22 of the Sick Industrial Companies (Special Provisions) Act, 1985.

Now, under Section 22 of the Act, where in respect of an Industrial Company, an enquiry under Section 16 is pending, or any scheme under Section 17 is under prepa-

ration or a sanctioned scheme is under preparation or a sanctioned scheme is under implementation or when an Appeal under Section 25 is pending, then no proceedings for the winding up of the industrial company or for execution, distress, or the like against any of the properties of the industrial company or the appointment of a receiver in respect thereof can be proceeded with, and no suit for the recovery of money or for the enforcement of any security against the industrial company shall lie or be proceeded with except with the consent of the Board for Industrial and Financial Reconstruction (BIFR) or as the case may be the Appellate Authority.

Further, Section 26 creates a bar of jurisdiction in respect of any order passed or proposal made under the Act so as to be questioned in a civil Court.

The Correct position of law has been enunciated by the Supreme Court in U.P. State Sugar Corporation –vs- M/s. Sumac International Ltd. AIR 1997 SC 1644. Explaining the relevant provisions of the Act, the Supreme Court observed: "It could not be said that there would be irretrievable injustice to the contractor, if the Bank Guarantees were allowed to be realised because the contractor was a sick industrial company in respect of which a reference was pending before the Board of Industrial and Financial Reconstruction under the Sick Industrial Companies (Special Provisions) Act, 1985. The mere fact that a reference under the 1985 Act is pending before the Board, is not sufficient to bring the case in the ambit of "irretrievable injustice" exception. Under the scheme of the said Act the Board is required to make such enquiry as it may deem fit for determining whether any industrial company has become a sick industrial company. Similarly, it cannot be said that its right to realise its claim, if established, would be affected by Section 22 of the said Act. Even under Section 22, there is no absolute bar against any suit for the recovery of money. The suit cannot be proceeded with except with the consent of the Board or the Appellate Authority. Therefore, in an appropriate case, the Board of the Appellate Authority is entitled to give its consent to such a claim being proceeded with".

The contract of Bank Guarantee being an independent one of the underlying contract and is autonomous, the necessary corollary of such independence and autonomy is that one is not to go beyond that contract and has not to look to any other contract including the underlying or primary one.

The Guarantee is an "autonomous" and imposes an "absolute" obligation on the Bank in its terms and the Bank is bound to pay when called upon to do so as long as the terms are complied with except in case of obvious fraud, of which the Bank has notice.

POWER OF THE COURT TO GRANT INJUNCTION :

It is an established law that the Court should not lightly interfere in the operation of the irrevocable documentary credit and that in order to restrain the operations of irrevocable letter of credit, performance bond or Guarantee, there should be serious dispute to be tried and there should be a good prima facie case of fraud.

In the U.P. Co-operative Federation Ltd. vs. Singh Consultants Engineers (P) Ltd. (1988) 1 SCR 1124, the Supreme Court observed: The nature of the fraud that the Courts talk about is fraud of an "egregious nature so as to vitiate the entire underlying transaction". It is fraud of the beneficiary, not the fraud of somebody else.

However, in Hindustan Steel Works Construction LTd. –vs- Tarapore & Co. 1996(6) J.T. (SC) 295 Air, 1986, SC 2268 the Supreme Court repealed a contention that the law laid down in U.P. Co-operative Federation Ltd. Case was that except in case of fraud and that too when it creates irretrievable injustice, the Courts should not interfere by restraining the beneficiary from encashing the Bank Guarantee. After an indepth discussion the Supreme Court came to the conclusion that fraud cannot be said to be the only exception. In a case where the party approaching the Court is able to establish that in view of the special equities in his favour and if injunction as requested is not granted then he would suffer irretrievable injustice, the Court can and would interfere.

This is also the position of law followed in England. In R.D. Harbottle (Merchantile) Ltd. –vs- National Westiminister Bank Ltd. (1977) 2 All E.R. 862, Justice Kerr has appro priately observed: "Only in exceptional cases would the Courts interfere with the machinery of irrevocable obligations assumed by Banks. In the case of a confirmed performance Guarantee, just as in the case of a confirmed letter of credit, the Bank was only concerned to ensure that the terms of its mandate and confirmation had been complied with and was in no way concerned with any contractual dispute which might have arisen between the buyer and seller".

The grant of injunction is a discretionary power in equity jurisdiction. The Bank Guarantee creates an irrevocable obligation to perform the contract in terms thereof. Performance of the contract does not give rise to cause nor is the Court justified on that basis, to issue an injunc-

tion from enforcing the contract i.e., Bank Guarantee. The parties are not left with no remedy. In the event if the dispute in the main contract ends in the party's favour, he is entitled to damages or other consequential reliefs.

In State Trading Corporation of India Ltd. –vs- Jainsons Clothing Companies JT 1995(5) SC 403, the Supreme Court observed that the existence of any dispute between the parties to the contract is not a ground for issuing an injunction to restrain the enforcement of Bank Guarantee. But that does not mean that the parties to the underlying contract cannot settle the disputes with respect to allegations of breach by resorting to litigation or arbitration as stipulated in the contract. The remedy arising ex-contractual is not barred and the cause of action for the same is independent of enforcement of the Guarantee.

The same principles will apply to cases where injunction is sought against a party seeking to invoke the Bank Guarantee because the net effect of such an injunction is to restrain a Bank from performing a Bank Guarantee. That is so, because one cannot do indirectly what one is not free to do directly".

The Court usually refrain from granting injunction to restrain the performance of the contractual obligations arising out of a letter of credit or a Bank Guarantee between the Bank and the beneficiary.

The Court should normally insist upon enforcement of the Bank Guarantee and the Court should not interfere with the enforcement of the contract of Guarantee unless there is a specific plea of fraud or specific equities in favour of the plaintiff. He must necessarily plead and produce all the necessary evidence in proof of the fraud in execution of the contract of the Guarantee, but not the contract either of the original contract or any of the subsequent events that may happen as ground for fraud.

In Sevenska Handels Bankan –vs- Indian Charge Chrome AIR 1994 SC 626, the Supreme Court has very rightly held that where Bank Guarantee which were irrevocable in nature, in terms, provided that they were payable by the guarantor to the owner on demand without demur, and that the owner would be the sole judge of whether and to what extent the amount had become recoverable from the contractor or whether the contractor had committed any breach of the terms and conditions of the agreement and that the right of the purchaser to recover from the guarantor any amount would not be affected or suspended by reason of any disputes that may have been raised by the contractor with regard to its liability or on the ground that proceedings were pending before any tribunal, arbitrator or Court with regard to such dispute.

The disputes between the parties relating to the termination of the contract cannot make invocation of the Bank Guarantee fraudulent.

GENERAL PRINCIPLES:

Now, we may sum up the general principles as evolved out in the various decisions of the Supreme Court as follows: -

1. A Bank Guarantee is ordinarily a bipartite contract between the issuing Bank and the beneficiary quite distinct and independent of the underlying contract, the performance of which it seeks to secure. To that extent, it can be said to give rise to a cause of action separate from that of underlying contract. If the document of Guarantee is in order, the Bank giving the Guarantee must honour the same to make payment.
2. The commitments of the Banks under a Bank Guarantee must be honoured and the Court should not interfere by granting injunction to restrain the performance of the contractual obligations arising out of Bank Guarantee. The contract of Guarantee is a contract which the Bank has undertaken to unconditionally and unequivocally abide by the terms of the contract. It is an act of trust with full faith to facilitate free flow of trade and commerce in internal or international trade or business.
3. The issuing Bank is bound to observe and honour the terms of Guarantee. The Beneficiary of a Bank Guarantee can not be restrained from invoking the Bank Guarantee, and the issuing Bank can not be injuncted from paying over the proceeds of the Bank Guarantee, except in the case of fraud which violates the entire underlying transaction or in a case where irretrievable injustice would be caused by the invocation or the encashment of the Bank Guarantee.
4. The existence of any dispute between the parties to the Contract is not a ground for issuing an injunction to restrain enforcement of Bank Guarantee. But that does not mean that the parties to the underlying contract cannot settle a dispute with respect to allegation of breach by resorting or litigation or arbitration as stipulated in the contract. The remedy arising ex-contrace is not barred and the cause of action for the same is independent of enforcement of Guarantee.
5. When the Principal Debtor is a sick industry under the Sick Industrial Companies (Special Provisions) Act, 1985, the encashment of the Bank Guarantee can be proceeded with the consent of the Board of Industrial and Financial Reconstruction (BIFR) or as the case may be, the Appellate Authority. ■