

Determination of Claim Period of Bank Guarantee in Context of Section 28 of the Contract Act, 1872

Bank guarantee is a very popular and effective commercial document in promotion of business. However, Section 28(b) of the Contract Act, 1872 read with Exception 3 has created a lot of confusion in determination of the Claim Period of a bank guarantee. Banks are divided in interpretation of the clause and application thereof. The author has endeavoured to arrive at the logical interpretation of the clause. Read on...



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Bank Guarantee is one of the most important and popular non-fund based banking facility in promotion of trade and commerce both in domestic and international markets. It is well defined under section 126 of the Contract Act, 1872 which states that a contract of guarantee is a contract to perform or discharge the liability of a third person in case of his default. The person who gives the guarantee is called the "Surety" (here the issuing bank), the person in respect of whose default the guarantee is given is called the "Principal Debtor"

(bank's client) and the person to whom the guarantee is given is called the "Creditor" (here the customer of bank's client, also known as beneficiary). The beneficiary of the bank guarantee has a right to ask the bank to fulfil its obligation in terms of the bank guarantee. It is a non-fund based banking facility since it does not involve outgo of funds from the bank when the client avails the facility, but may at a later stage evolves into financial liability if the client fails to discharge its commitment. A bank guarantee is usually an

unconditional and irrevocable document which has to be honoured without demur when invoked. Bank guarantee although having its genesis in the primary contract between the parties, is nevertheless an autonomous and independent contract. In the *State of Maharashtra vs. National Construction Company, 1996 (1) J.T. (S.C.) 156*, the Supreme Court 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 documents are in order, the Bank giving the Guarantee must honor 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 a similar pronouncement in *National Thermal Power Corporation Ltd. Vs. Flowmore Pvt. Ltd., AIR 1996 SC 445*, the Supreme Court categorically held: “A Bank

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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.”

Notwithstanding Clause

The Bank Guarantee is an agreement between the issuing bank and the beneficiary which requires specific and unambiguous interpretation. Parties are bound by the terms and conditions as mentioned in the guarantee document. There cannot be any liberal or generous interpretation and more specifically in favour of the beneficiary who has the absolute power to exercise its right as the sole arbiter while invoking the Bank Guarantee. In this context, the “Notwithstanding Clause” of a bank guarantee is the most important element. The usual format of this clause is as follows.

Notwithstanding anything contained herein:

1. Our [issuing bank] liability under this Bank Guarantee shall not exceed Rs.xxx [guarantee amount].
2. This Bank Guarantee shall be valid upto dd/mm/yyyy [validity date].
3. We are liable to pay this guarantee amount or any part thereof under this Bank Guarantee only and only if you serve upon us

a written claim or demand on or before dd/mm/yyyy [claim date].

The issuing bank undertakes to pay to the beneficiary the amount claimed or demanded under the Bank Guarantee regardless of any dispute between the parties pending before any court of law, tribunal or arbitration. Although, it is not mandatory, it is customary to fix the claim date few days or months after the validity date so that the notice of claim or demand reaches the issuing bank within such claim period.

Considering the importance of Bank Guarantee in promotion of trade and commerce, the Reserve Bank of India has issued guidelines to the commercial banks to ensure that where guarantees are invoked, payment should be made to the beneficiaries without delay and demur. An appropriate procedure for ensuring such immediate honouring of guarantees should be laid down so that there is no delay on the pretext that legal advice or approval of higher authorities is being obtained. Delays on the part of banks in honouring the guarantees when invoked tend to erode the value of the bank guarantees, the sanctity of the scheme of guarantees and image of banks.

It is well known practice that the “Notwithstanding Clause” of the bank guarantee would relieve and discharge the bank from liability under the guarantee on failure of the beneficiary of the guarantee

submitting the demand / claim with the bank on or before the expiry of claim period.

Section 28 of the Contract Act

However, the amendment to Section 28 of the Indian Contract Act, 1872 has created much anomaly in interpretation of the validity of the claim period of the bank guarantee. Original Section 28 was amended in 1997 with effect from 8th January, 1997. The amended Section 28 reads as follows.

“Every agreement:

- (a) by which any party thereto is restricted absolutely from enforcing his rights under or in respect of any contract, by the usual legal proceedings in the ordinary tribunals, or which limits the time within which he may thus enforce his rights; or
- (b) which extinguishes the rights of any party thereto, or discharges any party thereto, from any liability, under or in respect of any contract on the expiry of a specified period as to restrict any party from enforcing his rights, is void to that extent.”

There was further amendment in 2013 by which Exception 3 was inserted with effect from 18th January, 2013 which reads as follows.

“This section shall not render illegal a contract in writing by which any bank or

financial institution stipulate a term in a guarantee or any agreement making a provision for guarantee for extinguishment of the rights or discharge of any party thereto from any liability under or in respect of such guarantee or agreement on the expiry of a specified period which is not less than one year from the date of occurring or non-occurring of a specified event for extinguishment or discharge of such party from the said liability.”

Section 28(a) which was in fact the original Section 28 prior to amendment in 1997 intends to protect any party in a contract to initiate his right of remedy in a court of law within the time limit as stipulated in the Limitation Act, 1963. The purpose is obvious, noble and simple to understand.

The Law Commission in its Report of March, 1984, suo moto decided that Section 28 required amendment with justification as follows. “1.2 Under Section 28 of the Indian Contract Act, 1872 – to state the point in brief – an agreement which limits the time within which a party to an agreement may enforce his rights under any contract by proceedings in a court of law is void to that extent. But this Section does not invalidate an agreement in the nature of prescription, that is to say, an agreement which provides that, at the end of a specified period if the rights thereunder are not enforced, the rights shall cease to exist. This position creates serious

anomalies and hardship, apart from leading to unnecessary litigation. Prima facie, it appeared to the Commission that the Section stood in need of reform on this point.”

In context of above justification amendment in form of Section 28(b) was introduced with effect from 8th January, 1997. The amendment intends to clarify that the time restriction in a bank guarantee to lodge a claim or demand against the issuing bank will not extinguish right of the beneficiary in a bank guarantee to initiate legal proceeding in the court of law as per permissible time limit under the Limitation Act, 1963 either against the bank or the debtor on whose behalf the guarantee was issued. The clause “the usual legal proceedings in the ordinary tribunals” as mentioned in the unamended Section 28 or post amended Section 28(a) is applicable to Section 28(b) by virtue of logical connotation.

In spite of introduction of Section 28(b), there was little impact in banking transactions pertaining to bank guarantees. Bank guarantees with claim period lesser than the period of limitation under the Limitation Act (usually 3 years) were being issued without any difficulty. Whenever, there is any attempt by a party in a contract to prevent the beneficiary to invoke any bank guarantee, the judicial system, irrespective of the bonafide intent of the petitioner, has gone in favour of the beneficiary to uphold the irrevocable and unconditional

characteristic of a bank guarantee. It appears that the amendment to Section 28 was made more out of unfounded apprehension than ground reality. In fact, the aforesaid amendment was literally unknown to banking circle as well as corporate customers.

Union of India Vs IndusInd Bank Case

The incongruity and confusion of Section 28(b) surfaced out after introduction Exception 3 when the Union of India preferred appeals against IndusInd Bank Ltd. & Anr before the Supreme Court vide civil appeal no.9087-9089 of 2016 arising of SLP(Civil)16166-16168 of 2011 challenging the judgement of the Division Bench of Bombay High Court. In this matter the Union of India called upon the exporters to submit the necessary documents, failing which the bank guarantees would be enforced. As the exporters failed and neglected to furnish the documents, bank guarantees were invoked by the Union of India. The IndusInd Bank refused to pay under the said guarantees, stating that the same could be invoked only within the extended period of three months. It was argued by the Union of India that in view of Section 28 of the Contract Act, the period for making a claim cannot be limited to three months and that the period should be the period of limitation prescribed under the Limitation Act. The Division Bench of the Bombay High Court held that since

the bank guarantees were not invoked within the time prescribed in the guarantee document, the suits would have to be dismissed. The Supreme Court also upheld this decision, however mainly on the ground that the amendment of Section 28 in 1997 would not apply retrospectively to the case and as the subject guarantees were issued prior to such amendment, the appeals were not sustainable.

The Supreme Court after analysing various judgements also determined that limiting the period to make a claim against a guarantee is different from a fixing a time period within which a claim can be lodged. Where a claim is not lodged within the time period prescribed, no claim can be made thereafter. However, if a claim is made within the time prescribed and no payment is made against the claim, the claimant is entitled to sue within the limitation period. In view of the fact that no time restriction was envisaged in the clauses providing for invocation, the issue of Section 28 having any application did not arise.

Confusion of Exception 3

The Supreme Court while passing the order made an observation with regard to the amendment brought in Section 28 with effect from 18th January, 2013 by insertion of Exception 3 which limited the period provided under the Limitation Act from three years to one year in the case of banks and financial institutions which

issue a guarantee. The Supreme Court stated that: *"It may only be noticed, in passing, that Parliament has to a large extent redressed any grievance that may arise qua bank guarantees in particular, by adding an exception (iii) by an amendment made to Section 28 in 2012 with effect from 18.1.2013. Since we are not directly concerned with this amendment, suffice it to say that stipulations like the present would pass muster after 2013 if the specified period is not less than one year from the date of occurring or non-occurring of a specified event for extinguishment or discharge of a party from liability."* This statement has created immense confusion. It has led to the understanding that a claim period of three months as per the contract between the parties would be available after expiry of the guarantee tenure for lodging a claim before the Bank and not before the Court. Therefore it does not come under the purview of Section 28, rendering Exception 3 to Section 28 irrelevant in such a case.

The directive of the Supreme Court that such stipulations would pass muster after 2013 if the specified period is not less than one year from the date of occurring or non-occurring of a specified event for extinguishment or discharge of a party from liability has resulted in a scenario where Banks are now in a confusion

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whether the judgment requires the banks to provide for a claim period of at least one year.

The ambiguity in determination of claim period in a bank guarantee has divided the banks in three categories. First category of banks are adopting the position that the claim period in a bank guarantee is not governed by Section 28 of the Contract Act. Second category of banks are insisting the clients to insert claim period of one year in the text of the bank guarantee even if, not called for by the beneficiary. Third category of banks are entertaining or attempting to entertain the claim of invocation preferred by the beneficiary even after expiry of the claim period which was shorter than one year.

Threat to Future of Bank Guarantees

The confusion emanating from the interpretation of Section 28(b) read with Exception 3 is slowing but surely creating a threat to operation of bank guarantees. Usually a bank guarantee is given as a security for performance during the warranty period. If the claim period is made mandatorily of one year, it is obvious that the beneficiary will enjoy extended

warranty period beyond the period originally stipulated in the underlying contract between the parties.

Further, there is possibility of unscrupulous beneficiary invoking a bank guarantee for unethical financial gain beyond the stipulated claim period. This will make corporate customers apprehensive whether to open bank guarantees and such decision will no doubt affect the flow of trade and commerce.

Logical Interpretation and Application

It is imperative to keep the claim period of a bank guarantee outside the purview of Section 28 of the Contract Act. Bank guarantee is a special document which gives unquestionable, absolute and unilateral right to the beneficiary to prefer the claim against the guarantor. Consequently, the commitment of the bank is unconditional and irrevocable. The party opening the bank guarantee, even if has the justification in non-performance of the obligation as per the underlying contract, cannot prevent the beneficiary from invocation of the bank guarantee within the claim

period. He can only take shelter of the court of law to submit his plaint and resolve the dispute. Bank is a commercial body and not a legal forum. As such, the claim period in a bank guarantee

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is worked out as per mutual consent of the parties with reference to need of the underlying contract. It should not be governed by the Limitation Act which stipulates the time period for legal recourses under different circumstances. Further, Section 28 deals with the legal proceeding in ordinary tribunals. As such, the Exception 3 should not override the basic nature of Section 28. Therefore, the logical interpretation of Exception 3 to Section 28(b) can be explained as the right to make a claim before an ordinary tribunal pertaining to a dispute related to the claim in a bank guarantee is limited to one year. However, the basic condition is that the claim under the bank guarantee has to be made within the stipulated claim period of the bank guarantee which may be less than one year. The Reserve Bank of India has issued the Master Circular on Guarantees and Co-acceptance relating to the conduct of guarantee business by banks. In this context, it is suggested that apex bank may take necessary steps to avoid any interpretational issues so that free flow of trade and commerce continues unaffected. ■

