



# **BANK GUARANTEES: LEGAL INSIGHTS FOR BUSINESS**

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## Introduction[1]:

In today's business world, where companies can't easily assess a business partner's financial reliability, there is a need for tools that ensure secure payments. A "Bank Guarantee" is one such tool/instrument that provides assurance in commercial/business transactions. Let's explore what a Bank Guarantee is and how it benefits both the beneficiary and the service provider.

## What is Bank Guarantee?

Bank Guarantee is an instrument executed between bank, principal debtor and beneficiary. As per the provisions of Indian Contract Act,1872, a contract of guarantee is defined as a contract to perform the promise or discharge the liability of a third person in case of their default[2] . In the context of a Bank Guarantee:

- The **bank** acts as the "surety" or guarantor.
- The **service provider, the one on whose behalf the guarantee is issued**, is "principal debtor."
- The **beneficiary** is the party to whom the guarantee is given.

“ABC” is a construction contractor and enters into an agreement with XYZ, who requires the fencing around his plot to be built before the monsoon in next 3 months. “ABC” promises to build the fencing prior to monsoon. “XYZ” demands a Performance Bank Guarantee from “ABC”, in case he fails to perform his obligation. “ABC” fails to finish the construction within stipulated timeframe and thus “XYZ” sends a written notice to bank stating that ABC has not performed the contract and invokes the Bank Guarantee. The bank pays the amount under the Performance Bank Guarantee upon receiving such written demand.

[1]The article reflects the general work of the authors, and the views expressed are personal. No reader should act on any statement contained herein without seeking detailed professional advice.

[2]Section 126 of Indian Contract Act, 1872



Bank Guarantee is a financial instrument that assures performance or payment, depending on the nature of the guarantee agreed between the parties. Thus, the bank's secondary obligation to step in and pay the Beneficiary comes into picture when the primary obligation (the principal debtor 's performance) is not fulfilled.

### **Role of Bank Guarantees in Commercial/ business transactions:**

A Bank Guarantee plays a vital role in business transactions by acting as a financial safeguard, providing security and trust between parties in various business dealings. Its primary function is to assure the beneficiary that, in case the principal debtor (contractor, vendor, supplier) fails to fulfil its obligations, the bank will compensate the beneficiary up to the guaranteed amount. This creates a level of confidence in high-value transactions where risk management is essential.

In sectors like manufacturing, construction and infrastructure, Bank Guarantees are often used to secure contracts for the performance of works or services. For example, a Company may need a **Performance Bank Guarantee** to reassure the beneficiary that the work will be completed as agreed. Bank Guarantees are frequently used in supply chain and trade agreements where the beneficiary may require a **payment guarantee** to ensure the principal debtor delivers the goods or services as specified. Conversely, principal debtor may request a guarantee in the form of an advance payment guarantee to secure payments made before the delivery of goods or services.



## Types of Bank Guarantees:

Bank Guarantees can either be conditional or unconditional. Let us see the difference between them:

Aspects	Conditional Bank Guarantee	Unconditional Bank Guarantee
Definition	A Bank Guarantee that requires the Beneficiary to meet specific conditions or prove certain claims before invoking it.	A Bank Guarantee that allows the beneficiary to demand payment without meeting any specific condition or providing justification.
Invocation Requirement	Invocation requires proof of default or failure in terms specified in the contract, such as non-performance by the principal debtor.	Can be invoked on-demand without the need to provide reasons or proof of default, simplifying enforcement for the Beneficiary.
Bank's Liability	Bank's liability is conditional; it is triggered only upon satisfaction of the stipulated conditions in the guarantee.	Bank's liability is absolute and payable on-demand, irrespective of any dispute between parties.

As per the nature of business transaction there are different types of Bank Guarantees such as financial bank guarantee, Advance Bank Guarantee, Performance Bank Guarantee, deferred payment guarantees etc.



## Legal Aspects:

### Let us see the legal aspects to be checked while drafting Bank Guarantee:

- 1. Alignment with Underlying Contract:** Bank Guarantees needs to be issued in connection with an underlying contract (e.g., a construction or supply contract). It is important that the guarantee is consistent with the terms of the main contract and covers the obligations it is intended to secure.
- 2. Independent Contract:** A Bank Guarantee is an independent contract between the bank and the beneficiary, separate from the underlying contract between the debtor and the beneficiary. The bank is required to honour the Bank Guarantee as per its terms, regardless of disputes between the principal debtor and the Beneficiary or conditions in their contract. The Supreme Court has emphasized that honoring Bank Guarantees is essential, given the public interest involved[3].
- 3. Avoiding Ambiguities:** The language used in drafting Bank Guarantees should be clear and precise, which will reduce the risk of misinterpretation. Vague or ambiguous terms may lead to disputes about the interpretation of the respective Bank Guarantee.
- 4. Conditions of Invocation:** In order to prevent unauthorized or premature claims by the Beneficiary it is important that the terms or conditions under which the Bank Guarantee can be invoked (claimed) needs to be spelt out clearly. The Beneficiary can invoke the Bank Guarantee by making a written demand to the bank as per the concerned Bank Guarantee's terms.

**Case Reference:** In **UP State Sugar Corporation v. Sumac International Ltd.** (1997) [4], the Supreme Court ruled that the bank's liability to honour an unconditional guarantee arises as soon as it is invoked. The Courts shall have minimal intervention for the enforcement and shall only intervene in cases involving fraud or potential irretrievable damages. The disputes between the parties relating to the termination of the contract cannot make invocation of the bank guarantees fraudulent.

[3]United Commercial Bank v. Bank of India ((1981) 2 SCC 766) and Hindustan Steelworks Construction Ltd. v. Tarapore & Co[(1996) 5 SCC 34] ; M/S Garg Builders Versus Hindustan Prefab Ltd. And Anr(O.M.Ps.(I) (COMM.) 200/2021, 201/2021 & 202/2021)

[4]1996 INSC 1433



## 5. Jurisdiction and Governing Law:

It is crucial to include a clear jurisdiction and governing law clause in Bank Guarantee, especially in international transactions, to avoid cross-border legal complications.

The jurisdiction for resolving disputes related to Bank Guarantees is typically governed by the terms of the contract. Indian Courts have held that if a specific jurisdiction is mentioned in the Bank Guarantee, that jurisdiction will prevail, unless such jurisdiction is absolutely irrelevant and no part of cause of action has arisen in such jurisdiction.

This principle has been followed in **South East Asia Shipping Co. VS. Nav Bharat Enterprises Pvt. Ltd.** (1996)[5], In this case, the respondents had filed a suit for perpetual injunction against the appellant from enforcing bank guarantee dated July 16, 1977. The Bank Guarantee was executed in Delhi, however, it was sent to Mumbai where the underlying contract was executed and was to be performed. The parties spent 19 years in litigation and ultimately on 13th March 1996, the Supreme Court held, inter-alia, that merely because the Bank Guarantee was executed in Delhi and transmitted for performance in Mumbai, it does not give rise to a cause of action before the Delhi High Court. As per the Apex Court, the plaint for perpetual injunction against the enforcement of the Bank Guarantee, therefore, ought to be returned for presentation to the proper Court, i.e. the Courts in Mumbai.

**6. Validity and Expiry Dates:** for preventing Open-Ended Liability, Bank Guarantee should have clear validity and expiry dates.

**7. Extension Clauses:** In case the business transactions are of such nature that there might be requirement of extension in the timelines in the contract, then accordingly provision for extension of Bank Guarantee needs to be incorporated in the document.

[5] 1996 INSC 381



**8. Avoid Overextending Liability:** From the principal debtor's/applicant's point of view, it needs to be ensured that the Bank Guarantee does not expose them to excessive or unintended liabilities. For example, a performance guarantee should cover only specific aspects of performance, not every possible issue under the contract.

**9. Understanding Bank's Role:** Role of the bank as a guarantor, ensuring the bank's obligations needs to be clearly outlined and consistent with banking norms.

**10. Dispute Resolution Mechanism:** It is preferred that suitable dispute resolution mechanism is clearly defined in the Bank Guarantee in the event of dispute, which will reduce the risk of prolonged litigation or arbitration in case of a disagreement.

**11. Exception to Injunction Against Invocation:**

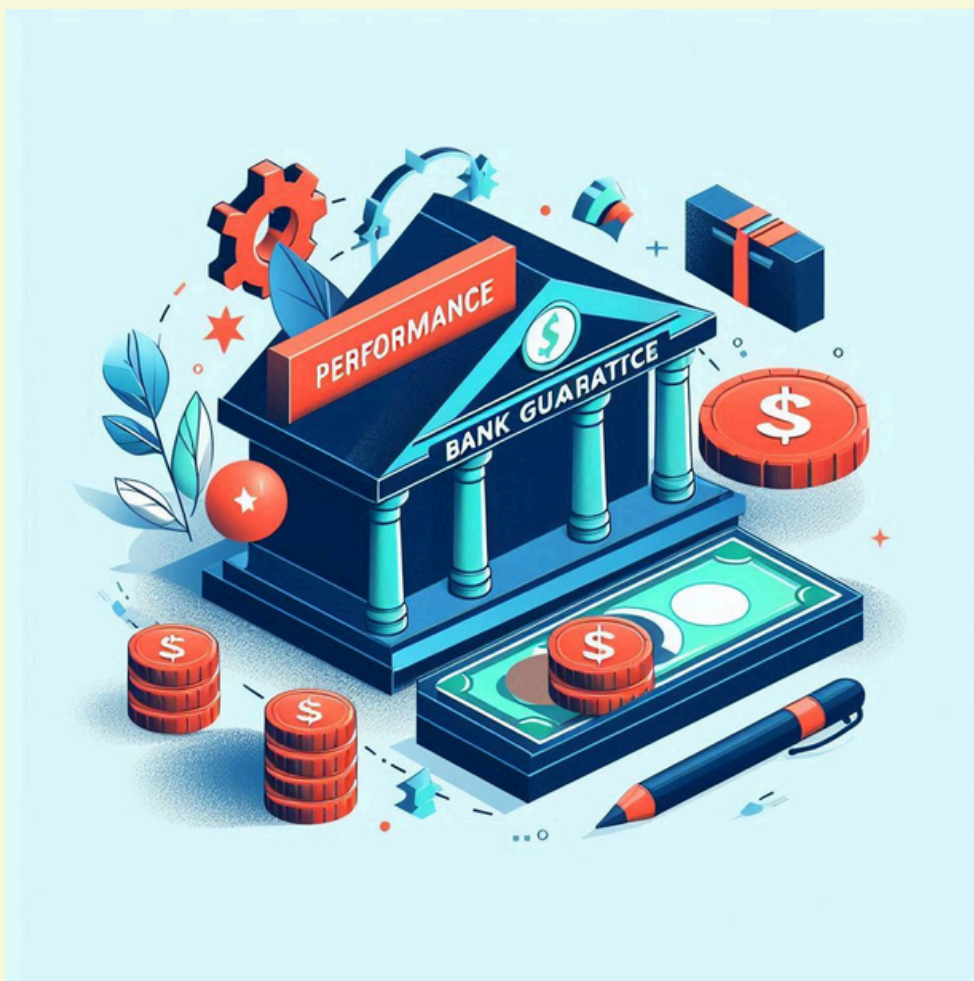
Generally, bank guarantee is to be honored when invoked properly. However, there are certain recognized principles<sup>[6]</sup> wherein, payment under a Bank Guarantee may be refused or restrained:

1. where the bank knows that the documents presented by the beneficiary for seeking enforcement are forged or fraudulent;
2. where a fraud by one of the parties to the underlying contract has been established, and the bank has notice of the fraud;
3. where a case of apprehension of irretrievable injustice is made out;
4. where the guarantee is conditional, and the condition has not been complied with;
5. where the conditions necessary for invoking a conditional bank guarantee have not arisen;
6. where the purpose for which a conditional guarantee was given has been accomplished;
7. where the period stipulated for invocation of the guarantee has expired.

## Conclusion:

Parties should ensure that the bank guarantee terms are unambiguous, enforceable, and tailored to their specific transaction needs to minimize disputes. For beneficiary, the inclusion of well-structured and robust bank guarantee clauses in contracts is essential for protecting their interests. These clauses act as a financial safeguard, ensuring that principal debtor perform as per their contractual obligations. For principal debtor, a clear and fair guarantee clause enhances their credibility while managing risks associated with unfair calls on the guarantee.

Proper bank guarantees facilitate smooth business operations, enabling corporates to engage confidently in high-value contracts.





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