



BANK GUARANTEES

ONCE MORE, the Supreme Court has reiterated the proposition that in the absence of fraud and irretrievable injury, injunction cannot be granted against an unconditional bank guarantee. The court so held in *Swenska Handelsbanken v. Indian Charge Chrome*.¹ After an exhaustive review of earlier decisions of the court, it emphasised that in the case of a confirmed bank guarantee or irrevocable letters of credit, enforcement cannot be interfered with, unless there is fraud and irretrievable injustice involved in the case and fraud has to be established.

Referring to *U.P. Co-operative Federation Ltd. v. Singh Consultants and Engineers Ltd.*,² the court observed that the fraud must be of the beneficiary and not of any one else. The fraud must be of an ‘egregious nature as to vitiate the entire underlying transaction’. An interesting feature of the 1994 judgment of the Supreme Court is a number of foreign cases cited in arguments. Amongst the cases so cited were the following :

- (i) *Itek Corporation v. First National Bank of Boston*,³
- (ii) *Handerson v. Canadian Imperial Bank of Commerce and Peat Marwick Ltd.*⁴; and
- (iii) *N.M.C. Enterprises Inc. v. Columbia Broadcasting System Inc.*⁵

The court pointed out that in all these cases, the plaintiff had made out sufficient showing of fraud to justify grant of an injunction. The situation is different if fraud is not established. The reasoning of the Supreme Court can be best understood if one bears in mind, (a) the object of the so-called bank guarantee; (b) the terms of the documents; and (c) commercial practice and assumptions.

The modern documentary credit has its origin from letters of credit. The letter of credit has developed over hundreds of years of international trade. It was intended to facilitate the transfer of goods between distant and unfamiliar buyer and seller. It was intended to facilitate the transfer of goods between distant and unfamiliar buyer and seller. It was found difficult for a buyer to pay for goods prior to their delivery. The bank's letter of credit came to bridge this gap. In such transactions, the seller (beneficiary) receives payment from the issuing bank when he presents a demand as per the terms of the documents. The bank must pay if the documents are in order and the terms of credit are satisfied. The bank, however, was not allowed to determine whether the seller had actually shipped the goods

1. A.I.R. 1994 S.C. 626 at 642, 646-8.

2. (1988) 1 S.C.C. 174.

3. 566 Fed. Sup. 1210 (U.S. District Court, Massachusetts).

4. 40 B.C. 318 (Berger J.).

5. 14 U.C.C. Reporting Service 1427 (New York Supreme Court) (Fein, J.).



or whether they conformed to requirements of the contract. Any dispute between seller and buyer must be settled between themselves. The courts, however, in carving out an exception to this rule of absolute independence, held that if there has been a "fraud in the transaction", the bank could dishonour the beneficiary's demand for payment. The courts have generally permitted dishonour only on the fraud of the beneficiary, not that of someone else.

In modern commercial transactions, various devices are used to ensure performance by contracting parties. The traditional letter of credit has taken a new meaning. Stand-by letters of credit are also used in business circles. Performance and guarantee bonds are also devices increasingly adopted in transactions. Courts have treated such documents as analogous to letters of credit.

Whether it is a traditional letter of credit or a new device, like performance bond or performance guarantee, obligation of the bank appears to be the same. Since it pledges its own credit, involving its reputation, it has no defence except in the case of fraud. The nature of the fraud that courts talk about, is the fraud of an "egregious nature as to vitiate the entire underlying transaction". It is the fraud of the beneficiary, not that of someone else. The bank cannot be compelled to honour the credit in such cases. Here, it would be proper for the bank to ask the buyer to approach the court for an injunction. The court, however, should not lightly interfere with the operation of irrevocable documentary credit. In order to restrain the operation of irrevocable letter of credit, performance bond or guarantee, there should be (i) a serious dispute to be tried; and (ii) a good *prima facie* act of fraud.

Sound banking system may require more caution in the issuance of irrevocable documentary credit. It would be for banks to safeguard themselves by other means, and, generally, not for courts to come to their rescue with injunctions unless there is established fraud.

The problem has arisen because of use of the word "guarantee", in a sense which is somewhat different from its ordinary connotation. In its general sense, "guarantee" is an accessory contract whereby one party undertakes to be answerable for the debt or default of another, who is primarily liable to a third party.⁶ The surety's liability does not arise, until the principal debtor has committed a default.

Section 126, Indian Contract Act defines a contract of guarantee as a contract to perform the promise or discharge the liability of a third person in case of his default. It follows, that the liability under a guarantee is collateral.⁷

But the position in the case of unconditional bank guarantees is radically different. The so-called bank guarantee, when it is couched in an unconditional and unqualified form, is really an independent agreement. It is not dependent upon, or subordinate, to the agreement between the beneficiary of the guarantee (*i.e.*, the person entitled to recover thereunder) and the person at whose instance the guarantee has been given. There are really two separate agreements, where the

6. Walker, *Oxford Companion to English Law* 542 (1980).

7. *Mahabir Shamsher v. Lloyds Bank*, A.I.R. 1968 Cal. 371; *Nagpur Nagrik Sahakar Bank Ltd. v. Union of India*, A.I.R. 1981 A.P. 1537.



bank guarantee is an unconditional one. The bank is not a surety but is an independent debtor to the beneficiary of the guarantees.

*P.M. Bakshi**

* Former Director, Indian Law Institute and former Member, Law Commission of India, New Delhi.