A Critical Appraisal of the Role of Bank Guarantees in Transnational Sales - An Indian Perspective

A Dissertation submitted to the National University of Advanced Legal Studies, Kochi in partial fulfilment of the requirements for the award of L.L.M Degree in International Trade Law

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CERTIFICATE

This is to certify that **Ms. Monisha. M, Reg. No: LM0219009** has submitted her dissertation titled, '**A CRITICAL APPRAISAL OF THE ROLE OF BANK GUARANTEES IN TRANSNATIONAL SALES - AN INDIAN PERSPECTIVE**' in partial fulfilment of the requirement for the award of Degree of Master of Laws in International Trade Law to The National University of Advanced Legal Studies, Kochi, under my guidance and supervision. It is also affirmed that, the dissertation submitted by her is original, bonafide and genuine.

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I declare that this dissertation titled, '**A CRITICAL APPRAISAL OF THE ROLE OF BANK GUARANTEES IN TRANSNATIONAL SALES - AN INDIAN PERSPECTIVE**' researched and submitted by me to The National University of Advanced Legal Studies in partial fulfilment of the requirement for the award of the Degree of Master of Laws in International Trade Law, under the guidance and supervision of **Dr. Athira P.S**, is an original, bona-fide and legitimate work and it has been pursued for an academic interest. This work or any type thereof has not been submitted by me or anyone else for the award of another degree of either this University or any other University.

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LIST OF ABBREVIATIONS

- CLP - Commercial Law and Practice
- FEDAI- Foreign Exchange Dealers Association of India
- ICC –International Chamber of Commerce
- ISP98 - International Standby Practices
- RBI – Reserve Bank of India
- UCC - Uniform Commercial Code
- UCP – Uniform Customs and Practice for Documentary Credits
- UNCITRAL – United Nations Commission on International Trade Law
- URCG - Uniform Rules for Contract Guarantees
- URDG- Uniform Rules for Demand Guarantees

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CHAPTER 1: INTRODUCTION

1.1 INTRODUCTION:

With the advent of globalization and the growth of international trade, there arose a need for increased security and protection for commercial transactions. The use of demand guarantees in transnational sales addresses this very need. A 'bank guarantee' is generally a short and simple instrument issued by a bank (or other financial institution) under which the obligation to pay a stated or maximum sum of money arises merely upon the making of a demand for payment in the prescribed form and sometimes also the presentation of documents as stipulated in the guarantee within the period of validity of the guarantee[1]. Bank guarantees is a method of financing employed in domestic and international trade where the bank provides the requisite security for a party's "financial" or "performance" obligation under a contract.

To be more specific, a bank guarantee is the absolute undertaking by the bank to pay the Beneficiary (i.e., the person in whose favour the Bank Guarantee is issued) an agreed sum, if its Customer (the applicant of the Bank Guarantee) fails to fulfill its obligations under the terms and conditions of the contract with the Beneficiary. It follows that it is bipartite contract between the bank and the Beneficiary, independent of the underlying contract between the buyer and the seller. Either the buyer or seller may avail a bank guarantee[2]. A buyer who is apprehensive about the seller not performing its obligations under the contract may require the seller to secure a guarantee from a bank to pay a certain amount in case of a default. Similarly, if the seller is insecure about the buyer's ability to pay the price, it may require the buyer to obtain a guarantee from a bank.

Many demand guarantees are payable on first demand without any additional documents, which reflects their origin in replacing cash deposits, although increasingly guarantees

[1] D. WARNE & N. ELLIOT, BANKING LITIGATION 277 (2d ed. 2005); J O'DONOVAN AND J PHILLIPS, THE MODERN CONTRACT OF GUARANTEE 525 (2003).

[2] Amrita Ganguli, Bank Guarantees: An Analysis, MANUPATRA, (February 21, 2020, 7:40 PM), http://www.manupatrafast.com/articles/PopOpenArticle.aspx?ID=70c1051d-5804-409a-a55b-5e0243dfc004&txtsearch=Subject:%20Finance/Banking.

require at least a statement indicating that the principal is in breach[3]. Therefore, a demand guarantee is like a substitute for cash[4] and must be honoured on presentation of a written demand that complies with the provisions of the guarantee[5]. Demand guarantees are particularly common in construction and project contracts, and are frequently required by Middle Eastern customers[6].

The International Chamber of Commerce ('ICC')[7] defines a demand guarantee in article 2(a) of its Uniform Rules for Demand Guarantees ('URDG')[8] as follows:

"For the purpose of these Rules, a demand guarantee (hereinafter referred to as "Guarantee") means any guarantee, bond or other payment undertaking, however named or described, by a bank, insurance company or other body or person (hereinafter called the "Guarantor") given in writing for the payment of money on presentation in conformity with the terms of the undertaking of a written demand for payment and such other document(s) (for example, a certificate by an architect or engineer, a judgment or an arbitral award) as may be specified in the Guarantee, such undertaking being given

(i) at the request or on the instructions and under the liability of a party (hereinafter called the "the Principal"); or

(ii) at the request or on the instructions and under the liability of a bank, insurance company or any other body or person (hereinafter "the Instructing Party") acting on the instructions of a Principal to another party (hereinafter the "Beneficiary")."

Goode[9] provides a somewhat broader definition than the more detailed definition found in article 2(a) of the URDG. He states that a demand guarantee may be defined as an

[3] P O'brien, *Letters of Intent and Demand Guarantees*, in ABLU 159 (1993).
[4] Intraco Ltd. v. Notis Shipping Corporation 2 Lloyd's Rep. (CA) 256, 257 (1981).
[5] *Financial Guide: Demand Guarantees*, SITPRO 2 (2007) (Apr. 6, 2020, 6:20 PM), www.sitpro.org.uk. (SITPRO was formerly the Simpler Trade Procedure Board; a non-departmental public body for which the United Kingdom Department of Trade and Industry has responsibility).
[6] *Report on the Use of Demand Guarantees in the UK*, SITPRO 5 (2003) (Apr. 6, 2020, 6:30 PM), www.sitpro.org.uk.
[7] For a full discussion of the International Chamber of Commerce (hereinafter the 'ICC') see *infra* Chapter 2.
[8] Uniform Rules for Demand Guarantees, ICC Publication no. 458 §2(a) (1992). For a full discussion of these rules see *infra* Chapter 2.

undertaking given for payment of a fixed or maximum sum of money on presentation to the party giving the undertaking of a demand for payment (nearly always required to be in writing) and such other documents (if any) as may be specified in the guarantee within the period and in conformance with the other conditions of the guarantee. Goode's definition is somewhat broader than the more detailed definition found in article 2(a) of the URDG, the scope of which is limited to guarantees in writing given for the account of a third party (as opposed to the issuer's own account), and providing for payment against a written demand and other specified documents. In reality, most demand guarantees are payable on 'first written demand' or 'simple demand' without any additional documents. In its truly simplest form, the simple demand guarantee authorises the beneficiary to make demand for payment in any form, including oral, and at any time within the period of effectiveness of the guarantee without justifying the legitimacy of the demand[10]. This mirrors the cash deposit origin as well as the traditionally superior negotiating power of most buyers and employers. However, there are some countries in which the requirement for additional documents is more common than in others. For instance, the demand guarantee may stipulate that the beneficiary must support his written demand by a statement of breach; a requirement that is also embodied in article 20 of the URDG[11].

A 'bank demand guarantee' can be described as a personal security (undertaking) in terms of which a bank promises payment to a beneficiary if a principal (often the bank's client) defaults in the performance of his obligation in terms of the underlying contract. The bank has to pay if the documents presented with the demand for payment comply with the documents that are mentioned in the text of the demand guarantee. For this reason, the bank's obligations are autonomous from the underlying contract between the beneficiary and the principal; which means that, in principle, the bank must pay if proper

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[9] ROY GOODE, GUIDE TO THE ICC UNIFORM RULES FOR DEMAND GUARANTEES 8-9 (ICC Publication No 510, 1992).

[10] E. E. Bergsten, *A New Regime for International Independent Guarantees and Stand-by Letters of Credit: The UNCITRAL Draft Convention on Guaranty Letters*, in INTERNATIONAL LAWYER 859, 868 (1993).

[11] Uniform Rules for Demand Guarantees, ICC Publication no. 458 §20 (1992), "*Article 20 Any demand for payment under the Guarantee shall be in writing and shall (in addition to such other documents as may be specified in the Guarantee) be supported by a written statement (whether in the demand itself or in a separate document or documents accompanying the demand and referred to in it) stating:*
(i) that the Principal is in breach of his ob1ligation(s) under the underlying contract(s) or, in the case of a tender guarantee, the tender conditions; and (ii) the respect in which the Principal is in breach."

complying documents are presented, even if the beneficiary and the principal have not stipulated that there is a default under the original underlying contract[12].

In this regard, demand guarantees differ from surety guarantees or bonds, in which the security lender (i.e., surety) is only involved if the principal party defaults in the performance of an obligation[13]. The above definitions of a demand guarantee also embrace instruments known as 'performance bonds'[14] or 'performance guarantees'[15]. These instruments are merely forms of demand guarantees. It is normal practice for construction contracts to require the contractor to provide some form of security to guarantee the performance of his obligations under the contract. In practice, performance guarantees tend to be used where the underlying obligation is not the payment of money, but the performance of other obligations such as those arising under a construction or engineering contract[16].

In *Edward Owen Engineering Ltd v. Barclays Bank International Ltd and Another,*[17] Lord Denning MR held that performance guarantees were virtually promissory notes payable on demand[18]. He also stated that[19]

"[a]ll this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. 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 has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The only exception is when there is clear fraud of which the bank has notice."

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[12] Filip De Ly, *The UN Convention on Independent Guarantees and Stand-by Letters of Credit*, in INTERNATIONAL LAWYER 831, 832 (1999).
[13] De Ly, *supra* note 12, at 832.
[14] E G GALLAGHER, THE LAW OF SURETYSHIP (2d ed. 2000).
[15] M BRINDLE & ET AL., LAW OF BANK PAYMENTS 672-673 (3rd ed. 2004).
[16] M HAPGOOD, PAGET'S LAW OF BANKING 729 (12th ed. 2003).
[17] Edward Owen Engineering Ltd v. Barclays Bank International Ltd and Another, 1 Lloyd's Rep 159, 166 (QB: 1978).
[18] *Id* at 170H.
[19] *Id* at 171A–B.

Bank Guarantee has substantially reduced the financial risk involved in commercial transactions. Bank guarantee is an effective method to gauge the creditworthiness of a business and is a tool that has proven fruitful to provide the necessary assurance to the Beneficiary[20]. As compared to its counterparts (i.e., Letter of Credit), Bank Guarantee requires fewer documents and is processed quickly by the banks (if all the documents are submitted)[21]. However, Bank Guarantee is fraught with its drawbacks. Take, for instance, the rigid stance taken by them to assess the creditworthiness and financial health of the business which adversely affects the time taken for processing the request. Banks consider good financial health a pre-requisite for providing Bank Guarantees. Therefore it naturally follows that they would be unwilling to assist businesses that are running on losses or having low cash reserves. Another point to note is the fact that at times, banks feel the need to demand collateral in addition to the nominal fee. Such a practice may prove to be cumbersome since this would amount to limiting the company's ability to finance its working capital in the future.

1.2 STATEMENT OF PROBLEM:

There is a lack of clarity surrounding the law and theory of bank guarantees and the actual practices adopted by the banks and this has necessitated the need for an in-depth study.

1.3 SCOPE OF STUDY:

Bank Guarantee is independent of the contract between the buyer and the seller, and this very independence is the crux of the 'Principle of Autonomy.' This Study shall attempt to evaluate how far the principle of autonomy stands diluted today. The already established exception to the principle of autonomy, namely fraud, shall be critically analyzed. The study shall also attempt to examine the recent developments in this area and evaluate the need to include illegality and nullity as exceptions to the Principle of Autonomy. This study also attempts to evaluate the effectiveness of the regulatory framework governing Bank Guarantees. Lastly, the study shall analyze data from bankers to ascertain the

[20] *Bank Guarantee: Uses, Eligibility & Process, Advantages*, CLEARTAX, (April 10, 2020, 7:00 PM) https://cleartax.in/s/bank-guarantee.
[21] *Id*

practical difficulties faced by them concerning Bank Guarantees. The scope of the study was initially designed in such a way as to conduct personal interviews of bankers to try and ascertain the practical reality with respect to bank guarantees. However, owing to extraneous reasons this was not possible and the author had to confine the scope of the study to conducting telephonic interviews with two bankers.

1.4 RESEARCH QUESTIONS:

1. Does the principle of autonomy apply absolutely in the case of bank guarantees or is it subject to certain exceptions? Is this a mandatory principle, or rather one that is subject in some degree to party autonomy?
2. How far are the policies adopted by banks and the regulatory scheme on lending activities issued by the Reserve Bank of India in line with the Uniform Customs Practice provisions and other internationally established rules and what are the shortcomings of the existing framework?
3. What are the practical difficulties faced by bankers in case of bank guarantees?

1.5 RESEARCH OBJECTIVES:

1. To determine the extent to which the Principle of Autonomy shall apply to bank guarantees.
2. To evaluate if the policies adopted by banks and the regulatory scheme on Bank Guarantees issued by the Reserve Bank of India are in line with the Uniform Customs Practice Provisions and other applicable international rules and to identify the shortcomings if any in the existing framework.
3. To identify and analyze the practical difficulties faced by bankers in case of Bank Guarantees.

1.6 HYPOTHESIS:

The rules and regulatory framework governing bank guarantees both at the international and the national level are not sufficient and fails to protect the rights of all the parties involved effectively.

1.7 RESEARCH METHODOLOGY:

The research methodology adopted for this Study is analytical. This Study is primarily doctrinal. An attempt shall also be made to employ the interview method to identify the practical difficulties faced by bankers in respect of demand guarantees.

1.8 CHAPTERIZATION:

1.8.1. Chapter 1- Introduction

This chapter gives a general overview regarding bank guarantees. The author has listed down certain objectives with respect to which dissertation shall be completed and has further mentioned research questions which shall help the audience to understand the purpose, need and scope of this study. The author has lastly outlined the research methodology proposed to be used. There is uncertainty surrounding the law and theory of bank guarantees and the actual practices adopted by the banks and this has necessitated the need for an in-depth study through this dissertation.

1.8.2. Chapter 2- Bank Guarantees and Related Laws: A Historical Analysis

This chapter traces the evolution of guarantees. It delves into the concept of demand guarantees by analyzing the role of the various parties involved in bank guarantees. It also examines the various types of bank guarantees involved in international trade. The chapter also sheds light on the various laws at the international level that govern demand guarantees. A distinction has been made between laws that are self-regulatory in nature on one hand and of official nature on the other.

1.8.3. Chapter 3- Principle of Autonomy- Independence of the Instrument of Guarantee from the Underlying Contract

This chapter gives an overview of the principle of autonomy which in essence states that a demand guarantee is independent both from the underlying trade transaction between the applicant for the credit and the beneficiary, and from the relationship

between the former and the issuing bank. In other words a demand guarantee is independent of the contract between the buyer and the seller. The chapter analyses the meaning of the term autonomy and also attempts to ascertain the nature of the principle of autonomy. To achieve this it delves into the various facets of the principle of autonomy such as the relationship between autonomy and various factors such as validity, interpretation, choice of law & jurisdiction and underlying transaction. Effort has also been made to analyze the functions of the principle of autonomy. The legal effects and the scope of autonomy have been elaborated upon. Lastly the chapter also traces the evolution of the principle of autonomy in India using case laws.

1.8.4. Chapter 4- Fraud and Other Exceptions to the Principle of Autonomy

This chapter deals with the exceptions to the principle of autonomy i.e., fraud and irretrievable harm or injustice. It looks into the meaning of the term fraud and is an attempt at ascertaining the standard of proof when it comes to establishing fraud. It goes on to analyze the applicable law. Lastly, this chapter scrutinizes the exception relating to irretrievable harm or injustice with the help of case law.

1.8.5. Chapter 5- Regulatory Control and Banking Practices Related to Demand Guarantees

This chapter deals with the regulatory control exercised in relation to demand guarantees by examining the master circular issued by the Reserve Bank of India in addition to the FEMA guidelines. This has been supplemented by information that has been obtained by interviewing two bankers. Effort has also been made to try and ascertain the procedure to be followed while issuing such demand guarantees. The telephonic interview has also helped identify the practical difficulty faced by bankers in relation to demand guarantees.

1.8.6. Chapter 6- Conclusion and Suggestions.

This chapter gives an overview of the problems (i) created by the autonomy principle; (ii) relating to fraud exception; and (ii) faced by the issuing and corresponding banks. The chapter also explores the nature of the administrative controls and elaborates the

practice followed by Indian courts. It identifies the need (i) to limit the autonomy principle; (ii) to bring about clarity in relation to the fraud exception; (iii) for unification of the law relating to demand guarantees; (iii) to develop a regulatory system; (iv) to distinguish documentary credits from demand guarantees; (v) to appoint a banking commission on demand guarantee in India; (v) to strengthen the banking ombudsman system; and (vi) for more internal checks and balances.

This work intends to shed light on the meaning and significance of demand guarantees as well as to understand the Indian standpoint of the role of bank guarantees in transnational sales. To this end, the study has been undertaken and while the research questions have been spelled out in this chapter, subsequent chapters shall endeavour to answer the same.

CHAPTER 2: BANK GUARANTEES AND RELATED LAWS: A HISTORICAL ANALYSIS

2.1 INTRODUCTION

In the past, cash deposits or earnest money was used by a party as a means to assure the counterparty of the performance of its obligations under the terms of the contract[22]. With the advent of globalization and the growth of international trade, the use of such methods proved to be expensive as it amounted to undue strain on the resources of the parties[23]. This, in turn, necessitated the need for an alternative source of financing, and consequently, the use of banks and other financial institutions gained momentum[24]. This practice evolved in due course of time and gave way to the mechanism whereby a written undertaking was provided by banks, in favour of the party, which was payable on demand[25]. Thus, bank guarantees emerged as an outcome of the changing market needs which called for an effective solution to address the risk of non-performance of contractual obligations in transnational contracts, more specifically contracts for the sale of goods, large construction contracts and other international contracts, where the consequences of default were quite serious and could not be easily remedied[26]. These factors may explain the substantial rise in the use of bank guarantees since 1960[27].

Bank Guarantees are also known as 'independent undertakings', 'performance bonds/guarantees', 'tender bonds/guarantees', 'independent (bank) guarantees', 'first demand guarantees', 'demand guarantees', and 'default undertakings'[28]. Either the buyer or seller may avail themselves of a bank guarantee. If they are procured by the buyer, their aim is to secure the payment of the price to the seller by substituting a "reliable paymaster"[29] for the buyer. If they are procured by the seller, their purpose is to secure

[22] Goode, *supra* note 9, at 8 and O'Brien, *supra* note 3, at 157.
[23] *Id*.
[24] *Id*.
[25] *Id*.
[26] *See* J. C. T. CHUAH, LAW OF INTERNATIONAL TRADE: CROSS-BORDER COMMERCIAL TRANSACTIONS 517-519 (4th ed. Sweet & Maxwell 2009).
[27] De Ly, *supra* note 12, at 832–833.
[28] M. Coleman, *Performance Guarantees*, Lloyd's Maritime and Commercial Law Quarterly 223, 223 (1990).
[29] Soproma v. Marine and Animal Byproducts Corpn, 1 Lloyds Rep. 367, 385 (1966).

the buyer for any potential claims for damages against the seller for non-delivery of goods, defective delivery or other cases of non-performance[30]. In other words, a buyer who is apprehensive about the seller not performing his obligations under the contract may require the seller to secure a guarantee from a bank to pay a certain amount in case of a default. Similarly, if the seller is insecure about the buyer's ability to pay the price, it may require the buyer to obtain a guarantee from a bank. The extent of the liability of a bank will depend upon the terms of the underlying contract and is usually expressed as a percentage of such a contract amount.

2.2 PARTIES TO BANK GUARANTEES:

2.2.1. Applicant: means the party indicated in the guarantee as having its obligation under the underlying relationship[31] supported by the guarantee. The applicant may or may not be the instructing party[32]. In other words, the applicant is the party (either the buyer or the seller) to the underlying contract who instructs his bank to issue a guarantee in favour of the beneficiary, so as to assure the performance of his obligations under the terms of the underlying contract. He is also known as the 'Principal' in certain cases he may also called the 'Instructing Party'.

2.2.2. Beneficiary: means the party in whose favour a guarantee is issued[33]. Simply put, the beneficiary is the counterparty to the underlying contract with the applicant and the one who is entitled to make a claim or demand to the guarantor for the guaranteed amount.

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[30] CAROLE MURRAY ET AL., SCHMITTHOFF'S EXPORT TRADE: THE LAW AND PRACTICE OF INTERNATIONAL TRADE 245 (11th ed. 2007).

[31] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §2 (2010) "*Underlying relationship means the contract, tender conditions or other relationship between the applicant and the beneficiary on which the guarantee is based."*

[32] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §2 (2010) *"Instructing party means the party, other than the counter- guarantor, who gives instructions to issue a guarantee or counter-guarantee and is responsible for indemnifying the guarantor or, in the case of a counter-guarantee, the counter-guarantor. The instructing party may or may not be the applicant."*

[33] *Id.*

2.2.3. **Guarantor:** means the party issuing a guarantee and includes a party acting for its own account[34]. Guarantor usually refers to the bank of the applicant which is instructed to issue the guarantee in favour of the beneficiary. It may also be called the 'Issuing Bank'.

Banks may issue bank guarantee in favour of beneficiaries residing abroad, either directly or through a correspondent bank in the beneficiary's country[35]. If a bank issues the bank guarantee directly to the beneficiary, then such a bank guarantee is called direct bank guarantee and the applicant, guarantor and beneficiary are the parties primarily involved in such direct bank guarantees. However, in situations where the applicant and beneficiary are situated in different countries, a counter-guarantee[36] maybe issued. A counter-guarantee means a method of financing international trade where two demand guarantees are issued by two different banks. This mechanism of issuing a counter-guarantee involves the following steps[37]:

- Firstly, the applicant's bank or the counter-guarantor, may instruct a second bank, the guarantor (usually a correspondent of the applicant's bank in the beneficiary's country or the beneficiary's bank) to issue a bank guarantee in favour of a beneficiary. The counter-guarantor then provides a guarantee to the guarantor (which guarantee is called the counter-guarantee) assuring that it will be compensated for its payment to the beneficiary under its bank guarantee.
- Following this, the guarantor issues the bank guarantee in favour of the beneficiary. The beneficiary may then make a claim to the guarantor for the specified amount and the guarantor is bound to pay the same to the beneficiary.

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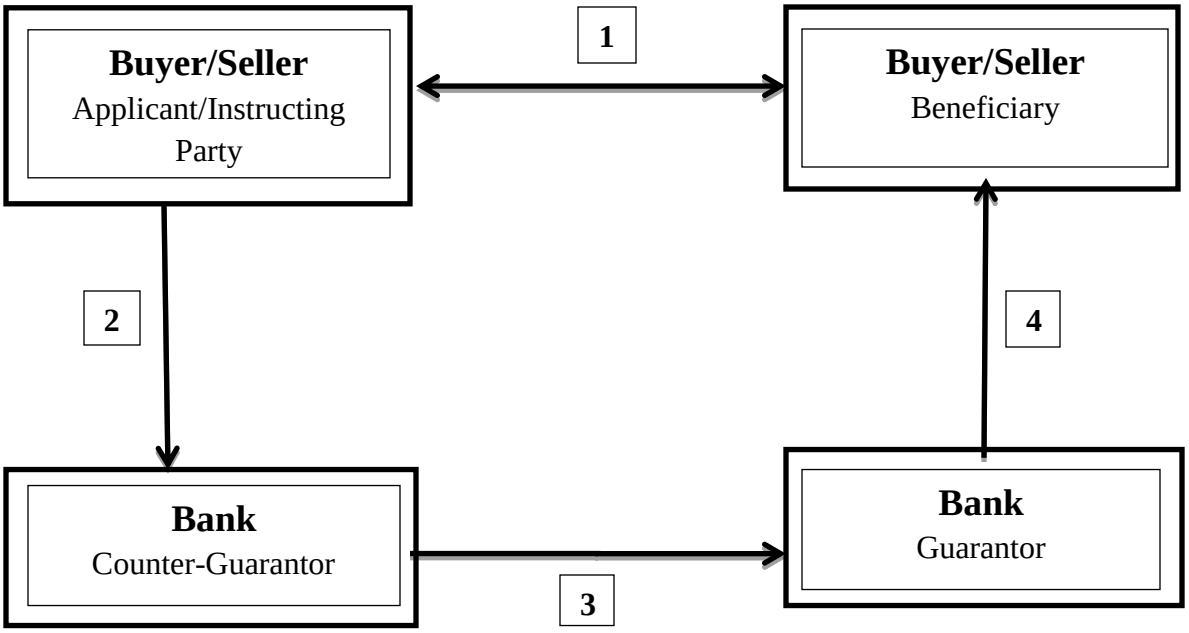
[34] *Id.*

[35] Reserve Bank of India, Master Circular, Guarantees, Co-Acceptances & Letters of Credit - RBI/2011-12/57 DBOD. No. Dir. BC. 8/13.03.00/2011-12, § 2.3 (Issued on July 1, 2011).

[36] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §2 (2010) *"Counter-guarantee means any signed undertaking, however named or described, that is given by the counter- guarantor to another party to procure the issue by that other party of a guarantee or another counter-guarantee, and that provides for payment upon the presentation of a complying demand under the counter-guarantee issued in favour of that party."*

[37] *What is a Counter-Guarantee*, LETTEROFCREDIT.BIZ, (April 12, 2020, 5:00 PM), https://www.letterofcredit.biz/index.php/2018/10/15/what-is-a-counter-guarantee/.

The Fig. 1, given below is an illustration of the process involved in issuing a counter guarantee:



1. Underlying transaction
2. Guarantee application/Counter Indemnity (from applicant to counter-guarantor)
3. Issuance of counter-guarantee
4. Issuance of bank guarantee

Fig. 1 –Process of issuing of a counter guarantee

From the process outlined above, it is evident that there are a few other parties involved in the case of a counter-guarantee besides the applicant, the beneficiary and the guarantor. They are:

2.2.4. **Counter-guarantor**: Counter-guarantor is the party issuing a counter-guarantee, whether in favour of a guarantor or another counter-guarantor, and includes a party acting for its own account[38].

2.2.5. **Instructing party:** means the party, other than the counter-guarantor, who gives instructions to issue a guarantee or counter-guarantee and is responsible for

[38] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §2 (2010).

indemnifying the guarantor or, in the case of a counter-guarantee, the counter-guarantor. The instructing party may or may not be the applicant[39].

A few additional parties involved in bank guarantees irrespective of whether it is a direct or an indirect bank guarantee are:

2.2.6. Presenter: means a person who makes a presentation[40] as or on behalf of the beneficiary or the applicant, as the case may be[41]. Should the beneficiary present a demand[42] directly to the guarantor, then the beneficiary becomes the presenter in such a situation.

2.2.7. Advising: means the party that advises the guarantee at the request of the guarantor[43]. The advising party is not under any obligation to the beneficiary under the bank guarantee and its role is limited to merely verifying the authenticity of the bank guarantee and to verify if the bank guarantee will be legally binding on the guarantor.

2.3. TYPES OF BANK GUARANTEES IN INTERNATIONAL TRADE[44]:

2.3.1. EXPORT GUARANTEE

2.3.1.1. Bid-Bond Guarantee: When an overseas buyer invites tenders from suppliers around the globe, he may ask that the tender or the bid to be accompanies by a bid-bond. A bid-bond is used to assure the party inviting the tender, of the performance of the terms of the bid by the bidder, should he be chosen. It is quite expensive for a buyer residing abroad to advertise the invitation

[39] *Id.*
[40] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §2 (2010) *"Presentation means the delivery of a document under a guarantee to the guarantor or the document so delivered. It includes a presentation other than for a demand, for example, a presentation for the purpose of triggering the expiry of the guarantee or a variation of its amount."*
[41] *Id.*
[42] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §2 (2010) *"Demand means a signed document by the beneficiary demanding payment under a guarantee."*
[43] *Id.*
[44] *See* S. N. GUPTA, LAW RELATING TO GUARANTEES 545-546 (6th ed. 2010).

for tender globally and this is one of the main reasons for insisting upon a bid-bond so as to ensure that the chosen bidder is obliged to perform his obligations in accordance with the terms of the bid and cannot withdraw from the same. Bid-Bonds are short-term bonds since, these bid bonds will be replaced by performance bonds[45] furnished by the supplier should his bid be selected. The guarantee amount for bid-bonds is between 1 per cent and 5 per cent of the contract amount.

2.3.1.2. **Performance Guarantee:** When an overseas buyer enters into a contract with an exporter he may not wish to rely merely upon the expertise, financial strength or credentials of the exporter and as an additional assurance for the performance of the contract, he may insist upon a performance guarantee being produced. A performance guarantee is where the bank (usually the exporter's bank) undertakes to financially compensate the overseas buyer for resultant loss in case the exporter fails to perform his obligations in accordance with the terms of the contract. In other words, the bank undertakes to pay liquidated damages upon demand by the overseas buyer. In all such cases the bank is bound to pay the fixed sum upon demand unless the exporter is able to get an injunction from the court directing the bank to refrain from doing so[46].

2.3.1.3. **Advance Payment Guarantee:** It is not uncommon for the exporter to ask the overseas buyer to pay an advance payment to cover the initial costs. However, at the same time the overseas buyer would also need to be assured of the fact that this advance payment will be returned should the exporter fail to comply with the terms of the contract. In such cases the overseas buyer may insist upon an advance payment guarantee. More often than not the bank of the overseas buyer who makes the advance payment through an overseas correspondent is instructed to secure a guarantee from the exporter. This guarantee is issued by a

[45] ERIC BISHOP, FINANCE OF INTERNATIONAL TRADE 78 (1st ed. 2004).
[46] Gupta, *supra* note 44.

bank acceptable to the buyer's bank. In this type of guarantee the amount of guarantee will be equal to the advance amount[47].

2.3.1.4. <u>Bank Guarantee for Warranty Obligations</u>: When the overseas buyer wants to secure any claim against the exporter for any defects that may arise after delivery, he may insist upon a bank guarantee for warranty obligations. In the case of such guarantees the exporter's obligation is not considered as discharged after delivery. Only after reasonable time has passed for any faults and omissions to be detected will the exporter be discharged of his obligation under the contract. Should a defect be detected after the delivery, the overseas buyer has the right to invoke this bank guarantee[48].

2.3.2. <u>IMPORT GUARANTEES</u>

2.3.2..1. <u>Import Guarantees for Missing Bill of Lading/Consignment:</u> arising before receipt of documents to enable the importer to clear the goods and avoid demurrage. Such bank guarantees are issued if imports are under Letter of Credit and adequate security/margin is provided[49].

2.3.2..2. <u>Import Guarantees for Provisional Assessment of Import Duty</u>: Such type of guarantee is given to the collector of customs for getting release of goods pending test reports etc.[50].

2.3.2..3. <u>Guarantees on behalf of overseas correspondents/branches:</u> As explained above banks can issue performance/bid bond guarantees on behalf of their overseas constituents provided they are covered by a counter-guarantee of the overseas correspondents/branches[51].

[47] *Id.*
[48] Gupta, *supra* note 44, at 546.
[49] *Id.*
[50] *Id.*
[51] *Id.*

2.3.2..4. Payment Guarantees: This type of guarantee is used to secure claims by the seller against the buyer for payment of the price under the underlying contract on the agreed date. Usually the amount of guarantee is the contract price[52].

2.3.2..5. Deferred Payment Guarantees: Deferred payment guarantees are usually issued by banks on behalf of their customers who wish to acquire capital goods, where the payment term is deferred or postponed. Here the Bank will undertake to make the payment either as a lump sum or in instalments on the accepted date(s) to the seller and thereafter the bank recovers the same from its customer. The Reserve Bank of India (RBI) has also issued guidelines[53] with respect to deferred payment guarantees.

2.4. LAW RELATING TO DEMAND GUARANTEES

In most countries, of both common law and civil law origins, there are no explicit statutory rules for bank guarantees. Disputes must, therefore, be primarily tackled under explicit contractual provisions, unwritten rules, principles of contract and commercial law, and precedents[54]. Considering the highly international character of the market for guarantees and the possibility of regulatory competition between various countries, there have been few initiatives at the national level to design regulations. Thus, initiatives have primarily been developed at the international level where a distinction should be made between self-regulation and official regulation. Concerning the former, one should focus on the work of the International Chamber of Commerce (ICC)[55] and with respect to the

[52] *Id.*
[53] Reserve Bank of India, Master Circular, Guarantees, Co-Acceptances & Letters of Credit - UCBs, RBI/2015-16/6, §1.1.7 (Issued on July 1, 2015),*"Deferred Guarantees (i) Banks, which intend to issue deferred payment guarantees on behalf of their borrowers for acquisition of capital assets should ensure that the total credit facilities including the proposed deferred payment guarantees do not exceed the prescribed exposure ceilings (ii) The proposals for deferred payment guarantees should be examined having regard to the profitability / cash flows of the project to ensure that sufficient surpluses are generated by the borrowing unit to meet the commitments as a bank has to meet the liability at regular intervals in respect of the instalments due. The criteria generally followed for appraising a term loan proposal for acquisition of capital assets should also be applied while issuing deferred payment guarantees."*
[54] De Ly, *supra* note 12, at 833.
[55] *Id.* at 834.

latter we shall be concentrating on the work of the United Nations Commission on International Trade Law (UNCITRAL).

2.4.1. SELF-REGULATION OR REGULATION THAT APPLIES ONLY IF THE SAME IS EXPRESSLY INCORPORATED:

The history of the ICC can be traced back to the aftermath of the First World War, where a need arose for a global system of rules to govern trade, finance, investment and commercial relations[56]. Consequently, in 1919, a group of entrepreneurs[57] comprised of industrialists, financiers and traders, came together at a meeting held in Atlantic City in New Jersey and founded the ICC[58]. One of the primary functions of the ICC is to establish a system of rules to help harmonise international trade practices[59]. These set of rules are voluntary in nature and hence can be classified as self-regulatory in nature.

For financing of international trade to be hassle free and devoid of confusion, there should be a set of uniform rules and guidelines that help these banks to deal with their counterparts in other countries. While countries may have their own national rules to govern trade finance, adopting such uniform rules and guidelines will aid in eliminating any conflict between the national rules of different countries[60]. The ICC has provided such rules and guidelines with respect to bank guarantees namely The Uniform Rules for Contract Guarantees ('URCG'), The Uniform Rules for Demand Guarantees ('URDG') and The International Practices Standby ('ISP98')[61].

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[56] *History*, INTERNATIONAL CHAMBER OF COMMERCE (April 15, 2020, 4:00 PM) https://iccwbo.org/about-us/who-we-are/history/.
[57] These entrepreneurs called themselves the "Merchants of Peace".
[58] International Chamber of Commerce
[59] *Celebrating 100-years of Making Business Work*, INTERNATIONAL CHAMBER OF COMMERCE (Nov 19, 2019, 7:04 PM), https://100.iccwbo.org/timeline .
[60] *Banking & finance-Global rules*, INTERNATIONAL CHAMBER OF COMMERCE (Nov 19, 2019, 7:08 PM), https://iccwbo.org/global-issues-trends/banking-finance/global-rules/.
[61] Andrea Frosinini, *Sources of the law relating to demand guarantees and standby letters of credit* (Nov 19,2019,7:15PM)file:///C:/Users/Admin/Downloads/Sources%20of%20the%20law%20relating%20to%20demand%20guarantees%20and%20standby%20letters%20of%20credit.pdf.

2.4.1.1. Uniform Rules for Contract Guarantees:

The ICC commissions on Banking[62] and Commercial Law and practice[63] began working on a set of uniform rules for regulating bank guarantees owing to the rising use of these instruments in international trade. In furtherance of this aim, the two commissions formed a Working Party. The Working Party together with various governmental and international commercial organisations (including the UNCITRAL), drafted the uniform rules. In 1978, the ICC approved and published the Uniform Rules for Contract Guarantees after about twelve years of concerted efforts. This was followed by another publication namely the 'Model Forms for Issuing Contract Guarantees' which was published in 1982[64].

The URCG shall apply to a guarantee only if parties expressly mention this in a guarantee[65]. If a party wishes that all the parties to the guarantee should be bound by the URCG, in such a case there should be a specific reference in the guarantee, to that effect stating that the guarantee is subject to the URCG[66]. This has been emphasised in article 1[67] of the URCG.

The URCG primarily applies to three types of guarantees i.e., the tender guarantee[68], the performance guarantee[69] and the repayment guarantee[70].

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[62] The ICC Banking Commission is a leading global rule-making body for the banking industry, producing universally accepted rules and guidelines for international banking practice.

[63] The ICC Commission on Commercial Law and Practice (CLP) develops ICC model contracts and ICC model clauses which give parties a neutral framework for their contractual relationships. These contracts and clauses are carefully drafted by experts of the CLP Commission without expressing a bias for any one particular legal system.

[64] *See* Uniform Rules for Contract Guarantees, ICC Publication No 325, Paris (1978); See also the 'Foreword" to the URCG at 6.

[65] Michelle Kelly-Louw, *Selective Legal Aspects of Bank Demand Guarantees*, 107 (2008).

[66] Uniform Rules for Contract Guarantees, ICC Publication no. 325 §1 (1978).

[67] Id. *"[t]hese Rules apply to any guarantee, bond, indemnity, surety or similar undertaking, however named or described ("guarantee"), which states that it is subject to the Uniform Rules for Tender, Performance and Repayment Guarantees ("Contract Guarantees") of the International Chamber of Commerce (Publication No 325) and are binding upon all parties thereto unless otherwise expressly stated in the guarantee or any amendment thereto."*

[68] "*Tender guarantee means an undertaking given by a bank, insurance company or other party ("the guarantor") at the request of a tenderer ("the principal") or given on the instructions of a bank, insurance company, or other party so requested by the principal ("the instructing party") to a party inviting tenders ("the beneficiary") whereby the guarantor undertakes - in the event of default by the principal in the obligations resulting from the submission of the tender - to make payment to the beneficiary within the limits of a stated sum of money.*"

The URCG through Article 9[71] laid down certain conditions that needed to be satisfied before one could invoke contract guarantees so as to prevent unfair calling of such guarantees. It specified that before the beneficiary could invoke his right of payment he should produce a judgment or arbitral award or the principal's written approval of the claim and its amount. So in essence this article excluded on-demand guarantees from the purview of the URCG. This article also meant that the beneficiary had to prove default by the principal, by going to court or submitting the dispute for arbitration, before he could invoke his right of payment. Essentially the requirements for a judgment or arbitral award as a condition of entitlement to pay were too far removed from international practice to be acceptable, coming close to crossing the line between a documentary guarantee and a surety ship guarantee[72]. This proved to be one of the contributing factors as to why the URCG was seldom used in guarantees. Another reason why the URCG failed to gain general acceptance in the market is because the rules are rather general, vague, fragmentary and conceptually fragile[73].

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[69] Uniform Rules for Contract Guarantees, ICC Publication no. 325 §2(b) (1978) *"Performance guarantee" means an undertaking given by a bank, insurance company or other party ("the guarantor") at the request of a supplier of goods or services or other contractor ("the principal") or given on the instructions of a bank, insurance company, or other party so requested by the principal ("the instructing party") to a buyer or to an employer ("the beneficiary") whereby the guarantor undertakes - in the event of default by the principal in due performance of the terms of a contract between the principal and the beneficiary ("the contract") - to make payment to the beneficiary within the limits of a stated sum of money or, if the guarantee so provides, at the guarantor's option, to arrange for performance of the contract."*

[70] Uniform Rules for Contract Guarantees, ICC Publication no. 325 §2(C) (1978) *"Repayment guarantee means an undertaking given by a bank, insurance company or other party ("the guarantor") at the request of a supplier of goods or services or other contractor ("the principal") or given on the instructions of a bank, insurance company or other party so requested by the principal ("the instructing party") whereby the guarantor undertakes——in the event of default by the principal to repay in accordance with the terms and conditions of a contract between the principal and the beneficiary ("the contract") any sum or sums advanced or paid by the beneficiary to the principal and not otherwise repaid to make payment to the beneficiary within the limits of a stated sum of money.*"

[71] Uniform Rules for Contract Guarantees, ICC Publication no. 325 §9 (1978).

[72] Roy Goode , *Abstract Payment Undertakings and the Rules of the International Chamber of Commerce*, 39 Saint Louis University Law Journal 725, 726 (1995).

[73] De Ly, *supra* note 12.

2.4.1.2. Uniform Rules for Demand Guarantees:

a. URDG 458:

Owing to the failure of the URCG, the ICC's commission on Banking Technique and Practice together with the Commission on International Commercial Law and Practice established a Joint Working Party to establish uniform rules related to such guarantees that were in line with the international practise[74]. The Joint Working Party conducted extensive research in this regard and ultimately draft rules were prepared by a smaller drafting group. The UNCITRAL Working Group on International Contract Practices also participated in the process by making quite a few recommendations for improvements[75]. The uniform rules were eventually approved by the two commissions and endorsed by the ICC in December 1991. In the end the rules embodied the collective knowledge and experience of the ICC's two commissions, professional and commercial associations and individual specialists across the world. In April 1992 the URDG were officially published[76]. This was followed in 1994 by another publication namely the 'Model Forms for Issuing Demand Guarantees'[77]. In contrast to the URCG, the URDG could be applied to demand guarantees as well[78].

b. URDG 758:

The revised URDG[79] contains thirty five articles and is applicable to any demand guarantee or counter guarantee that expressly makes a reference to the fact that it is subject to these rules[80]. The principle of autonomy inherent in bank guarantees is enshrined in Article 5[81] of the revised URDG and provides that the guarantee or the

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[74] Louw, *supra* note 65, at 110.
[75] *Id.*
[76] Uniform Rules for Demand Guarantees, ICC Publication No. 458 (1992).
[77] Model Forms for Issuing Demand Guarantees, ICC Publication No. 503(E), Paris (1994).
[78] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §1(a) (2010).
[79] Uniform Rules for Demand Guarantees, ICC Publication No. 758.
[80] *Supra* note 78.
[81] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §5 (2010) *"Independence of guarantee and counter-guarantee a) A guarantee is by its nature independent of the underlying relationship and the application, and the guarantor is in no way concerned with or bound by such relationship. A reference in the guarantee to the underlying relationship for the purpose of identifying it does not change the independent nature of the guarantee. The undertaking of a guarantor to pay under the guarantee is not subject to claims or defences arising from any relationship other than a relationship between the guarantor and the beneficiary. b) A counter-guarantee is by its nature independent of the guarantee, the underlying*

counter-guarantee is independent of the underlying contract between the beneficiary and the principal.

Article 15 of the revised URDG lays down the documentary requirements for making a demand and specifies that the demand should be accompanied by the documents specified in the guarantee along with the supporting statement by the beneficiary stating in what respect the applicant is in default[82]. Articles 27 to 30[83] of the revised URDG exempts the guarantor from liability on the quality of documents presented to it; on errors it may make in the transmission of documents or on translation; or the acts of its agents, subcontractors or any other third party whose services are being used by the guarantor; and any act or omission carried out by it in the course of carrying out the applicant's directives where it acts in good faith.

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relationship, the application and any other counter-guarantee to which it relates, and the counter-guarantor isin no way concerned with or bound by such relationship. A reference in the counter- guarantee to the underlying relationship for the purpose of identifying it does not change the independent nature of the counter-guarantee. The undertaking of a counter guarantor to pay under the counter-guarantee is not subject to claims or defences arising from any relationship other than a relationship between the counter-guarantor and the guarantor or other counter- guarantor to whom the counter-guarantee is issued."

[82] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §15(a) (2010) *"Requirements for demand a. A demand under the guarantee shall be supported by such other documents as the guarantee specifies, and in any event by a statement by the beneficiary, indicating in what respect the applicant is in breach of its obligations under the underlying relationship. This statement may be in the demand or in a separate signed document accompanying or identifying the demand."*

[83] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §27, §28, §29 and §30 (2010) *"<u>Article 27:</u> Disclaimer on effectiveness of documents The guarantor assumes no liability or responsibility for: a. The form, sufficiency, accuracy, genuineness, falsification, or legal effect of any signature or document presented to it; b. The general or particular statements made in, or superimposed on, any document presented to it; c. The description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods, services or other performance or data represented by or referred to in any document presented to it; or d. The good faith, acts, omissions, solvency, performance or standing of any person issuing or referred to in any other capacity in any document presented to it.*

<u>Article 28:</u> Disclaimer on transmission and translation a. The guarantor assumes no liability or responsibility for the consequences of delay, loss in transit, mutilation or other errors arising in the transmission of any document, if that document is transmitted or sent according to the requirements stated in the guarantee, or when the guarantor may have taken the initiative in the choice of the delivery service in the absence of instructions to that effect. b. The guarantor assumes no liability or responsibility for errors in translation or interpretation of technical terms and may transmit all or any part of the guarantee text without translating it.

<u>Article 29:</u> Disclaimer for acts of another party A guarantor using the services of another party for the purpose of giving effect to the instructions of an instructing party or counter-guarantor does so for the account and at the risk of that instructing party or counter-guarantor.

<u>Article 30:</u> Limits on exemption from liability Articles 27 to 29 shall not exempt a guarantor from liability or responsibility for its failure to act in good faith."

Articles 34[84] and 35[85] of the revised URDG relate to the governing law and jurisdiction respectively. It has been laid down that the governing law will be that of the location of the guarantor's/counter-guarantor's office/branch that issued the guarantee/counter-guarantee and disputes shall be resolved by a competent court of that jurisdiction.

2.4.1.3. International Standby Practices

The ICC Banking Commission on April 6, 1998, endorsed the International Standby practices and they took effect as of January 1, 1999[86]. The International Standby Practices[87] (ISP98) reflects generally accepted practice, custom, and usage of standby letters of credit. It provides separate rules for standby letters of credit in the same sense that the Uniform Customs and Practice for Documentary Credits (UCP) and the Uniform Rules for Demand Guarantees (URDG) do for commercial letters of credit and independent bank guarantees[88]. The ISP98 doesn't deal with unfair calling or fraud with respect to bank guarantees.

2.4.2. OFFICIAL REGULATION:

2.4.2.1. The UNCITRAL Convention on Independent Guarantees and Stand-by Letters of Credit:

From 1988 to 1995 the UNCITRAL[89] worked on a Uniform Law on International Guaranty. This eventually resulted in the drafting of the UNCITRAL Convention[90]. The

[84] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §34 (2010).
[85] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §35 (2010).
[86] De Ly, *supra* note 12, at 831, 836.
[87] International Standby Practices (ISP98) (A/CN.9/477) (1999).
[88] *Id.*
[89] In 1966, the United Nations created the UNCITRAL because it desired to play a more active role in reducing and removing legal obstacles to the flow of international trade. UNCITRAL's aim is to further the progressive harmonisation and unification of the law of international trade and its mandate is to be the main legal body in the field of international trade law within the United Nations system. UNCITRAL was initially composed of 29 states, but was expanded in 1973 to 36 states by a General Assembly resolution. Membership is structured so that a specified number of seats are allocated to each of the various geographic regions. Therefore, UNCITRAL is an intergovernmental body of the General Assembly that prepares international commercial law instruments designed to assist the international community in modernising and harmonising laws dealing with international trade. Various legal instruments have since been prepared by UNCITRAL. *See* the Explanatory Note by the UNCITRAL Secretariat on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, UN Doc A/CN9/431 (4 July 1996)

UNCITRAL adopted this Convention and opened it for signature by the General Assembly by its resolution 50/48 of 11 December 1995[91]. States were given a two-year period to sign the Convention, where after they had to accede to it[92].The Convention could only come into effect after it had been ratified by five states and the Convention only came into effect on 1 January 2000[93]. This convention can be considered official regulation since adoption of this convention by a state has the effect of making it a law. As of date[94] India has not ratified this convention and hence this Convention assumes less significance in the Indian context.

2.5. CONCLUSION:

Since there is a lack of legislative regulation for demand guarantees in India, and because of their highly international nature, the available international rules, such as the URDG, make it a natural choice for local banks to use. It has even been accepted by the World Bank as the rules for its standard guarantees.

It is recommended that banks investigate the possibility of making the URDG part of their current practice. As the ICC is currently in the process of reviewing the existing URDG, banks should also start to appoint the appropriate teams so that they can study the

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which accompanies the text on the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (1996) (hereinafter the 'UNCITRAL Explanatory Note').

[90] *See* the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (1996). For a discussion of the background to this UNCITRAL convention and a discussion of a previous draft of this Convention *see* Bergsten, *supra* note 10. For a further legislative history of the UNCITRAL Convention, *see* J E Byrne, *The International Standby Practices (ISP98): New Rules for Standby Letters of Credit*, 32 UNIFORM COMMERCIAL CODE LAW JOURNAL, 149 (Fall 1999); The Draft Convention on Independent Guarantees and Stand-by Letters of Credit, Report of the United Nations Commission on International Trade Law on the Work of its Twenty-Eigth Session, 2–26 May 1995, General Assembly, Official Records, 50th Session, Supplement No 17 (A/50/17).

[91] *See* the UNCITRAL Explanatory Note supra note 89, at 13.

[92] United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 1995), §24, in UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW (Nov 21, 2019, 9:50 PM), http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html

[93] United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 1995), §28, in UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW (Nov 21, 2019, 9:50 PM), http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html

[94] United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 1995), in UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW (Nov 21, 2019, 9:57 PM), http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html

revised URDG when it becomes available. This will enable banks to determine whether or not they should issue demand guarantees subject to it. It will also place them in a position to adequately advise their customers on whether they should issue or accept demand guarantees that are made subject to it. It is recommended that the banks use the international rules by incorporating them into the demand guarantee, it will be easier for banks, lawyers and courts to interpret them and to learn about their exact use, as they will provide them with some form of international standard to which they can be compared.

CHAPTER 3: PRINCIPLE OF AUTONOMY- INDEPENDENCE OF THE INSTRUMENT OF GUARANTEE FROM THE UNDERLYING CONTRACT

3.1 INTRODUCTION

Demand guarantee is a bi-partite contract between the bank and the beneficiary and a demand guarantee is independent of the underlying contract between the applicant and the beneficiary[95]. The resultant rights and obligations it creates are independent of such underlying contract[96]. In other words, a demand guarantee is independent both from the underlying trade transaction between the applicant for the credit and the beneficiary, and from the relationship between the former and the issuing bank[97]. Proof of default is not needed and issuers are not concerned with the underlying contract, nor can they raise any defence available to the underlying contractual party[98]. The principle of independence or autonomy of demand guarantees, means that the payment undertaking contained in a demand guarantee is separate from, and in the ordinary way independent of, the underlying contract giving birth to it; what the issuer is concerned with is whether the demand, complies with the terms and conditions of the undertaking, rather than with the disputes arising from the underlying contract[99]. This principle is predicated on the intention of the parties to a demand guarantee to let the beneficiary have access to prompt and certain payment should the underlying contract go wrong[100].

3.2 MEANING, AND NATURE OF AUTONOMY:

'Autonomy' necessarily means a 'bundle of legal consequences' that flow from the judicial characterization of an instrument as belonging to a class of payment instruments

[95] S.K.KAPOOR, CONTRACT -II, 9 (Central law Agency ed., 2007).
[96] *Id*.
[97] Roy. Goode, *Abstract Payment Undertakings in International Transactions*, 22 BROOKLYN JOURNAL OF INTERNATIONAL LAW 1, 12 (1996).
[98] I.E. Contracts Ltd v. Lloyds Bank Pic and Rafidain Bank, 2 Lloyd's Rep 205, 207 (1989).
[99] Richardson v. Polimex, 1 Lloyd's Rep. 161, 162 (1978); Bergerco Canada v. Iraqi State Co. for Food Stuff, 924 F. supp. 252, 258 (1996).
[100] Esal (Commodities) v. O.C.L, 2 Lloyd's Rep. 546, 549. (1985).

that the law has determined should be autonomous in nature[101]. Such circular reasoning leads, however, to something of a chicken-and-egg problem: a particular instrument is autonomous because it falls within a particular legal category, yet that category is only legally distinct because it covers only instruments that are considered to be autonomous[102]. This Gordian knot can nevertheless be cut by identifying certain meta-factors that can be used to identify whether a particular transaction falls within one legal category of transaction or another and then determining which of those legal categories require as a matter of commercial necessity to be treated as 'autonomous', which effectively means that it will give rise to certain judicial consequences (to be considered further below)[103].

3.2.1 Autonomy and Validity

One of the meta-factors used to identify autonomy is validity[104]. The validity of the payment undertaking or demand guarantee is isolated or abstracted from the underlying contract between the applicant and the beneficiary[105]. Factors that may render the underlying contract to be void, voidable, or result in termination or frustration will not, without more, have any bearing upon the demand guarantee[106]. In other words, said factors should affect the demand guarantee in a distinct, fundamental and independent manner for it to result in the frustration of the demand guarantee[107]. The isolation of the demand guarantee's validity from the underlying agreement is more attributable to the fact that these are factually separate contracts (and there is no general doctrine whereby the invalidity of one contract automatically invalidates an associated transaction) than to the operation of any distinct notion of autonomy[108].

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[101] Christopher Hare, *On Autonomy*, CML WORKING PAPER SERIES (Nov 19,. 2019 6:00 PM), http://law.nus.edu.sg/wps/.
[102] *Id.*
[103] *Id.*
[104] *Id.*
[105] *Id.*
[106] *Id.*
[107] Roy Goode, *Abstract Payment Undertakings* 226-227 (P Cane and J Stapleton, 1991).
[108] Hare, *supra* note 101.

3.2.2 Autonomy and Interpretation

A demand Guarantee is ordinarily a contract quite distinct and independent of the underlying contract, the performance of which it seeks to secure and the bank is required to honour the guarantee according to its terms[109]. When in the course of commercial dealings an unconditional demand guarantee is given or accepted, the beneficiary is entitled to realize such a demand guarantee in terms thereof irrespective of any pending disputes[110]. The Bank giving such a guarantee is bound to honour it as per its terms irrespective of any dispute raised by its customer[111]. Although generally contractual interpretation has favoured dictionary-bound literalism (subject to specified exceptions), recent years have seen the emergence of contextual interpretation, which allows the courts to look into the ' factual matrix ' of the contract in the search for meaning. Such a practice would be antithetical to the doctrine of autonomy, as it would allow courts to view demand guarantees in light of the underlying contract and thus challenge their isolationist existence through the backdoor. For instance in Gangotri Enterprises Limited v. Union of India and Ors.[112], the appellant contended that the bank guarantee could not be invoked because the contract had been performed to the satisfaction of the respondent as evidenced by the issue of the completion certificate. The Supreme Court in this case held that whether or not injunction can be granted must be decided taking into account the facts involved in each case and that the lower court had erred in dismissing the plea to grant an injunction. This decision had been viewed as controversial since it is a deviation from the established principle of autonomy,

3.2.3 Autonomy, Choice of Law and Jurisdiction:

URDG 758[113], lays down rules with respect to both governing law[114] and jurisdiction[115]. The essence of rule is that unless there is a condition to the contrary within the terms of

[109] Kirloskar Pneumatic Company Ltd. v. National Thermal Power Corporation Ltd. & another, AIR 308, (Bom: 1987).
[110] U.P. State Sugar Corporation v. Sumac International Ltd., AIR 1644, (SC: 1997).
[111] *Id*.
[112] Gangotri Enterprises Ltd. v. Union of India (UOI) and Ors., MANU 0516 (SC: 2016).
[113] Uniform Rules for Demand Guarantees, ICC Publication No. 758.
[114] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §34 (2010) *"a. Unless otherwise provided in the guarantee, its governing law shall be that of the location of the guarantor's branch or office*

the guarantee or counter-guarantee text, the governing law of a guarantee will be that of the place of business of the guarantor, and of a counter-guarantee will be that of the place of business of the counter-guarantor[116]. With respect to jurisdiction the rules state that the disputes between a guarantor and a beneficiary, under a guarantee, are to be settled by a competent court at the place of business of the guarantor. Also, disputes between a counter-guarantor and a guarantor, under a counter-guarantee, are to be settled by a competent court at the place of business of the counter-guarantor[117]. As reiterated above the parties are free to choose or agree upon any jurisdiction of their choice provided they provide for the same within the terms of the guarantee or counter guarantee[118].

3.2.4 Autonomy and Underlying Relationship

The autonomy of demand guarantees is described in Art.5 of the URDG[119] as,

"*Independence of guarantee and counter-guarantee*

a) A guarantee is by its nature independent of the underlying relationship and the application, and the guarantor is in no way concerned with or bound by such relationship. A reference in the guarantee to the underlying relationship for the purpose of identifying it does not change the independent nature of the guarantee. The undertaking of a guarantor to pay under the guarantee is not subject to claims or defences arising from any relationship other than a relationship between the guarantor and the beneficiary."

An important feature of autonomy is not only the separation of the guarantee from the underlying contract but also the fact that the payment undertaking under the guarantee is

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that issued the guarantee. b. Unless otherwise provided in the counter-guarantee, its governing law shall be that of the location of the counter-guarantor's branch or office that issued the counter-guarantee."

[115] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §35 (2010) *"a. Unless otherwise provided in the guarantee, any dispute between the guarantor and the beneficiary relating to the guarantee shall be settled exclusively by the competent court of the country of the location of the guarantor's branch or office that issued the guarantee. b. Unless otherwise provided in the counter-guarantee, any dispute between the counter-guarantor and the guarantor relating to the counter-guarantee shall be settled exclusively by the competent court of the country of the location of the counter-guarantor's branch or office that issued the counter-guarantee."*

[116] *Supra* note 114.

[117] *Supra* note 115.

[118] *Supra* note 114 & 115.

[119] Uniform Rules for Demand Guarantees, ICC Publication no. 758 §5 (2010).

independent of the underlying relationship between the applicant and the issuer. The autonomy principle isolates the issuing bank's obligations from 'the contractual relationships existing between banks [and] between the applicant and the issuing bank', as well as the underlying contract[120].

ISP98[121] also contains provisions related to this aspect of the principle of autonomy in article 1.07, which reads as follows:

"An issuer's obligations toward the beneficiary are not affected by the issuer's rights and obligations toward also has *the applicant under any applicable agreement, practice, or law."*

3.3 THE PURPOSES AND FUNCTIONS OF THE PRINCIPLE OF AUTONOMY

The object of using demand guarantee in foreign trade is to enable the beneficiary to receive immediate and certain payment from a recognized solvent issuer in his country, pending resolution of the on-going disputes[122]. It's a quick way to get payment in that the beneficiary can have funds in hand if his demand is in order. The payment is certain in part because the recognized solvent issuer's credit is replaced by the overseas account party's credit[123], and in part because the payment is caused by a demand rather than proof of claim.

A demand guarantee performs the role of risk distribution in order to achieve this purpose[124]. There is a shift in the burden of litigation and the beneficiary can immediately have the necessary funds by submitting a complying demand. Should he wish to recover

[120] Uniform Customs and Practice for Documentary Credits, UCP600 §4.
[121] *Supra* note 87.
[122] Ross Bicycles, Inc. v. Citibank, N.A., 2d N.Y.S. 538, 541 (1994).
[123] Banco General Runinahui, S.A. v. Citibank Intern., 97 F. 3d 480, 482 (11th Cir.: 1996); Insurance Co. of North America v. Heritage Bank, 595 F. 2d 171, 173 (1979); Continental Nat. Bank v. National City Bank, 69 F. 2d 312, 316 (1934); Brown v. United States Nat. Bank of Omaha, 371 N.W. 2d 692, 697 (Neb.: 1985).
[124] Security Finance Group v. N. KY. Bank and Trust, 858 F.2d 304, 307 (6th Cir.: 1988).

the money, the burden is on the applicant to initiate proceedings[125]. It also shifts the burden of proof and the risk of currency fluctuation; and, most importantly it shifts the forum of litigation in a transnational transaction. In order to exercise these roles, a demand guarantee must be independent of the underlying contract, and the payment undertaking found therein must have minimal external interference[126].

3.4 THE LEGAL EFFECTS OF THE PRINCIPLE OF AUTONOMY:

3.4.1.1 Independence of Contract Between the Beneficiary and the Applicant Party

Demand guarantees are independent of the underlying contract, and the issuer's duty is based solely on the terms and conditions contained within the demand guarantee[127]. When interpreting a demand guarantee the courts should not refer to the underlying contract[128]. Infringement of the underlying contract by the beneficiary in the absence of apparent fraud or illegality is not a basis for stopping payment nor is it a justification for the applicant to attach the demand guarantee[129].

3.4.1.2 The Issue of Set-Off by the Applicant

The applicant sometimes tries to offset a cross-claim arising from the underlying contract against the beneficiary's claim under a demand guarantee. It is important that each issuer will perform his duty under a demand guarantee, and the applicant cannot stop the issuer from fulfilling his duty just because he has a cross-claim against the beneficiary. In the same manner, the applicant cannot allege a set-off or a counterclaim to prevent the beneficiary from making a demand regardless of whether it emerges from the underlying transaction or not[130]. This is because, unlike a bill of exchange given directly between the buyer and the seller, a demand guarantee is given to the beneficiary by a third party issuer

[125] Itek Corp. v. First Nat. Bank of Boston, 730 F. 2d 19, 24 (1984); CKB & Assoc. v. Moore McCormack Petroleum, 734 S.W. 2d 653, 655 (Tex.: 1987); Foxboro Co. v. Arabian American Oil Co., 805 F. 2d 34, 36 (1st Cir.: 1986).
[126] Chung-Hsin Hsu, *The Independence of Demand Guarantees, Performance Bonds and Standby Letters of Credit*, 1 NTULR 3, 4 (2006).
[127] Turkiye v. Bank of China, 1 Lloyd's Rep. 132, 135 (1993).
[128] Jupiter Orrington Corp. v. Zweifel, 469 N.E. 2d 590, 593 (1984).
[129] Power Curber International Ltd v National Bank of Kuwait, 1 W.L.R. 1239, 1241 (1981).
[130] *Id.*

with the very intention of avoiding anything in the nature of the set-off or counterclaim; further, by granting a demand guarantee in favour of the beneficiary, the applicant has implicitly agreed not to raise any set-off or claim[131].

3.4.1.3 The Issues of Liquidated Damages and Penalty

Since a demand guarantee is independent of the underlying contract and its aim is to provide a reliable method of putting money into the beneficiary's hand until all the underlying conflicts are resolved, the applicant cannot claim that the amount drawn under a demand guarantee exceeds the amount due under the underlying contract[132]. The issuer cannot, by that same logic, use the underlying contract to evaluate whether the amount claimed by the beneficiary is justified as per the underlying contract[133]. If the demand does seem to match, then all the issuer would have to do is make the payment. If, according to the underlying contract, the beneficiary is not entitled to retain the money once the beneficiary is in possession of the money, then the applicant can claim it back in a separate action against the beneficiary[134]. An express or implied term of the underlying contract is the basis of the applicant's claim[135]. Consequently, where the underlying contract provides that the amount claimed under the demand guarantee is liquidated damages for the default of the applicant, the applicant cannot reclaim the money on the ground that the beneficiary has not suffered any loss, except if the sum is a penalty and is not a genuine and reasonable pre-estimate of the damage at the time the underlying contract is concluded[136].

If the funds taken under the demand guarantee were to constitute a penalty, the applicant is entitled to reclaim any amount over and above the actual loss suffered by the beneficiary[137]. Nonetheless, the amount stated in the demand guarantee is anything but a penalty as between the beneficiary and the issuer. Owing to the principle of autonomy,

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[131] *Supra note 129.*
[132] *Supra* note 123.
[133] San Diego Gas & Elec. Co. v. Bank Leumi, 50 CAL. RPTR. 2d 20, 25-27 (1996); Bank of N.C. v. Rock Island Bank, 630 F.2d 1243, 1254 (1980);
[134] Wood Hall Ltd. v. Pipeline Authority, 141 C.L.R. 443, 454 (1979).
[135] G. McMeel, *Pay now, argue later* 1 L.M.C.L.Q. 5, 6 (1999).
[136] Dunlop Pneumatic Tyre Co. Ltd. v. New Garage and Motor Co. Ltd., A.C. 79, 86-87(1915).
[137] Workers Trust Bank Ltd. v. Dojap Ltd. A.C. 573, 582. (1993); McGregor, Damages, par. 557 (16th ed. 1997); Telenois, Inc. v. Village of Schaumburg, 628 N.E.2d 581, 584-586 (1993), confirmed in 633 N.E. 2d 16 (1994).

the issuer cannot look at the underlying contract to determine whether the damage is liquidated, or if it is a genuine and reasonable pre-estimate or not[138]. That is also because the applicant can reclaim the sum in the future unless it is intended to be liquidated damages.

3.4.2 Independent of the Relationship Between the Issuer and the Applicant

Apart from the underlying contract between the beneficiary and the applicant, demand guarantees are also independent of the relationship between the issuer and the applicant as stated above[139]. Consequently, neither the account party's repudiation of the mandate nor the account party's inability to place the issuer in funds can be the reason for the issuer to dishonour its own independent undertaking. According to the same rationale, the validity of any alteration to a demand guarantee does not require the consent of the applicant (although it needs the consent of the beneficiary) and the fact that, as a result, the issuer may forfeit its right of reimbursement from the applicant does not preclude the beneficiary from drawing on the demand guarantee as altered[140]. Owing to the independent nature of demand guarantees and also due to its risk allocation function[141] where the risk of the applicant's insolvency is shifted to the issuer, the applicant's insolvency is generally accepted as having no effect on a demand guarantee[142].

3.4.3 The Independence of the Counter-Guarantee from the Primary Guarantee

In a transaction involving a four-party demand guarantee, the applicant asks its bank (called the counter-guarantor) to order another bank in the beneficiary's country (called the main guarantor) to grant a primary guarantee in the beneficiary's favour[143]. In addition, the counter guarantor issues a counter-guarantee to affirm the repayment duties it owes to the primary guarantor[144]. In reality, the repayment obligation can also be

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[138] Birdwell v. Ferrell, 746 S.W. 2d 338, 341 (1988).
[139] North American MFRS. Export Asso. v. Chase Nat. Bank, 77 F. Supp. 55, 55 (1948); Kingdom Sweden v. New York Trust Co., 96 N.Y.S. 2d 779, 791 (1949); Naugatuck Sav. Bank v. Fiorenzi, 654 A. 2d 729, 734 (Conn.: 1995).
[140] Bolivinter Oil SA v. Chase Manhattan Bank, 550 F. 2d, 886-887.
[141] Re Deloitte & Touche Inc., 2 Bank. L.R., 310-311 (1993).
[142] Insurance Co. of North America v. Heritage Bank, 595 F. 2d 171, 173 (1979).
[143] Guarantees and Counter-Guarantees, TEB (Jan 1, 2020, 7:00 PM), https://www.teb.com.tr/sme/guarantees-and-counter-guarantees/ .
[144] *Id.*

bolstered by an indemnity contract instead of a counter-guarantee. If the counter guarantor's undertaking to reimburse the primary guarantor takes a documentary form, the counter-guarantor's undertaking is a counter-guarantee[145]. Whereas if the counter guarantor undertakes to reimburse the primary guarantor for any damage sustained while acting on his advice but it does not provide for the documents required to trigger the duty, the undertaking is a contract of indemnity[146]. Therefore, these relationships between the primary guarantor and the counter guarantor are related but distinctly separate-one arising from the agency contract[147] and the other arising from the counter-guarantee or contract of indemnity. The primary guarantor acts in dual capacity while issuing the primary guarantee on the instruction of the counter guarantor. As between himself and the beneficiary he acts as a principal; however, as between himself and the counter guarantor he acts as the counter guarantor's agent. The counter-guarantee is of a similar nature to the primary guarantee and the obligation under it has to take effect according to its own terms. The counter-guarantee is independent of: (i) the underlying contract between the beneficiary and the applicant[148] (ii) the relationship between the counter-guarantor and the applicant, and (iii) the primary guarantee[149].

English courts, however recently examined the counter-guarantee's independence from the primary guarantee on two separate occasions. Phillips. J, in Turkiye v. Bank of China[150] and the Court of Appeal, in Wahda Bank v. Arab Bank[151], recognized that the counter-guarantee was an independent contract in the sense that, without regard to anything extraneous, it could be operated by a demand on its own. Nonetheless, both Courts held that the counter-guarantee was so closely linked to the primary guarantee (just as the accessory guarantee is related to the underlying contract) that it had to be regulated by the very same law as the primary guarantee[152]. These two rulings undermine the principle of autonomy so as to allow the counter-guarantee to be regulated by the same law as the primary guarantee. This outcome could have been achieved by other

[145] I.E. Contractors v. Lloyds, 2 Lloyd's Rep.500, 502 (1990).
[146] Professors Goode and Bertrams use "mandate" to denote this relationship, *see supra* note 9, at 20
[147] *Id.*
[148] Turkiye v. Bank of China, 1 Lloyd's Rep. at 251, C.A. (1998).
[149] Gulf Bank, 2 Lloyd's Rep., 150-151 (1994); Mitsubishi v. Gulf Bank, 1 Lloyd's Rep. 499, 502 (1996).
[150] Turkiye v. Bank of China, 1 Lloyd's Rep. 132 (1993).
[151] Wahda Bank v. Arab Bank,1 Lloyd's Rep. 470 (1996).
[152] *Supra* note 151, at 470, 473; *Supra* note 150, at 135-136.

means without violating this principle. Admittedly, in some respects, the counter-guarantee is related to the primary guarantee; nevertheless, they are independent of each other.

Another related issue is whether the counter-guarantee is independent of the mandate which the counter guarantor has issued. Some jurists opine that the counter-guarantee, being an abstract payment undertaking, is also independent of the mandate acquired from the counter-guarantor, and that violation of that mandate is not in itself a basis for refusal to comply with the primary guarantor's demand[153]. There are also researches that indicate that some German courts accept this strict approach, but the same is not favoured by French and Dutch courts[154]. In the cases reviewed in these researches, the French and Dutch courts, in determining whether to accept the claim of the primary guarantor under the counter-guarantee analysed whether the primary guarantor had violated its mandate either by making payment against non-conforming documents or allowing the claim of the beneficiary under the primary guarantee even after the maturity date[155].

As far as English law is concerned, the Court of Appeal in I.E. Contractors v. Lloyds[156] and in Esal (Commodities) v. O.C.L.[157], had analysed whether the primary guarantor had violated the counter-guarantor's instruction when deciding on the validity of the primary guarantor's claim[158]. It is suggested that the stance taken by Professor Bertrams is desirable. This is because firstly, the counter-guarantee is often used to fulfil or strengthen the reimbursement obligation of the counter guarantor resulting from the strict adherence of the mandate by the primary guarantor. From the circumstances, it is difficult to conclude that the counter-guarantee should be independent of the mandate and that the counter-guarantee will be payable even if the primary guarantor has infringed the mandate.

Secondly the aims of the autonomy principle cannot sufficiently explain the independence of the counter-guarantee from the mandate, or in other words are

[153] Goode, *supra* note 72; at 725, 734-735.
[154] R. BERTRAMS, BANK GUARANTEES IN INTERNATIONAL TRADE, 146-49 (2nd ed. 1996).
[155] *Id*.
[156] I.E. Contractors v. Lloyds, 2 Lloyd's Rep., 496 (1990).
[157] Esal (Commodities) v. O.C.L., 2 Lloyd's Rep., 546 (1985).
[158] *Supra* note 157, at 550, 551, 553; I.E. Contractors v. Lloyds, 2 Lloyd's Rep., 502 (1990).

inadequate to do so. The assertion that the counter-guarantee is not independent of the mandate will restrict the counter-guarantee's autonomy from the primary guarantee. That's intended to be so because of counter-guarantees' nature of reimbursement. Nonetheless, in principle the counter-guarantee is independent of the primary guarantee. So the counter-guarantee is not impacted even if the primary guarantee is invalid or otherwise devoid of legal effects[159]. Moreover, the claim of the primary guarantor under the counter-guarantee is not automatically fraudulent if the beneficiary of the primary guarantee is guilty of fraud[160]. In short, the counter-guarantee may be said to be autonomous of the primary guarantee to the extent that the primary guarantor does not violate the mandate received from the counter guarantor.

3.5 SCOPE OF AUTONOMY

Demand guarantees are payable 'on demand', which means that the guarantor or the bank has a binding obligation to pay the guarantee amount when a demand is made by the beneficiary[161]. It is important to note that a demand guarantee as described above is to be distinguished from a conditional guarantee (non-autonomous)[162].While a conditional guarantee is payable upon non-performance of an underlying obligation by the applicant, in a demand guarantee, the guarantor is required to pay upon first demand by the beneficiary. In Wuhan Guoyu Logistics Group Co Ltd v Emporiki Bank of Greece SA[163], the English Court of Appeal indicated that '[w]here an instrument

(i) relates to an underlying transaction between the parties in different jurisdictions;

(ii) is issued by a bank;

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[159] *Supra* note 149.
[160] *Id.*
[161] G PENN, ON-DEMAND BONDS - PRIMARY OR SECONDARY OBLIGATIONS, 4 Journal of International Banking Law 224 (1986).
[162] Jeremy Glover, *UK: Defining The Difference Between On-demand Bonds And Guarantees*, MONDAQ, (Jan 19, 2020, 7:04 PM), https://www.mondaq.com/uk/construction-planning/227802/defining-the-difference between-on-demand-bonds-and-guarantees.
[163] Wuhan Guoyu Logistics Group Co Ltd v Emporiki Bank of Greece SA, 1. Lloyd's Rep 273 (2014).

(iii) contains an undertaking to pay "on demand" (with or without the words "first" and/or "written"); and

(iv) does not contain clauses excluding or limiting the defences available to a guarantor; it will almost always be construed as a demand guarantee'.

In *Edward Owen Engineering Ltd. v Barclays Bank International Limited*[164], the facts were as follows- British suppliers agreed to erect green houses in Libya. They had established a performance guarantee of ten per cent of the contract price issued by the English bank payable at the Libyan bank. The letter of credit was never opened. The English suppliers considered this as a repudiation of the contract. The Libyan importers claimed on the demand guarantee. It was held that the Libyan importers indeed had the right to call upon the guarantee irrespective of the dispute concerning the underlying contract. The on demand guarantee was payable on first demand without proof or conditions. Performance guarantees are effectively obligations to pay on demand within the terms of the guarantee, irrespective of the rights and wrongs of any dispute between beneficiary and principal under the terms of their separate contract, subject only to fraud. Lord Denning stated that,

"*It has been long established that when a letter of credit is issued and confirmed by a bank, the bank must pay it if the documents are in order and the terms of the credit are satisfied. Any dispute between buyer and seller must be settled between themselves. The bank must honour the credit... To this general principle there is an exception in the case of what is called established or obvious fraud to the knowledge of the bank…..and so, as one takes instance after instance, these performance guarantees are virtually promissory notes payable on demand. So long as the Libyan customers make an honest demand, the banks are bound to pay and the banks will rarely, if ever, be in a position to know whether the demand is honest or not. At any rate they will not be able to prove it to be dishonest. So they will have to pay. All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not*

[164] *Supra* note 17..

concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, 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."

The same principle was reiterated by the Supreme Court of India in the case of U.P. Cooperative Federation Ltd. v. Consultants and Engineers (P) Ltd.[165] The court held in this case that,

"commitments of banks must be honoured free from interference by the courts. Otherwise, trust in commerce internal and international would be irreparably damaged. It is only in exceptional cases, that is, to say in case of fraud or in case of irretrievable injustice be done, the court should interfere."

3.6 APPLICATION OF PRINCIPLE OF AUTONOMY IN INDIA

Courts in India regard the principle of autonomy as one of the vital principles that are applied to demand guarantees. In the case of Pesticides India (Mewar Oil & General Mills Ltd) v. State Chemicals and Pharmaceuticals Corporation of India[166], the petitioners raised a dispute concerning breach of contract by the State Chemicals and Pharmaceuticals Corporation of India with respect to the supply of the goods in accordance with the contract conditions. The court held that a guarantor bank is not concerned with the performance of the obligation undertaken in the guarantee. If the terms of guarantee imposed an absolute obligation to pay, the bank is liable to pay. Any dispute between the beneficiary and the bank's client may be settled through arbitration or appropriate legal methods[167].

[165] U.P. Cooperative Federation Ltd. v. Consultants and Engineers (P) Ltd., 1 SCC 174 (1988).
[166] Pesticides India (Mewar Oil & General Mills Ltd) v. State Chemicals and Pharmaceuticals Corporation of India, A.I.R. Del., 73 (1932).
[167] *Id.*

Earlier, the Delhi High Court in the case of Banwarilal Radhe Mohan V. Punjab Stare Co-operative Supply & Marketing Federation Ltd.[168] refused to prohibit the bank from making bank guarantee payments under the terms of the said guarantee. The court held the performance guarantee to be an "autonomous contract." The terms of the bank guarantee impose an absolute obligation on the bank. As such, the presence of disputes between both the parties under the underlying contract or the prospect of referring such disputes to arbitration or of pending litigation has no relation whatsoever to the Bank's responsibility under the guarantee. Banks are bound to pay without demur irrespective of the pendency of any arbitration proceedings in relation to primary contract between the parties[169]. Even in case of the company on whose behalf the demand guarantee is issued becomes a sick company, the autonomy principle of bank guarantee is not affected[170].

In Hindustan Steel Works Construction Ltd. v. Tarapore and Company[171], the Andhra Pradesh High Court stated that the bank guarantee would only be encashable if the arbitrators concluded that the contractor had committed a breach of the contract and the court granted an injunction to prevent the beneficiary from encashing the guarantee. The facts of this case related to a construction contract. The contractor provided a performance guarantee in accordance with the requirements of this construction contract. The conflict between the parties arose because the work was not done within the contracted time. An arbitrator was selected to settle the dispute. The beneficiary had in the meanwhile called upon the bank to pay the amount under the guarantee. The injunction granted by the High Court was set aside by the Supreme Court on appeal. The Supreme Court observed:

"*A bank guarantee is an independent and distinct contract between the bank and the beneficiary and is not qualified by the underlying transaction and the primary contract between the person at whose instance the bank guarantee is given and the beneficiary. In case of unconditional bank guarantee the nature of the obligation of the bank is absolute and not dependent upon any dispute or proceeding between the party at whose instance*

[168] Banwarilal Radhe Mohan V. Punjab Stare Co-operative Supply &Marken'ng Federation Ltd, A.I.R. Del., 357 (1982).
[169] Interior's India v. Balmer Lawrie & Co Ltd, A.I.R Del., 16 (2007).
[170] AVN Tubes Ltd V. Steel Authority of lndia, A.I.R. M.P., 53 (1996).
[171] Hindustan Steel Works Construction Ltd. v. Tarapore and Company, AIR AP, 82 (1990).

the bank guarantee is given and the beneficiary. Whether the bank guarantee is towards security deposit or mobilization advance or working funds or for due performance of the contract, if the same is unconditional and if there is stipulation that the bank should pay on demand without any demur and that the beneficiary shall be the sole judge not only on the question of breach of contract but also with respect to the amount of loss or damages, the obligation of the bank could remain the same and that obligation has to be discharged in the manner provided in the bank guarantee"[172].

In Ansal Engineering Project Ltd. v. Tehri Hydro Development Corporation Ltd.[173], the contractor failed to complete the construction within the period agreed upon. The corporation called upon the bank to pay the bank guarantee amount. The contractor sought an injunction to restrain the corporation from invoking the guarantee. It was contended that unless the amount due and payable was determined by a competent court or tribunal, the guarantee could not be encashed. Repelling the contention, the Supreme Court said,

"*Bank guarantee is an independent and distinct contract between the bank and the beneficiary and is not qualified by the underlying transaction and the validity of the primary contract between the person at whose instance the bank guarantee was given and the beneficiary. The bank unconditionally and irrevocably promised to pay on demand, the amount of liability undertaken in the guarantee without any demur or dispute in terms of the bank guarantee. The object behind is to inculcate respect -for free flow of commerce and trade and faith in the commercial banking transactions unhedged by pending disputes between beneficiary and the contractor*"[174].

In Minerals & Metals Trading Corporation of India Ltd v. Surajbalaram Sethi[175], a division bench of the Calcutta High Court held that a bank guarantee does not enjoy the autonomy of an irrevocable letter of credit because it depends on a contract between the beneficiary and a third party and should not be invoked unless there is some act or

[172] Hindustan Steel Works Construction Ltd. v. Tarapore and Company, A.I.R. S.C 2272 (1996).
[173] Ansal Engineering Project Ltd. v. Tehri Hydro Development Corporation Ltd., SCR (4) Supp, 226 (1996).
[174] *Id.*, at 454 per Nanavathi J.
[175] Minerals & Metals Trading Corporation of India Ltd v. Surajbalaram Sethi, 74 Cal WN 99 (1970).

omission on the part of the third party under guarantee. Two Bank guarantees had been executed in this case. One bank guarantee contained a stipulation that the dispute between the parties would not constitute a reason for the bank to withhold the payment. But there was no such explicit stipulation with respect to other guarantee. Thus, when the conflict arose between the parties, the question before the court was whether the injunction which would prevent the bank from executing the bank guarantee could be issued for both guarantees. The Division Bench upheld the trial court's order and only granted the injunction in respect of that bank guarantee which did not contain the term 'irrespective of the dispute between the parties', and held that the bank would be obligated to pay. The court drew the difference between an irrevocable credit letter and a bank guarantee. The court observed that the seller is only obligated to perform those acts expressly mentioned in the letter of credit for securing payment under the letter of credit. No third party is involved in any way. But in the case of a bank guarantee, default by a third party is a prerequisite. There was always the question of happening of a contingency that rendered the guarantee enforceable[176].

Regard is given to the documents involved in the transaction when applying the autonomy principle. This aspect is illustrated by the Supreme Court in State of Maharashtra v. National Construction Co.[177], where the court said,

"*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 honour the same and make payment. Ordinarily, unless there is an allegation of fraud or the like, the courts will not interfere, directly or indirectly, to withhold payment, otherwise trust in commerce, internal and international, would be irreparably damaged. But that does not mean that the parties to the underlying contract cannot settle their disputes with respect to allegations of breach by resorting to litigation or arbitration as stipulated in the contract. The remedy arising*

[176] *Id.*
[177] Maharashtra v. National Construction Co., 2 l SCC 735 (1996). Also *see* RoshanIal Anand v. Mercantile Bank Ltd., 45 Com. Cas. 519 (Del.: 1975).

ex contractu is not barred and the cause of action for the same is independent of enforcement of the guarantee[178]*".*

Analysis of the above case shows that the autonomy of demand guarantees is entitled to protection and the court refrain from interfering with the autonomy of demand guarantees unless there is an accusation of fraud. Bank has a duty to honour the guarantee as and when the demand is made and disputes with respect to the underlying contract will not affect the enforcement of the guarantee.

3.7 CONCLUSION:

Thus, the breach of the underlying contract by the beneficiary is not a ground for requiring the issuer to make payment, neither is it a reason for the applicant to attach the demand guarantee. The applicant cannot, by the same rationale, complain that the sum drawn under the demand guarantee exceeds the sum due under the contract underlying it. After the beneficiary is in possession of the money if, as per underlying contract, he is not entitled to keep the money, the applicant can reclaim it by bringing a separate action against him. Although the independence principle stops the account party from raising a set-off defence against the beneficiary's claim under a documentary guarantee, the principle cannot restrain the issuer from raising statutory set-off against the beneficiary's claim;[179] nor can it be used to prevent the issuer from alleging equitable set-off against the beneficiary's claim, provided that the issuer's cross claim is so closely connected with the beneficiary's claim that it would be manifestly unjust to allow the beneficiary to enforce payment without taking into account the issuer's cross claim[180].

Furthermore, if there is no express choice of law in a documentary guarantee, it is inappropriate to infer the parties' intention from the choice of law clause in the underlying contract, for the principle of independence severs this inference[181]. Because of

[178] *Id.*, at 741.
[179] Stein v. Blake, 1 A.C. 243 at 251 (1996), per Lord Hoffmann.
[180] B.I.C.C. Plc. v. Burndy Corp., 1 ALL E.R. 417, 427 (1985), per Dillon, L.J.
[181] Wahda Bank v. Arab Bank, 1 Lloyd's Rep. 470, 473 (1996); Turkiye v. Bank of China, 1 Lloyd's Rep. 132, 135 (1993).

the principle of independence, a documentary guarantee cannot fairly be said to be closely connected with the country whose law is the governing law of the underlying contract[182]. By the same reasoning, it is also not suitable to say that the parties to a counter-guarantee intend the counter-guarantee to be governed by the same law as that of the primary guarantee[183].

It is evident that the courts have succinctly condensed the law relating to demand guarantees in which the principle of autonomy plays a pivotal role. The autonomy of demand guarantee is entitled to protection and the court should refrain from interfering with their autonomy. It can be seen that the principle underlying the independence rule is that invocation of demand guarantee cannot be mixed up with other disputes between the parties regarding underlying contract. Bank has a duty to honour the demand guarantee as and when the demand is made.

[182] *Id.*
[183] Turkiye v. Bank of China 1 Lloyd's Rep. 132 (1993); Wahda Bank v. Arab Bank Plc. 1 Lloyd's Rep. 470, C.A. (1996).

CHAPTER 4: EXCEPTIONS TO THE PRINCIPLE OF AUTONOMY:

4.1 INTRODUCTION

While in a majority of cases the principle of autonomy achieves the desired output and the principal is willing to undertake the risk of a probable loss in light of the gains that will come about from the successful completion of the commercial transaction, it should also be noted that the very same principle of autonomy may give rise -if applied too rigidly- to inequitable results in certain situations. Accordingly a few exceptions to the principle of autonomy have been identified. They are: (i) fraud and (ii) cases where encashment of the guarantee would result in irretrievable harm or injustice[184].

4.2 FRAUD:

In case of fraud, the bank or court can stop the demand guarantee from being invoked. The fraud exception relies on the maxim "*fraus omnia corrumpit*" (fraud vitiates everything) which authorises a bank to not make payment when there is reason to believe that fraud is involved. In the case of United City Merchants v Royal Bank of Canada[185], Lord Diplock stated:

"*The exception of fraud on the part of the beneficiary seeking to avail himself of the credit is a clear application of the maxim ex turpi causa non oritur actio or, if plain English is to be preferred, 'fraud unravels all'. The courts will not allow their process to be used by a dishonest person to carry out the fraud*".

Thus, through this exception, the veil of the principle of independence is pierced. Although such exception is necessary to limit the activities of fraudsters, its scope should be carefully circumscribed so as not to deny commercial utility to an instrument that exists to serve as an assurance of performance under the underlying contract or

[184] Darshit Jain, *Injunction On Invocation Of Bank Guarantee : Case Laws & Principles*, LIVELAW (4, Apr. 2020, 6:30 PM), https://www.livelaw.in/know-the-law/injunction-on-invocation-of-bank-guarantee-case-laws-156146.
[185] United City Merchants v Royal Bank of Canada, AC 168, 184 (1983).

repayment of down payments made[186]. Indeed, it is only natural for the principal, when the risk of a call has materialized, to claim that the demand for payment is fraudulent since, in practice the only available defence to escape payment under an independent guarantee is the one of fraud[187].

4.2.1 What is Fraud?

Fraud can be defined as "A false representation of matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of what should have been disclosed that deceives and is intended to deceive another so that the individual will act upon it to her or his legal injury"[188]. Professor Goode defines fraud as, "A false statement knowingly and intentionally included in a document to be used against the deceived party"[189].

A definition of fraud more specifically related to bank guarantees could be, "The condition whereby the beneficiary's demand for payment has no conceivable basis under the underlying relationship"[190]. In a demand guarantee the beneficiary is entitled to seek payment of the guarantee amount if the principal has not fulfilled his contractual obligation. However, there may be circumstances where the beneficiary may seek to invoke the bank guarantee for reasons based on bad faith. Herein, to identify a call as fraudulent may prove futile considering the difficulty to detect suspicious behaviour. In addition, there is wide discrepancy as to what constitutes fraud even among courts and jurists. The UNCITRAL Convention and in particular article 19[191] tries to remedy this discrepancy by listing situations whereby payment need not be made. Article 19 reads as follows:

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[186] G Xiang and RP Buckley, *A Comparative Analysis Of The Standard Of Fraud Required Under The Fraud Rule In Letter Of Credit Law*, 13 in DUKE JOURNAL OF COMPARATIVE AND INTERNATIONAL LAW, 293.

[187] R BERTRAMS, BANK GUARANTEES IN INTERNATIONAL TRADE, KLUWER LAW INTERNATIONAL, 257 (3rd ed., 2004).

[188] Fraud, THE FREE DICTIONARY, (10th April, 2020 5:45 PM) http://legal-dictionary.thefreedictionary.com/specific.

[189] Frias Garcia R. L., *The Autonomy Principle Of Letters Of Credit*, 3 MEXICAN LAW REVIEW, 69 (2009) (Apr 10, 2020 6:00 PM), http://biblio.juridicas.unam.mx/revista/pdf/MexicanLawReview/5/arc/arc4.pdf.

[190] Bertrams., *supra* note 154, at 25

[191] United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 1995), United Nations Commission on International Trade Law (Apr 05, 2020 3:40 PM), http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html

"Article 19. Exception to payment obligation

(1) If it is manifest and clear that:

(a) Any document is not genuine or has been falsified;

(b) No payment is due on the basis asserted in the demand and the supporting documents; or

(c) Judging by the type and purpose of the undertaking, the demand has no conceivable basis, the guarantor/issuer, acting in good faith, has a right, as against the beneficiary, to withhold payment.

(2) For the purposes of subparagraph (c) of paragraph (1) of this article, the following are types of situations in which a demand has no conceivable basis:

(a) The contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized;

(b) The underlying obligation of the principal/applicant has been declared invalid by a court or arbitral tribunal, unless the undertaking indicates that such contingency falls within the risk to be covered by the undertaking;

(c) The underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary;

(d) Fulfilment of the underlying obligation has clearly been prevented by wilful misconduct of the beneficiary;

(e) In the case of a demand under a counter-guarantee, the beneficiary of the counter-guarantee has made payment in bad faith as guarantor/ issuer of the undertaking to which the counter-guarantee relates.

(3) In the circumstances set out in subparagraphs (a), (b) and (c) of paragraph (1) of this article, the principal/applicant is entitled to provisional court measures in accordance with article 20."

The three situations that have been outlined that enable one to invoke the fraud exception is:-

(a) any document is not genuine or has been falsified;

(b) no payment is due on the basis asserted in the demand and the supporting documents; or

(c) judging by the type and purpose of the undertaking, the demand has no conceivable basis to determine if a demand has conceivable basis regard must be had to the underlying obligation.

Some of the conditions laid down in article 19(2) which describe a situation when a demand has no conceivable basis are controversial. Firstly, in respect of the first situation in 19(2)(a) i.e., 'where the contingency or risk against which the undertaking was designed to secure the beneficiary has undoubtedly not materialized', the convention does not specify the standard to be applied in determining whether a contingency has occurred. There is no clarity for determining the occurrence of such contingency or risk. A second situation that may give rise to controversy is contained in art. 19(2)(c). Article 19(2)(c) states that where the underlying obligation has undoubtedly been fulfilled to the satisfaction of the beneficiary then the demand must be said to lack a conceivable basis. What is problematic here is that the reference to "undoubtedly" is unclear. Although there is no doubt that it is an objective test that must be applied, it remains open to different banks to adopt different standards of proof. Consequently, different jurisdictions have applied different standards[192]. It is evident that article 19 gives more importance to the nature of the beneficiary's misconduct as opposed to his state of mind or intention. In other words the convention does not require any evidence with respect to the beneficiary's intention to defraud. The article also established how abuse of demand can be determined by examining the underlying contract. Although the convention does not provide an exhaustive list of the grounds which would constitute fraud, it nevertheless provides guidance for courts to enhance their application of the fraud rule. The provisions of the convention provide an excellent international standard, as they are clear and narrow in scope.

[192] J CHUAH, LAW OF INTERNATIONAL TRADE, 525 (3rd ed., Sweet & Maxwell, London, 2005).

4.2.2 The Standard of Proof of Fraud

When a beneficiary makes a fraudulent call, the principal must take measures to ensure that the bank need not pay the guarantee amount. One of the ways to ensure this is to obtain an injunction[193]. It will not suffice to merely state the existence of fraud; the party must state the ingredients on the basis of which fraud is alleged. In reality the principal will need to prove the facts alleged by him. Lastly, the facts and circumstances need to be analysed in their entirety to determine if a case of fraud has been made out. The main purpose of the usage of this high standard of proof of fraud depends on the potential negative consequences that may affect the reputation of bank and the business of the beneficiary accused of fraud[194]. On the other hand, a high standard of proof will also discourage the principal from making false allegations as to the existence of fraud and will in effect uphold the effectiveness of the demand guarantee as an instrument of finance[195].

In Texmaco Ltd. v. State Bank of India and others[196] it was held that the bank must pay according to its guarantee, 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. The facts of the case were that at the request of the petitioner company the respondent bank had given an irrevocable and unconditional performance guarantee in favour of the State Trading Corporation of India Ltd, (S.T.C.) which provided *inter alia* that in the event of the company's failure to fulfil their contractual obligations the bank shall pay to S.T.C on its first demand the guarantee amount without any contestation, demur or protest and/or without any reference to the company and/or without questioning the legal relationship subsisting between S.T.C, and Texmaco. The guarantee was later invoked by the S.T.C. and they asked the bank for full payment. The petitioner company there upon filed a suit. A question, therefore arose whether the Texmaco was entitled to the injunction as asked for, restraining the bank from making any payment to S.T.C. The Court said that in the

[193] Shivani Kumbhojkar, *India: Bank Guarantees And Injunction On Their Invocation*, MONDAQ (Jun 25, 2020, 9:00 PM), https://www.mondaq.com/india/financial-services/958018/bank-guarantees-and-injunction-on-their-invocation.
[194] Grace Longwa Kayembe, The Fraud Exception In Bank Guarantee, 43 (2008).
[195] *Id.*
[196] Texmaco Ltd. v. State Bank of India and others A.I.R Cal, 44 (1979); Indian Cable Co, Ltd, v. M/s Plastic Products Engineering Co, A,I,R. Cal, 370 (1979).

absence of any special equities and the absence of any clear fraud, the bank must pay on demand, if so stipulated and whether the terms are such must have to be found out from the performance guarantee as such. Though the guarantee was given for the performance by Texmaco in an orderly manner their contractual obligation was taken by the bank to repay the amount on first demand and without contestation, demur or protest as without reference to Texmaco and without question the legal relationship subsisting between S.T.C. and Texmaco. The performance guarantee further provided that the decision of S.T.C. as to the liability of the bank under the guarantee shall be final and binding on the bank. It has further stipulated that the bank should forthwith pay the amount due, "notwithstanding any dispute between S.T.C. and Texmaco." In that context the moment a demand is without protest and contestation the bank is obliged to pay irrespective of any dispute as to whether there has been performance of the contractual obligation by the party. There was no question here of any fraud or equity entitling Texmaco to an injunction.

In general, it is settled law that an injunction cannot be obtained against the encashment of a bank guarantee if, on its terms, that guarantee is unconditional. One exception to that rule is fraud. The logic behind this is that the guarantee must be enforced on its own terms; and if the guarantee is stated to be 'unconditional' other instruments/documents should not be used in order to imply any conditions on the encashment of the guarantee.

In one of the more recent decisions on the point, Vinitec Electronics Pvt. Ltd. v. HCL Infosystems Ltd[197], the Supreme Court noted:

"11. The law relating to invocation of bank guarantees is by now well settled by a catena of decisions of this Court. The bank guarantees which provided that they are payable by the guarantor on demand is considered to be an unconditional bank guarantee. When in the course of commercial dealings, unconditional guarantees have been given or accepted the beneficiary is entitled to realise such a bank guarantee in terms thereof irrespective of any pending disputes…

[197] Vinitec Electronics Pvt. Ltd. v. HCL Infosystems Ltd 1 SCC, 544 (2008).

"12. When in the course of commercial dealings an unconditional bank guarantee is given or accepted, the beneficiary is entitled to realise such a bank guarantee in terms thereof irrespective of any pending disputes. The bank giving such a guarantee is bound to honour it as per its terms irrespective of any dispute raised by its customer. The very purpose of giving such a bank guarantee would otherwise be defeated. The courts should, therefore, be slow in granting an injunction to restrain the realisation of such a bank guarantee. The courts have carved out only two exceptions. A fraud in connection with such a bank guarantee would vitiate the very foundation of such a bank guarantee. Hence, if there is such a fraud of which the beneficiary seeks to take advantage, he can be restrained from doing so. The second exception relates to cases where allowing the encashment of an unconditional bank guarantee would result in irretrievable harm or injustice to one of the parties concerned. Since in most cases payment of money under such a bank guarantee would adversely affect the bank and its customer at whose instance the guarantee is given, the harm or injustice contemplated under this head must be of such an exceptional and irretrievable nature as would override the terms of the guarantee and the adverse effect of such an injunction on commercial dealings in the country. The two grounds are not necessarily connected, though both may coexist in some cases…"

This position of law has been consistently maintained by the Supreme Court. Yet, the scope of the 'fraud' exception continues to be controversial. What exactly constitutes a 'fraud in connection with the bank guarantee' is still ambiguous. Assume that the contract between the parties expressly states that the guarantee can only be invoked if there is non-performance. The recitals of the guarantee make reference to the contract between the parties. Further, the facts are such that a default by one party X is occasioned only by the default of the other Y (As an illustration, where X has to transfer possession of land to Y; Y has to construct a building on that land – X refuses to hand over possession). It is unclear if the invocation of the bank guarantee in such cases can be held to be 'fraud'; thereby entitling one to restrain encashment and if 'X' in this example can successfully restrain Y from encashing the bank guarantee

There is no clarity on whether there should be a fraud in the creation of the guarantee; such that the guarantee itself can be entirely avoided or if mere proof of dishonesty in the invocation of the guarantee will suffice. The Supreme Court has offered no clear answer to the question of what is meant by 'fraud' in this connection (except stating that the fraud must be of an "egregious" nature – BSES v. Fenner[198]). However, a decision of a Division Bench of the Bombay High Court, namely, Maytas Infra v. Utility Energytech[199] suggests that the threshold for fraud is extremely high. The Court stated:

"Recitals in the preamble do not control operative part of the deed. In the present case, the operative part may be making a mere reference to the bank undertaking pecuniary responsibility of the appellants to the first respondent for due performance of the contract and for payment of any money but that part or clause does not mean that the parent contract is to be read into the obligations of the bank to make payment of money in favour of the EPC contractor/ first respondent…"

The Court went on to suggest that the fact that a party in encashing a guarantee is violating the underlying contract between the parties with complete impunity would not be sufficient for establishing 'fraud'. It is to be hoped that when a matter comes up before the Supreme Court, a less rigid viewpoint is taken. The question can perhaps be settled by allowing Courts to look at the conduct of the parties in individual cases and deciding on the basis of equitable considerations. At the very least, there appears to be some need for clarity as to what 'fraud' is and what can be considered as 'irretrievable injury' in this regard.

Each case has to be examined in the light of the following (1) Whether demands for enforcing the bank guarantees has been made strictly In accordance with the terms of the document concerned; or (2) Whether there is any allegation of fraud against the beneficiary of which the bank has notice; or (3) Whether there is any special equity arising out of the particular situation of the case giving rise to a strong prima facie arguable case against enforcement of the bank guarantee or not[200].

[198] BSES v. Fenner, 2 SCC 728 (2006).
[199] Maytas Infra v. Utility Energytech, 111 BOM. L. R 3693.
[200] Banerjee and Banerjee v. Hindustan Steel Works Construction Ltd, AIR Cal 374 (1986).

This test was applied in Banerjee and Banerjee v. Hindustan Steel Works Construction Ltd[201]. In the instant case the bank guarantees were given pursuant to the express terms of the contract entered into between the petitioner, a principal debtor and the respondent, a beneficiary (a company for construction of works in the Super power Thermal project). Out of the seven bank guarantees, two were in lieu of security deposit and five were for securing mobilisation advance by the respondent to the petitioner. Under the terms of guarantees for enforcement of the guarantees the respondent had to make a written demand stating that the petitioner has committed breach of any terms of the contract and the extent and the quantum of loss or damage suffered or to be suffered by the respondent as a result thereof. The decision of the respondent regarding the quantum of damage was not to be questioned or challenged by the banks or fulfilment of these two conditions, the bank was bound to release the guaranteed amount. However, the respondent while seeking the enforcement of the bank guarantees failed to discharge its duty as the sole judge to quantify the damages and to mention the extent of recoveries made by it although it was within its special knowledge. Although a large amount was recovered by the respondent there was no whisper about the same in the demand letters. It was held that by suppressing the material fact from the bank the respondent attempted to recover the entire sum under the seven guarantees and the suppression of such material fact in the demand letters have given rise to a special equity in favour of the petitioner to stop payment by the bank on the basis of these demand letters. Although in the petition, there was no allegation of fraud, the said wilful false representation by the beneficiary that the entire guaranteed amount has become due and payable by suppressing the facts of recoveries already made, was a factor, which must be treated on the same footing as fraud giving rise to a special equity and must be treated as an exception to the general rule that the court should not Interfere In these matters.

In M/s Synthetic Foams v. Simplex Concrete Piles (India) Private Limited[202], the facts were that the completion of the contract by the plaintiff has been withheld not due to any default of the plaintiff but due to the intervening fire which has taken place at the site. There is nothing to suggest that the plaintiff has committed any default in the

[201] Banerjee and Banerjee v. Hindustan Steel Works Construction Ltd, AIR Cal 374 (1986).
[202] M/s Synthetic Foams v. Simplex Concrete Piles (India) Private Limited, AIR 1988 Delhi 207.

performance of the contract or any breach of the terms of the order, whereas the perusal of letter filed by the plaintiffs shows that the guarantee was sought to be invoked by the defendant on the ground that the plaintiff had not fulfilled the obligation contained in the terms and the conditions of the order, which is misrepresentation of facts. Also, the contract has been cancelled by the defendant due to technical reasons and also due to Increase in prices rather than due to any fault of the plaintiff.

The bank guarantee was as follows: "*We, Indian overseas Bank hereby agree and undertake that if in your opinion any default is made by M/s Synthetic Foams Ltd, in performing any of the terms and/or conditions of the order or if in your opinion they commit any breach of the order or there is any demand by you against M/s Synthetic Foams Ltd, then on notice to us by you, we shall on demand and without demur and without reference to M/s Synthetic Foams Ltd, immediately pay to you, in any manner in which you may direct, the said amount of rupees 1,00,000/- (Rupees one lakh only) or such portion thereof as may be demanded by you not exceeding the said seen and as you may from time to time require.*

The courts stated that[203]:

"*Where there are allegations of misrepresentation or suppression of material facts or violation of the terms of guarantee, the courts would not hesitate in granting an interim injunction. In this context, misrepresentation or suppression of material facts or violation of the terms of the guarantee can be treated as species of the same genus as fraud. What is necessary is that there exists special equity in favour of the plaintiff to grant of injunction. No doubt an obligation of a bank under the bank guarantee is absolute, but such an absolute obligation arises only if the conditions of the bond are satisfied and if the demand made on the bank is in strict accord with its terms and there is no element of fraud, misrepresentation or suppression of material facts involved but where there are allegations of fraud, misrepresentation or suppression of facts made by the party against the beneficiary and there is prima facie evidence to suggest that there is some truth in these allegations then there would possibly be no absolute bar operating against the*

[203] *Id.*

courts from granting an interim injunction restraining the bank from making the payment on the basis of the bank guarantee. Similar would be the position where the demand made by the beneficiary is in violation of the conditions of the bond or is not in strict accord with its terms keeping in view the nature of obligation of the bank the terms of the bank guarantee would have to be strictly construed in such cases."

Accordingly in the instant case an injunction was granted restraining the defendants from enforcing the bank guarantee[204].

Dealing with the question of fraud, it has been held that fraud has to be an established fraud. The following observations of Sir John Donaldson, M.R. in Bolivinter Oil SA v. Chase Manhattan Bank[205] hold merit:

"…The wholly exceptional case where an injunction may be granted is where it is proved that the bank knows that any demand for payment already made or which may thereafter be made will clearly be fraudulent. But the evidence must be clear, both as to the fact of fraud and as to the bank's knowledge. It would certainly not normally be sufficient that this rests on the uncorroborated statement of the customer, for irreparable damage can be done to a bank's credit in the relatively brief time which must elapse between the granting of such an injunction and an application by the bank to have it discharged."

The aforesaid passage was approved and followed by this Court in U.P. Cooperative Federation Ltd. v. Singh Consultants and Engineers (P) Ltd[206]

By enunciating the general principle of non-interference by the courts in respect of the bank guarantee the courts only intended that the International trade and commerce should function smoothly without interference from court. At the same time, the courts expected that the merchants and traders in international trade and commerce will honour their respective commitments and the business honesty would be maintained. By the theory of non-interference in cases of bank guarantees, certainly the courts did not intend that international trade and commerce should flourish by adopting dishonest unscrupulous

[204] *Id.*
[205] Bolivinter Oil SA v. Chase Manhattan Bank, 1 All ER 351, CA (1984).
[206] U.P. Cooperative Federation Ltd. v. Singh Consultants and Engineers (P) Ltd., AIR 2239 (1988).

practice. These trade practices and the commitments by the banks are treated on a different level by the courts and are allowed to function without interference from courts only with the view that the trust in international commerce is not damaged in any way and not for encouraging mala-fide activities of unscrupulous traders. If so, fraud could not have been made an exception to the general principles of non-interference by courts.

4.2.3 Applicable Law to Standard of Fraud

Dan Taylor, the Vice President of the ICC Banking Commission stated that "Jurisdiction and fraud are two matters which the UCP cannot deal with due to the legal nature of the UCP"[207]. This means that to make any effective legal instrument to combat fraud in the case of demand guarantees there is need to involve the government with the aim to reach and maintain a public interest. Parties must be careful in drafting their contract because a fraudulent contract cannot be made or entered into, to accommodate their personal interests. The applicable law should include the revised UCC article 5-109[208] or article 19 of the UN Convention. Article 19(1) creates a sort of equilibrium between parties' interests. No rights arise under the Convention entitling account party to avoid reimbursement of payment though an exception exists under article 19 giving to the applicant the possibility to block payment through a request of a provisional court measure. Moreover, article 20 establishes the provisional court measures that must be ordered when there is a "high probability" of fraudulent or abusive circumstances outlined in article 19[209]. Instead, the UCP 600 does not deal with fraud because in no way it mentions the fraud directly but it might be thought that the essence of the set of rules is the protection of banks in case of fraud. This can be seen through some articles that try to enclose this protection:

[207] Stated by Dan Taylor, Vice President of the ICC Banking Commission. Statement at the 2000 Annual Survey of Letter of Credit Law and Practice, New York, (9 Mar 2000).
[208] Uniform Commercial Code (UCC), §5-109, Fraud and Forgery (6 April 2020, 5:50 PM) https://www.law.cornell.edu/ucc/5/5-109.
[209] United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 1995), §20(1), United Nations Commission on International Trade Law (6 April, 2020, 9:50 PM), http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_status.html.

- Art. 34: "A bank assumes no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any document, or for the general or particular conditions stipulated in a document or superimposed thereon ..."

- Art. 12(b): "By nominating a bank to accept a draft or incur a deferred payment undertaking, an issuing bank authorizes that nominated bank to prepay or purchase a draft accepted or a deferred payment undertaking incurred by that nominated bank".

Apart the elements enclosed in these articles, the UCP doesn't deal with the fraud exception. Same goes for ISP 98 and URDG because there is no provision to define fraud standards whereby guarantor or account party is entitled to withhold payment[210] (Provide a reference here). Regard will need to be given to the prevailing case law and it should be left to the decision of the court. ISP 98 in this regard expressly provides that: "it does not define or otherwise provide for defences based on fraud, abuse, or similar matters and that these matters are left to applicable law"[211] .

4.3 IRRETRIEVABLE HARM OR INJUSTICE:

The second exception relates to cases where allowing the encashment of an unconditional bank guarantee would result in irretrievable harm or injustice to one of the parties concerned. The harm or injustice contemplated under this head must be such an exceptional and irretrievable nature that it would override the terms of the guarantee and the adverse effect of such an injunction on commercial dealings in the country would be severe[212]. The second exception to the rule of granting injunction, i.e., the resulting of irretrievable injury, has to be such a circumstance which would make it impossible for the guarantor to reimburse himself, if he ultimately succeeds[213]. This will have to be decisively established and it must be proved to the satisfaction of the court that there

[210] Tesi Di Laurea, *International Sales: Bank Guarantees,* (Apr 6, 2020, 10:30 PM) http://tesi.cab.unipd.it/53149/1/Galante_Valeria.pdf
[211] *Supra* note 87, at § 1.05
[212] *Infra* note 214 at 568.
[213] U.P. Coop. Federation Ltd. v. Singh Consultants and Engineers (P) Ltd., 1 SCC 174 (1988).

would be no possibility whatsoever of the recovery of the amount from the beneficiary, by way of restitution[214].

As regards irretrievable injustice, reference is made to the decision in Itek Corporation v. First National Bank of Boston[215], where it was held that to avail of this exception, certain 'exceptional circumstances' which make it impossible for the guarantor to reimburse himself if he ultimately succeeds, will have to be decisively established.

In U.P. State Sugar Corporation v. Sumac International Limited[216], the circumstances in which the invocation of a Bank Guarantee or payments made pursuant thereto could be interdicted had been restated. While spelling out the essentials of irretrievable injustice in this context, the Apex Court had recorded the following observations:

"When in the course of commercial dealings an unconditional bank guarantee is given or accepted, the beneficiary is entitled to realize such a bank guarantee in terms thereof irrespective of any pending disputes. The bank giving such a guarantee is bound to honour it as per its terms irrespective of any dispute raised by its customer. The very purpose of giving such a bank guarantee would otherwise be defeated. The courts should, therefore, be slow in granting an injunction to restrain the realization of such a bank guarantee. The courts have carved out only two exceptions. A fraud in connection with such a bank guarantee would vitiate the very foundation of such a bank guarantee. Hence if there is such a fraud of which the beneficiary seeks to take the advantage, he can be restrained from doing so. The second exception relates to cases where allowing the encashment of an unconditional bank guarantee would result in irretrievable harm or injustice to one of the parties concerned. Since in most cases payment of money under such a bank guarantee would adversely affect the bank and its customer at whose instance the guarantee is given, the harm or injustice contemplated under this head must be of such an exceptional and irretrievable nature as would override the terms of the guarantee and the adverse effect of such an injunction on commercial dealings in the

[214] *Id.*
[215] Itek Corporation v. First National Bank of Boston, 566 Fed Supp. 1210 (1984).
[216] U.P. State Sugar Corporation v. Sumac International Limited, AIR SC 1644 (1997).

country. The two grounds are not necessarily connected, though both may coexist in some cases."

On the question of irretrievable injury which is the second exception to the rule against granting of injunctions when unconditional bank guarantees are sought to be realised the court said in the above case that, "the irretrievable injury must be of the kind which was the subject-matter of the decision in the Itek Corporation Case."[217] In that case an exporter in USA entered into an agreement with the Imperial Government of Iran and sought an order terminating its liability on stand-by letters of credit issued by an American Bank in favour of an Iranian Bank as part of the contract. The relief was sought on account of the situation created after the Iranian revolution when the American Government cancelled the export licences in relation to Iran and the Iranian Government had forcibly taken 52 American citizens as hostages. The US Government had blocked all Iranian assets under the jurisdiction of United States and had cancelled the export contract. The Court upheld the contention of the exporter that any claim for damages against the purchaser if decreed by the American Courts would not be executable in Iran under these circumstances and realisation of the bank guarantee/letters of credit would cause irreparable harm to the plaintiff. This contention was upheld. "*To avail of this exception, therefore, exceptional circumstances which make it impossible for the guarantor to reimburse himself if he ultimately succeeds will have to be decisively established. Clearly, a mere apprehension that the other party will not be able to pay, is not enough."* In Itek case (supra) there was a certainty on this issue. Secondly, there was good reason, in that case for the Court to be prima facie satisfied that the guarantors i.e. the bank and its customer would be found entitled to receive

Reference may also be made to the observations of B.N.Kirpal, in Dwarikesh Sugar Industries Ltd. v. Prem Heavy Engineering Works (P) Ltd.[218]:

"Numerous decisions of this Court rendered over a span of nearly two decades have laid down and reiterated the principles which the courts must apply while considering the question whether to grant an injunction which has the effect of restraining the

[217] *Supra* note 215.
[218] Dwarikesh Sugar Industries Ltd. v. Prem Heavy Engineering Works (P) Ltd.(1997) 6 SCC 450.

encashment of a bank guarantee… The general principle which has been laid down by this Court has been summarised in the case of U.P. State Sugar Corpn. As follows: The bank giving such a guarantee is bound to honour it as per its terms irrespective of any dispute raised by its customer. The very purpose of giving such a bank guarantee would otherwise be defeated. The courts should, therefore, be slow in granting an injunction to restrain the realization of such a bank guarantee. Since in most cases payment of money under such a bank guarantee would adversely affect the bank and its customer at whose instance the guarantee is given, the harm or injustice contemplated under this head must be of such an exceptional and irretrievable nature as would override the terms of the guarantee and the adverse effect of such an injunction on commercial dealings in the country."

The second exception to the rule of granting injunction, i.e., the resulting of irretrievable injury, has to be such a circumstance which would make it impossible for the guarantor to reimburse himself, if he ultimately succeeds. This will have to be decisively established and it must be proved to the satisfaction of the court that there would be no possibility whatsoever of the recovery of the amount from the beneficiary, by way of restitution. The concept of irretrievable injustice, or damages, or special equities would come into play where the parties to a contract having been provided with internal adjudicative mechanism, attempts to frustrate results of such an internal adjudication by recourse to encashment of bank guarantee, particularly when under the terms and conditions of the contract, including the terms of the guarantee, such determination is 'final', of course subject to the limitations spelled out in such contracts. An attempt to over-reach the process of adjudication with intent to cause irreparable prejudice to the other side would be a circumstance which would influence the decision or tilt the special equities in favour of the applicant before the Court.

4.4 CONCLUSION:

Fraud is a unique exception to the principle of autonomy. When we consider this exception regard must be had to the underlying contract. Mere suspicion of fraud, without

any evidence, would not be sufficient. All the necessary and clear evidence proving fraud must be necessarily pleaded and produced. Fraud must be established and proven beyond every reasonable doubt through clear and reliable evidence.

The fraudulent events can be enclosed in three categories (UNCITRAL Principles): lack of genuine documentation; lack of right of payment by the beneficiary; demand without substantial basis. Fraud must be accepted and known to the bank before it has made its payments. If a bank pays without knowledge of the fraud, the bank is protected from action; otherwise, bank is liable. Once fraud is ascertained, the bank's payment shall be blocked and a preliminary injunction may be granted. The applicable law in case of fraud is weak because it is left more autonomy to judges in case law resolutions.

The second and only other exception to the principle of autonomy which is recognised in India is in cases resulting in irretrievable injury or injustice. To establish the fact that such an exception is applicable, it must be proved that there exists such a circumstance which would make it impossible for the guarantor to reimburse himself, if he ultimately succeeds. In other words it must be proved to the satisfaction of the court that there would be no possibility whatsoever of the recovery of the amount from the beneficiary, by way of restitution.

CHAPTER 5 REGULATORY CONTROL AND BANKING: PRACTICES RELATED TO DEMAND GUARANTEES

5.1 INTRODUCTION

There have been widespread efforts both at the international level and at the national level to regulate banking practices in relation to demand guarantees. The central authority for regulating such practice in India is the Reserve Bank of India (RBI)[219]. Accordingly the RBI has issued circulars and notifications to regulate the same, which more often than not is in conformity with the practice recommended by the International Chamber of Commerce (ICC)[220]. These guidelines laid down by the ICC have not been formally adopted in India i.e., there is no concrete law in this regard[221]. However banks in India are following these guidelines and have issued several instructions to their branches in conformity with these guidelines[222]. There arises a need to determine how far the practice followed by banks, the regulations passed by the RBI is in accordance with the uniform customary practices.

5.2 USE OF INTERVIEW METHOD

The author had conducted telephonic interviews of two bankers whose opinions have been duly recorded and critically evaluated. Interviewee 1 is employed with the Union Bank of India. The Union Bank of India is a nationalised bank and it was established on 11th November 1919 with its headquarters in the city of Mumbai[223].

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[219] "Reserve Bank" means the Reserve Bank of India constituted under section 3 of the Reserve Bank of India Act, 1934 (2 of 1934).

[220] *Administrative Control And Banking Practice Relating To Documentary Credit*, SHODHGANGA 271 (Apr 25, 2020 8:00 AM) https://shodhganga.inflibnet.ac.in/bitstream/10603/23911/15/15_chapter%208.pdf.

[221] *id*

[222] *id*

[223] *About Us*, UNION BANK OF INDIA (Apr 25, 2020 8:15 AM), https://www.unionbankofindia.co.in/english/aboutus-profile.aspx.

Interviewee 2 is employed with the Federal Bank. Federal Bank Limited is a major Indian commercial bank in the private sector headquartered at Aluva, Kerala[224]. The Bank was incorporated on April 23, 1931 as the Travancore Federal Bank Limited, Nedumpuram under the Travancore Companies Regulation, 1916[225]. The Bank was licensed under the Banking Regulation Act, 1949, on July 11, 1959 and became a scheduled commercial bank under the Second Schedule of Reserve Bank of India Act, 1934 on July 20, 1970[226].

Bank practices in India are governed by the Banking Regulation Act, 1949[227]. The forms of business that a banking company may engage in are prescribed in the Act[228]. The Act gives power to the RBI to control advances by banking companies by issuing directions to the banks including matters related to demand guarantees[229]. These directions may be issued in the interest of public as well as in the interest of banking policy. They are binding on the banks[230]. The powers are wide enough to exercise effective control over all banks. If any bank commits a breach of the directives, it is liable to be penalised[231].

5.3 MASTER CIRCULAR ISSUED BY THE RBI[232]

The RBI on July 1, 2015 issued a master circular which is a consolidated list of all the guidelines and instructions issued by the RBI up until June 30, 2015 on demand

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[224] *About Us*, FEDERAL BANK (Apr 25, 2020 8:30 AM), https://www.federalbank.co.in/about-us.
[225] *Id.*
[226] *Id.*
[227] Banking Regulation Act, 1949 [As amended by The Banking Regulation (Amendment) Act, 2017] (30 of 2017), (25th April 2020 9:00 AM) https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/BANKI15122014.PDF.
[228] Banking Regulation Act, 1949 [As amended by The Banking Regulation (Amendment) Act, 2017] (30 of 2017), §6 (25th April 2020, 9:30 AM) https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/BANKI15122014.PDF.
[229] Banking Regulation Act, 1949 [As amended by The Banking Regulation (Amendment) Act, 2017] (30 of 2017) (25th April 2020, 9:40 AM) https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/BANKI15122014.PDF.
[230] Banking Regulation Act, 1949 [As amended by The Banking Regulation (Amendment) Act, 2017] (30 of 2017), §21(1) and §21(2) (25th April 2020 9:50 AM) https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/BANKI15122014.PDF.
[231] Corporation Bank v. D. S. Gowda, 5 SCC 213 (1994).
[232] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015 (25th April 2020, 10:00 AM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813.

guarantees along with other instruments of finance. The guidelines laid down in relation to demand guarantees in essence are as follows:

As a general rule, banks may provide only financial guarantees and not performance guarantees except for schedule banks after exercising due caution[233]. Guarantees should not be issued for periods exceeding ten years in any case[234].

The total volume of guarantee obligations outstanding at any time may not exceed 10 per cent of the total owned resources of the bank comprising paid up capital, reserves and deposits. Within the overall ceiling, proportion of unsecured guarantees outstanding at any time may be limited to an amount equivalent to 25% of the owned funds (paid up capital + reserves) of the bank or 25% of the total amount of guarantees, whichever is less[235].

Banks should preferably issue secured guarantees[236]. Banks should generally provide deferred payment guarantees backed by adequate tangible securities or by counter guarantees of the Central or the State Government or public sector financial institutions or of insurance companies and other banks[237].

With respect to unsecured guarantees, Board of Directors of the banks should fix suitable proportions for issuance of unsecured guarantees on behalf of any individual constituent

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[233] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, § 1.1.2 (26th April 2020, 11:00 PM). https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813.*"1.1.2 Purpose (i) As a general rule, banks may provide only financial guarantees and not performance guarantees. (ii) However, scheduled banks may issue performance guarantees on behalf of their constituents subject to exercising due caution in the matter."*

[234] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, § 1.1.3 (26th April 2020, 11:10 PM). https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

[235] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, § 1.1.4 (26th April 2020, 11:15 PM). https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

[236] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, § 1.1.5 (26th April 2020, 11:20 PM). https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813.*"A secured guarantee means a guarantee made on the security of assets (including cash margin), the market value of which will not at any time be less than the amount of the contingent liability on the guarantee, or a guarantee fully covered by counter guarantee/s of the Central Government, State Governments, public sector financial institutions and / or insurance companies."*

[237] *Id.*

so that these guarantees do not exceed a - (a) reasonable proportion of the total obligations in respect of unsecured guarantees provided by the bank to all such constituents at any time, and (b) reasonable multiple of the shareholdings in the bank[238].

Banks, which intend to issue deferred payment guarantees on behalf of their borrowers for acquisition of capital assets should ensure that the total credit facilities including the proposed deferred payment guarantees do not exceed the prescribed exposure ceilings[239]**.** The proposals for deferred payment guarantees should be examined having regard to the profitability / cash flows of the project to ensure that sufficient surpluses are generated by the borrowing unit to meet the commitments as a bank has to meet the liability at regular intervals in respect of the instalments due. The criteria generally followed for appraising a term loan proposal for acquisition of capital assets should also be applied while issuing deferred payment guarantees[240].

It is also to be noted that Primary (Urban) Co-operative Banks (PCBs)[241] should not issue, either to a court or to government, or any other person, a guarantee on behalf of or on account of any importers guaranteeing payment of customs duty and / or import duty, or other levies, payable in respect of import of essential commodities[242] without taking, as security for issue of such guarantees, a cash margin equivalent to at least one half of the amount payable under the guarantee[243].

The RBI also lists a few safeguards that should be followed by banks while issuing financial guarantees safeguards:

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[238] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, July 1, 2015, § 1.1.6 (26th April 2020, 11:30 PM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

[239] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, § 1.1.7(i) (26th April 2020, 11:30 PM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

[240] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, § 1.1.7(ii) (26th April 2020, 11:30 PM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

[241] small-sized co-operatively organised banking units which operate in metropolitan, urban and semi-urban centres to cater mainly to the needs of small borrowers, viz., owners of small scale industrial units, retail traders, professionals and salaried classes

[242] The term "essential commodities" shall mean such commodities as may be specified by the Reserve Bank of India from time to time.

[243] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, § 1.1.6 (27th April 2020, 12:00 AM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813.

(i) It should be issued in security forms serially numbered to prevent issuance of fake guarantees[244].

(ii) Guarantees above a particular cut-off point, as may be decided by each bank, should be issued under two signatures in triplicate, one copy each for the branch, beneficiary and Controlling Office / Head Office. It should be binding on the part of the beneficiary to seek confirmation of the Controlling Office / Head Office as well for which a specific stipulation be incorporated in the guarantee itself[245].

(iii) The guarantees should not normally be allowed to the customers who do not enjoy credit facilities with the banks but only maintain current accounts. If any requests are received from such customers, the banks should subject the proposals to thorough scrutiny and satisfy themselves about the genuine need of the customers. Banks should be satisfied that the customers would be in a position to meet the claims under the guarantees, when received, and not approach the bank for credit facility in this regard. For this purpose the banks should enquire into the financial position of the customers, the source of funds from which they would be in a position to meet the liability and prescribe a suitable margin and obtain other security, as necessary. The banks may also call for the detailed financial statements and Wealth-tax / Income-tax returns of the customer to satisfy themselves of their financial status. The observations of the banks in respect of all these points should be recorded in banks' books[246].

(iv)Where the customers enjoy credit facilities with other banks, the reasons for their approaching the bank for extending the guarantees should be ascertained and invariably,

[244] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, § 1.3(i) (27th April 2020, 12:10 AM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813.

[245] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, § 1.3(ii) (27th April 2020, 12:13 AM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

[246] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, § 1.3(iii) (27th April 2020, 12:20 AM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

a reference should be made to their existing bankers with whom they are enjoying credit facilities[247].

(v) Banks, when approached to issue guarantees in favour of other banks for grant of credit facilities by another bank, should examine thoroughly the reasons for approaching another bank for grant of credit facilities and satisfy themselves of the need for doing so. This should be recorded in bank's books[248].

When it is considered necessary to issue such guarantees, the banks concerned should ensure that the relative guarantee document, beyond a stipulated amount, should be signed by two authorised officials jointly after obtaining proper sanction and authority and proper record of such guarantee issued being maintained[249]. The credit proposals should be subjected to usual scrutiny by the lending bank ensuring that the proposals conform to the prescribed norms and guidelines and credit facilities are allowed only if the bank is satisfied about the merits of the proposal and the availability of another bank's guarantee should not result in a dilution of the standards of evaluation of the proposal and financial discipline in lending[250].

The RBI also stated that there have been a number of complaints on non-payment or delay in payment of bank guarantees upon invocation. The reason for the same has been narrowed down to (i) their fear of difficulty in realising the amount due from their constituents once invoked and (ii) dilution of security (i.e., non-obtention of adequate margin)[251]. The above aspects may inhibit banks to pay the beneficiaries promptly when guarantees are invoked and they adopt dilatory tactics in respect of invoked guarantees. It is absolutely essential for banks to appraise the proposals for guarantees also with the

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[247] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, §1.3(iv) (27th April 2020, 12:25 AM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

[248] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, § 1.3(v) (27th April 2020, 12:30 AM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

[249] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, §1.3 (27th April 2020, 12:35 AM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

[250] *Id.*

[251] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, §1.4(ii) (27th April 2020, 12:40 AM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

same diligence as in the case of fund based limits and obtain adequate cover by way of margin so as to prevent the constituents to develop a tendency of defaulting in payments when invoked guarantees are honoured by the banks[252].

The RBI has also upheld the judgement of the Supreme Court that commitment of banks must be honoured free from interference by the courts and it is only in exceptional cases, that is to say, in case of fraud or in case where irretrievable injustice would be done, if bank guarantee is allowed to be encashed, the court should interfere[253].

5.4 FEMA GUIDELINES[254]:

The Reserve Bank must approve the issue of guarantees in favour of foreign lenders or suppliers (in the case of Supplier's Credits). Reserve Bank will grant the required permission to the concerned authorised dealer, while granting approval for raising the foreign currency loan/credit. The concerned authorised dealer may make the necessary remittance without reference to Reserve Bank, in the event of invocation of the guarantee. A report should, however, be sent to Reserve Bank giving full details citing reference to the approval for furnishing the guarantee. A copy of the claim received from the overseas party should be enclosed with such report.

5.5 DEMAND GUARANTEES - PROCEDURE FOLLOWED BY BANKS IN INDIA

The procedure primarily followed by banks in India while issuing demand guarantees is as follows[255]:

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[252] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, §1.4(iii) (27th April 2020, 12:45 AM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

[253] Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015, §1.4(v) (27th April 2020, 12:50 AM) https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813.

[254] Notification No. FEMA.8/2000-RB (May 3, 2000).

[255] This has been summarized on the basis of the interview with interviewee 1 and interviewee 2. See also *Chapter 26 - Guarantees*, UNION BANK OF INDIA (April 22, 2012, 6:00PM), https://www.unionbankofindia.co.in/pdf/BELG_26_ALLiquityRMPolicyGuarantees.pdf.

Only certain branches are authorised to issue export/import related guarantees. All other branches have to therefore approach the nearest authorised branch for issue of such guarantees on behalf of their customers. Interviewee 1 stated that there were around 92 authorised branches which were equipped to deal with export/import demand guarantees and that this number has increased post amalgamation of the Union Bank. Interviewee 2 stated that only 'A category branches' were authorised to deal with import/export demand guarantees.

A request letter from the customer for issuing bank guarantee together with underlying contract/documentary evidence is to be obtained. The underlying contract/documentary evidence is then scrutinised to ensure that there are no onerous clauses.

The format (draft) guarantee to be issued is to be obtained. Normally, the format of guarantee in favour of government departments is prescribed by the department concerned. The formats of other guarantees are liable to differ to suit the requirements of each beneficiary. As far as the Bank is concerned, the format has to be scrutinised to ensure that bank's liability is restricted to a certain amount and remains valid for a definite period of time. The model bank guarantee[256] prescribed by Government of India provides for such limitations as to amount and validity period.

In cases where the beneficiary insists on bank guarantee format different from that of the Model Form of Bank Guarantee, the same should be vetted by Bank's legal officer or penal advocate ensuring that there is no onerous clause. The legal opinion[257] should be held on record till the reversal of guarantee. Normally liability under the guarantee should be reduced proportionately upon execution of obligation or contracts. Suitable clause should be incorporated for reducing liability, wherever possible, in order to avoid excess claims.

Authorised branches have to select overseas correspondent bank with which sufficient credit lines and testing arrangements have been arranged by Investment Banking Division. Thereafter tested request for issuance of bank guarantee is to be drafted.

[256] See Annexure 1

[257] These guarantees must be permitted by sanctioning authority not below Regional Head. This was reiterated by both interviewee 1 and 2.

Among others, format of guarantee to be issued is to be furnished to correspondent bank. Besides, counter guarantee for the value of guarantee for a period extending 15 days beyond expiry date of the guarantee is to be issued in the same tested message. Details of commission payable are to be called for and amount remitted thereafter to the debit of party's account.

Every guarantee to be issued must be entered in a serial order in the Letter of Guarantee (L/G) Register and this serial number must be shown on every page of the guarantee bond. Each page must also bear rubber stamp showing the name of the Bank and the branch. Full particulars of the guarantee including commission collected should be entered in the LG Register.

Full commission on guarantee must be recovered according to guidelines, before delivering the guarantee to the customers/transmitting the message to correspondent bank, except in those cases where recovery of commission in instalments is permitted. Duly stamped counter indemnity[258], properly executed by the customer should be obtained along with other documents prescribed in the sanction advice.

Cash margin/other securities stipulated are to be obtained beforehand. Entries of the same are to be made in Margin Register (party-wise).

Guarantees contain an undertaking to pay on a mere demand without delay or demur. When such a demand is received by the issuing branch within the validity period of the guarantee, payment has to be made immediately.

In case margin held is insufficient to honour the claim, payment is to be made to the debit of 'Payment under Invoked Guarantee' account. A formal notice should be sent to the customer claiming reimbursement together with interest. A suitable report is also sent to the Regional Office. While no additional security documents are needed, the banks bear in mind that Law of Limitation (3 years) relating to legal action for recovery, operates from the date of payment of claim amount. In case repayment of the amount paid is rescheduled or converted to a loan account entailing repayment in instalments, separate security documents have to be obtained.

[258] See Annexure 2 for the format of a counter indemnity.

If the bank is unable to honour the claim due to its late receipt or on account of receipt of restraint order from the court, reasons for non-payment are to be intimated to the beneficiary and details passed on to the Regional Office.

Banks usually diarise expiry dates of all guarantees for calling back the original guarantee bond and for reversal of liability. In case guarantees have expired, customer should be advised to obtain back the original guarantee bonds duly discharged or obtain a separate letter of discharge confirming that Bank stands discharged from all liabilities under the guarantee. In the case of foreign exchange related guarantees the liability can be reversed on receipt of confirmation from overseas correspondent bank to the effect that relative guarantee bond has been surrendered to them duly discharged.

In the event the customer is unable to return the guarantee or obtain a letter of discharge from the beneficiary, branch should obtain a letter from the customer i) Confirming that he has completed all obligations under the contract, ii) That there are no disputes between him and the beneficiary, iii) Requesting the Bank to cancel the guarantee from its current records, iv) Undertaking that he continues to be liable to the bank till such time bank procures return of the original bond or letter of discharge.

On receipt of above letter, bank should write to the beneficiary for returning original guarantee or to send a letter of discharge. If there is no response to the letter within 30 days from the date of receipt of postal acknowledgement card, branch may reverse liability in its books.

Guarantee can be extended on receipt of a letter of request from customer and beneficiary giving valid reasons for such extension. Commission for the extended period is to be collected in advance. Tested message[259] for extending validity is to be sent to overseas bank.

[259] SWIFT message types are the format or schema used to send messages to financial institutions on the SWIFT (*Society for Worldwide Interbank Financial Telecommunication*) network.

5.6 DIFFICULTY FACED BY BANKERS

A difficulty faced by the banks in India in relation to demand guarantees relates to fraud. In 2011, the RBI through a notification[260] brought to public knowledge instances of attempt to defraud by using fake bank guarantees. Bank Guarantees purportedly issued by a couple of bank branches in favour of different entities were presented for confirmation by other commercial banks/individuals representing some beneficiary firms. The guarantees were submitted along with Confirmation Advice/Advice of Acceptance. Except for one beneficiary who was the reporting banks customer, the remaining beneficiaries and applicants were neither the customers of the bank nor were they known to the bank branch officials. A scrutiny of the bank guarantees revealed that these bank guarantees were fraudulent and the signatures of the bank officials appearing on the bank guarantees were forged. The bank branches purported to have issued the bank guarantees also confirmed that they had not issued the same. Even the format of the bank guarantees and their serial numbers did not match with that of the bank. Most of the frauds are going unnoticed by authorities. Only when one of the parties raises dispute, the matter comes to light. Both interviewee 1 and interviewee 2 revealed that more often than not the fraud goes unnoticed.

The practice found in India is that every major bank participant has its own training manuals and guidelines. These internal practices resulted in creating massive fraud which goes undetected. This shows the absence of clear supervision over banking related financial scam.

It can be seen that most of the U.C.P. provisions which are incorporated in India are followed through guidelines issued by FEDAI[261]. However most of the banks are following their own internal procedures as FEDAI guidelines are only directory in nature. There are no penal consequences for any violations. Apart from this a voluntary code was issued by the Reserve Bank of India to set minimum standards of banking practices for

[260] RBI/2011-12/206, DNBS(PD).CC. No.245 /03.10.42 /2011-12, September 27, 2011, (3rd May 2020, 9:00 PM) https://www.rbi.org.in/Scripts/BS_NBFCNotificationView.aspx?Id=6738

[261] The Foreign Exchange Dealers Association of India (FEDAI) is an association of banks that specializes in the foreign exchange markets in India. (These institutions are also called Authorised Dealers or ADs.) Created in 1958, the body regulates the rules that determine commissions and charges that are attached to the interbank foreign exchange business.

banks to follow when they are dealing with individual customer[262]. According to this, the bank will inform the individual customer if the information provided by him for making a payment abroad is adequate or not. In case of any discrepancies the bank will advise the individual customer immediately provide assistance to him to rectify and complete the same.

India, being a developing country, has considerable limitations on its foreign exchange reserves. Taking this into account, whenever a bank guarantee is issued on behalf of a buyer by a bank in India, the seller inevitably insists that it should be confirmed by another bank in his own country. Alternatively, the seller insists that a negotiating bank in his country should be authorized to collect the amount from the correspondent of the issuing bank, merely on a demand. In the latter case, the negotiating bank being assured of payment tends to be more inclined to accept documents though they are not strictly in conformity with the terms of the bank guarantee. When the documents are ultimately presented to the issuing bank in India, it is of little consequence whether the documents are really within the terms of the demand guarantee or not, because payment has already been realized by the seller and settling the dispute is practically not possible.

In the Punjab National Bank a manager, later aided by his young subordinate, engineered fraudulent transactions totalling about $1.8 billion from 2011 to 2017[263]. The fraud happened owing to the alleged misuse of the SWIFT interbank messaging system and incomplete ledger entry. The manager had issued a series of guarantees sent to other banks so that they would provide loans to a customer, in this case a group of Indian jewellery companies. These were sent to overseas branches of banks, thought to be almost all Indian, that would then lend money to the jewellery firms. He did so using the bank's SWIFT system to log in with passwords that allowed him, and in at least some instances a more junior official, to serve as both the person who sent messages and as the person who reviewed them for approval. After entering the transactions on SWIFT, despite normal bank practices of regular rotations he did not record them on the bank's

[262] *See Code of Banks Commitment of Individual Customers*, BANKING CODES AND STANDARDS BOARD OF INDIA, (3rd May, 2020, 9:10 PM) http://www.bcsbi.org.in/Pdf/CBCC2018.pdf

[263] *PNB scam: Same person sent requests for bank guarantees, approved them*, WION, (3rd May, 2020, 9:20 PM), https://www.wionews.com/india-news/pnb-scam-same-person-sent-requests-for-bank-guarantees-approved-them-33322.

internal system. Because PNB's internal software system was not linked with SWIFT, employees were expected to manually log SWIFT activity. If that was not done, the transactions did not show up on the bank's books. This case points to a breakdown in checks and balances, and standard banking practices. This case also illustrates how banks fail to supervise such activities and points towards how there have been rising incidents of fraud owing to collusion with bank employees.

Asked about the password sharing, in the telephonic interview both interviewee 1 and interviewee 2 said that it was not the best practice, but in the everyday bustle of Indian banks it happens. However, both of them maintained that this is a transgression and bankers who do so are liable to be punished.

Both interviewee 1 and interviewee 2 maintained that post-PNB incident, both Union bank and Federal bank have their internal software system linked with SWIFT and thereby there is no scope for manually logging in such data.

5.7 CONCLUSION:

It is evident that in order to prevent banks from adopting dilatory tactics in respect of invoked guarantees, it is absolutely essential for banks to obtain adequate cover by way of margin so as to prevent the constituents to develop a tendency of defaulting in payments when invoked guarantees are honoured by the banks.

The interviewees have made it evident that more often than not instances of fraud go unnoticed. This is because every major bank participant has its own training manuals, guidelines and internal practices and this has resulted in instances of massive fraud which goes undetected. This is attributable to the absence of clear supervision over banking related financial scam. The FEDAI guidelines and the voluntary codes issued by the RBI are all merely directory in nature and there are no penal consequences for violation of the same.

It still remains that the administrative control over demand guarantees remains only a paper. In actual practice the banks in India enjoys the discretionary power to indulge in

guarantee transactions with minimum regulatory framework. Though such a freedom for banks to transact is appreciable from the commercial point of view it should not be a shelter for fraudulent activities

CHAPTER 6: CONCLUSION AND SUGGESTIONS

6.1 INTRODUCTION

The discussions in the previous chapters have revealed that demand guarantees is a method of financing employed in domestic and international trade, where the bank provides the requisite security for a party's "financial" or "performance" obligation under a contract. Apart from this, as banking institutions play a pivotal role in promoting the use of these instruments they serve as a means to increase the foreign exchange reserves of a nation. They are now used as guaranteeing instrument which assures satisfactory performance of the contract. The law in this area is ambiguous. The study of this aspect revealed the intricacies involved in this transaction.

6.2 CONCLUSIONS

6.2.1 Problems Created by Autonomy Principle

Under the basic rule of the principle of autonomy, the underlying contract between the buyer and the seller does not affect obligation of the issuing bank to pay the guarantee amount. Payment of the guarantee amount by the issuing bank however, does not ensure that the buyer gets the goods he has contracted. While the beneficiary gets security from the bank for the goods he supplies, the buyer gets no security for the procurement of the contracted goods.

Scholars and courts have been struggling for the solution to the question as to how strictly this rule of autonomy should be applied. The autonomy principle is misused by unscrupulous parties to indulge in commercial frauds. To overcome this abuse, courts have recognized the exceptions to the principle of autonomy.

6.2.2 Practice Relating to Fraud Exception

The fraud exception represents a departure from the principle of autonomy. Fraud rule allows banks and courts to interfere with the payment under a demand guarantee when

fraud is involved. There is a lot of ambiguity surrounding this exception. It is mainly because the standard of fraud cannot be fixed. The divergent views of courts and commentators regarding the standard of fraud illustrate the conflict between two different policy considerations. The rules and standards regarding the fraud exception offer no clarity with respect to identifying the fraudulent parties. The fraud exception law is dicey since it may enable an unscrupulous seller to manipulate the incautious buyers and third parties.

The U.C.P. does not contain provision for defeating fraud. The lack of provision to defeat fraud in the U.C.P. indicates that the intention of the drafters was to leave it to the municipal law. This is a wise decision because the municipal laws of various countries regarding fraud in demand guarantees are not uniform. Moreover it creates an incentive for various jurisdictions to fashion fraud rule to suit the marketability of guarantees issued by banks in their countries.

In the United States of America, Article 5 of the Uniform Commercial Code[264] contains provision addressing fraud and forgery. The provision makes it clear that fraud must be found either in the documents or must have been committed by the beneficiary. It must be "material" and the standard for injunctive relief is high. The burden remains on the

[264] Uniform Commercial Code (UCC), §5-109, "*Fraud and Forgery, If a presentation is made that appears on its face strictly to comply with the terms and conditions of the letter of credit, but a required document is forged or materially fraudulent, or honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant:*
(1) the issuer shall honor the presentation, if honor is demanded by (i) a nominated person who has given value in good faith and without notice of forgery or material fraud, (ii) a confirmer who has honored its confirmation in good faith, (iii) a holder in due course of a draft drawn under the letter of credit which was taken after acceptance by the issuer or nominated person, or (iv) an assignee of the issuer's or nominated person's deferred obligation that was taken for value and without notice of forgery or material fraud after the obligation was incurred by the issuer or nominated person; and
(2) the issuer, acting in good faith, may honor or dishonor the presentation in any other case.
(b) If an applicant claims that a required document is forged or materially fraudulent or that honor of the presentation would facilitate a material fraud by the beneficiary on the issuer or applicant, a court of competent jurisdiction may temporarily or permanently enjoin the issuer from honoring a presentation or grant similar relief against the issuer or other persons only if the court finds that:
(1) the relief is not prohibited under the law applicable to an accepted draft or deferred obligation incurred by the issuer;
(2) a beneficiary, issuer, or nominated person who may be adversely affected is adequately protected against loss that it may suffer because the relief is granted;
(3) all of the conditions to entitle a person to the relief under the law of this State have been met; and
(4) on the basis of the information submitted to the court, the applicant is more likely than not to succeed under its claim of forgery or material fraud and the person demanding honor does not qualify for protection under subsection (a)(1)."

applicant to show by evidence that fraud was committed and mere allegation of fraud is not sufficient. The courts in India shaped the fraud rule by taking into account the United States decisions relating to fraud exception. An analysis of cases in India shows that the practical applicability of the fraud rule is very limited. Only when fraud is established the courts will grant an injunction to prevent the bank from making paying on the credit. It is found that fraud rule is necessary to limit the activities of fraudsters but its scope must be carefully delimited so as not to deny commercial utility of the instrument. The courts also face difficulty since rules relating to fraud are diverse and unclear. This creates a situation where the decisions of courts relating to fraud are criticized.

6.2.3 Problems Faced by Issuing and Corresponding Banks

The rights of issuing bank and its problems are also matters of concern. Issuing banks are entitled to get reimbursement once they complied with the terms of the guarantee. This is based on the general principle of law of agency that an agent is only entitled to reimbursement from his principal if he acts in accordance with his instructions. Therefore if the buyer commits breach of the term, the issuing bank has a right to sue him. The judicial decisions show that the right of the issuing bank depend on the fulfilment of the agreed terms. These terms may vary from case to case. So it is difficult to determine the scope of the rights of issuing banks.

Similarly the duties of correspondent banks and their problems are also far from satisfactory. The payment to the beneficiary is made by the correspondent bank situated in the beneficiary's country on the basis of instructions received from the issuing bank. This creates certain obligation on the correspondent bank also. The obligations vary according to the nature of the function they agree to perform. If they agree merely to advise the beneficiary, their liability is limited. If they add confirmation to the credit, the obligation to pay will arise. In the United Kingdom courts use broad discretion and apply the test of reasonableness in deciding the duties of correspondent bankers. The judicial trend seems to be liberal. This affects the interest of the applicant as he has no contractual relationship with the correspondent bank. So he cannot sue or claim damages for any breach of obligation by the bank.

6.2.4 Nature of Administrative Controls over Demand Guarantees in India

Administrative control over demand guarantees and the practice followed by banks in India are not beneficial for the applicant. Administrative controls are mainly based on the guidelines and master circulars issued by the Reserve Bank of India from time to time. Both interviewee 1 and 2 stated that these circulars are aimed at protecting the solvency and liquidity of banks. Many banks in India have their own internal measures to regulate activities connected with demand guarantees. Even though they try to bring the international standards in their circulars they often fail to implement it in practice. Lack of uniformity and liberal rules governing demand guarantees creates a platform for fraudsters to indulge in fraud.

6.2.5 Practice of Indian Courts

In India there is no statute which specifically governs demand guarantees. The courts try to apply the provision regarding guarantees embodied in the Indian Contract Act, 1872 to decide cases relating to demand guarantees. Apart from this, they also apply the legal principles laid down by English courts. This creates confusion. The study of various decisions shows that there is no clarity regarding the principles applicable to demand guarantees in India. The courts in India equate bank guarantees with letters of credit. They often create confusion regarding these instruments. They have failed to carve out a clear law. However, the courts in earlier period were aware of the distinction between letters of credit and bank guarantees. They made it clear that there is a distinction not merely on the function but also in their legal nature. The irrevocable letter of credit payment does not depend on the performance of obligations by the seller. It depends only on those duties expressly imposed under the letter of credit. In the case of bank guarantee unless there is some act or omission or commission on the part of the third party, payment would not become due. There is always the question of contingency on the occurrence of which the guarantee becomes enforceable. If this is accepted the principle of indemnity cannot be applied to decide bank guarantee cases.

Later this trend changed. Now in every case, courts treat both the instruments as analogous. They often say that there is no practical difference between a bank guarantee

and letter of credit. All depends on the facts of each and every case apart from the language of the document. This situation has arisen due to the absence of clear legislative provisions. It is also pertinent to note that interviewee 1 stated that when it comes to the Union Bank the guidelines that apply to demand guarantees are the same as that which applies to a letter of credit.

To overcome the above difficulties the following suggestions are made.

6.3 SUGGESTIONS:

6.3.1 Need to Limit Application of Autonomy Principle

The principle of autonomy dictates that the banker is obliged to make payment without regard to any defences which the applicant may have against the beneficiary. The principle of autonomy of demand guarantees should, in principle, be jealously guarded, because it is essential for the preservation of the unique quality of the demand guarantee as an attractive instrument for international transactions. However, public policy considerations in favour of the fraud exception require that in certain cases the principle of autonomy should give way to the broader purpose of making sure that parties who engage in unjust or fraudulent transactions should not use the judicial process in furtherance of their fraudulent purpose.

As the demand guarantee is separate and independent of the underlying contract, and the bank is not even a party to the underlying contract, it follows that in the absence of established fraud and injustice, the bank should in all other instances pay, despite any disputes regarding the underlying contract. Even where the underlying contract is a nullity (*i.e.* it does not exist), the bank should still pay and it should not be possible to obtain an injunction against the bank to prevent payment in such a case. If all these types of exceptions are allowed, it would mean that the original purpose why demand guarantees were created – to be similar to cash deposits – would become meaningless. This stance has been reiterated by both interviewee 1 and 2 in their interview.

6.3.2 Need for Clarity in Application of Fraud Rule

The fraud exception to the rule of autonomy, as developed by courts remains elusive. Courts have not identified the degree of fraud required to hold that there is fraud justifying the violation of the principle of autonomy. Only when the case is adjudicated it will become clear whether the conduct at issue comes within the fraud exception. Apart from this, to define the fraud is a very difficult task. If it is defined too narrowly the effectiveness of fraud rule will be lost. A very rigid standard of fraud may encourage growth of fraudulent conduct by beneficiaries and discourage the use of demand guarantees by applicants. On the other hand, if fraud is defined too widely the fraud rule may be abused by an applicant who does not want the issuer to pay the credit simply because it will not make profit from the underlying transaction. If obstruction of payment of a demand guarantee is permitted too often, business confidence in demand guarantees will be destroyed.

Therefore, a proper standard of fraud should be one reflecting a sensible compromise between the competing interests. It should serve the purpose of the fraud rule and be workable for the courts. Courts should provide some guidelines to determine the fraud situations. It is suggested that while framing guidelines in India, a combination of the provisions of the revised U.C.C. article and the UNCITRAL Convention can be made.

6.3.3 Need for Unification of Law Relating to Demand Guarantees

So far, no attempt has been made to standardize the laws relating to demand guarantees through international conventions. Cross-border trade has increased dramatically and there is a greater need for harmonization of commercial law including law relating to demand guarantees at international level. Obvious methods of creating transnational commercial law include international conventions and forms of soft law such as model laws, international restatements and contractually incorporated uniform rules. Though the adaptation of the Uniform Customs and Practice by almost all the countries in the world made the basic principles applicable to demand guarantees “uniform" throughout the world, it became effective only when the parties incorporate it in their contract. The

UNCITRAL convention becomes applicable only in those countries, which have ratified it. To overcome all these problems international cooperation is needed.

6.3.4 Need to Develop Regulatory System for Demand Guarantee Dispute Resolution

The number of disputes involving demand guarantees is on the increase both at national and international levels. The judicial mechanism is slow and often confusing. This calls for an extra-judicial mechanism for resolving these disputes. International Commercial Arbitration is one such regulatory mechanism. Apart from this the Documentary Instruments Disputes Resolution Expertise also works as a dispute regulatory body at international level. However, in order to exercise their benefit as an effective regulatory mechanism the parties should contemplate them in the contract. Thus the parties need to incorporate an arbitration provision in the underlying sales contract in order to subject them to international commercial arbitration. The provision could state that an arbitrator may award compensatory and consequential damages in case a demand guarantee has no conceivable basis, or involves material, egregious, wilful or intentional fraud. There are no legal or contractual barriers to limit the use of international commercial arbitration in demand guarantee disputes in India.

Therefore, separate regulatory mechanisms to tackle these disputes need to be developed. The proposed system should involve the direct participation of banks and thereby enhance the general acceptability of such a dispute resolution system.

6.3.5 Need to Distinguish Documentary Credits from Demand Guarantee

Non-recognition of the distinction between documentary credit and ordinary bank guarantee creates confusion. A letter of credit that functions as a guarantee should be treated as such under the law. The strict application of the rule of autonomy is commercially justifiable in them case of letters of credit. Autonomy principle is effective because banks pay upon receipt of documents. These documents provide some security for banks as they transact with title to the goods. There is no such security in the case of bank guarantees. While there is commercial quid pro quo for the principle of autonomy in

letters of credit, there is no such justification in bank guarantees. So the analogy between letters of credit and bank guarantees needs a reappraisal.

Therefore, separation of these instruments based on its nature is essential. This calls for making special rules based on UNCTTRAL and U.C.P. provisions relating to demand guarantees. They must be codified. In order to overcome the uncertainty created by conflicting decisions, a special legislation codifying the principles of demand guarantees could be made.

6.3.6 Need to Appoint a Banking Commission on Demand Guarantees in India

Reserve Bank of India should appoint a committee to study the problems faced by buyers and beneficiaries in dealing with demand guarantees. They should suggest the measure to reconcile the problems and also effective measures to prevent frauds. They should consider methods to strengthen the existing measure of lending operations concerning demand guarantees.

6.3.7 Need to Strengthen the Banking Ombudsman System

Banking Ombudsman system is at present functional in India. They are playing a pivotal role to settle disputes between banks and their customers. Their functions include the authority to decide the demand guarantee issues. But cases decided are few. Therefore there is a need to strengthen the banking ombudsman system and encourage them to decide the disputes relating to demand guarantees also.

6.3.8 More Internal Checks and Balances

According to a Deloitte India Banking Fraud study conducted in 2012 among private, public, multinational and cooperative banks, 20 per cent of respondents admitted to falling prey to a high level of fraudulent documentation. Interestingly, 64 per cent said that bank frauds in general involved at least one employee while the rest acknowledged a collusion involving more than one bank employee[265]. These fraudulent transactions take place despite a certain level of precaution among financial institutions in the domestic

[265] *Bank Guarantees: Beware of Fraudsters*, MONEYCONTROL (May 2, 2020, 7:00 PM) https://www.moneycontrol.com/news/trends/features-2/bank-guarantees-bewarefraudsters-1177599.html.

market. There is a definite need for more checks and balances when it involves international transactions.

Thus, the above work seeks to shed light on the meaning and significance of demand guarantees and attempts to understand the Indian standpoint of the role of demand guarantees in transnational sales. It illustrates how the principle of autonomy is not absolute in the case of demand guarantees and explains the exceptions to this principle. It illustrates the policies adopted by banks and the regulatory scheme on lending activities issued by the Reserve Bank of India and tries to analyze how far they are in line with the Uniform Customs Practice provisions and other internationally established rules. It has also laid out the shortcomings of the existing framework. This work further endeavours to identify the practical difficulties faced by bankers in case of bank guarantees.

It is the finding of the researcher that the rules and regulatory framework governing bank guarantees both at the international and the national level are not sufficient and fails to protect the rights of all the parties involved effectively.

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ANNEXURE 1: MODEL FORM OF BANK GUARANTEE BOND[266]

GUARANTEE BOND

1. In consideration of the President of India (hereinafter called 'the Government') having agreed to exempt _____ [hereinafter called 'the said Contractor(s)'] from the demand, under the terms and conditions of an Agreement dated _____ made between _____ and_____for_____ (hereinafter called 'the said Agreement'), of security deposit for the due fulfilment by the said Contractor(s) of the terms and conditions contained in the said Agreement, on production of a bank Guarantee for Rs. _____ (Rupees_____ Only) We, _____, (hereinafter referred (indicate the name of the bank) to as 'the Bank') at the request of _____ [contractor(s)] do hereby undertake to pay to the Government an amount not exceeding Rs. _____ against any loss or damage caused to or suffered or would be caused to or suffered by the Government by reason of any breach by the said Contractor(s) of any of the terms or conditions contained in the said Agreement.

2. We _____ (indicate the name of the bank) do hereby undertake to pay the amounts due and payable under this guarantee without any demur, merely on a demand from the Government stating that the amount claimed is due by way of loss or damage caused to or would be caused to or suffered by the Government by reason of breach by the said contractor(s) of any of the terms or conditions contained in the said Agreement or by reason of the contractor(s)' failure to perform the said Agreement. Any such demand made on the bank shall be conclusive as regards the amount due and payable by the Bank under this guarantee. However, our liability under this guarantee shall be restricted to an amount not exceeding Rs. _____.

[266] Annexure 1, Master Circular- Guarantees, Co-Acceptances & Letters of Credit – UCBs, RBI/2015-16/6, DCBR.BPD. (PCB) MC No.8/09.27.000/2015-16, July 1, 2015 https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9813

3. We undertake to pay to the Government any money so demanded notwithstanding any dispute or disputes raised by the contractor(s)/supplier(s) in any suit or proceeding pending before any Court or Tribunal relating thereto our liability under this present being absolute and unequivocal.

The payment so made by us under this bond shall be a valid discharge of our liability for payment thereunder and the contractor(s)/supplier(s) shall have no claim against us for making such payment.

4. We,_____ (indicate the name of bank) further agree that the guarantee herein contained shall remain in full force and effect during the period that would be taken for the performance of the said Agreement and that it shall continue to be enforceable till all the dues of the Government under or by virtue of the said Agreement have been fully paid and its claims satisfied or discharged or till_____ Office/Department/Ministry of_____ certifies that the terms and conditions of the said Agreement have been fully and properly carried out by the said contractor(s) and accordingly discharges this guarantee. Unless a demand or claim under this guarantee is made on us in writing on or before the _____ we shall be discharged from all liability under this guarantee thereafter.

5. We, _____ (indicate the name of bank) further agree with the Government that the Government shall have the fullest liberty without our consent and without affecting in any manner our obligations hereunder to vary any of the terms and conditions of the said Agreement or to extend time of performance by the said contractor(s) from time to time or to postpone for any time or from time to time any of the powers exercisable by the Government against the said Contractor(s) and to forbear or enforce any of the terms and conditions relating to the said agreement and we shall not be relieved from our liability by reason of any such variation, or extension being granted to the said Contractor(s) or for any forbearance, act or omission on the part of the Government or any indulgence by the Government to the

said Contractor(s) or by any such matter or thing whatsoever which under the law relating to sureties would, but for this provision, have effect of so relieving us.

6. This guarantee will not be discharged due to the change in the constitution of the Bank or the Contractor(s)/Supplier(s).

7. We, _____ (indicate the name of bank) lastly undertake not to revoke this guarantee during its currency except with the previous consent of the Government in writing.

8. Dated the_____ day of _____for _____ (indicate the name of the Bank)

ANNEXURE 2: FORMAT OF COUNTER INDEMNITY

Dear Sirs,

In Consideration of your having agreed to execute/countersign, executed/countersigned at my/our request a letter of Guarantee, dated _____ in favour of_____ in respect of _____

I/We hereby undertake and agree to indemnify you, your successors and assigns at all times and from time to time from and against all loss, damage and all actions, suits, proceedings, accounts, claims, expenses, costs and demands whatsoever which you may incur, sustain or be put to by reason or on account of your having given / countersigned the said Guarantee or otherwise howsoever and I/We also hereby undertake and agree to pay to you on demand all sums of money, costs, charges and expenses incurred in respect thereof or otherwise in relation to the premises and also to pay you interest on ail such moneys at your ruling rate.

And I/We further agree that any request made upon you by _____for payment or any sum or sums of money in pursuance of the said Guarantee shall be a sufficient authority to you to for making any such payment and that notwithstanding anything contained in the said Guarantee executed by you it shall not be incumbent upon you to enquire whether any such amount or amounts is/are in fact due.

Notwithstanding any dispute between us and the said _____you shall be entitled to act in accordance with the guarantee executed by you and to make payments thereunder without any consent from us and I/We agree that the payment by you under this guarantee is to be conclusive that the claim has arisen and of the amount of such claim.

This counter indemnity will extend to any amendment/s extension/s of the guarantee for which we may be applying from time to time and which you may agree to grant subject to your absolute right and discretion whether to amend/extend the guarantee or not and without casting any obligation on you for amending the said guarantee.

This counter Indemnity shall be binding on me/us and our legal and personal representatives, successors and assigns and our liability hereunder shall remain in force until such time as we procure for you return of discharge of aforesaid guarantee.

"That if or any reason the Bank is prevented by any action initiated by me/us from making payment to the beneficiary, of the guarantied amount, I/We will also be liable to pay the Bank, apart from other amounts payable to Bank, Guarantee commission for the period for which I/We delay, by such action, the payment of discharge of the guarantee."

Yours faithfully,

Place:

Date:

ANNEXURE 3: PLAGIARISM REPORT

Monisha_Dissertation11Oct2020

By Athira P S

General metrics

85,166	13,344	657	53 MIN 22 SEC	1 HR 42 MIN
characters	words	sentences	reading time	speaking time

Score

This text scores better than 72% of all texts checked by Grammarly

Writing Issues

1038	288	750
Issues left	Critical	Advanced

Plagiarism

10

sources

4% of your text matches 10 sources on the web or in archives of academic publications