Advanced Contracts, Tendering and Public Procurement
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Special Contracts: Guarantee - Part 02

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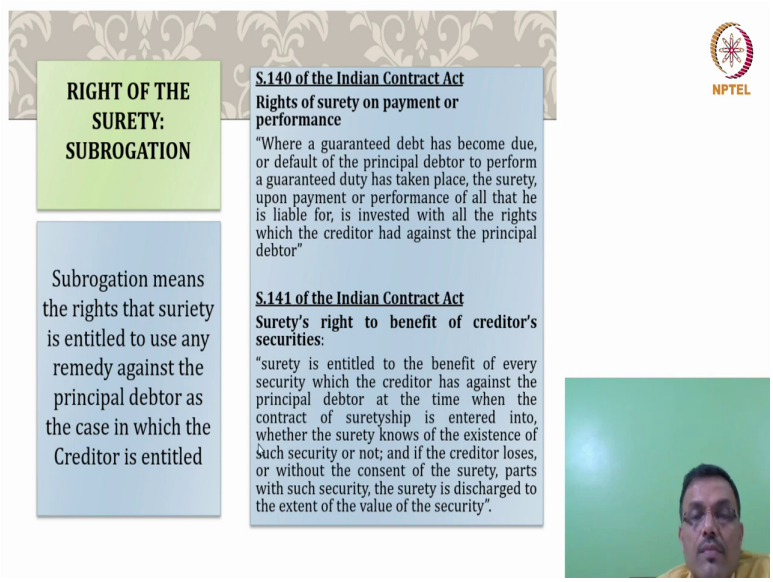

The surety under a contract to guarantee possesses certain rights, and it is important to discuss these rights alongside their liability. The surety has rights against the principal debtor, rights against the creditor, and rights in relation to co-sureties. These rights can be categorized in this manner.

When we consider the right of the surety against the creditor, we examine how and where this right comes into play. If the surety is sued by the creditor and the creditor expects the surety to bear the responsibility for the debtor's default, then the surety is obliged to make the payment and fulfill the claim of the creditor as per the terms of the contract.

Upon fulfilling this obligation, the doctrine of subrogation comes into effect. The Indian Contract Act addresses the doctrine of subrogation in Section 140 and 141. Subrogation implies that the surety is entitled to all the remedies that the creditor has against the debtor. Consequently, the creditor is discharged from the contract since they have been paid by the surety, and the surety assumes the position and rights of the creditor.

It is a scenario of surety versus the debtor. That is the relationship of what subrogation does. surety in subrogation gets everything that the creditor had, so the creditor is duty bound to hand over all documents, all securities, whether the surety knew about it or not, he must now

give everything to the surety and claim his discharge from the contract. That is what subrogation means.

Subrogation means to step into someone else's obligation, someone else's role, or to take over that kind of an obligation or a role, and to empower yourself with all the rights that the creditor would have as against the debtor. So, that is what subrogation will do.

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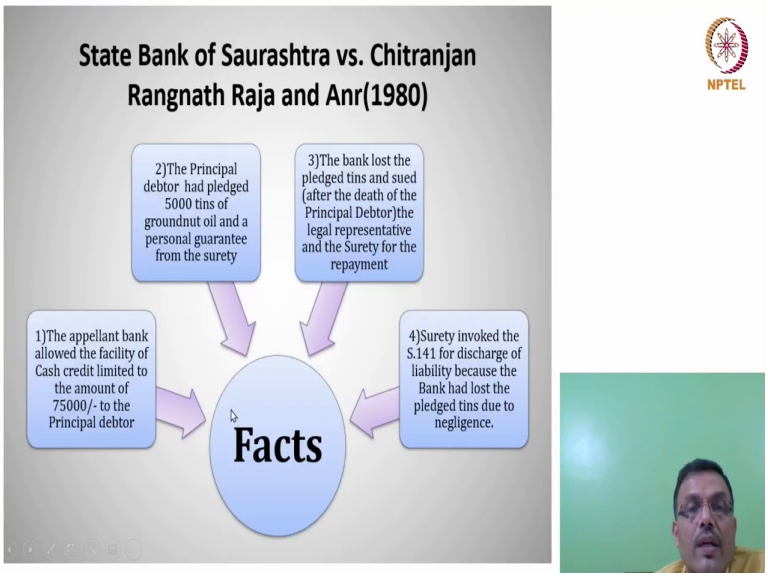

We can further understand the concept through the case of State Bank of Saurashtra versus Chitranjan Rangnath Raja. In this case, the appellant bank had allowed for a cash credit limit of 75,000 to the principal debtor. The principal debtor had pledged assets worth 5000 tons of groundnut oil with a personal guarantee from the surety as well. The pledged securities are either lost, or they are not taken care of by the banks. Now, we say that pledge is an extension of bailment. So, does the bank have a duty as a bailee to take care of the secured goods? If they fail in the duty to take care of the secured goods, what happens to the contract of guarantee, especially the rights of the surety. The Court wanted to address the issue of whether the surety can claim discharge of the contract due to the bank’s negligence in taking care of the security.

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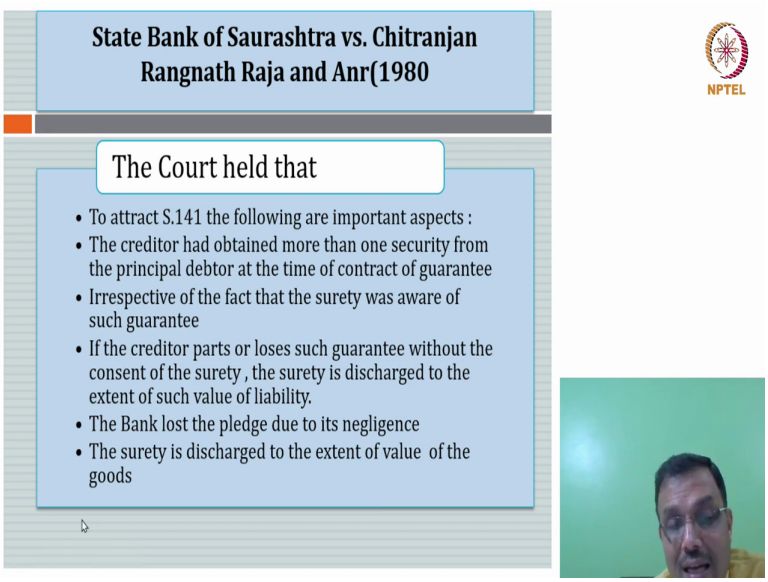

In order to attract section 141, the following aspects are very important. The creditor should have obtained the security from the principal debtor at the time of contract of guarantee. Now, whether such a security was something that the surety knew or not does not matter. Whatever the creditor, he is duty bound to give it to the surety. But if the creditor leaves, or gives the security, or loses such a security in a contract of guarantee, without the consent of the surety, then the surety to that extent should or can claim discharge from his liability.

So, when the bank loses the pledged goods or the secured goods due to its own negligence, the bank cannot make the surety responsible or liable. And the surety can claim discharge to the extent of the value of the goods that are lost by the bank. This is a counter argument that the surety can do for his liability.

He can blame the bank for its own negligence in this contract, and then claim discharge to that extent. So, the surety will be liable only if the bank has done equity or has operated the contract with clean hands, without any attribution of negligence to its own conduct in that contract itself.

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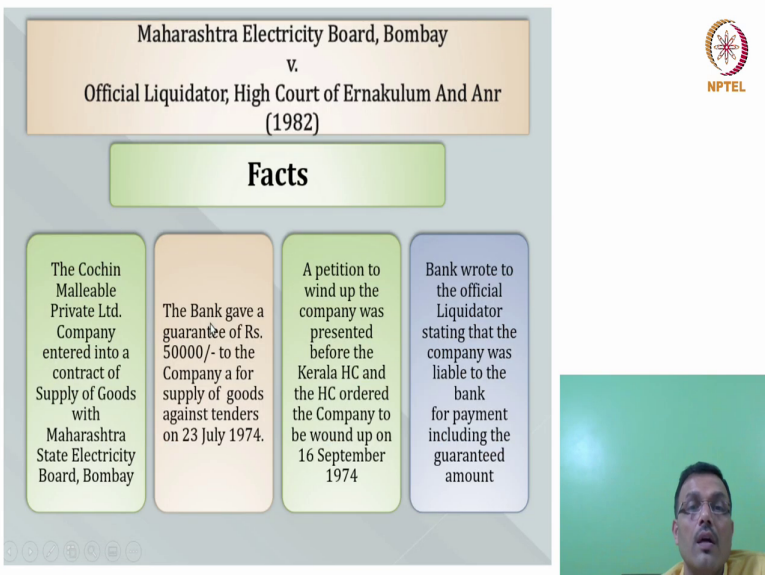

Going forward we look at a very important aspect of what we call as bank guarantee. The case of Maharashtra Electricity Board Bombay versus the Official Liquidator, High Court of Ernakulum is another instant case that can be looked into. Now, a contract for the supply of goods was entered into by Cochin Malleable Private Limited with Maharashtra State Electricity Board and a bank guarantee was supplied in this case of 50,000.

Now, whenever you take part in tenders or in government procurement, every contractor or every supplier must give a bank guarantee. And the bank guarantees interesting defense, are unique, unique because in India, it is the banks that support contracts and economic transaction by standing as a surety or a guarantor to their own customers. So, this is one of the services that banks usually provide for. Interestingly, when bank guarantees provided, a pro forma of the nature of guarantee is usually given in the tender itself.

So, what should be content of the bank guarantee and the bank must sign and then the contractor deposits with the accountant. This usually is also called as performance bank guarantee because if the performance somehow gets delayed or stopped or is not performed, then the encashment of the bank guarantee usually happens.

However, in India, one must understand that when banks give guarantee, can they revoke it at any given point of time, or can they impose any precondition for the encashment of a bank guarantee. So, the nature of bank guarantee in India is very important for us to understand for this type of guarantee.

A petition to wind up the company came up and came to the High Court and the High Court said that this Cochin company should be wound up. Now, the bank wrote to the official liquidator stating that the company was liable to the bank for the payment including the guaranteed amount that is 50,000, that is what the bank wrote to the official liquidator of this Cochin company. So, that was the facts of this case.

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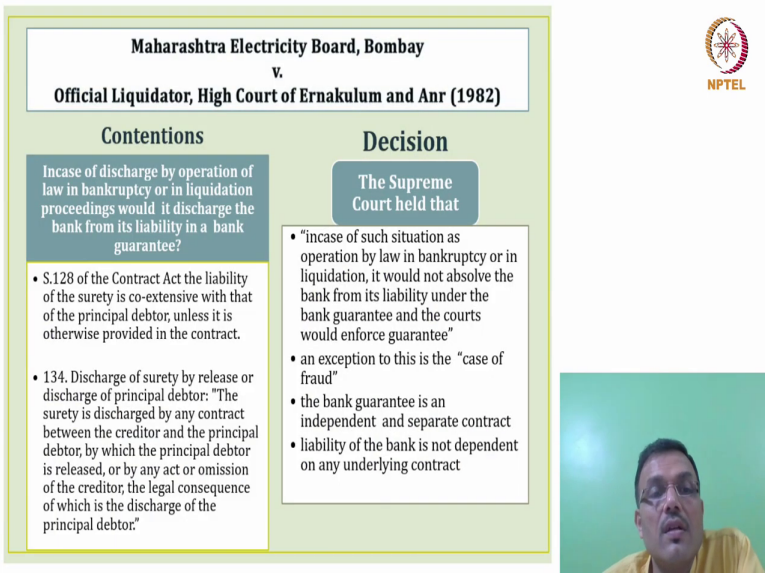

In case of discharge by operation of law in bankruptcy or in liquidation proceedings, only discharge the bank permits liability in a bank guarantee. Because please note, bank guarantees in India are irrevocable and unconditional. So, once you are given a guarantee, even if the company gets liquidated, will your guarantee stand as an independent guarantee to the Maharashtra Electricity Board. This was the major issue.

The Supreme Court in this case, held in such a situation as operation of law is bankruptcy or liquidation it would not absolve the bank from its liability under the bank guarantee and the courts would enforce the guarantee which means that the Maharashtra Electricity Board can encash the bank guarantee when the company gets into liquidation and the bank cannot claim discharge from its responsibility even though the company went into liquidation.

The only exception where a bank can claim discharge is in case of fraud or in case of irretrievable injustice. So, bank guarantees are liable irrespective of whether the actions of the contractor amounts to non-performance, short performance, or delayed performance. And interestingly if in case the company gets into liquidation or insolvency, the bank guarantee shall stand.

So, the Supreme Court very interestingly says that, irrespective of what happens to the tender bank guarantee is an independent and a separate contract. It is an assurance from the bank to the government. And it is not dependent upon what happens to the contractor per se, or what is the action of the contractor per se. So, the underlying contract between the government and the contractor has nothing to do with the bank guarantee, and bank guarantee is a separate enforceable contract. And the bankruptcy of the company does not absolve the bank from its guarantee. So, it is a very significant judgment having very wide ramifications and impact and we will notice that in most government tenders, encashment of a bank guarantee has always been a very critical issue, not many have encashed bank guarantee. And wherever they have encashed people do not know what is the law on bank guarantee.

And we think that if the debtor or the contractor has gone insolvent or bankrupt, then the bank guarantee automatically is also a discharge or it is in the negative. Now, having said all these one should understand the bank guarantee is irrevocable and it is unconditional. So, this is the nature of bank guarantee in India. However, banks abroad are in the habit of giving revocable as well as conditional bank guarantee. when tenders ask for bank guarantee they must be very clear, which is the bank should that should give the guarantee because in global tenders and global contracts, it could be a bank from other jurisdictions which may give bank guarantees.

In the Maharashtra Electricity Board case and several other supreme court judgments that the courts have taken bank guarantee very seriously as an instrument to support economic activity and they have said that when a bank guarantee is submitted for encashment, because it is a separate contract and a separate promise from the bank, the bank may not give any notice to the contractor.

The government also need not serve any notice to the contractor. So, the contractor need not be informed that there is such a process of encashment that is happening. The banks cannot ask why the government is encasing bank guarantee, this question about being judgmental on the encashment of the bank guarantee is not permitted as they lack jurisdiction to ask such questions. Third, and very importantly, the courts have also said that bank guarantee encashment should not be stopped by any kind of injunction or stay order from any court as the whole purpose of giving bank guarantee gets defeated if there is an injunction or stay that is granted by the courts.

So, it is supposed to be an equitable and immediate remedy for nonperformance or for any kind of loss that may occur to the government and hence any kind of court process that stops that kind of equitable remedy or a safe remedy gets defeated if lower courts start granting injunction for the same.

So, the ground for injunction is only if there is fraud that can be proved Or the parties can go to the court and say that the encashment will cause irretrievable injustice to them, which are very rare cases to prove. So, in all probabilities bank guarantee will be immediately encashed within a couple of working days, and you will notice this will facilitate economic transactions, it will immediately compensate any loss that the government may suffer from the actions of the contractor.

And this is a very important tool or a weapon to ensure that contractors comply with the tender conditions with the contractual conditions. And they do not commit any default in government contracts. Because government contracts is not something that only affects government as a party in the contract. Finally, most of the government contracts their public sector projects their public welfare projects, citizens and public naturally get affected if these contractors do not complete the job. hence it is imperative in government protection and citizens and public welfare protection, that the bank guarantee is used as a tool. It is a weapon in a sense or a kind of threat that if you do not perform we will encash it, but usually, encashment is in the rarest of rare cases, whether the government feels aggrieved by the actions of the contractor where he deliberately or intentionally fails to perform the contract. the banks also take encashment very seriously. So, you will notice that the customer's reputation in such cases gets adversely impacted and maybe the banks will not support him in other future transaction It seems to work well with the legal system so that contracts become enforceable and parties take such promises and obligations seriously and they perform those obligations or they face consequences not only in that contract with arbitration and damages, but also for future transactions, because unless you have the support of the bank, in terms of financial backing, you will not be able to take part in future tenders and future contracts as well. vis-a-vis bank and the customer encashment of a bank guarantee comes with serious consequences. And that I think most contractors will be aware of, for which compliance with promises and contracts becomes more critical and useful.

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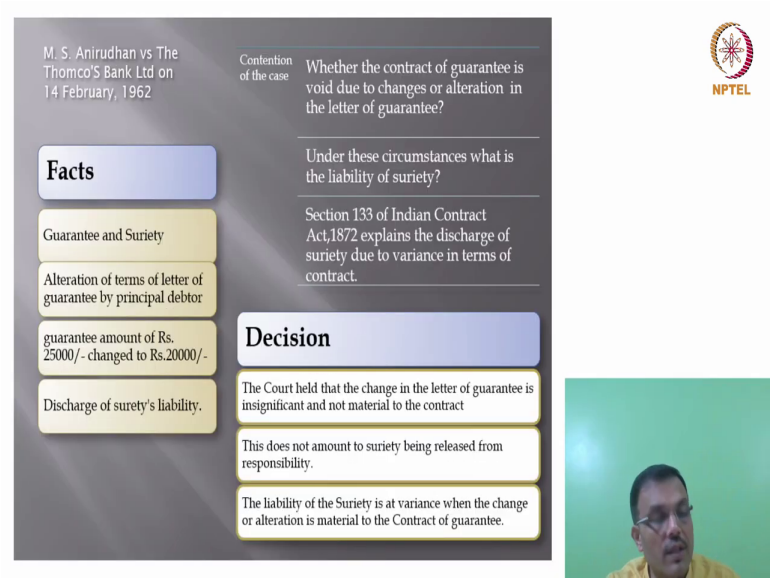

Concluding the contract or guarantee, another very interesting case is the M. S. Anirudhan versus The Thomco'S Bank Limited. It is a 1962 judgment and this will probably tell us how the interpretation of contract law is very important to determine the liability of parties to the contract. The issue in this case was about the kind of consent that is required from the surety which is an independent consent because it is an independent obligation.

Any kind of misrepresentation or fraud, as I told you earlier, will make the contract or the surety as voidable at his option. However, having said this, there is another interesting provision under the Indian Contract Act which very interestingly says under Section 133 of the Indian Contract Act that the surety shall be discharged in case there is any kind of variance in the terms of the contract, which does not have his consent.

While the contract or the principal contract is between the debtor and the creditor, the surety must be involved in any kind of modification or alteration of that kind of a contract. So, variance in the terms of the contract, if it is the liability of the surety, amounts to him being a party as it is a tripartite contract.

And to that extent, if the surety is not involved in the changes of the terms and conditions of the contract, he can claim discharge of a contract. So, there is this kind of protection saying any variance without the consent of the surety will not be held against him, and he should be entitled to claim discharge of his contractual liability. Now, what had happened in the M. S.

Anirudhan case was, initially the contract stated that the debt is around 25,000 and the surety agreed to it and signed the contract.

Later, when the debtor took this document, which the surety had signed and submitted to the bank, the bank said that they had only agreed to 20,000. Now, with some kind of whitener this '5' was changed into 20 and the loan was disbursed. Later on, the surety comes to know that he had signed on a document which was 25,000 but the actual loan and the contract now says 20,000 and this is variance, So, he claims that he should be discharged from his obligations under that particular contract. there are multiple things in this case that are very relevant and important, first and the foremost is that there is a plea called the plea of non-est factum. Now, the plea of non-est factum very clearly state that this is not my deed.

And it states very clearly that look I had signed for a deed in which the amount was 25,000. Now, the same contract says 20,000. So, this is not my deed, plea of non-est factum. This was claimed by the surety. Second, he claimed discharge under 133 saying that there is variance. Now, what is variance? you will notice that variance in the contract must be either material or immediate.

In material, it means what is material in a contract of guarantee. Since, material in the contract of guarantee would include the loan amount which will actually increase or decrease the liability of the surety, it could include the tenure of the loan that is also very relevant and important and you will also notice that to a larger extent it will affect the rights of the surety adversely, thereby increasing his responsibility or liability and those are the kind of variances that the surety can definitely claim discharge under 133. So, if there are non-material variances, the question is can the surety claim discharge.

So, variance must be divided into material and non-material. Or can we say any kind of variance will discharge the surety from his liability? Now, if you say any kind of variance, then that is a very broad ground. And you will notice that, that will help sureties to get away from their obligation, even if small changes have been made from time to time. The courts were sure that this provision is there because, for example, in government contracts, suppose the bank guarantee is given, and the bank states that if there is any kind of changes between the contractor then when any kind of variance takes place, the bank will claim the discharge of the contract. So, in government contracts, variance does happen, but that variance should be material and it should adversely impact the surety's liability.

That is what the court wanted to say. Now, in this case, the variance that was from 25,000 to 20,000, the liability of the surety reduced. Now, because there is reduction of liability can the surety claim discharge? If there is an enhancement, the surety could claim discharge, because that is the reason why the section is there to protect the interest of the surety.

Justice Raitula while deciding this case, did infuse how section 133 will be operationalized. He said that look if the variance is significant and material, the surety can claim discharge. If that significant in material variance increases or enhances the labiality of the surety then absolutely, he can claim discharge absolutely, otherwise, I think the surety cannot use section 133 to claim discharge from his contract.

That is a fantastic case for all to read and to understand. And it is one case that looks at how a small section called 133 is operationalized and interpreted by the courts of law and why the surety must read 133 in case he wants to claim discharge from his responsibilities and obligations. I think with that, we should close the discussion on contract of guarantee. What we have learned so far is that this is a very important kind of contract.

It is a tripartite contract, there are different forms of guarantee, bank guarantee being the most significant form that supports government contracts. Bank guarantee is a separate and independent contract as it is not dependent upon the underlying contract within the government and the contractor. It can be encash Without condition and it cannot be revoked. There are only few grounds on which an injunction or stoppage of the encashment of a bank guarantee can be done. Fraud and error, or irretrievable injustice are two grounds.

Operationalizing bank guarantee becomes very critical. It is performance bank guarantee. It impacts everyone around. And we have seen how the liability of the surety is coextensive with that of the principal debtor. When I say coextensive, it means that the surety can be sued first, the debtor may not be sued at all. So, the creditor can approach the surety and claim the money. So, he can be sued first and the decree can also be implemented against the surety first.

So, the term coextensive has been very widely interpreted by the courts. And the surety can then claim subrogation, he can step into the shoes of the creditor and claim subrogation if he discharges the liability of the creditor. And we know that the surety can claim discharge in case of variance, but that variance must be significant, material and adversely impact his liability. These are some of the aspects of that contract to guarantee clearly demarcates. What

is important for us to understand here is also that that now when you talk about any of these special contracts with guarantee or agency as what we are going to discuss next, there is an implied indemnity in all these cases. So, the debtor must indemnify the surety because of the debtor's fault if the surety has incurred some responsibility, there is an implied indemnity that the debtor should give the surety. So, indemnity exists in several other forms of contracting, rather, it is implied in every contract, that due to your actions, if someone suffers any kind of an injury, you are duty bound to indemnify the same. So, that is the sum existence of the contract of guarantee.