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# BANK GUARANTEE & ARBITRATION: A LEGAL ANALYSIS

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## ABSTRACT

Bank guarantees play a vital role in arbitration proceedings as they serve as a form of financial protection to ensure that parties fulfill their contractual commitments. This study delves into the importance of bank guarantees in arbitration, illustrating their relevance through case studies such as the *Skypower Solar India Pvt Ltd v. Sterling and Wilson International FZE case*. The research also explores legal viewpoints on when and how bank guarantees can be invoked or restrained, particularly under Section 9 of the Arbitration & Conciliation Act, 1996. It discusses the different types of bank guarantees, such as conditional and unconditional, with a specific focus on their usage in construction contracts. The research also delves into the distinctions between performance guarantees, advance payment guarantees, and retention guarantees, outlining the specific criteria for invoking each type. It has been observed that bank guarantees may be withheld in instances of substantial fraud or to prevent irreparable harm, as highlighted in landmark cases such as *Himadri Chemicals Industries Ltd. v. Coal Tar Refining Co. and N.N. Global Mercantile Pvt. Ltd. v. Indo Unique Flame Ltd. & Ors.* The criteria for court intervention are strict, indicating a reluctance to intervene unless there is clear evidence of fraud or a potential for significant injustice. The paper concludes that while bank guarantees are typically upheld for arbitration purposes, legal precedents dictate when injunctions may be warranted. This approach aims to maintain a fair balance between upholding financial agreements and safeguarding parties from potential fraud or harm in commercial transactions.

## I. INTRODUCTION

### A. Introduction

Bank guarantees are crucial in arbitration, acting as a financial security measure to guarantee that contractual responsibilities are fulfilled. The importance of bank guarantees in arbitration was emphasized in the *Skypower Solar India Pvt Ltd v. Sterling and Wilson International FZE*<sup>1</sup> case. In a significant ruling on November 10, 2023, the Delhi High Court outlined the conditions in which a bank guarantee could be necessary to protect one party's claims in arbitration proceedings. It was highlighted that such a request should only be made if there is solid proof that the other party intends to hide assets or hinder the enforcement of the arbitral decision. This verdict emphasizes the delicate equilibrium that courts must uphold in respecting bank guarantees while also safeguarding the legitimate interests of those involved in arbitration proceedings. The Court further drew a comparison between a bank guarantee order under Section 9<sup>2</sup> of the Arbitration & Conciliation Act<sup>3</sup> 1996 (“**A&C Act**”) and an attachment order before judgment in the Civil Procedure Code<sup>4</sup> 1908 (“**CPC**”). However, it highlighted that Section 9 of the A&C Act is not limited by the CPC. The Court emphasized the importance of analyzing the petitioner's case, considering the balance of convenience, and determining if the respondent's actions could impede the arbitration award enforcement before granting an order to protect claims.

### B. Concept of Bank Guarantee.

When dealing with bank guarantees, transactions usually include three participants: the person or entity owed money (creditor), the individual or company responsible for repayment (principal debtor), and the financial institution providing the guarantee (bank). These guarantees are issued by banks or financial institutions on behalf of contractors (the "**principal**") to assure employers (the "**beneficiary**") that specific contractual obligations will be met. The purpose of a bank guarantee is to provide assurance to the beneficiary that financial responsibilities will be fulfilled by the contractor. It is important to note that a bank guarantee is a separate agreement from the original contract.

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<sup>1</sup> FAO (OS) (COMM) 29 of 2022

<sup>2</sup> Arbitration & Conciliation Act, No. 26 of 1996, Section 9, Acts of Parliament, 1996

<sup>3</sup> *Id*

<sup>4</sup> Code of Civil Procedure, Act No. 5 of 1908, Acts of Parliament, 1908

## II. Types of Bank Guarantee

### A. Bank Guarantee in a General Contract

#### I. Conditional Bank Guarantee<sup>5</sup>

The bank guarantee can only be invoked if all the specified terms and conditions are met. Once these conditions are satisfied, the holder has the right to cash in the guarantee. If the conditions are not met, the bank is required to deny payment.

#### II. Unconditional Bank Guarantee

A bank guarantee that requires the bank to pay only when requested by the creditor is known as an unconditional bank guarantee. This type of guarantee differs from a standard contract for guaranty outlined in Section 126 of the Indian Contract Act, 1872. It is a legal principle that if a bank guarantee does not contain any conditions for payment in its operative part, it is deemed to be unconditional.

In the *Gujarat Maritime Board v. Larsen and Turbo Infrastructure Development Projects Limited & Another*<sup>6</sup> case, the Supreme Court examined the High Court's discretionary power under Article 226 of the Indian Constitution in regard to preventing an unconditional bank guarantee from being invoked. The Court clarified that when it comes to a performance bank guarantee, if there is a condition that allows the beneficiary to decide whether a breach has occurred, then the bank must honor that decision. However, any disputes regarding the breach itself should be resolved between the parties involved in the contract, as these matters involve complex factual disagreements that are not within the jurisdiction of High Courts in Article 226 proceedings. The Supreme Court has also ruled that if a written demand is made by the beneficiary to invoke a bank guarantee because of a breach in the original contract, the bank must fulfill the payment obligation once the breach is proven.

### B. Bank Guarantee in Construction Contract

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<sup>5</sup> Ilamparithi BoologaSundaraVijayan, *Bank Guarantees in Construction Projects*, LinkedIn (Sept. 22, 2023), <https://www.linkedin.com/pulse/bank-guarantees-construction-projects-article36-ilamparithi/>.

<sup>6</sup> Gujarat Maritime Bd. v. Larsen & Toubro Infrastructure Dev. Projects Ltd., (2016) 10 SCC 46

## **I. Performance Bank Guarantee**<sup>7</sup>

A performance bank guarantee is a guarantee provided by the contractor to ensure that they will complete the construction project as per the terms of the contract. This serves as protection for the employer in case the contractor does not meet their performance obligations as outlined in the agreement.

In the case of a performance bank, the bank is only liable to make payment (I) after a breach) of contract and, (II) when the affected party has suffered loss or damage. On the other hand, an advance payment guarantee requires the bank to make payment to the beneficiary if there is non-performance of the contract, regardless of the reason for such non-performance.

## **II. Advance Bank Guarantee**

An advance bank guarantee is a form of security that guarantees the repayment of funds given to the contractor in advance by the employer. It safeguards the employer's financial stake should the contractor fail to fulfill their obligations or complete the project after receiving the advance payment.

## **III. Retention or Maintenance Guarantee**

Retention or maintenance guarantees offer reassurance to the employer that the contractor will address any problems or faults that may arise within a set maintenance period after the project is finished. This guarantee acts as a safety net against potential issues, giving the employer confidence in the project's overall quality and longevity.

## **III. Judicial Trends**

There are two main circumstances in which a bank guarantee may not be released or cashed. The first is if there is a significant fraud that the (i) bank is aware of, and (ii) is committed by the beneficiary with intent to benefit from it. This fraud must be serious enough to render the original transaction invalid.

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<sup>7</sup> Suvijit & Pallavi Jain, *Role of Bank Guarantee in the Infrastructure Sector*, 4 INDIAN J.L. & LEGAL RSCH. 1 (2022-2023).

Another exception to the usual non-intervention policy is when there are specific circumstances that warrant an injunction to prevent irreparable harm or injustice. Claims of fraud or irretrievable injustice must be backed by concrete evidence and cannot be vague.

***A. Guidelines for the grant or refusal of an injunction concerning bank guarantee.***

In the landmark case of *Himadri Chemicals Industries Ltd. v. Coal Tar Refining Co.*<sup>8</sup>, the Supreme Court has outlined the current legal stance on injunctions pertaining to bank guarantee enforcement. After reviewing numerous past cases, the Court has established specific principles for determining whether an injunction should be granted to prevent the encashment of a bank guarantee. These guidelines are detailed below:

- i. *“While dealing with an application for injunction in the course of commercial dealings, and when an unconditional Bank Guarantee or Letter of Credit is given or accepted, the Beneficiary is entitled to realize such a Bank Guarantee or a Letter of Credit in terms thereof irrespective of any pending disputes relating to the terms of the contract.*
- ii. *The Bank giving such guarantee is bound to honour it as per its terms irrespective of any dispute raised by its customer.*
- iii. *The Courts should be slow in granting an order of injunction to restrain the realization of a Bank Guarantee or a Letter of Credit.*
- iv. *Since a Bank Guarantee or a Letter of Credit is an independent and a separate contract and is absolute in nature, the existence of any dispute between the parties to the contract is not a ground for issuing an order of injunction to restrain enforcement of Bank Guarantees or Letters of Credit.*
- v. *Fraud of an egregious nature which would vitiate the very foundation of such a Bank Guarantee or Letter of Credit and the beneficiary seeks to take advantage of the situation.*
- vi. *Allowing encashment of an unconditional Bank Guarantee or a Letter of Credit would result in irretrievable harm or injustice to one of the parties concerned.”*

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<sup>8</sup> Himadri Chemicals Indus. Ltd. v. Coal Tar Refining Co., (2007) 8 SCC 110

### ***B. Fraud***

The Supreme Court addressed the matter of whether a fraudulent invocation of a bank guarantee was eligible for arbitration in the case of *N.N. Global Mercantile Pvt. Ltd. v. Indo Unique Flame Ltd. & Ors*<sup>9</sup>. The Appellant argued that the bank guarantee had been fraudulently invoked against the agreed terms of the work order and that it was a conditional guarantee tied to the completion of work.

The Supreme Court stated that disputes regarding fraudulent invocation of a bank guarantee can be settled through arbitration since they involve private parties and not public law. The Court differentiated between serious fraud allegations and simple fraud and held that by noting that mere allegations of simple fraud do not justify avoiding arbitration

The court referenced the cases of *A. Ayyasamy v. A. Paramasivam*<sup>10</sup> and *Rashid Raza v. Sadaf Akhtar*<sup>11</sup> to establish a twin test for determining the arbitrability of disputes involving fraud. This test involves (i) proving that the fraud impacts the entire contract, including the arbitration agreement, and (ii) that the allegations of fraud involve private matters between the parties rather than public issues

Following the mentioned criteria, the Court determined that it would be permissible to decline sending the parties to arbitration in situations where there are significant fraud accusations that could constitute a criminal offense, or if the allegations are intricate enough to necessitate extensive evidence evaluation by a civil court.

It was expressed that all types of disputes, whether civil, commercial, or contractual/non-contractual, could be resolved through arbitration based on the Arbitration Act of 1996 as it does not specifically exclude any category of disputes. Additionally, the court determined that the civil aspect of fraud is generally acceptable for arbitration in modern arbitration practices, with the exception being if the fraud directly impacts the validity of the initial contract or if it affects the integrity of the arbitration agreement itself.

Due to these conclusions, the Court declined to intervene in the enforcement of the bank guarantee, as disputes between the parties were deemed private and not subject to public law.

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<sup>9</sup> *N.N. Glob. Mercantile Pvt. Ltd. v. Indo Unique Flame Ltd.*, (2021) 4 SCC 379

<sup>10</sup> *A. Ayyasamy v. A. Paramasivam*, (2016) 10 SCC 386

<sup>11</sup> *Rashid Raza v. Sadaf Akhtar*, (2019) 8 SCC 710

Nevertheless, it was noted that the Appellant could pursue interim relief under Section 9 of the Arbitration Act, as the dispute was deemed arbitrable.

### *C. Irretrievable injury*

In the important ruling of *Svenska Handelsbanken v. M/s Indian Charge Chrome & Others*<sup>12</sup>, the Supreme Court clarified the meaning of "to prevent irretrievable injustice" by drawing on legal principles established in the case of *Itek Corporation v. The First National Bank of Boston*<sup>13</sup> in the United States District Court, Massachusetts.

### **Facts of the Itek Corporation (supra) case:**

The case involves events during the Iranian Revolution, where the American Government cancelled Iran's export license and froze all Iranian assets. The Plaintiff cited force majeure as the reason for their inability to fulfill their obligations, but the Iranian importer opted to use the bank guarantee. As a result, the US exporter sought legal remedy to be released from their obligations under the stand-by letter of credit issued by an American Bank for the Iranian Bank as outlined in their contract.

### **Ruling of United States District Court**

The District Court ruling stated that the contractor should receive a preliminary injunction because even if damages are awarded by US courts, they could not be enforced in Iran due to the circumstances there.

Following the instructions provided, the United States District Court in Massachusetts noted that the current circumstances clearly show that there is no sufficient legal remedy available. The court stated that the claims of irreparable harm are real and urgent, not just mere speculation. According to the court, if the relief requested is not provided, it would result in irreparable harm to the party for whom the bank guarantee was issued.

The Supreme Court ruled in the *Svenska Handelsbanken* (supra) case that in order to obtain an injunction against invoking a bank guarantee, a strong case of irreversible harm must be

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<sup>12</sup> *Svenska Handelsbanken v. M/s Indian Charge Chrome*, (1994) 1 SCC 502

<sup>13</sup> *Itek Corp. v. First Nat'l Bank of Bos.*, 566 F. Supp. 1210 (D. Mass. 1983).

demonstrated, similar to the situation in the Itek Corporation (*supra*) case.

The Court ruled that if the Plaintiff successfully obtains a decree for damages, there should be no issue in recovering the funds from a friendly country. The Court also noted that failing to honor a bank guarantee in international banking transactions could result in serious harm to the Indian guarantor bank and have detrimental effects on the country's interests, beyond just financial loss for the borrower or plaintiff.

The threshold or criteria for proving "*irretrievable injury*" established in the Itek Corporation (*supra*) case was also utilized by the Court in the *National Thermal Power Corporation Ltd. v. Flowmore Pvt. Ltd. & Another case*<sup>14</sup>.

The Respondents in the above referred case tried to explain why the injunction given by the High Court was justified by stating that (a) the guarantees were not invoked according to their terms, and (b) the Appellant invoked the guarantees while arbitration was ongoing, even though both parties agreed not to do so until after arbitration and an award had been made.

Ultimately, the Court ruled that this did not cause any irreversible harm to the Respondent, citing the Itek Corporation (*supra*) case. Therefore, the guarantees could still be enforced.

#### IV. CONCLUSION

Bank guarantees are carefully examined by legal authorities to guarantee they can be enforced and invoked correctly. This examination is crucial to uphold the reliability of the financial tool and the protection it offers in commercial transactions. The issue of whether disputes involving bank guarantees can be subject to arbitration has been clearly defined through legal precedents like *Skypower Solar India Pvt Ltd v. Sterling and Wilson International FZE and Gujarat Maritime Board v. Larsen and Turbo Infrastructure Development Projects Limited*. These cases outline the specific circumstances where injunctions against bank guarantees can be either allowed or rejected, providing guidance in resolving such disputes through arbitration. These rulings emphasize that disputes related to bank guarantees are inherently suitable for arbitration if the contract in question includes an arbitration clause. This supports the idea that

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<sup>14</sup> National Thermal Power Corp. Ltd. v. Flowmore Pvt. Ltd., (1995) 4 SCC 515



arbitration is a fitting venue for settling business disputes, including those related to bank guarantees. It is crucial to minimize intervention when invoking bank guarantees.

Typically, courts follow a principle of non-intervention, unless there are extraordinary circumstances that threaten fairness and business prosperity. Courts are careful when it comes to preserving the integrity of bank guarantees, getting involved only in exceptional cases where there is clear proof of fraud or serious damage. Parties looking for injunctions against bank guarantees should be very careful and should only take legal action if their situation meets the specific criteria outlined by the court.