



June 29, 2021

Dear Reader

We bring to you an important Banking & Finance update. There has been a significant judgement (**Judgement**) by the Hon'ble Delhi High Court on July 28, 2021 passed in the matter of *Larsen & Toubro Limited & Anr v/s Punjab National Bank & Anr*. The central issue in question is the issue of claim period under bank guarantees. Our update provides an analysis of this judgement ([available here](#)) and its implication for businesses.

Background

Section 126 of the Indian Contract Act, 1872 (**Contract Act**) defines Contract of Guarantee to mean *"a contract to perform the promise, or discharge the liability, of a third person in case of his default. The person who gives the guarantee is called the 'surety'; the person in respect of whose default the guarantee is given is called the 'principal debtor', and the person to whom the guarantee is given is called the 'creditor'."*

In a contract of Bank Guarantee three parties are involved, viz the applicant (i.e. the debtor), the surety (i.e. the issuing bank) and the beneficiary (i.e. the creditor).

A contract of Bank Guarantee involves the following important features:

1. Underlying contract between the applicant (i.e. the debtor) and the beneficiary (i.e. the creditor)
2. Maximum amount that can be claimed under the Bank Guarantee
3. Period of validity of the Bank Guarantee
4. Period within which claim must be made by the beneficiary

The period of validity of the Bank Guarantee and the claim period under a Bank Guarantee are not necessarily same. The claim period under a Bank Guarantee may be over and above the period of validity of the Bank Guarantee.

As per Section 28 (a) of the Contract Act, an agreement shall be void to the extent:

- a. It restricts a party thereto **absolutely from enforcing** its rights under or in respect of a contract; or
- b. Which **limits the time** within which a party thereto may **enforce** its rights under or in respect of a contract; or

As per Section 28 (b) of the Contract Act, an agreement shall be void to the extent:

- a. It **extinguishes the rights** of any party thereto, under or in respect of any contract on the expiry of a specified periods so as to restrict any party **from enforcing its rights; or**
- b. It **discharges any party** thereto, from any liability, under or in respect of any contract on the expiry of a specified periods so as to restrict any party **from enforcing its rights.**

The first part of Section 28 i.e. sub-section (a) deals with restriction on enforcement of rights or limiting the time of enforcement of rights while second part of Section 28 i.e. sub-section (b) deals with extinguishment of rights or discharge of liability leading to restriction on enforcement.

Section 28 of the Contract Act provides for certain exceptions to the above restriction. One of these being Exception 3 which was introduced vide the Banking Law (Amendment) Act, 2012 (hereinafter referred to as **Amendment Act**) which came into force on ^{January} 18, 2013. The said Exception 3 deals with **guarantee agreement of a bank or a financial institution.**

As per the said Exception 3, a contract in writing, by which any bank or financial institution stipulate a term in a guarantee or any agreement, making a provision for guarantee for **extinguishment of the rights** or **discharge of any party thereto from any liability** under or in respect of such guarantee or agreement **on the expiry of a specified period which is not less than one year** from the date of occurring or non-occurring of a specified event for extinguishment or discharge of such party from the said liability, **shall not be illegal under Section 28 of the Contract Act.**

Post the above amendment and taking guidance from circulars issued by Indian Bank's Association (**IBA**) which were based on legal opinions obtained by IBA, banks started a practice of incorporating/insisting on incorporation of a minimum claim period of 12 months (i.e. the grace period beyond the validity of the bank guarantee) in the bank guarantees.

A view is prevalent that if a bank issues a bank guarantee with a claim period of less than 12 months then it will not have the benefit of the said Exception 3. It would stand exposed to the period of limitation under the Limitation Act, 1963 which would be 30 years in a case when the Government is the guarantee beneficiary and 3 years when some other party is the guarantee beneficiary.

Present Judgement of Hon'ble Delhi High Court

The Judgement held that

1. A view that the law mandates to stipulate a claim period of 12 months in the bank guarantee failing which it shall be void under Section 28 of the Contract Act, is an erroneous view.
2. The said Exception 3 does not deal with the claim period for lodging a claim with the issuing bank or under bank guarantee.
3. The said Exception 3 deals with a period within which a beneficiary can approach a court/tribunal to enforce its rights in case of refusal to pay by the guarantor bank.

ELP Comment:

The consequence of incorporating a minimum claim period of 12 months in the bank guarantee is that the liability of the issuing bank remains open during such a claim period. Also, the applicant/borrower has to pay commission and keep alive the collaterals/cash margins for or during such claim period, even if validity of a bank guarantee is much shorter or has expired. Moreover, the period of limitation under the Limitation Act, 1963, for initiating proceeding would be available beyond the said claim period.

Basis the Judgement, banks may now have to prescribe a minimum period of 12 months for a beneficiary to approach a court/tribunal and not a minimum claim period of 12 months for making a claim.

The Judgement provides much needed clarity and interpretation on the said Exception 3 and will help the banks and applicants to prescribe the claim period as per the contractual arrangement (and not the minimum claim period of 12 months) between the parties (applicant and beneficiary) and to keep open their (issuing bank's and applicant's) liabilities only for a contractually agreed period.

We trust you will find this an interesting read. For any queries or comments on this update, please feel free to contact us at insights@elp-in.com or the authors –

Babu Sivaprakasam, Partner – babusivaprakasam@elp-in.com

Yogesh Pirthani, Partner – yogeshpirthani@elp-in.com

Disclaimer: The information provided in this update is intended for informational purposes only and does not constitute legal opinion or advice. Readers are requested to seek formal legal advice prior to acting upon any of the information provided herein. This update is not intended to address the circumstances of any particular individual or corporate body. There can be no assurance that the judicial/quasi-judicial authorities may not take a position contrary to the views mentioned herein.



ECONOMIC
LAWS
PRACTICE
ADVOCATES & SOLICITORS

MUMBAI | NEW DELHI | BENGALURU | AHMEDABAD | PUNE | CHENNAI

Email: Insights@elp-in.com