OPEN BOOK EXAMINATION

341

Roll No.…………………

Time allowed : 3 hours *Maximum marks : 100*

Total number of questions : 6 *Total number of printed pages : 7*

NOTE : *Answer **ALL** Questions.*

1. Read the following comprehension and answer the questions that follow :

BANK GUARANTEE

The liability of the bank under a guarantee depends on two fundamental criteria, *viz*., the amount guaranteed and the period of guarantee. These two factors have to be specifically stated since in the absence of any one or both of these factors the bank's liability could be unlimited, either in the amount guaranteed or the period during the guarantee. The banker should also obtain counter guarantee from his customer on whose behalf he has given the guarantee, so that in case he is required to pay the guarantee he can fall back on the counter guarantee to claim the amount paid by him.

Amount guaranteed

When the bank issues a guarantee, the first and foremost consideration that should weigh in a banker's mind is the amount of guarantee he is called upon to issue. In the guarantee agreement, the amount has to be specifically stated, both in figures and words. While stating the amount that the bank would guarantee to pay, care should be taken to state whether the amount is inclusive of all interest, charges, taxes and other levies. This is important to avoid unnecessary disputes regarding liability of the bank. On invocation, the bank is liable to pay whole amount of the guarantee, unless an earlier case of fraud has been brought to its notice.

One more point deserves to be considered here with reference to guarantee *i.e.*, right of general *lien* becoming that of particular *lien*. Banker's right of general *lien* is displaced by circumstances which show an implied agreement being inconsistent with the right of general *lien*. In Vijay Kumar *v*. M/s. Jullundur Body Builders, Delhi and Others [A.I.R. 1981, Delhi 126], the Syndicate Bank furnished a bank guarantee for ₹90,000 on behalf of its customer. The customer deposited with it as security, two fixed deposit receipts, duly discharged, with a covering letter stating that the said deposits would remain with the bank so long as any amount was due to the bank from the customer. Bank made an entry on the reverse of receipt as

"*Lien* to BG 11/80". When the bank guarantee was discharged, the bank claimed its right of general *lien* on the fixed deposit receipt, which was opposed on the ground that the entry on the reverse of the letter resulted in the right of a particular *lien*, *i.e.*, only in respect of bank guarantee.

The Delhi High Court rejected the claim of the bank and held that the letter of the customer was on the usual printed form while the words written by the officer of the bank on the reverse of the deposit receipt were specific and explicit. They are the controlling words, which unambiguously tell us what was in the minds of the parties at the time. Thus, the written word prevail over the printed 'word'. The right of the banker was deemed to be that of particular *lien* rather than of general *lien*.

Period of guarantee

Banks always specify the period for which their guarantee subsists and an additional period during which a claim has to be made on the bank to make payment. The former period during which the guarantee subsists is called the 'validity period' and the latter, the 'claim period'. If any default has been committed by the debtor (*i.e.*, the bank's customer), it should be within the validity period. It is, thus, necessary as a matter of great caution that this period be specified to the exact date, for example, "this guarantee is valid up to 31st December, 2017".

Once this outer limit for the bank to guarantee a default of the debtor is fixed then the creditor can make a claim only if the default has occurred within this period; and for any default other than this period, bank cannot be held liable. Once a default is made then the surety has to make a claim on the bank to make good the loss within the claim period.

Claim period in a guarantee

In a guarantee, it is necessary to provide for a period slightly longer than the validity period for the beneficiary to make a claim. The claim period is usually a few months more than the validity period of the guarantee. Since if the debtor was to commit a default on the last day of the validity period, then the beneficiary can at the earliest invoke the same only on the next day. Taking into account the time to communicate the invocation, *etc*., the claim period should at least be 15 to 30 days more than the validity period. For example, if the validity period of the guarantee is up to 31st December, 2017, then the claim period would normally be up to 31st January, 2018.

Amendment to section 28 of the Indian Contract Act, 1872 and its effect on bank guarantee

Prior to the amendment of section 28 of the Indian Contract Act, 1872, most bank guarantees had a standard clause at the end of their guarantee agreements. As per this clause, the beneficiary was required to enforce his claims within a period of 3 to 6 months, failing which the bank's liability was extinguished and hence, the rights of the beneficiary. The above clause was necessitated due to the fact that in absence of it, government departments and municipal bodies need to file a suit against the bank under bank guarantee within a period of 30 years after making claim. The bank would, therefore, be required to carry forward this liability for a long period and thereby required to make provision for the same in the balance sheet. Added to this, the customer's cash margin and security would have to be retained either till the guarantee is returned by the beneficiary or till the expiration of the period of limitation.

Though this clause had been challenged before various High Courts, the High Courts have held such clauses in the bank guarantees to be valid and not violative of section 28 of the Indian Contract Act, 1872.

However, from 1st January, 1997, section 28 of the Indian Contract Act, 1872 has been amended due to which the standard limitation clauses in the bank guarantees through which the banks extinguished their liability has been declared illegal. As such, at present if a beneficiary was to invoke the guarantee within the claim period, for a default committed by the debtor during the validity period then in case the bank did not make payment, the beneficiary can sue the bank within normal period as provided in the Limitation Act, 1963. This period under the Limitation Act, 1963 is 30 years in case the beneficiary is a government department or municipal body and 3 years in all other cases.

Therefore, it is prudent to insist that the bank guarantee be returned after the claim period, duly cancelled by the beneficiary or a certificate be obtained from the beneficiary that there are no claims under the guarantee; till such time the cash margin and the security of the debtor (customer) has to be retained.

Counter guarantee and other security

Though a bank guarantee is a contingent liability, it is always prudent for a banker to secure this contingent liability in case it is enforced. This can be done by obtaining a counter guarantee-*cum*-indemnity executed by the customer in favour of the bank. The counter guarantee-*cum*-indemnity should be carefully drafted to ensure that in case the banks were to make payment on behalf of the customer then the customer in turn should not only make good the amount paid by the bank to the creditor but also any expenses connected therewith including cost of the attorney, any interest on the delayed payment, taxes and other levies. It is to take care of all the above payments that the counter guarantee also includes an indemnity aspect. The counter guarantee should also include a clause that it would remain in force till the guarantee given by the bank subsists, *viz*., till the bank is duly discharged by the beneficiary or a certificate to this effect is issued by the beneficiary.

Though the counter guarantee-*cum*-indemnity is taken as security for every guarantee issued by the bank, its value would depend on the financial standing of the person/company giving the counter guarantee. Hence, it is preferable that keeping in mind the financial worth of the counter guarantor, necessary security in the form of fixed deposits, mortgage, *etc*. be obtained or the existing charge of the debtor be extended to cover the guarantee.

Payment under bank guarantee

Before making payment, a banker has to ensure that the invocation of the guarantee has been properly done failing which he may not have any recourse against the debtor. The banker should also see that no order of injunction has been passed by any court of law prohibiting the bank from making payment. In case a banker makes payment in spite of there being an order by a competent court in which the bank is a party, then the bank will be answerable for contempt of court.

Questions —

(a) Banks issue different types of guarantees on behalf of their customers. Briefly explain the nature of each type of bank guarantee.

(10 marks)

(b) State in brief the precautions to be taken by the banks — (i) while issuing a bank guarantee; and (ii) before making payment under the bank guarantee.

(10 marks)

(c) What requirements a banker should ensure in deciding whether the invocation made is proper in case of payment under a bank guarantee ?

(5 marks)

(d) While issuing a guarantee the bank omits to mention the amount and period of the guarantee. Can the bank still be held liable ? What would be the extent of liability ?

(5 marks)

(e) What is 'validity period' and 'claim period' in a bank guarantee ?

(5 marks)

(f) Can the bank in a guarantee issued by it restrict the claim period so as to avoid its liability ? Discuss.

(5 marks)

(g) What is a counter guarantee and when is it obtained ?

(5 marks)

(h) What is an order of injunction ?

(5 marks)

2. (a) Kangana Tea Estate located in Dimapur district is a unit of Manisha Foods Ltd., Siliguri. The company operates in production and sale of fine quality Assam tea. Sanjay, aged 62 years, a long-time employee of the company, deals with day-to-day accounts function of Manisha Foods Ltd. You are the in-charge of treasury function of the company. You are on leave till another week from now, as there is a medical emergency, staying with your parents in a village that takes two days to reach from Siliguri.

Roshan, Managing Director of the company, is on an international business trip. He received an SOS from the estate manager that there has been fire in the Tea Estate office building. Though there has been no casualty, more than 20 employees got injured while escaping out of the building and 24 employees have been hospitalised in a private nursing home located in the nearest town, about 45 kilometers from the estate office. Rescue work is still on.

You have received a call from Roshan, your MD, for ₹25 lakh to be made available to the Estate Manager at the earliest. He is not conversant with remittance of money through electronic mode by the bank.

Prepare a note for Roshan, giving details of the new age mechanism for transfer of funds electronically to enable him to issue suitable instructions to Sanjay.

(10 marks)

(b) Comment on the following :

(i) The BASEL III accord deals in capital adequacy norms to be fulfilled by banks.

(ii) Mortgage by deposit of title deeds is called English mortgage.

(iii) Customer segmentation refers to classification of customers into different groups for the purpose of identifying their requirements.

(iv) Financing under micro finance is without collateral.

(v) Assignment is a term associated with loan against life insurance policy.

(vi) In case of pledge, possession remains with the borrower.

(vii) Nomination can also be done for home loans.

(viii) RBI is a banker to the government.

(ix) Tier-II capital shall not exceed 50% of Tier-I capital.

(x) Commercial papers are issued at par value.

(2 marks each)

3. Why letters of credit and letters of guarantee issued by banks on behalf of their customers not shown in the balance sheet as advances are reported separately as off balance sheet items ?

(5 marks)

4. Sunshine Ltd. is sanctioned ₹10 crore cash credit limit but utilises only ₹8 crore on an average at contracted rate of 20%. The borrower will have to pay a commitment fee @ 0.50% on the unused portion of the credit limit. Additionally, the bank insists for margin (cash deposit) of 20% of the utilised limit and 5% of the unutilised portion. Reserve requirement imposed by central bank is 10% of the deposits. In light of the above —

(i) What is the revenue from this loan to the bank ?

(ii) Work out estimated funds outlay for the borrower.

(5 marks)

5. Discuss salient features of the 'Banking Ombudsman Scheme'. On what grounds can a customer lodge a complaint of deficiency in service with respect to loans and advances to the Office of Banking Ombudsman ?

(5 marks)

6. Neelima opened a savings bank account with Dhan Bank. She was handed over a copy of rules and regulations for operating the account. It provided that the cheque book should be kept under lock and key and for loss, if any, arising from not complying with requirement, the bank will not be responsible.

Neelima kept the cheque book in drawer and one of her office colleagues took off one cheque leaf and by forging her signature withdrew ₹2 lakh from the bank. She claimed refund of this amount from the bank. Bank refused to pay stating that the loss has been caused due to negligence on part of the customer. She has filed an appeal against the bank.

Give your decision on the case with reasons.

(5 marks)

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