

**SUPREME COURT OF INDIA**

State Bank of India

Vs.

Mula Sahakari Sakhar Karkhana Ltd.

C.A.No.2801 of 2006

(S. B. Sinha and P. K. Balasubramanyan, JJ.)

06.07.2006

**JUDGEMENT**

**S. B. SINHA, J.:-**

1. Leave granted.

**BACKGROUND FACTS**

1. The Respondent is a co-operative society. It has a sugar factory. It entered into a contract for installation of a paper plant at village Sonai on turnkey basis so as to enable it to utilize the left over material called "bagasse" of the sugarcane with M/s. Pentagon Engineering Pvt. Ltd. (for short "Pentagaon"). The total value of the contract was Rs. 3,40,00,000/-. Pentagon furnished a performance guarantee in regard to the machinery supplied by it. The said contract contained a clause for retention of 10% of the contract price by the cooperative society in the following terms:

"15.2.4 5% of the contract price shall be payable after satisfactory commissioning and working of the plant for three months that is three months from the achievement of the performance guarantee as stipulated in clause Nos. 8 and 9 above, by a separate letter of credit.

15.2.5 5% of the contract price shall be paid after six months after satisfactory commissioning of the plant and continuous successful working of the plant during the period i.e. six months working of the plant as per clauses 8 and 9 above, by a separate letter of credit."

2. Pentagon, however, by a letter dated 6th April, 1985 suggested for a modification as regards the said payment clause regulating the co-operative society to waive its rights to retain the said 10% of the contract price, and in its turn proposed to have a letter of credit so that they can furnish appropriate bank guarantee; to which the co-operative society accepted stating:

"You have also to submit the performance guarantee at 10% of the contract price, if the same guarantee is not received the karkhana is entitled to recover it from the balance payment and accordingly we have deducted it for want of performance guarantee."

3. Pentagon in response thereto by its letter dated 16th April, 1985 agreed to the said proposal stating:

"...As per agreement you have to open separate L/C for 10% retention which is still not done by you. As soon as you open L/C, we will give you Bank Guarantee for the retention money within 10 to 15 days thereafter."

4. The Bank Guarantee/Indemnity was thereafter furnished by the Appellant herein on or about 7th September, 1985; the relevant clauses whereof read as under:

"Please find enclosed herewith the bank guarantee bearing No. 85/17 dated 4th September, 1985 issued by State Bank of India, Dombivli Industrial Estate Branch, Dombivli.

The guarantee is issued in pursuance of our agreement for paper project dated 25.9.1983. The guarantee covers 10% retention amount of Rs. 34 lacs.

An amount of Rs. 13,76,285/- is retained from the Pro forma Invoices of the material reached at site.

Kindly release the amount of Rs. 13,76,285/- to be retained by you immediately on receipt of this guarantee and oblige."

## THE DISPUTE

5. Disputes and differences arose by and between the co-operative society and Pentagon. The contract of Pentagon was terminated by the co-operative society by a notice dated 17th July, 1987. A claim of Rs.3,23,28,209.10 was also raised. Pentagon not only denied and disputed its liability to pay the said sum but also, on the other hand, asserted that an amount of Rs.4,66,73,300/- was due and owing to it by a letter dated 18th July, 1987.

6. The Bank Guarantee was thereafter invoked by the co-operative society. The demand of the co-operative society invoking the said Bank Guarantee met resistance from the Appellant stating that it had executed an agreement of indemnity pursuant where to or in terms whereof only losses, claims, damages, actions and costs which might have been suffered by it, were covered and the transaction in question does not constitute Bank Guarantee. It was, therefore, contended that unless the cooperative society proved any loss or damage for design, performance, workmanship or supply of any defective material through a competent court or authority, the Appellants were not liable to pay the said amount.

## PROCEEDINGS

7. Co-operative society thereafter filed a suit in the Court of Civil Judge, Senior Division, Ahmednagar which was numbered as Special Civil Suit No. 310 of 1987. An application was filed by the co-operative society in the said suit for a direction upon the Appellant to deposit the amount of Rs.34,00,000/-.

## ORDER OF THE COURT

8. The matter relating to passing of an interim order went up to the High Court. The High Court by an order dated 23rd February, 1988 directed that the said amount be retained by the Appellant

subject to the condition that in the event, the suit is decreed the said amount would be paid with interest @ 12% per annum. The suit was dismissed. An appeal was preferred thereagainst by the co-operative society before the High Court. The High Court construing the said agreement dated 25.9.1983 to be a Bank Guarantee decreed the suit directing Appellant to pay the said sum of Rs.34,00,000/- with interest @ 14% per annum.

The Appellant is, thus, before us.

## SUBMISSIONS

9. Mr. G.E. Vahanvati, learned Solicitor General appearing on behalf of the Appellants submitted that:

(i) On a true construction of the document dated 4th September, 1985, it would be seen that the same is a contract of indemnity and not a Bank Guarantee.

(ii) The High Court committed a manifest error in considering the oral evidence adduced by the parties in construing the said document dated 4th September, 1985.

(iii) Interest awarded @ 14% per annum is contrary to and inconsistent with the directions of the High Court as contained in its order dated 23rd February, 1988.

10. Mr. Naphade, learned Senior Counsel appearing on behalf of the co-operative society, on the other hand, submitted that:

(i) the substance of the matter must be considered in the backdrop of events in which the Bank Guarantee was furnished by the Appellant and for that purpose surrounding circumstances were relevant. As the terms of contract need not necessarily be gathered from one document, the relevant circumstances could also be considered, they being:-

(a) The document in question is by way of a letter. It refers to the original agreement dated 29.5.1983 in terms whereof the co-operative society agreed to purchase from Pentagon the paper plant on turnkey basis. The said agreement stipulates that final payment should be made to the supplier on his furnishing a Bank Guarantee to the co-operative society for design, performance, workmanship or against defective materials or equipment supplied.

(b) Pantagon was a client of the Appellant and it had approached it for furnishing the Bank Guarantee.

Strong reliance in this behalf has been placed on S. Chattanatha Karayalar v. The Central Bank of India and Others [1965 (3) SCR 318] and P. L. Bapuswami v. N.Pattay Gounder [1966 (2) SCR 918]. AIR 1965 SC 1856

AIR 1966 SC 902

## BANK GUARANTEE

11. The Operative portion of the Bank Guarantee dated 7th September, 1985 reads, thus:

"NOW THEREFORE THIS BANK GUARANTEE is made in favour of Mula Sahakari Sakhar Karkhana Ltd. by State Bank of India (Dombivli Industrial Estate Branch) agreed security the State Bank of India (Dombivli Industrial Estate Branch) hereby agrees and undertake subject to the terms and conditions set forth in this agreement to indemnify and keep indemnified Mula Sahakari Sakhar Karkhana Ltd. against all losses, claims, damages actions and cost in respect of such sums which the supplier shall become liable to pay as the terms of the said order."

In addition to the aforementioned, the Appellant agreed to the other terms and conditions referred to therein, stating :

"NOTWITHSTANDING anything hereinbefore contained, our maximum liability under this guarantee is restricted to Rs. 34,00,000/- (Rupees Thirty four Lacs only). This guarantee shall remain in force up to 3rd September, 1987 unless a suit or action to enforce claim under this guarantee is filed against us on or before the 3rd September, 1987 all right under this guarantee shall be forfeited and we shall be relieved and discharged from all liabilities hereunder."

12. The High Court, however, despite noticing the said document in extenso, committed a manifest error in opining:

".....The recital in the preamble in question itself cannot be the foundation to interpret the document

in question as a document of indemnity....."

Although it was opined that the same was intended to be a contract of indemnity, the High Court wrongly observed:

".....There was no objection of any kind referred to or placed on the record by the appellants. The Officer of the Bank stated before the Court that the document in question was intended to be a contract of guarantee and not a contract of indemnity. The written document (Exhibit-46) as quoted above lays emphasis on the preamble as under....."

Yet again, in the said paragraph, the operative portion of the document was erroneously described as a preamble stating:

".....The preamble of the document in question creates an impression that the said document is a contract of indemnity and not a contract of guarantee....."

13. The High Court, furthermore, inserted some words in the said document which in fact were not there, as for example, in paragraph 31 of the impugned judgment it added the term "unequivocal condition" which term did not find place in the document in question. Similarly, in paragraph 34, it was stated:

".....The appellants are entitled to their claimed money without any delay or demur. The nature and need of such commercial contracts and documents need to be respected by the parties concerned....."

Yet again, it was stated:

"If the terms and conditions of the Bank Guarantee are unconditional and absolute, the respondents have no choice but to honour the same....."

(Emphasis added)

14. No such terms were used in the said document. The approach of the High Court on construction

of the said document was, thus, patently wrong.

15. The High Court committed a manifest error in terming the operative portion of the document as a preamble. It had inserted terms and expressions which did not find place in the document in question.

The High Court furthermore considered the oral evidence adduced by the parties despite the bar contained in Sections 91 and 92 of the Indian Evidence Act holding:

(i) ".....The testimony of these witnesses, in no way, derogates the document in question. On the contrary, the evidence supports the purpose and object of the execution of the Bank Guarantee in question. It also supports that the parties, specially the appellants are the creditors-beneficiaries, the respondents-Bank are the guarantors - the surety and the supplier is M/s. Pentagon the principal debtor. As we have noted and as contemplated under Section 124 of the Contract Act, such Bank Guarantee should have three ingredients, i.e., creditor, guarantor and principal debtor. On a bare reading of this document, it is nothing but a tripartite agreement between the parties. M/s. Pentagon submitted the said Bank Guarantee by its letter dated 7th September, 1985 to the appellants. The appellants, as noted above, without any demur or objection, accepted this document as a Bank Guarantee and based upon the same, the amount was released. There is no evidence to support that in absence of this bank guarantee, the amount would not have been released by the appellants."

(ii) ".....Therefore, according to us, the express terms of the written agreement in question, supported by the testimony of the respondent Bank's Officer itself, apart from the appellants, some statements in the cross-examination or raising doubts about the nature of the agreement by one of the Bank witness, that itself would not affect the written agreement in question....."

(iii) ".....In this background, we cannot overlook the circumstances under which the particular words were used and/ or misused....."

16. A document, as is well known, must primarily be construed on the basis of the terms and conditions contained therein. It is also trite that while construing a document the court shall not supply any words which the author thereof did not use.

17. The document in question is a commercial document. It does not on its face contain any ambiguity. The High Court itself said that ex facie the document appears to be a contract of

indemnity. Surrounding circumstances are relevant for construction of a document only if any ambiguity exists therein and not otherwise.

18. The said document, in our opinion, constitutes a document of indemnity and not a document of guarantee as is clear from the fact that by reason thereof the Appellant was to indemnify the co-operative society against all losses, claims, damages, actions and costs which may be suffered by it. The document does not contain the usual words found in a bank guarantee furnished by a Bank as, for example, "unequivocal condition", "the co-operative society would be entitled to claim the damages without any delay or demur" or the guarantee was "unconditional and absolute" as was held by the High Court.

19. The High Court, thus, misread and misinterpreted the document as on scrutiny thereof, it had opined that it was a contract of guarantee and not a contract of indemnity.

20. The document was executed by the Bank in favour of the co-operative society. The said document indisputably was executed at the instance of Pentagon.

21. We have hereinbefore noticed the surrounding circumstances as pointed out by Mr. Naphade as contained in Clauses 15.2.4 and 15.2.5 of the contract vis-a-vis the letters exchanged between the parties dated 6.4.1985, 11.4.1985, 16.4.1985 leading to execution of the document dated 07.09.1985 by the First Appellant in favour of the co-operative society.

22. We are, however, unable to accept the submissions of the learned Senior Counsel that the bank guarantee must be construed in the light of other purported contemporaneous documents. A contract indisputably may be contained in more than one document. Such a document, however, must be a subject-matter of contract by and between the parties. The correspondences referred to hereinbefore were between the co-operative society and Pentagon. The said correspondences were not exchanged between the parties hereto as a part of the same transaction. The Appellant understood that it would stand as a surety and not as a guarantor.

23. The decision of this Court in *S. Chattanatha Karayalar (supra)* on which reliance was placed by Mr. Naphade is not applicable to the fact of the present case. Therein, the construction of a promissory note executed in favour AIR 1965 SC 1856, At P. 1861, Para 4 of a Bank was in question. The said promissory note was construed in the context of the letters and the hypothecation agreement executed by the borrower on the basis whereof it was held that the status of the Appellant therein with regard to the overdraft amount was that of a surety and not that of a co-applicant. In the said decision itself, Ramaswami, J. opined:

".....The provisions of Section 92 of the Evidence Act do not apply in the present case, because Defendant 3 is not attempting to furnish evidence of any oral agreement in derogation of the promissory note but relying on the existence of a collateral agreement in writing Exs. A and G which form parts of the same transaction as the promissory note Ex. B....."

24. The High Court proceeded on the basis that Section 92 of the Evidence Act would be attracted in the instant case but despite the same it referred to the oral evidence so as to find out the purported circumstances surrounding the transaction, which in our view, was not correct.

25. In P.L. Bapuswami (supra), relied upon by Mr. Naphade, this Court was concerned with a question as to whether Ex. B-1 therein was a transaction of mortgage by conditional sale or a sale with a condition of re-transfer in the light of Section 58(c) of the Transfer of Property Act. We are not concerned with such a case here. AIR 1966 SC 902

26. It is one thing to say that the nature of a transaction would be judged by the terms and conditions together with the surrounding and/or attending circumstances in a case where the document suffers from some ambiguities but it is another thing to say that the court will take recourse to such a course, although no such ambiguity exists.

[See Bishwanath Prasad Singh v. Rajendra Prasad and Anr. [(2006) 2 SCALE 699] 2006 AIR SCW 4235

27. It is beyond any cavil that a bank guarantee must be construed on its own terms. It is considered to be a separate transaction.

28. If a construction, as was suggested by Mr. Naphade, is to be accepted, it would also be open to a banker to put forward a case that absolute and unequivocal bank guarantee should be read as a conditional one having regard to circumstances attending thereto. It is, to our mind, impermissible in law.

29. In New India Assurance Company Ltd. v. Kusumanchi Kameshwara Rao and Another [(1997) 9 SCC 179], it is stated:

".....It is obvious that when such guarantee bonds are reduced to writing the express terms of this writing containing the guarantee bond would be the repository of the obligations of the guarantor flowing from the surety bond. As per Sections 91 and 92 of the Indian Evidence Act, 1872 no evidence dehors the terms of the agreement, whether documentary or oral, can be led by the parties to get out of the express terms thereof. Whether the express terms of the guarantee bond give rise to the contract of guarantee sought to be enforced will be the only limited enquiry which could be gone into by the courts while deciding the rights and obligations flowing from such contract of guarantee which is a tripartite contract between the creditor, principal debtor and the surety. Once such suretyship agreement is established on the clear terms of the bond then as laid down by the aforesaid decisions of this Court no latitude can be given to the contracting party, namely, the surety or even the principal debtor to enable them to get out of the obligations of the suretyship agreement flowing from such contract, except in exceptional circumstances as indicated in these decisions."

30. In *Hindustan Construction Co. Ltd. v. State of Bihar and Others* [(1999) 8 SCC 436], the guarantee in question was in the following terms: 1999 AIR SCW 3747, Paras 11 and 12

".....We, State Bank of India, incorporated under the State Bank of India Act, 1955, and having one of our branches at Nyayamurti C.N. Vaidya Marg, Fort, Bombay-400 023 (hereinafter referred to as 'the said Bank'), as instructed by the contractor, agree unconditionally and irrevocably to guarantee as primary obligator and not as surety merely, the payment of the Executive Engineer, Kharkai Dam Division II, Icha, Chaliama, Post Kesargarhia, District Singhbhum, Bihar, on his first demand without whatsoever right of objection on our part and without his first claim to the contractor, in the amount not exceeding Rs.10,00,000 (Rupees ten lakhs only) in the event that the obligations expressed in the said clause of the above-mentioned contract have not been fulfilled by the contractor giving the right of claim to the employer for recovery of the whole or part of the advance mobilisation loan from the contractor under the contract....."

31. Despite such conditions, holding that the guarantee in question was a performance guarantee, this Court opined: 1999 AIR SCW 3747, Paras 12 and 13

".....The Bank, in the above guarantee, no doubt, has used the expression "agree unconditionally and irrevocably" to guarantee payment to the Executive Engineer on his first demand without any right of objection, but these expressions are immediately qualified by following:

"... in the event that the obligations expressed in the said clause of the above-mentioned contract have not been fulfilled by the contractor giving the right of claim to the employer for recovery of the whole or part of the advance mobilisation loan from the contractor under the contract."

This condition clearly refers to the original contract between HCCL and the defendants and postulates that if the obligations, expressed in the contract, are not fulfilled by HCCL giving to the

defendants the right to claim recovery of the whole or part of the "advance mobilisation loan", then the Bank would pay the amount due under the guarantee to the Executive Engineer. By referring specifically to clause 9, the Bank has qualified its liability to pay the amount covered by the guarantee relating to "advance mobilisation loan" to the Executive Engineer only if the obligations under the contract were not fulfilled by HCCL or HCCL has misappropriated any portion of the "advance mobilisation loan". It is in these circumstances that the aforesaid clause would operate and the whole of the amount covered by the "mobilisation advance" would become payable on demand. The bank guarantee thus could be invoked only in the circumstances referred to in clause 9 whereunder the amount would become payable only if the obligations are not fulfilled or there is misappropriation. That being so, the bank guarantee could not be said to be unconditional or unequivocal in terms so that the defendants could be said to have had an unfettered right to invoke that guarantee and demand immediate payment thereof from the Bank."

32. It was clearly held therein that the bank guarantee constitutes a separate, distinct and independent contract between the bank and the defendants.

33. In this case, the document in question does not specifically refer to any particular clause of the contract. In fact the contract does not contain any clause requiring Pentagon to furnish any Bank Guarantee.

34. We may now consider the decision in *Daewoo Motors India Ltd. v. Union of India and Others* [(2003) 4 SCC 690]. The bank guarantee involved therein inter alia read as under: 2003 AIR SCW 1225, Paras 12 and 13

"We, Times Bank Ltd., PTI Building, Parliament Street, New Delhi, 110 001 further agree that the demand made by the President of India any money so demanded notwithstanding any dispute raised by M/s Daewoo Motors India Ltd. in any proceeding before any court or tribunal.

We, Times Bank Ltd., PTI Building, Parliament Street, New Delhi 110 001 further agree that the demand made by the President of India shall be conclusive as regards the amount due and payable by us under these presents as out of liability under these presents are absolute and unequivocal;"

Construing the terms thereof, this Court held:

"From a perusal of the above clauses, it is abundantly clear that the bank guarantee furnished by the Bank is an unconditional and absolute bank guarantee. The Bank has rendered itself liable to pay the

cash on demand by the President of India "notwithstanding any dispute raised by M/s. Daewoo Motors India Limited in any proceeding before any court or tribunal". It is worth noticing that the clause in the bank guarantee specifically provides that the demand made by the President of India shall be conclusive as regards the amount due and payable by the Bank under this guarantee and the liability under the guarantee is absolute and unequivocal. In the face of the clear averments, it is trite to contend that the bank guarantee is a conditional bank guarantee. Therefore, the Bank has no case to resist the encashment of the bank guarantee. Inasmuch as we have held that the bank guarantee is an unconditional bank guarantee, the case of Hindustan Construction Co. Ltd. v. State of Bihar is of no avail to the appellant." 1999 AIR SCW 3747

The said decision, in the facts and circumstances of the case, cannot be said to have any application here.

35. We are not oblivious of the decisions of this Court where, save and except the cases of fraud or irretrievable evil, the Bank has been held liable to pay the guaranteed amount without any demur whatsoever. In an instructive judgment, M. Jagannadha Rao, J. in Federal Bank Ltd. v. V.M. Jog Engineering Ltd. and Others [(2001) 1 SCC 663] referring to Uniform Commercial Practice of Documentary Credits and a catena of decisions of this Court as also the English Courts, dealt with a case where a fraud was alleged and observed: 2000 AIR SCW 3639, Para 58

"Thus, not only must "fraud" be clearly proved but so far as the bank is concerned, it must prove that it had knowledge of the fraud. In United Trading Corpn. S.A. v. Allied Arab Bank it was stated that there must be proof of knowledge of fraud on the part of the bank at any time before payment. It was also observed that it

"would be sufficient if the corroborated evidence of the plaintiff usually in the form of contemporary documents and the unexplained failure of a beneficiary to respond to the attack, lead to the conclusion that the only realistic inference to draw was 'fraud'."

[See also Dwarikesh Sugar Industries Ltd. v. Prem Heavy Engineering Works (P) Ltd. and Another, (1997) 6 SCC 450] and M/s. BSES Ltd. (now Reliance Energy Ltd.) v. M/s. Fenner India Ltd. and Anr. JT 2006 (2) SC 192]. 1997 AIR SCW 2415

2006 AIR SCW 721

36. However, in this case, we have no doubt in our mind that the document in question constitutes a contract of indemnity and not an absolute or unconditional bank guarantee. The High Court, therefore, erred in construing the same to be an unconditional and absolute bank guarantee.

## RATE OF INTEREST

37. Contention of Mr. Vahanvati as regards the rate of interest is also incontrovertible. The order dated 23rd February, 1988 clearly states that the amount would be repaid with an interest @ 12% and in that view of the matter, the High Court could not have directed payment of interest @ 14%.

38. For the reasons aforementioned, the impugned judgment cannot be sustained which is set aside accordingly. The decree of the trial court is restored. The appeal is allowed with costs. Counsel's fee assessed at Rs. 5000/-.

Appeal allowed.