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### THE THIRD EXCEPTION TO SECTION 28 OF THE CONTRACT ACT, 1872 AND CLAIM PERIODS UNDER BANK GUARANTEES

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Larsen & Toubro Limited (L&T) filed a writ petition against Punjab National Bank (PNB), the Indian Banks Association (IBA) and the Reserve Bank of India (RBI) before the Delhi High Court challenging PNB's and IBA's interpretation of the third exception to Section 28 of the Indian Contract Act, 1872 (ICA). The issue arose because L&T in its ordinary course of business, routinely submitted performance bank guarantees/ advance bank guarantees while bidding for government contracts and also submitted bid bonds/ bid security in the form of bank guarantees (BGs). PNB compelled L&T to keep the claim period under the BG alive for a minimum period of one year, regardless of whether L&T required the BG for a shorter period. The implications of this for L&T was that it incurred unnecessary expenses for payment of commission charges on the BG and for maintaining collateral security in support of the BG during the extended claim period. Hence L&T also joined IBA and RBI as Respondents in the writ petition as it was a policy decision which affected all persons who availed of such banking facilities.

A Single Judge of the Delhi High Court by judgment dated 28<sup>th</sup> July 2021 in "**Larsen and Toubro Limited v. Punjab National Bank and Another**", Writ Petition No. 7677 of 2019, has for the first time, in interpreting the third exception to Section 28 of the ICA in the context of a BG held that the provision did not provide for a minimum claim period under a BG.

The dispute arose since PNB, by way of communications dated 18.08.2018 and 28.03.2019, insisted on a mandatory and an unalterable claim period of a minimum 12 months for BGs. This interpretation was pursuant to circulars issued by the IBA dated 10.02.2017 and 05.12.2018. The claim period in a BG is a grace period awarded beyond the validity period of the BG to make a demand on the bank for a default, which default occurred while the BG was valid. PNB was of the view that a claim period which is less than 12 months would render the claim period void and will effectively increase the claim period under the BG to 3 years (or 30 years for the government) under the Limitation Act, 1963 (**Limitation Act**).

The High Court in interpreting the provision set out the historical amendments made to Section 28 of the ICA. Prior to the first amendment, the ICA voided all agreements that restrained contractually, but not statutorily, the right to enforce a legal remedy. As a result, in 1997, Section 28 was amended with an exception that permitted for the contractual relinquishment of a right to enforcement after the completion of the period of the right. A second amendment was necessitated since, in light of the 1997 amendment, banks had concerns that under amended Section 28 it would not be possible to limit their liability under BGs to a specified period and it would be governed

as per the Limitation Act. Therefore in 2013 the third exception to Section 28 of the ICA was inserted which reads as follows:

*Exception 3.—Saving of a guarantee agreement of a bank or a financial institution.— This section shall not render illegal a contract in writing by which any bank or financial institution stipulates 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.*

In light of the 2013 amendment to Section 28, IBA issued an opinion which said:

*"4. In view of the foregoing, it will be a safer course in the interest of the banks, though not obligatory under law, to issue every guarantee (regardless of the guarantee period) with a minimum claim period of one year on top of the guarantee period so as to avail benefit of Exception 3 to Section 28 of Indian Contract Act, 1872." (sic)*

The Court observed that prior to the amendment of Section 28 of the ICA, if there was a restriction on the time period within which a right was to be enforced, but the right continued to survive after that period, such a restriction was void. This was remedied by the 1997 amendment wherein a contractual restriction of a remedy was void but a restriction on the period of the enforcement of that right was valid. However, since the period of the claim could be construed from three years for private parties and 30 years for government entities, it was decided to curtail that period to a minimum of one year by the 2013 amendment. As such, the 2013 amendment set out the time period by which a beneficiary could enforce rights under a BG to be a minimum of one year and it did not affect the claim period. The Court relied on the counter of PNB in these proceedings which said:

*"It is to address one of such issue, the legislature have inserted Exception -3 to Section 28 of the Indian Contract Act, 1872, which inter alia, provides that in case a term is provided for in the Guarantee and Agreement by the Bank or Financial Institution that in case no claim is filed before the Court of Law within a period, which is not less than 12 months, from the date of occurring or non-occurring of the specified event the liability of the Bank shall get extinguished and the Bank shall stand discharged from its liability under the Bank Guarantee."*

Accordingly, the High Court held PNB's communications dated 18.08.2018 and 28.03.2019 and IBA's opinions dated 10.02.2017 and 05.12.2018 to be erroneous interpretations of the law and held that there is no mandatory requirement that the claim period for a BG had to be for 12 months. PNB, IBA and RBI have a right of appeal against the judgment of the Learned Single Judge and it is to be seen whether the matter is pursued further in appeal.

- Thriyambak J. Kannan (Partner)

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