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LAW IN FOCUS

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Laws and Practice relating to Encashment of Bank Guarantee

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Generally, the government or its departments, statutory incorporations, foreign importers etc. in their tender document requires submission of bid bond, bank guarantee, letter of credit up to a certain percentage of the contract value.

The Schedule banks provide such guarantees at the request of and on behalf of the contractor to above third party beneficiaries as the said Bank are empowered to do so under Bank Companies Act 1991. The Banks in return takes security of cash deposit with variable margins and/or other collaterals.

As per the terms and conditions, the guarantees issued by the Banks are unconditional and payable immediately on demand by the beneficiary. This has no relation with the terms and conditions of the procurement contract executed between the contractor and the beneficiary.

The beneficiary, on the other hand, in circumstances, where the contractor fails to render the contractual work, cause delay or violate any other important term of the contract cancel the work order/ contract and request the bank to Encash the Guarantee.

The contractors are generally not happy with such instruction of the procuring entity as they always come up with different excuses. It is often observed that the procuring contract does not specify the event of default. Even if there are terms specifying event of default allowing termination, in most cases, the contract is silent as to the timing of encashment of bank guarantee.

This is surely a weakness of drafting of the procurement contract, which left out the major agreement between the beneficiary and the contractor on "event of encashment."

The contractor as dissatisfied in reply to the instruction of encashment of the Bank Guarantee issued by the Beneficiary to the Bank goes to the court for temporary injunction and writes to the bank requesting not to make payment as the matter is pending before the court, therefore, it is sub judice and/or state that the beneficiary is acting illegally and/or he/she has already obtained a show cause notice from court.

This puts the Bank in dilemma. The Bank without assessing its legal position in depth, stop making payment and/or cause delay in making payment even though the Guarantee stipulates that "payment shall be made immediately without questioning the validity of such instruction". In few cases, the Banks favour their client, the contractor and indirectly assist by not making payment. This is surely not only a violation of the Bank Guarantee agreement, but also a serious flaw in the commercial transactions compared to international standard.

The Bank often favours the clients as there are alleged issues of malpractice within the beneficiary procuring entity, which puts the Bank into the possible failure to recover of Bank dues from contractor. Further, if there is low cash margin or insufficient collateral, this may lead to non payment.

On the other hand, the contractors often do not come up with clean hands. By manufacturing false documents and giving false information or in collusion with the procuring entity etc. the contractor often sign contract which they simply not capable of performing.

This is a total confusion in the system which generally leads to several litigations in both district court and Supreme Court, arbitrations and even criminal cases. Further, the Bank loses its reputation as a Guarantor locally and internationally.

This is also a vital reason for failure to utilise the government fund, delay in development and infrastructural works.

If the technical and financial evaluations are genuine and the procuring contract states the "event of encashment" of Bank Guarantee, this should reduce the said confusion. The contractor are also required to submit power of attorneys, joint venture agreement etc. as required under invitation for tender in consultation with lawyers so that bid is not rejected due to the fault in documentation. The Bank Guarantee may also incorporate clauses similar to the "event of encashment" even though this renders the Guarantee conditional. The tender document containing draft contract, notification of award, bank guarantee should be drafted with care.

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