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ahead of the curve

# Assessing the Response to Surety Bonds and the Way Forward



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## I. Background

India is increasingly acknowledging the need for the investment in the infrastructure sector as a pivotal step towards its goal of becoming a \$5 trillion economy by 2024–25.<sup>1</sup> In the Union Budget, 2022, the Finance Minister introduced “surety bonds” as a risk management tool<sup>2</sup> as these can accelerate the growth of the infrastructure sector. The Minister proposed these bonds as a substitute for bank guarantees (“BGs”) with a vision to facilitate investments in the infrastructure sector by guaranteeing the performance of a diverse set of contractual obligations.<sup>3</sup> Wider use of this new financial product in the future could substitute BGs in other sectors as well.

In the infrastructure sector, surety bonds are guarantees that an insurance company (surety) issues on behalf of a contractor (principal debtor) in favour of a project owner (creditor).<sup>4</sup> For instance, a contractor may require bid bonds as a pre-qualification for participation in a competitive bid process administered by the project owner.<sup>5</sup> Similarly, surety bonds can also replace the traditionally used BGs or standby letters of credit as a guarantee for performance.<sup>6</sup>

With the introduction of surety bonds in India, the Insurance Regulatory and Development Authority of India (IRDAI) has issued the IRDAI (Surety Insurance Contracts) Guidelines, 2022 (“**2022 Guidelines**”), to provide a legal framework for it and regulate and develop the business, especially in light of its unique features and risks.<sup>7</sup> The 2022 Guidelines stipulates providing surety bonds for infrastructure projects if the project owner is a government or private entity.<sup>8</sup> A surety provider should be a registered Indian insurance company as defined under the Insurance Act, 1938, besides meeting the other criteria in the 2022 Guidelines.<sup>9</sup>

Surety bonds provide financial stability and confidence by ensuring that contractual obligations are met. Additionally, risk allocation is improved, as these bonds move the risks of long-term infrastructure project financing away from banks to insurance companies, i.e.,

<sup>1</sup> Press Information Bureau, *Finance Minister Smt Nirmala Sitharaman releases Report of the Task Force on National Infrastructure Pipeline for 2019-2025*, 31 December 2019, available at <https://pib.gov.in/PressReleaseDetail.aspx?PRID=1598055> (accessed on 17 March 2024).

<sup>2</sup> Insurance Regulatory and Development Authority of India, *Report of the Working Group on suitability of offering of surety bond by Indian insurance industry*, 30 September 2020, available at <https://irdai.gov.in/document-detail?documentId=395601> (accessed on 24 February 2024) (“**Working Group**”).

<sup>3</sup> IANS, *Surety bonds instead of bank guarantees in govt procurements: FM*, 1 February 2022, available at <https://www.deccanherald.com/business/union-budget/surety-bonds-instead-of-bank-guarantees-in-govt-procurements-fm-1076922.html> (accessed on 17 March 2024).

<sup>4</sup> Id.

<sup>5</sup> David J. Barru, *How to Guarantee Contractor Performance on International Construction Projects: Comparing Surety Bonds with Bank Guarantees and Standby Letters of Credit*, 37 GEO. WASH. INT’L L. REV. 51 (2005).

<sup>6</sup> Id.

<sup>7</sup> IRDAI (Surety Insurance Contracts) Guidelines, 2022, available at <https://irdai.gov.in/document-detail?documentId=1090056> (accessed on 17 March 2024).

<sup>8</sup> Clause 6.4, 2022 Guidelines.

<sup>9</sup> Clause 3, 2022 Guidelines.

entities that are not reliant on public deposits to fulfil these obligations, and protect the taxpayer from the loss of public funds.<sup>10</sup>

These bonds not only protect project owners' interests, but also promote a more competitive market by allowing smaller contractors to bid on large-scale projects. With this new instrument, the contractor can boost the availability of liquidity and capacity of contractors, thereby strengthening the infrastructure sector.<sup>11</sup>

The first surety bond product was launched in December 2022.<sup>12</sup> However, the general consensus is that such products have been slow to garner interest and acceptability.<sup>13</sup> Despite evidence of the industry-wide demand for surety bonds for infrastructure projects, insurers and project owners have their concerns in accepting these bonds.<sup>14</sup> In May 2023, noting various such representations, the IRDAI amended the 2022 Guidelines to reduce the solvency ratio requirement and remove the 30-per cent exposure limit applicable on each contract.<sup>15</sup> Yet, concerns from the industry persist and to understand why, it is crucial to examine the nature of the product, including its difference from traditional instruments, and the challenges voiced by stakeholders.

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<sup>10</sup> *Supra* note 2, Paragraph 1.1.

<sup>11</sup> Press Information Bureau, Shri Nitin Gadkari launches first-ever 'Surety Bond Insurance' for infrastructure projects, 19 December 2022, available at <https://www.pib.gov.in/PressReleasePage.aspx?PRID=1884946> (accessed on 25 February 2024).

<sup>12</sup> A Saravanan, A Paul Williams, Surety bonds are key to infrastructure growth, 23 May 2023, The Hindu BusinessLine, available at <https://www.thehindubusinessline.com/opinion/surety-bonds-are-key-to-infrastructure-growth/article66885842.ece> (accessed on 25 February 2024).

<sup>13</sup> George Mathew, *Surety bonds: Slow take-off likely as pricing, reinsurance concerns remain*, Indian Express, 4 February 2022, available at <https://indianexpress.com/article/business/market/surety-bonds-slow-take-off-likely-as-pricing-7755851/> (accessed on 17 February 2024); Gladys Tejura, *Surety Bonds: The Challenge for Indian Insurers*, Tinubu, 31 October 2022, available at <https://www.tinubu.com/blog/surety-bonds-the-challenge-for-indian-insurers> (accessed on 17 February 2024).

<sup>14</sup> Vikash Khandelwal, *Budget 2022: Time to raise awareness and acceptance of Surety Bonds*, The Economic Times, 30 January 2022, available at [https://economictimes.indiatimes.com/markets/bonds/budget-2022-time-to-raise-awareness-and-acceptance-of-surety-bonds/articleshow/89219376.cms?utm\\_source=contentofinterest&utm\\_medium=text&utm\\_campaign=cppst](https://economictimes.indiatimes.com/markets/bonds/budget-2022-time-to-raise-awareness-and-acceptance-of-surety-bonds/articleshow/89219376.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst) (accessed on 17 February 2024).

<sup>15</sup> BS Reporter, *IRDAI lowers the solvency requirement for surety bonds to 1.5 times*, Business Standard, 16 May 2023, available at [https://www.business-standard.com/finance/insurance/irdai-lowers-the-solvency-requirement-for-surety-bonds-to-1-5-times-123051600982\\_1.html](https://www.business-standard.com/finance/insurance/irdai-lowers-the-solvency-requirement-for-surety-bonds-to-1-5-times-123051600982_1.html) (accessed on 17 February 2024).

## II. Nature Of Bank Guarantees and Surety Bonds

### Bank Guarantees



BGs generally act as safeguards for investments or interests in a commercial contract.<sup>16</sup> For example, in case of a public construction project, the project owner requires a bank-issued guarantee (**BG**) for the contractor, which can be evoked in case of improper or non-performance of contractual obligations.

A BG requires collateralisation through cash margins generally maintained as fixed deposits.<sup>17</sup> Banks ordinarily waived this collateral requirement and cross-subsidised the product when offered as part of a larger set of financial products by the same bank, making it relatively hassle-free for contractors. The non-performing assets (**NPA**s) crisis in the Indian banking system brought BGs under scrutiny, and it is no longer common to get collateral waivers or low-priced BGs.<sup>18</sup> These issues were phasing the middle- and small-sized contractors out of the market, which could have throttled infrastructural development.

A BG is designed with the “independence principle” – an independent and distinct contract between the bank and the beneficiary that is not qualified by the underlying transaction and

<sup>16</sup> Cyril Amarchand Mangaldas, *The Law Pertaining to Injunctions against the Invocation of Bank Guarantees Legal Compendium*, 2022, available at <https://www.cyrilshroff.com/wp-content/uploads/2023/01/Legal-Compendium.pdf> (accessed on 17 February 2024).

<sup>17</sup> Ajay Sawhney et al., *Replacement of Bank Guarantee with Surety Bonds in Government Procurement: A Welcome Relief*, Cyril Amarchand Mangaldas Blog, April 2022, available at <https://corporate.cyrilamarchandblogs.com/2022/04/replacement-of-bank-guarantees-with-surety-bonds-in-government-procurement-a-welcome-relief/> (accessed on 17 February 2024).

<sup>18</sup> *Supra* note 2, paragraph 1.21.

the primary contract between the beneficiary and the party who requested the BG.<sup>19</sup> BGs can be conditional or unconditional. A conditional BG states specific conditions for the invocation of the guarantee and does not give the beneficiary an unfettered right to invoke and demand payment, whereas an unconditional BG provides the beneficiary an unconditional right to invoke the guarantee irrespective of disputes between the parties.<sup>20</sup> Encashment of an unconditional BG does not require the bank to be perfectly satisfied of improper performance of contractual obligations or reasons for such improper performance.

If the BG is conditional, an injunction against its encashment and invocation can be obtained if its conditions have not been fulfilled.<sup>21</sup>

For unconditional BGs, Indian courts have consistently held that a beneficiary cannot be restrained from encashing the BG except in case of special equities or where fraud has been established as a triable issue<sup>22</sup> due to strong prima facie evidence.

- (a) Fraud: The fraud must be egregious, i.e., it must vitiate the entire underlying transaction. Further, only the beneficiary must have committed such fraud, not anyone else.<sup>23</sup>
- (b) Special equities: Special equity is a broad term denoting the existence of special circumstances that justify the injunction against BGs. However, irretrievable injustice or harm must accompany the special equities to justify the injunction.<sup>24</sup>

In both cases, when called upon, banks merely provide payment and do not perform the guaranteed obligations as they have no expertise in carrying out underlying contracts, e.g., a construction contract.<sup>25</sup>

The judicial approach in India in case of BGs, especially unconditional BGs, is to intervene only in exceptional cases, which makes these instruments favourable to project owners.<sup>26</sup> Further, BGs and stand-by letters of credit (which are similar instruments) have a well-established place in commerce, which gives project owners' confidence in granting contracts.<sup>27</sup>

<sup>19</sup> *Hindustan Steelworks Construction Ltd v Tarapore & Co.*, (1996) 5 SCC 34.

<sup>20</sup> *Hindustan Construction Co. Ltd v State of Bihar*, AIR 1999 SC 3710.

<sup>21</sup> *U.P. Expressways Industrial Development Authority v. Sahakar Global Ltd*, 2022 SCC OnLine All 782.

<sup>22</sup> *Ansal Engg. Projects Ltd. v. Tehri Hydro Development Corpn. Ltd.*, (1996) 5 SCC 450.

<sup>23</sup> *U.P. Cooperative Federation Ltd. v. Singh Consultants and Engineers (P) Ltd.*, (1988) 1 SCC 174.

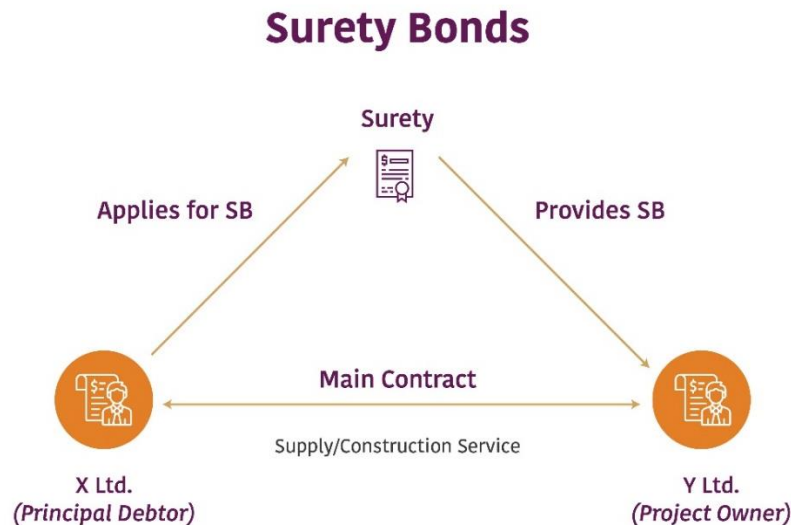
<sup>24</sup> *Svenska Handelsbanken v. Indian Charge Chrome*, 1994 AIR 626.

<sup>25</sup> *Supra* note 2, paragraph 1.12.

<sup>26</sup> *Supra* note 2.

<sup>27</sup> *Supra* note 5.

## Surety Bonds



A surety bond is defined as a contract in which a surety/insurer guarantees a project owner that the contractor or principal will meet the contractual obligations and that the project owner will receive a monetary compensation by the surety, should the principal fail to deliver on the promise.<sup>28</sup> Unlike financial guarantees/corporate bonds that refer to financial obligations to repay the debts or loans, 'surety bonds' refer to the performance or delivery obligations the principal in the insured project must complete.<sup>29</sup>

As opposed to BGs, which usually require collateral, surety bonds only require a payment of a premium like other insurance products.<sup>30</sup> A surety bond not requiring any collateral frees up capital, especially for middle- and small-sized contractors, where such capital would have otherwise been locked into a bank. A surety bond is enmeshed with the underlying transaction, as it is intended to be a "backstop" for the performance of the contractual obligations rather than mere payment to the project owner by the surety.<sup>31</sup> Unlike a BG, a surety bond does not follow the "independence principle". Instead the surety guarantees the project owner complete performance of the underlying contract, usually capped by the penal sum of the bond.<sup>32</sup> The Working Group constituted by the IRDAI on surety bonds ("**Working Group**") marks this feature as a distinction between surety bonds and BGs.<sup>33</sup> However, for the surety to perform its obligations when called upon, the project owner must convince the surety of its liability on the bond by proving default-based termination of the underlying contract.<sup>34</sup> This

<sup>28</sup> *Supra note 2*, pg. 17.

<sup>29</sup> *Supra note 2*, para 1.3.

<sup>30</sup> Nitin Zamre, *Getting surety bonds ready*, The Financial Express, 17 May 2023, available at <https://www.financialexpress.com/opinion/getting-surety-bonds-ready/3090316/> (accessed on 17 February 2024).

<sup>31</sup> *Supra note 5*.

<sup>32</sup> *Supra note 5*, read with Clause 4.1 of the 2022 Guidelines.

<sup>33</sup> *Supra Note 2*, Paragraph 1.3.

<sup>34</sup> *Supra note 5*.

requirement prolongs the enforcement of surety bonds, making them less favourable to project owners as, unlike unconditional BGs, these do not ensure quick “cash in hand”.

Globally, similar to BGs but unlike other insurance products, the surety generally has the right to be indemnified for its loss as it is also in the nature of a contract of guarantee.<sup>35</sup> However, the 2022 Guidelines should stipulate that the right of subrogation be specially clarified and included in the 2022 Guidelines to avoid uncertainty. While the 2022 Guidelines set out that surety bonds will be similar to a guarantee, the acceptance of premium for underwriting the bonds may differentiate the products such that there is no clear and implicit right of subrogation.

Surety bonds incorporate certain elements of a BG while retaining characteristics of an insurance product (such as payment of premium). This hybrid insurance product is primarily intended to create a level-playing field for contractors of differing capacities vying for public and private construction contracts and cater particularly to those who have difficulty in accessing BGs.<sup>36</sup>

Surety Bonds (“SBs”)	Bank Guarantees (“BGs”)
1 Generally provided by an insurance company.	Generally provided by a bank or a financial institution.
2 Not issued as conditional/unconditional.	Classified as conditional or unconditional guarantees which affects the manner of encashment.
3 Requires only payment of a premium like other insurance products and unlike BGs which frees up capital for the principal debtor.	Requires collateralisation by the principal debtor through cash margins generally maintained in the form of fixed deposits.
4 Surety provides a guarantee to a project owner that the principal debtor will meet its contractual obligations and that a monetary compensation will be paid to the creditor by the surety, if the principal fails to deliver on its promise, capped by a penal sum – independence principle is <b>not</b> followed.	BG is designed with the ‘independence principle’, such that banks/financial institutions are <i>financially</i> obligated to repay the creditor, independent of the underlying performance obligations.
5 Recently developed instruments incorporating certain elements of a BG while retaining characteristics of an insurance product (such as payment of premium).	BGs are well-established instruments with a history of judicial precedents lending commercial certainty.

<sup>35</sup> Id., Clause 4.1 of the 2022 Guidelines read with Section 145 of the Indian Contract Act, 1872.

<sup>36</sup> *Supra* note 2, page 67.

### III. Issues identified in uptake of Surety Bonds

Surety bonds, launched less than a year ago, have still not become popular as financial instruments. Following are some issues associated with their adoption and a growing demand for change in the governing legal framework to strengthen rights of stakeholders.<sup>37</sup>

#### 1. Awareness about surety bonds

As a matter of logistics, contractors tend to be in more regular contact with banks for a variety of financial needs as compared with insurance companies, which do not have a regular interface with contractors. This points to the deficit of information regarding the availability of such products. Contractors may also lack expertise in dealing with such specialised financial products, including analysis and negotiations over favourable terms. When given a choice between well-established BGs and a new product, contractors may gravitate towards the known in the absence of any remedial intervention.

#### **Suggested Remedy:**

The industry, at the behest of the Ministry of Road Transport and Highways of India (“MoRTH”) and other relevant authorities, may carry out soft interventions such as promoting awareness/training sessions for contractors. Additionally, the insurance companies could collectively create an awareness and outreach campaign. To facilitate effective dissemination of information, the MoRTH and other authorities can facilitate required contact between contractors and insurance companies. Thus, collaborative efforts by the industry and the Government could remove the lack of awareness regarding surety bonds.

#### 2. Challenges in pricing of surety bonds

Globally, insurers take certain factors into account for providing approval to select contractors:

- capital (analysis of financial statements),
- capacity (analysis of work history), and
- character (analysis of contractor reputation).<sup>38</sup>

The cost of a surety bond tends to be market-driven and can vary based on the underwriter’s assessment of risk associated with a contractor.<sup>39</sup> Surety bonds are also priced using actuarial analysis, which relies on past data to ascertain the likelihood of default and the bond being called upon, so that pricing can be adjusted for possible losses and costs.<sup>40</sup> Since this is a new product, this data is absent from the Indian surety bonds

<sup>37</sup> *Supra* note 13.

<sup>38</sup> *Supra* note 2, paragraphs 4.33-4.35.

<sup>39</sup> *Supra* note 2, paragraph 4.37.

<sup>40</sup> The Actuarial Club, *Surety Bond: How Do They Actually Work & Actuarial Considerations*, available at <https://theactuarialclub.com/2023/06/25/surety-bond-how-do-they-actually-work-actuarial->

market, which poses a pricing challenge for insurance companies.<sup>41</sup> For other insurance products, reliance on international technical experience in underwriting and pricing helps overcome this challenge.<sup>42</sup> Commentators suggest that this strategy may not be directly transferrable to the Indian context.<sup>43</sup>

This would mean that certain losses may have to be incurred by insurance companies and written off to gather data and eventually see success in this product. Additionally, contractors and insurance companies appear to have a mismatch in expectations with regard to the pricing range of surety bonds.<sup>44</sup> Insurance companies have indicated that surety-bond purchasers' unwillingness to pay adequate premium or provide collateral has made it difficult to launch the product. It has also been pointed out that insurers may find it unsustainable to offer surety bonds at a cheaper price than BGs, especially because it is new and not much historical data is available. For insurers, the economic viability of surety bonds may be doubtful without the financial comfort of pricing, collateral, and reinsurance.

### **Suggested Remedy:**

As surety bonds are a new and untested product, it is likely that insurance companies would require certain facilitating elements such as reinsurance support, and collateral to provide surety bonds. Insurers may even require premiums that are not substantially cheaper than BGs, especially until the product takes off and they gain more experience. For insurance providers, these considerations are crucial from the perspective of maintaining solvency and pursuing profitability.

The 2022 Guidelines address issues of risk mitigation for insurers by prescribing an underwriting philosophy with restrictions on solvency ratio and management of exposure. However, insurers will be likely to manage risk through higher pricing of the surety bonds, which they can mitigate only if in possession of adequate risk-related information. To facilitate information sharing, the Working Group suggested:

- (i) collaboration between insurance companies and banks (likely to have existing records); and
- (ii) creation of a centralised database for information related to surety bonds.

This may assist insurers in collecting information regarding the contractor's key financial indicators, credit history, and working capital condition. Additionally, NHAI too could make

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[considerations/#Actuarial\\_Considerations](#) (accessed on 17 February 2024).

<sup>41</sup> *Supra* note 16.

<sup>42</sup> Hari Radhakrishnan, *Surety Insurance in India - The Road Ahead*, LinkedIn, 23 January 2023, available at <https://www.linkedin.com/pulse/surety-insurance-india-road-ahead-hari-radhakrishnan> (accessed on 17 February 2024).

<sup>43</sup> *Id.*

<sup>44</sup> George Mathew, *Surety Bonds Market Fails to Kick Off*, The Indian Express, 25 September 2023, available at <https://indianexpress.com/article/business/market/surety-bonds-market-fails-to-kick-off-8954407/#:~:text=The%20ambitious%20plan%20of%20the,to%20technical%20and%20financial%20impediments> (accessed on 1 February 2024).

the data available for creation of a centralized database. NHA is in a unique position to share data on the performance of different contractors with regards to completion of projects as per schedule. While data from Banks could disclose whether or not a contractor has defaulted in the past or how many of them have done so; data from NHA could add the parameter of punctuality and incentivise cheaper premia for high performers on this parameter.

If implemented, highlighting these alternatives may require awareness-building initiatives among contractor entities who may not otherwise see a reason to transition to surety bonds.

### **3. Conditionality of surety bonds**

The encashment of BGs is well-settled and lends certainty to project owners, allowing for relatively smooth conduct of commercial transactions. Global experience has shown that enforcement of a surety bond is fraught with more difficulty.<sup>45</sup> As an insurance company, the surety is generally required to be convinced of the underlying default before it admits liability.<sup>46</sup> This is in contrast to BGs, especially unconditional BGs, which can be practically encashed “on-demand”.<sup>47</sup> To convince itself of the underlying default, the surety usually investigates the project, halting construction for a lengthy period, leading to delays in the overall timeline. If the surety denies liability, legal action may follow and the surety would retain its funds until a decree, halting operations further. The certainty found in litigation involving BGs may also not be found in litigation over a surety bond, considering this financial product is quite new in India. Thus, the conditionality and associated costs of surety bonds are another challenge to its wider acceptance.

#### **Suggested Remedy:**

Addressing the challenge posed by the conditionality and associated costs of surety bonds requires a multifaceted approach. One suggested remedy is to improvise the existing framework to include clear guidelines for determining default, expedited procedures for surety investigation, and mechanisms to minimize project disruptions during the investigation period. Additionally, providing incentives for sureties to promptly resolve disputes and expedite the release of funds in cases of non-liability could help mitigate delays and operational halts. Furthermore, enhancing legal clarity and certainty surrounding surety bond enforcement through targeted legislative and judicial reforms (as detailed below) can foster greater confidence in the use of surety bonds, thereby promoting their wider acceptance in commercial transactions.

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<sup>45</sup> *Supra* note 5.

<sup>46</sup> *Supra* note 5.

<sup>47</sup> *Supra* note 19.

#### 4. Legal framework and recovery of claims

Discussion around the surety bonds (as an insurance product) suggests these four legal challenges perceived by the insurance providers: (i) lack of clarity on right of subrogation and indemnity, (ii) no recourse under the Insolvency and Bankruptcy Code, 2016 (“**IBC**”), (iii) low priority treatment in recovery of claims, and (iv) contract enforcement record in India.<sup>48</sup>

##### a. **Right of subrogation and indemnity**

Commentators suggest that confusion exists in the industry regarding the surety’s right of subrogation and the contractor’s obligation to indemnify the surety.<sup>49</sup>

The 2022 Guidelines established surety bonds as contracts of guarantee.<sup>50</sup> Under the Indian Contract Act, 1872, a contract of guarantee under Section 126 has an implied promise to indemnify the surety, giving the surety the right to recover payment from the principal debtor.<sup>51</sup> Upon invocation of a guarantee, it is well-established that the corollary contract of indemnity would kick in, resulting in the guarantor stepping into the shoes of the creditor pursuant to its right of subrogation.<sup>52</sup> The 2022 Guidelines established surety bonds as contracts of guarantee, which would suggest that an implied indemnity may be inherent to such bonds. However, despite this legal analysis, the general perception is that such bonds do not require an obligation of indemnity for contractors, which could be acting as a deterrent for insurance providers who are sceptical of making recoveries.

Globally, despite the differences, surety bonds and BGs share a crucial similarity – if default occurs, the defaulting contractor will be obligated to indemnify the bank/surety for payment/performance done on its behalf.<sup>53</sup> The obligation to indemnify may have the potential to cause financial setbacks to a contractor, depending upon the financial strength and asset size.<sup>54</sup> Since default can be catastrophic, the contractor is usually highly motivated to meet its obligations rather than pay up after default on the obligation.<sup>55</sup> This means that if the indemnity obligation is clarified, it will act as further incentive to the contractor to adhere to its contractual obligations.

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<sup>48</sup> *Supra* note 16.

<sup>49</sup> *Supra* note 11.

<sup>50</sup> Clause 4.1, 2022 Guidelines.

<sup>51</sup> Sections 126 and 145, The Indian Contract Act, 1872.

<sup>52</sup> *Orbit Towers Pvt Ltd v. Sampurna Suppliers Pvt Ltd*, C.P (IB) No. 2046 /KB/201; Varun Tandon and Divij Kumar, *Treatment Of Contract Of Guarantee Under Ibc: Unrest Amongst Creditors*, Mondaq, 11 May 2020, available at <https://www.mondaq.com/india/contracts-and-commercial-law/930636/treatment-of-contract-of-guarantee-under-ibc-unrest-amongst-creditors> (accessed on 17 February 2024); Rita Lowe, *Guarantees: Rights of Subrogation*, CMS-Law Now, 18 December 2007, available at <https://cms-lawnow.com/en/ealerts/2007/12/guarantees-rights-of-subrogation> (accessed on 17 February 2024).

<sup>53</sup> *Supra* note 5.

<sup>54</sup> *Supra* note 5.

<sup>55</sup> *Supra* note 5.

### Suggested Remedy:

The Working Group noted that the 2022 Guidelines should explicitly provide for a right of subrogation.<sup>56</sup> Although the 2022 Guidelines do not reflect this recommendation, some may consider that it may still be implied from the nature of surety bond as a contract of guarantee. However, for abundant clarity and legal certainty, the 2022 Guidelines may be amended to reflect this implication. The Working Group had suggested the need to modify the general indemnity agreement to a specific surety-based indemnity agreement, but it is unclear how this has played out in practice.<sup>57</sup> This requires a deeper analysis based on real terms and conditions of the average surety bond product in the market. Such an analysis will determine if the legal analysis holds relevance and strengthen the case for a clarificatory amendment.

### b. Recovery of claims under IBC

When the contractor defaults on their obligation, and the surety has fulfilled the guarantee obligation, the surety will make a demand on the contractor to indemnify them, pursuant to a clarification in the 2022 Guidelines that such a right of subrogation exists, if implemented as suggested above. In this case, if the contractor does not pay up, the surety could proceed in two ways: (i) initiate insolvency proceedings if the conditions provided in insolvency law are satisfied, or (ii) initiate legal action under debt recovery laws in India. Commentators have voiced concern that debts owed to general insurance, including a surety bond, may not be treated as “financial debt” under Section 5(8) of the IBC.<sup>58</sup> This leads to the possible right of the insurance provider to recover claims upon deciding to pursue insolvency proceedings against the contractor.

### Suggested Remedy:

As the 2022 Guidelines establish that surety bonds are contracts of guarantee,<sup>59</sup> the guarantor, pursuant to the right of subrogation, would ordinarily assume the position of the creditor and become eligible for indemnification due to fulfilling the contractual obligations or making payments. Arguably, then, it would be treated as a creditor under the IBC if the contractor defaults in indemnification. However, a clear right of subrogation is yet to be clarified in the 2022 Guidelines. Similarly, upon default on a BG, banks can presently convert any debt the principal debtor owes them into a loan recovery under the IBC.<sup>60</sup>

The definition of “financial debt” includes “*any counter-indemnity obligation in respect of a guarantee, indemnity, bond, documentary letter of credit or any other instrument*”

<sup>56</sup> *Supra* note 2, Chapter V, Recommendation 4(e).

<sup>57</sup> *Supra* note 2, Chapter V, Recommendation 4(c).

<sup>58</sup> *Id.*

<sup>59</sup> Clause 4.1, 2022 Guidelines.

<sup>60</sup> *Supra* note 2, page 67.

*issued by a bank or financial institution*".<sup>61</sup> The debt the principal debtor owes a guarantor ought to be included within the scope of financial debt recoverable under IBC to strengthen the remedies available to sureties.

In its current design, the surety bond may not ordinarily constitute a "financial debt" that the principal debtor owes to the surety (assuming subrogation is permitted for such surety bonds). The surety cannot claim a better right than what was originally available to the project owner when taking on the project owner's responsibility to recover of monies from the principal debtor. In the absence of any lending-borrowing transaction between the project owner and the principal debtor, the surety cannot inherit the qualification of a financial creditor upon subrogation. Accordingly, invocation of a surety bond does not oblige the principal debtor to repay the surety, to constitute financial debt under Section 5(8) of the IBC. The Supreme Court in *Anuj Jain v. Axis Bank Limited*<sup>62</sup> held that to constitute a "financial debt" under the IBC, the essential criterion is the need for 'a disbursement against the consideration for time value of money'. Therefore, while financial debt may include any of the methods for raising money or incurring liability as prescribed in sub-clauses (a) to (f) of Section 5(8) of the IBC, such a method would fall within the ambit of "financial debt" only if it is essentially a disbursement against the consideration for time value of money.

The Working Group recommended inserting of an explanation to the definition of "financial debt" to this effect. It also suggested that insurers may choose to obtain personal guarantees from promoters of the contractor entity for comfort and explore alternatives in reinsurance to limit their exposure.<sup>63</sup>

### c. Low priority in recovery of claims under IBC

Sureties that face default by the principal debtor should be categorised as "financial creditors". For distribution purposes under the IBC, their priority would hinge on the existence of security outlined in the indemnity contract.<sup>64</sup> Given that the objective is to prevent capital from being locked in as a security interest under BGs, surety bonds are likely to be unsecured contracts. Consequently, surety bond issuers are likely to be unsecured creditors, receiving a lower priority than secured financial creditors,<sup>65</sup> which may act as a disincentive for insurance companies.

However, as surety bonds are a relatively new product untested in the market, the insurance companies may hesitate to provide surety bonds with low premiums as stakeholders expect.<sup>66</sup> Secured surety bonds may emerge as a response to this discrepancy, particularly where the contract value is substantial, which could lead to

<sup>61</sup> Section 5(8), Insolvency and Bankruptcy Code, 2016.

<sup>62</sup> *Anuj Jain v. Axis Bank Limited*, ((2020) 8 SCC 401).

<sup>63</sup> *Supra* note 2, Recommendation 3 and paragraph 1.12.

<sup>64</sup> Section 3(30), Insolvency and Bankruptcy Code, 2016.

<sup>65</sup> Section 53, Insolvency and Bankruptcy Code, 2016.

<sup>66</sup> *Supra* note 2, paragraphs 4.33-4.35; *Supra* note 45.

the establishment of a security interest within the surety-principal debtor indemnity relationship. This, however, raises a legal issue.

The definition of “secured creditor” under the IBC depends on the definition of “security interest”, which excludes performance guarantees from its ambit.<sup>67</sup> This means that if the contract of indemnity were secured, the insurance provider may still be excluded from it as surety bonds are like performance guarantees. This may be a concern for those insurance providers requiring collateral for provision of surety bonds in their products, as their priority as secured creditors is not certain. Because the product is new, the signalling effect to insurance companies could be that despite contracting for priority they will not be assured of priority treatment, which could totally discourage insurance providers from venturing into the surety bond market.

Further, proposing ‘secured surety bonds’ may challenge the fundamental premise of surety bonds as being financial products which do not lock up capital.

#### **Suggested Remedy:**

To address concerns about insurers being treated as “unsecured creditors” given lower priority and the omission of surety bonds (as “performance guarantees”) from the definition of “security interest”, it may be required to revisit the definition of “security interest” in the IBC and make appropriate amendments. The Working Group had recommended that surety bonds be explicitly incorporated into the IBC and treated on par with BGs to reassure insurers, thereby encouraging them to provide surety bonds.<sup>68</sup>

While secured surety bonds would lock up a certain amount of capital, surety bonds can still be more economically viable than BGs. Banks can require 50–100 per cent of the contract value as collateral to provide the BGs, whereas insurance companies demanding 20 per cent or less of the contract value as collateral still frees up considerable amount of working capital for the contractors. This would meet the objective of keeping more capital unlocked, relative to BGs, while still providing comfort to insurance companies. By securing the obligations of the contractor with collateral and reinsurance alternatives, insurance companies may even be able to relax the requirement for higher premiums. With growing confidence in the product and relevant contractors, insurance companies may start to grant collateral waivers in due course.

#### **d. Issues in contract enforcement in India**

If it is not possible or appropriate to pursue an insolvency proceeding against the contractor, the surety may initiate legal action under debt recovery laws. In case of any other contractual dispute, the surety may also initiate legal action outside the

<sup>67</sup> Section 3(31), Insolvency and Bankruptcy Code, 2016.

<sup>68</sup> *Supra* note 2, Chapter V, Recommendation 4 (b).

insolvency process. In both cases, the certainty of contractual enforcement has an important signalling effect for insurers.

Surety bonds are common instruments in developed countries such as Singapore, Japan, the United States, etc., where contract enforcement has significantly more public confidence than in India.<sup>69</sup> In 2020, India ranked only 163rd out of 191 countries in the Contract Enforcement indicator – where higher ranking (i.e., a lower numerical value) implies better contract enforcement.<sup>70</sup> In India, the legal issues indicate that the enforcement of surety bonds may become a lengthy, complicated, time-consuming and expensive process for all parties.

Lagging progress attributable to judicial delays – owing to long-pending vacancies, backlog of cases, and procedural delays by parties – has dampened faith in contract enforcement.<sup>71</sup> Before surety bonds were introduced in the construction sector in 2022, litigation related to surety bond was restricted to the unrelated areas of “bail bonds” or “decree bonds”.<sup>72</sup> Consequently, the untested product of “surety bonds” may face significant legal disputes related to enforcement methods its initial years until legal precedents are established. Therefore, even where other legal challenges are addressed, accessing those legal remedies will hinge on improvements made to address the issue of judicial delays.

### **Suggested Remedy:**

Enforcement of contracts related to surety bonds is directly linked to larger dialogue on judicial reforms in the country. These judicial reforms should prioritize streamlining legal procedures, reducing case backlogs, and ensuring timely resolution of dispute. Additionally, there's a need to strengthen the infrastructure of the judicial system, including the use of technology for case management and dispute resolution. Moreover, measures to enhance transparency, accountability, and consistency in judicial decisions can further bolster confidence in contract enforcement mechanisms. By implementing comprehensive judicial reforms, India can significantly improve its business climate, attract investment, and promote overall economic growth.

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<sup>69</sup> *Supra* note 2, paragraph 4.2.

<sup>70</sup> Department of Justice, *Enforcement Indicator – Ease of Doing Business*, 2020, available at <https://dashboard.doj.gov.in/eodb/> (accessed on 17 February 2024).

<sup>71</sup> *Id.*

<sup>72</sup> *UCO Bank vs. Jawahar Rice and General Mills and Ors.*, AIR2006J&K57; *The State of Maharashtra vs. Dadamiya Babumiya Sheikh and Ors.*, AIR 1971 SC 1722.

#### IV. Suggested Next Steps

In the previous section, some problems have been identified and remedies have been suggested. However, their implementation requires further research and some tangible next steps. While general policy issue regarding contract enforcement in India can be tackled through broader judicial reforms initiatives, some of the challenges discussed in this paper may require clarification from the concerned authorities in the form of amendments to existing laws. Also measures should be taken to facilitate dialogue between different stakeholders. By adopting a multi-stakeholder and solution-oriented approach, this section sets out the possible next steps that can help in improvising the market response to surety bonds in India:

S. No.	Issue identified	Objective	Expected outcomes	Actionable (including nodal Ministries/ Government departments)
1.	<b>Awareness about surety bonds</b>	<p>Building awareness among contractors on the terms required to make surety bonds viable and providing analysis of long-term benefits.</p> <p>Reducing information deficit by conducting awareness sessions, creating intermediaries, and a database of regulated insurers.</p>	Better understanding by contractors and relative harmony between stakeholders on the acceptable terms of surety bonds.	<ol style="list-style-type: none"> <li>1. Conducting workshops for various government departments on the functioning of surety bonds and its advantages.</li> <li>2. Conducting awareness sessions for contractors by the MoRTH; Ministry of Railways and other such ministries directly connected to infrastructure development.</li> <li>3. Maintaining a government-supported database of insurers who can be approached.</li> </ol>

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S. No.	Issue identified	Objective	Expected outcomes	Actionable (including nodal Ministries/ Government departments)
2.	<b>Challenges in pricing of surety bonds</b>	Set up initiatives to boost collaboration between insurance companies and banks for data sharing; accelerate the creation of a centralised database under law to collect information related to surety bonds.	Improved risk mitigation through availability of risk information for pricing of surety bonds.	<ol style="list-style-type: none"> <li>1. Roundtable discussions with Indian Banks' Association, National Highways Authority of India and IRDAI to formulate means of collaboration on data sharing with non-banking company insurers.</li> <li>2. Discussion between Department of Financial Services ("DFS"), IRDAI, and Ministry of Law and Justice to enable the creation of a centralised database.</li> </ol>
3.	<b>Recourse mechanisms: Right of subrogation and indemnity</b>	<p>Examining surety bond products and market practice to determine the use of indemnity agreements.</p> <p>Increasing awareness on remedies and clarification regarding the existence of the right of subrogation and indemnity as intended by the Working Group.</p>	Improved awareness about recourse mechanisms among insurance providers to encourage greater availability of surety bond products.	Consultations between DFS, IRDAI, and industry members to understand market practice on recourse mechanisms and undertake clarificatory amendments to legislative instruments.
4.	<b>Recovery of claims and low priority of claims under IBC</b>	<p>Increasing awareness on applicability of IBC to insurance providers, vis-à-vis defaulting contractors.</p> <p>Examining market feedback on priority of claims for insurance providers under IBC.</p>	Clarity on the applicability of IBC and enhanced protection to insurance providers as sureties.	Consultations between DFS, IRDAI, Ministry of Corporate Affairs, and industry members to seek feedback on applicability and interpretation of rights under the IBC, including necessary amendments to IBC, if required.

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