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Contract of Suretyship in Nepal: Analysis with Provisions and Precedents

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ABSTRACT

The superstructure of guarantee contract stands on the basis of the Surety who takes responsibility of principal debtor and ensures to perform liability to the Creditor in case the debtor defaults. The purpose of this study is to analyze the role of surety in the contract of suretyship on the basis of legal frameworks and judicial decisions of Supreme Court of Nepal and common law countries. As a doctrinal Research, it will adopt exploratory doctrinal and analytical research design. It is based on the doctrinal sources. It uses the qualitative data; collected from both primary as well as secondary sources of law.

1. INTRODUCTION

Contract of Suretyship is specific types of contracts. The Surety (Guarantor) has to play a significant role to conclude and perform the contract; therefore, it is also known as contract of Guarantee. The superstructure of guarantee contract stands on the basis of the Surety who takes responsibility of the principal debtor and ensures to perform liability to the Creditor in case of defaults of the principal debtor. In this work, the term Guarantee is used interchangeable with Suretyship.

The Nepalese contract law provides that, in case a third party provides guarantee under the above situation and in case the person who has to repay the loan does not repay it or fulfill the obligation to be fulfilled, the person guaranteeing such loan or obligation shall repay the loan or fulfill the condition according to the contract. Such Contract relating to guarantee must have been concluded in written form and the terms and conditions are determined by the contract (Civil Code (S.563), 2074 B.S.).

Contract of Suretyship is a tri-partite contract. The parties involved in this contract are: Creditor, Surety and Debtor and three contractual relations can be established between these three parties with each other. The Surety has to assure the Creditor to repay the debt in case of default by the debtor. The debtor is primarily liable to repay the debt and the Surety will be liable secondarily, only when the debtor defaults. That is why, the debtor is called 'principal debtor' and Surety is called 'favored debtor'. It is necessary to study the role of Surety in the contract of Guarantee in Nepalese Context as there are some amendments and additions in the new law of contract of 2074 B.S. This paper is an attempt to analyze positive role of the Surety as an important party in the Contract of Suretyship, on the ground provided by the Nepalese legal provisions and the precedents in this regard.

There are a number of literatures regarding this area. But there is found no such work published and based on the current provisions and precedents. The analysis will be based mainly on the law relating to contract of Suretyship provided in Chapter 7 of Part-V of Muluki Civil Code 2074 B.S. Theoretically, the contract of Suretyship was established by the common law courts. In the case of *Birkmyr V. Darnell* of 1704, the English court held that, when a person buys goods on credit, the other person promises to pay the price if the buyer does not pay; this type of a collateral undertaking to be liable for the default of another is called a contract of guarantee.

In the case of *Swan V. Bank of Scotland* of 1836, the court held that a contract of guarantee is a tripartite agreement between the creditor, the principal debtor, and the surety. Therefore, a contract of Suretyship owes three characteristics- (a) There must be a distinct promise by the surety to be answerable for the liability of the Principal Debtor. (b) The liability is enforceable only when the liability of the principal debtor is legally enforceable, the surety can be made liable. But, a surety cannot be made liable for a debt barred by statute of limitation. (c) The consideration in such a contract is nothing but the promise to do something for the benefit of the principal debtor may be sufficient consideration for Surety.

A Surety is someone who agrees to take responsibility for the debt, default or miscarriage of another. It is one of the major sorts of specific contracts practiced in the business sector. The main objective of this contract is to enable the debtor to acquire the debt. The role of the Surety is to backing the principal debtor in the course of loan transaction.

After the enactment of Contract Act 2056 B.S., the contract of Suretyship, one of the specific contracts, was arranged in Nepalese contract law. The erstwhile Act Relating to Contract

2023 B.S. was silent, but the Muluki Ain of 2020 B.S. and banking laws have made some provisions in this regard. In this paper, discussion is made not only on the provisions but also the precedents relating to guarantee contract. Particularly, the paper will be concentrated to analyze the role of Surety in contract of suretyship provided in the Muluki Civil Code, 2074 B.S., (Chapter-7 of Part V). The objectives of this work are: -

- i. To review the provisions and precedents relating to contract of Suretyship.
- ii. To analyze the roles, responsibilities and discharge of Suretyship.

2. METHODOLOGY

As legal research it is based on doctrinal sources. Being a Qualitative Research, this study is based on analytical approach and critical appraisal of the judicial decisions and legal frameworks in Nepal. It will use the qualitative data; collected from both primary as well as secondary sources of law.

Primary Sources: This article uses legal frameworks contained in the concerned statutes such as Muluki Civil Code, 2074 B.S., (Part-V); Contract Act, 2056 B.S.; provisions provided in Muluki Ain, 2020 B.S. and judicial decisions of the Supreme Court of Nepal as primary sources of data. **Secondary Sources:** The books, articles, cases, critique, analysis and interview of law experts published in law journals used as secondary sources of data.

Source and Technique of Data Collection: The data for this study are acquired purposively from the legal provisions from Rajpatra and case laws from Nepal Kanoon Patrika, the government publications. There are provisions of general contract and specific contracts (Civil Code 2074 B.S., Part-V and the Contracts Relating to Bailment; Pledge or Deposit; Agency; Carriage of Goods; Lease; Hire-purchase; Wages; Indirect or Quasi-Contracts; and Unjust Enrichment). Among them, the Contract of Suretyship is purposively selected as sample for this study.

Limitation of the study: This paper is based on the literary works. The study is based mainly on the provisions and precedents of contract of Suretyship. It is focused on and limited to the laws on 'the Contract of Suretyship' in Nepal.

3. RESULT AND DISCUSSION

3.1 Nepalese Legal Provisions on Suretyship

Muluki Ain 2020 B.S.: The provision of Jamani Garneko is provided in the Muluki Ain 2020 (the then Common Code of Nepal) for the purpose of providing some rules regarding Guarantee. This Chapter has 12 sections. This provision is arranged only for public official arrangement not for the business transactions.

Recovery of Debts of Banks and Financial Institutions Act, 2058 B.S.: Section 26 of this Act contains about liability of guarantor that 'the liability of a guarantor furnishing guarantee for a borrower shall be limited only to the amount of guarantee furnished. Notwithstanding

anything contained in the prevailing law, the liability referred to in this provision may be realized directly from the guarantor.

Contract Act 2056 B.S.: Chapter- 4 (Sections 15-21) of the Contract Act 2056 B.S. has managed the contract of Guarantee as a specific contract in a separate chapter. It has provided definition, liability of guarantor, and termination, relation with the debtor, substitution of Creditor and equal sum liability. The Act Relating to Contract of 2023 B.S. had not given any provision of Contract of Suretyship.

Muluki Civil Code, 2074 B.S.: The Chapter 7, Part V of Muluki Civil Code, 2074 B.S. has clearly provided provisions relating to this contract. Section 563 contains that, 'if a contract is made by which a third party undertakes to repay the loan borrowed by or discharge the liability promised by a person in case of that person's default, a contract of Suretyship shall be deemed to be made.'

This law has provided provisions on liability of Surety; discharge of Surety; continuing guarantee; relationship between the Surety and debtor; substitution of Creditor; revocation of guarantee by Surety; equal liability of co-sureties. Such broader provisions were not provided in the erstwhile Contract laws.

If the third party gives the guarantee pursuant to above circumstances and the person fails to repay or discharge such loan or liability, the Surety must repay the loan or discharge the liability according to the terms and conditions of the contract. The terms and conditions of guarantee shall be as determined in the contract. This provision is an addition in this Act. Such a contract of guarantee must be made in written form; otherwise, such liability is not enforceable by court. This Act of 2074 B.S. has substituted Jamani Garneko Mahal (the provision of Suretyship) of the erstwhile Muluki Ain of 2020 B.S.

3.2 Role of Surety in Creating Contract of Suretyship

Surety has to play a significant role to conclude the contract of Suretyship. The superstructure of contract of guarantee stands on the shoulder of the Surety.

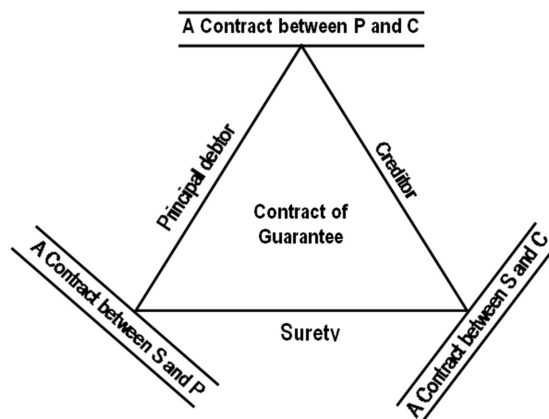


Figure 1: Creation of Contract of Suretyship

Source: This Figure is derived from 'Principles of Business Law' (Kalika, 2018)

Here, S stands for surety, P for Principal and C for Creditor. It is three-party contract, where three parties, S, P, and C, are involved. They are bound in a triangular relationship and three collateral contracts come into existence. They can be depicted in the following figure (Kalika, 2018 A.D.).

According to Section 563 of Muluki Civil Code, 2074 B.S. the surety's liability shall be created as follows:

- a. The liability of the surety shall arise as soon as the principal debtor fails to discharge the liability (to be discharged by Principal Debtor).
- b. The liability of the surety shall be the same as that of the liability of principal debtor. The surety shall remain liable until the principal debtor becomes free from the liability.
- c. The liability of the surety shall not be discharged merely because the principal debtor becomes free from the liability by operation of law.
- d. Notwithstanding anything contained above, if both security and guarantee have been given for any loan or liability, the surety shall not be liable to the extent covered by the security so provided.

In the case of *Shakuntala Homagain v. Rastriya Banijya Bank (2065 B.S.)*, Supreme Court of Nepal mentions the essentials of a valid contract of Guarantee. There must be dues of debt between the bank and debtor; the agreement of guarantee must be between bank and surety; the surety let to sell the collateral; the principal debtor is primarily liable; the surety is secondarily liable after default of principal debtor; the contract must be legally valid and the contract must not be against contract law.

The Supreme Court of Nepal held a verdict in the case of *Damodar Ropeways and Construction Co. v. Ministry of Finance, HMG. (2072 B.S.)* that the time and place of creation of liability of surety is determined by the terms of contract. The liability of surety is always secondary. It will arise only when the principal debtor defaults. Before starting liability of principal debtor, no liability of surety will arise. The contract of suretyship cannot be without condition and should be interpreted in entire context.

Here is better to see the expression made by M. L. Tannan that emphasizes the important role of the Surety in the business sector. 'When banker advances are not secured by means of collateral, securities and the personal security of the borrower is inadequate, Guarantees play an important role'. Tannan further adds 'The need for this form of security arise not only when an application for loan cannot offer any tangible security, but also, when the banker finds that the position of the customer indebted to him has weakened as a result of the depreciation in the value of the collateral security deposited thus leaving the banker's advance inadequately secured' (Tannan, 1993 A.D.).

There are, some forms of trade practices in the following circumstances, no strong role of Surety is existed at the time of creation. This attempt also helps to distinguish a 'guarantee' from other guarantee like business activities.

3.3 Role of Surety Extinguishing Liability

According to Section 564 (3-4) of Muluki Civil Code 2074 B.S., a Contract of guarantee shall be effective immediately when the principal debtor breaches the obligation of repayment or discharging liability to the creditor, and the creditor may cause the surety to discharge such liability. The term 'creditor' means a person who has lent a loan, and this term includes a person who is entitled to obtain any benefit from, or have any act done, by the person who is bound to repay the loan or discharge the liability.

However, the creditor shall give a notice to the principal debtor to perform the contract according to its terms and conditions before claiming the surety under the contract of guarantee for the fulfilment of the obligations according to the contract.

The Surety promises to undertake others liability that has to be fulfilled. Except otherwise provided, the liability of the Surety is coterminous with that of the principal debtor. Until and unless the default of principal debtor, there is no liability of Surety is raised. The Surety should not extinguish his liability, if principal debtor's primary liability is extinguished by the specific performance or any other modes. In the circumstances of void or unenforceable contract of Creditor with principal debtor, the Surety shall not to play any role to extinguish the liability (Coutts & Co. V. Browne Lecky, 1947 A.D.).

The liability of the Surety may differ case to case because of its special nature. There arises a question of creation of Guarantee, whether the risk assumed by the Surety is only the default of principal debtor as it is extended to the invalidity and or unenforceability of the principal contract itself.

Himalayan Bank Ltd. V. Nepal Bank Ltd. (2075 B.S.): when a bank gives guarantee in the name of the beneficiary party, it creates liability independently, and not affected by the source agreement even though its main source is disputable between the parties.

Here is better to see some cases how Nepalese court has made liable the Surety and determined its extinguishing role. The case of Nanda Gopal Rajbhandari V. HMG, office of the council of Ministers and others (2040 B.S.) supports the principle of secondary liability of Surety. The court has given verdict that- 'whenever the debt isn't recovered from Principal Debtor the Surety will be liable. If liability of Principal Debtor is not properly determined, there is no question of determination of the liability of Surety.' The legal principle is that surety's liability is co-extensive to the liability of Principal Debtor. It is also accepted by the case of Swamilal V. Batukprasad.

Swamilal Shrestha and others V. Batukprasad, General Manager of Indhan Sasthen, 2055 B.S.): When entire debt could not be recovered from the sale of property pledged by the principal debtor, then the Surety will be liable for remaining part of the uncovered debt. It means the liability of Surety is of secondary nature that was managed in the then provision of Jamani Garneko No. 6. The verdict in the case of Swamilal v. Batuk Prasad further interprets about the first action against Principal Debtor. The debtor is the causal party, its liability is of primary nature, that is why the first action is to be taken against the principal debtor and the liability of Surety is of secondary nature, therefore, secondary action is to be taken against the Surety. A single prosecution at a time against Principal Debtor & Surety is not the proper way of legal remedy for the protection of interest of the Creditor.

Ganesh Bahadur v. Baburam Giri and others, 2037 B.S.): The verdict of this case was in connection of No. 6 of the then provision of Jamani Garneko. The sale of property of Surety, before the sale of property of principal debtor, will be against the No. 6 of provision of Jamani garneko. Thus the leading case regarding Suretyship verdict by the Nepalese court has established supporting rule of primary liability of 'Principal debtor' and Surety was regarded as the 'favoured debtor'.

Ramsharan V. Agricultural Development Bank and others, 2052 B.S.): In the course of decision of this case the court has supported the obligatory aspect of Surety. The role of the Surety may be to pledge own property as a Guarantor and such property would not be free before the full payment of the debt to the Creditor.

Siva Gautam and others V. Toya Nath Pandey, 2046 B.S.): The verdict of this case has established a principle of Guarantee differently. A father is Surety of his son, separated under the rule of partition, is not discharged on the ground of relationship of the father and son. They have their own individual identity in the contract. Father, as a Guarantor has to fulfill his secondary liability created by the contract of guarantee.

3.4 Determination of the Surety's Liability

The section 564(1-4) of the current Civil Code of 2074 B.S. provides the provisions relating to the liability of a Surety under the contract of Guarantee. Except otherwise agreed in the contract the liability of the Surety is coterminous with that of the principal debtor. The liability of Surety shall emerge from the very time, when the principal debtor does not meet his liability (Civil Code, 2074 B.S., S.564 (1)(a)). The Surety is regarded as a 'favoured debtor' and is liable secondarily. The liability of the principal debtor is imposed on the Surety only after the non-performance of contract by the principal debtor. According to section 564(2) the liability of the Surety will be limited to the extent of security, if there is the guarantee of security of property as well as guarantee of liability. The liability of the Surety is not terminated simply because of termination of debtor on the ground of operation of law.

The Section 564(1)(c) provides that, discharge of principal debtor by operation of law (death or insolvency of Principal Debtor) does not discharge the Surety from his liability. The liability of Surety shall be continuing in the following circumstances:

- a. The Surety will be liable for the remaining part of the debt from the sale of security of the principal debtor.
- b. The Surety will be liable for the rest of the security in possession of the Creditor in case of loss of some of the securities.
- c. The Surety will be liable for any alterations if that is on the consent of the Surety, and that does not harm to Surety's interest.
- d. The Surety will be liable for the entire debt, if- the principal debtor is 'minor' or becomes 'insolvent' or his contingent death.

According to the sub-section 4 of Section 563 of Muluki Civil Code, 2074 B.S., the Surety will be liable only when he had promised in written form. The terms and conditions are determined by the contract. This is addendum in the current law of suretyship. The nature of Surety's liability can be as follows:

Co-extensive Nature of Liability: The liability of the Surety is of co-extensive nature (Unity Finance Ltd. V. Wood Cock, 1963). It is extended to the liability and duty as that of the principal debtor (Section 564(1)(b)). It means, the Surety will not be generally discharged from his liability sprang up from the Guarantee contract. It is a kind of duty of Surety to the Creditor promised at the time of concluding the contract.

Contingent and Secondary Nature of Liability: The liability is created or starts after the default of the principal. It is the turn of Surety known as favoured debtor, to look carefully at the default of Principal Debtor or contingent event to extinguish his liability. Such a type of liability is conditional on the contingent event, the bad intention or inability of the principal debtor. Its essence is touched in the (Section 564(1)(b)).

Limited Nature of Liability: The liability of Surety can be limited by the Surety and concerned parties by any condition or an exceptional provision by putting in the contract. Where security of property and guarantee of liability is provisioned at the same time in the contract the liability of the Surety is limited to the extent of the security. In the case of co-sureties, the liability may be limited to a fixed amount and time. Where there is Guarantee is of continuing nature that can be revoked by the Surety for future transaction before three months.

The court held in the case of Kamala Amatya V. Himalayan Bank Ltd. (2070 B.S.) that, as per the principle of suretyship, the liability of Surety will be for the remaining part of liability of the principal debtor after sale of the property pledged. Likewise, the Supreme Court held in the case of Lumbini Bank Ltd. V. Sangita Tripathi (2073 B.S.) that according to the principal of suretyship, the Surety is liable to pay the promised amount by selling his collateral only

when principal debtor defaults. The liability of Surety is limited to the extent of the amount accepted. The collateral is returned to the surety when he fulfils entire dues.

3.5 Role and Rights of Surety Discharging the Contract

A Surety in the Contract of Suretyship has to play a vital role for its natural termination. Because the Surety can motivate the principal debtor to fulfill primary liability, if not possible, he himself is to be ready to fulfil the secondary liability. The Surety is the 'favoured debtor' who has the interest entering into the contract adhered to the interest of the principal debtor.

By Relationship of Surety with the Principal Debtor: The Section 566 of the Civil Code has provided the provisions relating to the relationship between the Surety and principal debtor. Except otherwise provided, in the contract in relation to the surety and the principal debtor the following provisions shall be applicable.

- a. The surety can cause the principal debtor to repay the loan or discharge the liability according to the contract.
- b. If the principal debtor has given any property as security to the surety for the guarantee given by him while creating liability, the surety should play a role of Bailee without the consent of the principal debtor.
- c. If a guarantee is given for any loan or liability for any specific purpose, the object, nature or terms and conditions of the liability cannot be altered without the consent of the surety.
- d. The Surety has an 'implied contractual right' to be indemnified by the debtor against the liabilities he insures (Toussaint V. Martiannant, 1987). It is the general rule that, one who ensures expenditure at another's request that is entitled to indemnity or reimbursement.

By Enjoying Rights Against the Creditor, Principal Debtor and Co-sureties: A Surety can enjoy the rights against the Creditor after the fulfillment of entire liability. It is the Surety to substitute the Creditor, e.g., right of subrogation, indemnity.

Subrogation: According to Section 572, a Surety who is discharged from the entire debt is entitled to step into the shoes of the rights of creditor against the debtor and all the securities held by the Creditor in respect of the debt (Forbes V. Jackson, 1882 A.D.).

After the substitution the Surety not only can demand the security which is in the possession of Creditor, but also to ask all the rights of the Creditor after the creation of subrogation rights. Even though the liability of debt extinguishes, the security is notionally kept alive for the benefit of the guarantor, who is entitled to have it transferred to him. Right of subrogation of Surety is depended on the implied contract with the consent of the debtor. It is the right, protection in the interest of Surety. It is to prevent from unjust enrichment to the debtor, who would otherwise obtain the release of his securities without the payment of dues (Yonge v. Revnell, 1852 A.D.).

Indemnity: Section 571 has provided the right to be indemnified of the Surety can be enforced. After the fulfillment of the responsibility by the Surety on the default of primary liability, the duty of the debtor arises towards the Surety to pay the debt, interest of the debt, and any other charges or amount.

Where the above dues and liabilities is not fulfilled or repaid by the debtor, and need of prosecution for that, the Surety has the right to be indemnified of all those amount of debt, interest of the debt, expenses of prosecution recovering the dues and other expenses (section 571). The right to indemnity is not only provided in the statutes but also is the matter of the implied contract. After recovering of such expenses, the Surety will be discharge from the contract of guarantee of Suretyship.

In the case of *Saraswati Shrestha V. Sunrise Bank Ltd.* (2073 B.S.) the court held that, personal guarantee creates personal liability. It is not assignable to a third person without the consent of both of the parties.

Other Circumstances the Surety Discharges: Besides the above circumstances, there are other situations, provided in the section 565 of the Civil Code:

Except otherwise is expressed in the contract, in general, the following circumstances discharge the Surety from his liability. If -

- Any material alteration in the contract without the consent of Surety.
- Any contract of novation is made discharging the debtor from his liability.
- Any act of the Creditor which discharges the debtor by accord and satisfaction or extension of time bar to payment or not to prosecute.
- Any act of Creditor causes an adverse impact on the Surety's right to legal remedy against debtor.
- The Creditor losses, damages or returns any security obtained by him from the debtor to the extent of the value of that security.
- Any payment or fulfillment of the liability is made by the principal debtor.
- In case contract of suretyship was concluded by misrepresentation, or concealment of fact, or any co-sureties dissented (section 568).

However, the surety cannot be discharged from the liability:

- simply because effort is not paid by the Creditor or not followed the legal remedy against the principal debtor.
- in case of co-sureties, all the sureties are not discharged when any of the Sureties absolves from his or her liability.
- simply because of any dispute arises regarding the contract.

4. CONCLUSION AND IMPLICATIONS

Contract of Guarantee provisioned in the current law is a positive sign in the development aspect of Nepalese Business Law. It has amended erstwhile provisions and added some new provisions. Nepalese law has some distinct provisions than Indian law - Like provisions regarding the relationship between Surety and principal debtor (section 566), and wider definition of 'Sahu'/Creditor (section 564 (3)). There were some provisions in Contract Act 2056 B.S. and Muluki Ain, 2020 B.S. also had provisions for government official management. However, the provisions relating to contract of suretyship are not sufficient. There is room for reformation as per the need of time. Nepalese law of Guarantee has not provided clear provision regarding the consideration for Surety like in Indian law of Guarantee (Sec-127).

The contract of suretyship is pervasive in the business sectors that may be in banking, construction, trading and any other business areas. This article opens the door for the study of nascent provision of continuing guarantee, impact study of the provisions in past three years, comparative study of Nepalese laws with that of the common law countries. The business and management sectors may get benefit in business operation by the study of law of guarantee.

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