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A Review of the Civil Liability of Banks for Breaching or Failing To Fulfill the Contractual Obligations of Bank Finance

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ABSTRACT

One of the most obvious intersections between economics and law is financial and banking issues, one of which is concerned with monetary obligations and the breaching of these obligations. The contractual obligation of bank financing includes provisions that clearly define and establish the rights, liabilities and the obligations of both sides. Due to their top legal significance, these contracts are usually written by legal advisors and experts. These contracts include definitions, the loan amount, the manner in which the loan should be spent, the repayment deadline, the manner of settlement of possible disputes, the governing laws, and the dispute resolution offices. In terms of contractual liability, in case of violation of the contract, the sides are obligated to compensate. Finance is a type of foreign loan and must be paid to the provider along with its interests in a given time. The most important feature of finance is the non-involvement of the investor country in the benefits and losses of the projects to which the loan money goes. The purpose of the present study was to review the civil liability of banks for breaching or failing to fulfill the contractual obligations of bank finance.

Keywords: *Civil Liability, Obligations, Contract, Bank, Finance*

INTRODUCTION

In the domain of foreign financing, the issue of borrowing type of financing is usually interrelated to various legal forms including: international bank loans, securities, retention money, promissory note, and other borrowing related documents. The common feature between these borrowing documents is that all of them include a basic agreement by the lender on provision of the demanded amount and borrower's obligation for repayment of the received loan. In these methods, the borrower receives a loan from a lender institution and is obliged to pay the repayment installments in given times. In addition, in these methods the lender is not involved in ROI (Return on Investment) risk. In fact the borrower provides the lender with a guarantee letter from the government or a commercial bank obliging the guarantee issuer to compensate for negligence of the loan receiver. The funds of the subject of this category are considered as the debts of the government and or the banking system of the country due the guarantee. In general it can be stated that in the Islamic Republic of Iran, the government can legally borrow from domestic and foreign sources for the purpose of financing of infrastructural projects. If the government aims for financing through borrowing from the central bank or issuing bonds (government-issued securities), it is said that the government has taken a direct domestic borrowing action. However, if the government uses domestic finance sources or budget notes for financing its projects, it is said that the government has taken an indirect domestic borrowing action. Nevertheless, if the government aims to finance its projects through receiving intergovernmental loans and receiving loans from international institutions and, issuing currency bonds, it is said that the government has taken a direct foreign borrowing action.

One of the most conventional methods of foreign borrowing is foreign finance of projects. In terms of vocabulary, finance is defined as financial support. In Iran's legal concepts and laws, this concept is more exclusively defined as usage of credit lines for receiving loans from international financial institutions. In general, finance can be considered as a mechanism in which the borrowing country and the lender country sign a contract on supplication of the required manpower, technologies, machinery, equipment, raw materials, and financing of a project by the investor country; when the project becomes operational, the borrower commits itself to repay the entire costs of the project to the investor country. In this method, a certain amount agreed by the sides of the contract is borrowed from a country or institute by another country and the amount of the loan should be repaid to the investor along with the interests in a given amount of time (usually between 5 to 10 years). This method is an indirect investment method. In order for the lender to make sure of the on time repayment of the paid loan, receives specific credible guarantees from the borrower country. In this regard various methods are used one of which is incorporation of multiple countries or institutions in the payment of the loan; this puts more pressure on the borrower in case of occurrence of problems regarding repayment.

A finance contract is signed between various international loan provider sources and loan receivers after several negotiations and obtaining an agreement. In general, bank finance contract is a credit line provided for the Iranian Banks by foreign banks and institutions verified by the Central Bank of the Islamic Republic of Iran for the purpose of execution of new infrastructural, production and development projects as well as procurement of technologies, machinery, capital equipment, and technical-engineering services (Zamani, 2009: 96).

In many cases, breaching of contract results in occurrence of financial losses and based on the general rules governing contracts, the losses inflicted must be compensated. This is referred to as contractual liability. The contract law which is officially recognized by the majority of legal systems around the globe requires the sides of contracts to be committed to the obligations listed in the contract. In cases the committed party breaches its commitments; there would be losses that need to be compensated. Whenever the loss is inflicted by breaching of a contractual obligation, there is said to be contractual liability; and whenever there is no contractual relationship between the sides and a loss is inflicted through an action or nonfeasance, there is said to be a non-contractual liability (Katoozian, 2009:71).

The contractual obligation of bank financing includes provisions that clearly define and establish the rights, liabilities and the obligations of both sides. Due to their top legal significance, these contracts are usually written by legal advisors and experts. These contracts include definitions, the loan amount, the manner in which the loan should be spent, the repayment deadline, the manner of settlement of possible disputes, the governing laws, and the dispute resolution offices. In terms of contractual liability, in case of violation of the contract, the sides are obligated to compensate (Ghasem Zadeh, 2008:41).

In terms of contractual liability, one side of a contract may get exposed to losses due to breaching or failing to fulfill the contract provisions by the other side. In this case, the delinquent side is obliged to compensate the loss inflicted on the other side; unless it proves that the cause of its inability to fulfill its obligations was an inevitable accident. In terms of non-contractual liability, the sides of the contract consider no obligations for compensation for losses caused by breach of contract.

Considering the above mentioned content the purpose of the present study was to review banks' civil liability for breaching or failing to fulfill the contractual obligations of bank finance.

METHODS

In terms of purpose, the present study is considered as an applied sturdy and in terms of methods, it is considered as a descriptive-analytic study. The present study has been performed through library studies in addition to making use of several data banks and related articles. Once the research data were collected through library studies, they were inserted into the main study frame with the association of the supervising professor. It is worthy of mentioning that the data have been analyzed in descriptive and analytic fashions.

CIVIL LIABILITY

The necessary thing for realization of civil liability is existence of personal loss and a harmed person. The question that comes up here is that would there be an issue of compensation if a loss is inflicted on a person because his own fault or not? For example, a driver who negligently crashes and causes himself harms. Here, unlike what is usually assumed, there would be no civil liability since it is not rational to oblige a person to compensate for the losses he/she has inflicted on him/herself (Ansari, 2012: 177).

Based on the same logic that holds that a person cannot sign a contract with him/herself, he/she cannot be liable against him/herself. This is because there is only one person rather than a beneficiary and a liable person. But if there were two persons, one liable and the other beneficiary, then there would be a dispute that needs to be settled; this is the main constituent of the issue of civil liability. On this basis, the liable is a person responsible against another person and there would be civil liability when the liable has taken an action against the law or customs of society. Inflicting a loss on another person may be the result of an action or a nonfeasance. By nonfeasance it is referred to omission of a duty. Losses may be in either forms of defection or wastage of a property, or loss of interests. Most losses or compensated for by money and the necessity of compensation is based upon the law and social justice. According to the general legal principle, whoever inflicts a legally unauthorized loss on another person is obliged to compensate for it.

In most cases losses inflicted on others are caused by a direct action or nonfeasance of a person or the actions or duty omissions of other followers and dependent persons. Based on this content, civil liability can be defined as follows:

"Civil responsibility is defined as a person's obligation to compensate for the losses inflicted on others due to his/her direct actions or nonfeasance, and or the actions and duty omissions of other followers and dependent persons (Katoozian, 1999: 72).

FINANCING CONTRACTS AND ITS DIFFERENT VARIETIES

Types of International Contracts

Open contracts, closed contracts, residence contracts, refund contracts, commercial contracts, health contracts, postal contracts, multilateral contracts, bilateral contracts, friendship contracts, GENEVA contracts, political contracts, cultural contracts, customs unity contracts, consular contracts and etc. (Moosa Zadeh, 2010: 48).

Types of contracts of financing from international sources

According to the suggestions of the ministry of economic affairs and the organization of domestic management and planning, and with reference to the article 6 of the law of insertion of articles in laws, the board of ministers in May of 2006 approved the regulations of the aforementioned article.

Based on it and for the purpose if financing, the Iranian governmental corporations are allowed to take actions towards signing contracts with foreign and Iranian investors (Haratian Nejadi, 2015: 45).

The Iranian countries should provide their projects in the forms of developmental plans in related sectors along with reports on technical, economic and financial justification of the projects and counts that require the guarantee of government to the organization of domestic management and planning. On this basis, the ministry of economy takes action regarding guaranteeing the payment of contractual obligations of the Iranian Governmental Corporation once the plan is accepted by the foreign investment board.

Government's guarantee is not umbilical to the actions and liabilities of the Iranian corporations in their payment of their contractual obligations. In addition, the central bank of the Islamic Republic of Iran must ensure the compatibility of the receiving and payment methods with the investment methods listed in the article one of the regulation, and then it should inform the council of economy about the issue once the former compatibility is approved. Hence in the view of Iranian Law, the following five types of foreign investment are allowed in Iran:

- The direct investment method of finance
- The BOT (Build-operate-transfer) method
- Other similar methods (except for BOT (Build-Own-operate)) include:
  - Build-Own-Operate (BOO)
  - Build-Own-Operate-Transfer (BOOT)
  - Build-Lease-Transfer (BLT)
- Buy Back contracts
- Joint Venture

Investigation of types of contracts of financing from international sources

The Direct Investment Method of Finance

Financing from international sources is possible in two general forms:

- Corporate Finance
- Project Finance

The first type is accompanied by full commitment and the repayment of the financial obligations of the project is possible through the sum of assets of the corporations. The second type of finance is considered to be of limited commitment and even no commitment at all in some cases. In these contracts the source of repayment of the obligations of the project is the income yielded from the selling of the products and capitals related to the project. This type is more accepted by executive organs. Generally, finance is a short-term method of transfer of capital to the country because once the deadline on the repayment of the loan is reached; the amount of the loan must be repaid along with its interests. On this basis the most important condition in the context of receiving foreign loan is the allocation of the received loan to projects that are of economic justification and are accompanied by a logical ROI rate.

Finance contracts are signed by two sides one being an international lender and the other being a user of international loans after several negotiations are done and an agreement is reached. It generally includes provisions that establish and clearly define the rights, liabilities, and the obligations of the both sides. Since the sides of these contracts are located in two or multiple different countries each with a different judicial jurisdiction, the manner of adjustment of the legal sections, the governing laws and the offices of dispute resolution have constantly remained important issues. Hence in most contracts these counts are clearly defined and adjusted by the legal advisers and experts who write the contracts. These contracts include definitions, the loan amount, the manner in which the loan should be spent, the repayment deadline, the manner of settlement of possible disputes, the governing laws, and the dispute resolution offices and etc. which would be investigated in details in the upcoming chapters.

In summary, finance contracts hold that a foreign bank or an institution gives a loan to a specific country or corporation for the purpose of a specific operation and has no actual control on the manner in which the money is spent, hence the lender faces no commitment in terms of fruitfulness of the project and receives guarantees for the on time payment of the installments.

Finance and its Different Methods

The act of financing for commercial affairs, procurement and or investment is referred to as finance. Financing is aimed at undertaking economic activities in the contexts of commerce, production, service provision and supplication of the working capital for production and commerce organizations.

- Commerce such as import/export
- Production: for import of raw material and the machinery of the production line and other equipment
- Services: export of technical and engineering services
- Working capital: sources required for continuation of current activities in economic units: the required working capital is supplied through financing.

Most of developing countries have limited resources and in these countries the investors need to rely on the foreign capitals and other sources. However, the issue should be viewed from the perspective of the investor and it should be defined what composition of debt and capital must be used while financing.

Finance Sources

Sources of financing are in terms of time length divided into the three groups of short-term. Mid-term and long-term:

- Usance Refinance
- Finance
- Buy Back

If the foreign finance is granted under the guarantee of either of the government, the central bank, and or other financial institutes, it is considered as borrowing and in other cases, it is said that a non-burrowing finance has taken place.

On this basis, Finance, refinance and Usance belong to the borrowing type while the BOO, BOT and, buy back belong to the non-burrowing group (Zeinal Zadeh, 2011: 8).

Finance

When the seller would not accept long-term letters of credit and the buyer is not able to open a letter of credit because of lack of liquidity, the buyer usually asks a financial institute to enter the deal and pay the price of the contract in cash. Such facilities are usually long term (Haratian Nejadi, 2015: 50).

Refinance

Making use of short-term interbank facilities is referred to as refinance. At the time of contract, the seller receives the amount of the contract in cash from the broker bank and the buyer repays the bank with respect to the contract signed by him/her and the bank.

Short Term Financing

It is used to back up temporary investment in current assets. Usually once the financial manager develops the plans necessary for investment in current assets and anticipates the required resources in the next year, he/she should think about the finance of his/her plan and make a decision regarding the manner of financing. Short-term loans are usually used for temporary investment in current assets (Kasmati et al., 2002).

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This type is more accepted by executive organs. Generally, finance is a short-term method of transfer of capital to the country because once the deadline on the repayment of the loan is reached; the amount of the loan must be repaid along with its interests. On this basis the most important condition in the context of receiving foreign loan is the allocation of the received loan to projects that are of economic justification and are accompanied by a logical ROI rate.

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Legal Barriers of foreign Financing in Iran

Currently the legal perspective on the phenomenon of foreign financing is changing and there are efforts towards actions that seem to be able to persuade an international flow of capital and technical knowledge. This results in root changes in both national and international policy makings considering this phenomenon. It is worthy of mentioning that other countries are becoming more versatile towards the phenomenon of direct foreign investment as well. The documents published during the past decade regarding the importance of private foreign investment, especially direct foreign investment show that this type of investment is necessary for the economic growth and development of countries since it not only results in increase of capital sources for country, but also is considered as a tool for transfer of technology, management of and access to international sales markets. According to one of the most important principles of international law, which states the permanent governance of countries over their natural resources, every country has a right to set and execute its foreign investment policies according to its national qualifications according to its rules, regulations, priorities and national goals. No country is forced to adopt a preferential behavior against foreign investors (Fotoohi, 2013: 119).

The Process of Bank Finance

Increased investment is a main precondition for economic development and the different methods used by different societies for financing of their investment projects play important roles in the facilitation of investment, and hence are followed by accelerated economic development. Muslim economists have proven that financing through PLS, compared to FRS is more efficient in terms of reduction of production costs, growth of capitals, risk taking of the society, monitoring of commercial units and prevention of bankruptcy of banks. On the other hand, some other Muslim economists have shown that PLS is advantageous over FRS when first of all, the phenomenon of information asymmetry and its two accompanied risks of bad choice and moral dangers are not serious, and second, the society is not in an uncertainty state. Otherwise, Islamic banking may through increasing the costs of financing for investment projects, result in increased exchange costs and increased risks of bankruptcy for Islamic Banks as well as dampening of the development of the community.

CONCLUSIONS

One of the most conventional methods of foreign borrowing is foreign finance of projects. In terms of vocabulary, finance is defined as financial support. In Iran's legal concepts and laws, this concept is more exclusively defined as usage of credit lines for receiving loans from international financial institutions. In general, finance can be considered as a mechanism in which the borrowing country and the lender country sign a contract on supplication of the required manpower, technologies, machinery, equipment, raw materials, and financing of a project by the investor country; when the project becomes operational, the borrower commits itself to repay the entire costs of the project to the investor country. In this method, a certain amount agreed by the sides of the contract is borrowed from a country or institute by another country and the amount of the loan should be repaid to the investor along with the interests in a given amount of time (usually between 5 to 10 years). This method is an indirect investment method. In order for the lender to make sure of the on time repayment of the paid loan, receives specific credible guarantees from the borrower country. In this regard various methods are used one of which is incorporation of multiple countries or institutions in the payment of the loan; this puts more pressure on the borrower in case of occurrence of problems regarding repayment.

It is worthy of mentioning that in terms of long term loans, machinery procurement and equipment procurement and etc. that require significant amounts of financial facilities, finance is used.

The borrowing methods that can be named as loan usually include a repayment guarantee and Iranian law these are of two types:

- Making use of credit facilities received from foreign banks and financial institutions
- Making use of facilities of developmental banks such as the World Bank and the Islamic Development Bank

Among the most important advantages of finance it can be referred to these points: entry of new financial sources for projects; maintenance of the governing role of the government; non-involvement in investment risk: thorough identification of the manner of execution of projects; complete centralized technical and financial control: consistence with the technical and executive systems of the country; on time payment of project costs and, development of capital market.

Despite its advantages, finance also has certain disadvantages that include requirement of long time lengths for signing contracts, legal and budgetary limitations, limitation of resources in case of increased resource requirements, the necessity of existence of suitable economic conditions, the necessity of existence of suitable political conditions, and lack of complete transfer of knowledge and technical skills. Considering the mentioned advantages and disadvantages it can be said that suitability of definition of the project, desirability of the finance structure and having a competent managerial team are effective on the acceleration of the process of finance.

In addition, as a final point in this context it should be mentioned that foreign finance is in terms of the paid loan divided into two categories of export credit and commercial loans. There are several factors that improve the possibility of success in attraction of foreign financial sources.

The most important one of these factors is existence of a general legal structure that has the least rates of making references to other laws and regulations. Currently the law of attraction and supporting foreign capitals is not sufficient for the needs of the country. On this basis there seem to be a necessity for reviewing these rules.

This review will only be effective when the existing barriers in the constitution are removed from the path of foreign capitals. For the purpose of giving generality to the foreign investment rules a predetermined fixed procedure must be taken into account.

Referring to certain rules, especially in the context of tax, and bank affairs and performance is foreseeable. However excessive reliance on other rules and regulations can also mitigate the attraction of foreign investments; especially in case of old laws. In terms of acceptance and entry of foreign investment after the issuance of a new law, significant amendments have been made in the context of supplication of the required security for foreign investors.

As a result, the context for foreign investment is currently much more suitable than it was before.

In the view of international law, one of the very rights of every country is the ability to nationalize the properties or assets of foreigners; this principle is based on the famous principles of international law and the only thing under debate in this context is the manner of evaluation of compensation.

In this formula, regarding the investor countries, the phrase of immediate, sufficient and effective compensation is envisaged and for the developing host countries, the formula presents the phrase of fair compensation.

Based on the current Iranian Law, there is emphasis on legality and fairness of expropriation and hence, both the foreign and national investors are provided with equal advantages and rights in Iranian Law.

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