

A BRIEF WRITE-UP ON GUARANTEES

July 24, 2014





INTRODUCTION

Guarantee is security in form of a right of action against a third party called the surety or the guarantor. The English law defines a 'guarantee' as a 'promise to answer for the debt, default or miscarriage of another'. In simple terms, a Guarantee means, the promise to pay another's debt or fulfill another's contractual obligations, if that party fails to pay its debt or perform its obligations. It can either be a promise for the execution, completion, or existence of something or a promise or an assurance attesting to the quality or durability of a product or service.

CONTRACT OF GUARANTEE

- A contract of guarantee pre-supposes a principal debt or an obligation that the principal debtor has to discharge in favour of the creditor. A contract of Guarantee is governed mainly by the provisions of the Indian Contract Act, 1872 ("Contract Act"). Section 126 of the Contract Act defines a contract of guarantee as a contract to perform the promise or discharge the liability of a third person in case of his default. The person who gives the guarantee is called the "surety", the person in respect of whose default the guarantee is given is called the "principal debtor" and the person to whom the guarantee is given is called the "creditor". The Contract Act uses the word 'surety' which is same as a 'guarantor'.
- In India, a contract of guarantee may be oral or written. It may even be inferred from the course of conduct of the parties concerned.
- In a contract of guarantee, there are two contracts, the principal contract between the principal debtor and the creditor as well as the secondary contract between the creditor and the surety. The contract of the surety is not a contract collateral to the contract of the principal debtor but is an independent contract.

ESSENTIALS OF A VALID CONTRACT OF GUARANTEE

- Essentials of a valid contract: Since a contract of guarantee is a species of contracts, the general principles governing contracts are applicable here. Thus, all the essential requirements of a valid contract (such as free consent, valid consideration, etc.) are required to be fulfilled.
- A principal debt must pre-exist: A contract of guarantee seeks to secure payment of a principal debt. Thus, it is necessary that a recoverable principal debt must pre-exist. There cannot be a contract to guarantee a time barred debt. The House of Lords, as early as 1836, in the Scottish case of *Swan vs. Bank of Scotland* [(1836) 10 Bligh NS 627] held that if there is no principal debt, there can be no valid guarantee.
- Consideration: Consideration received by the principal debtor is sufficient for the surety. Anything done, or any promise made for the benefit of the principal debtor can be taken as sufficient consideration to the surety for giving guarantee.

TYPES OF GUARANTEE

The main types of guarantees are as follows:

- Personal/ Corporate Guarantee: A Personal/ Corporate Guarantee is a guarantee in which an individual/ corporation agrees to be responsible for the financial obligations of or the performance of contractual obligations by the principal debtor to the creditor, in the event the principal debtor fails to discharge his financial obligations or perform the contractual obligations. A personal/ corporate guarantee, almost by definition, is unsecured, which means it is not secured by or tied to any specific asset of the surety. However, in case of a corporate guarantee, it is essential to peruse the charter documents of the corporation in order to ensure that the corporation is authorised to issue the corporate guarantee and to verify the prescribed limit. Further, it is essential that the necessary resolutions are passed for the purpose.

MY IRONCLAD
GUARANTEE!

- **Bank Guarantee:** A Bank Guarantee is an innovative financial instrument whereby, the bank itself stands as a guarantor for a particular amount and whereby, if the beneficiary of the bank guarantee perceives that there has been a breach of contract by the other party, he can encash the bank guarantee and avail of the amount immediately, without having to undergo the hassles of litigation.
- **Continuing Guarantee:** A Continuing Guarantee is a guarantee in which a person agrees to be held responsible for a series of transactions for the financial obligations of or the performance of contractual obligations by the principal debtor to the creditor, in the event the principal debtor fails to discharge his financial obligations or perform the contractual obligations. In the case of continuing guarantee, so long as the account is a live account *i.e.* the account is not settled and there is no refusal on the part of the guarantor to carry out the obligation, the period of limitation does not at all start to run and that is the view taken by the Supreme Court in the case of ***M/s. Margaret Lalita Samuel vs. Indo-Commercial Bank Limited*** [(1979) 2 SCC 396], and the said proposition was also followed in the case of ***Union Bank of India, Ernakulam vs. T.J. Stephen & Others*** [AIR 1990 Kerala 180].

INVOCATION OF GUARANTEE

- A contract of guarantee is a contract of *strictissimi juris*. The surety receives no benefit and no consideration and therefore, is entitled to insist upon a rigid adherence to the terms of his obligations by the creditor.
- Under the Contract Act, the liability of a surety is co-extensive with that of the principal debtor (*unless otherwise provided by the contract of guarantee*), the surety cannot, in the absence of a contract to the contrary, require the creditor to recover the debt from the principal debtor personally or from other securities furnished by the principal debtor for repayment of the loan either by way of hypothecation, pledge or mortgage.
- Section 13 (11) of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, which governs the enforcement by the secured creditor of the security interest created in favour of the creditor without the intervention of court or tribunal, further impresses upon the aforesaid right of the secured creditor to recover the debt from the surety without first recovering the same from the principal debtor personally or from other securities.



REVOCAION OF GUARANTEE AND DISCHARGE OF SURETY

A contract of guarantee may be revoked and a surety may be discharged in any of the following ways:

- By mutual consent of the parties;
- By death of the surety;
- By variance in contract between the principal debtor and creditor without the consent of the surety;
- By release or discharge of the principal debtor;
- By compounding or granting of time by the creditor to the principal debtor without the consent of the surety;
- By impairment of surety's eventual remedy against the principal debtor on account of the creditor's act or omission; and
- Where the contract of guarantee is obtained by misrepresentation or concealment by the creditor or with his knowledge.



RIGHTS OF THE SURETY

- Where a debt has become due or default of the principal debtor to perform a duty has taken place, the surety, upon payment or performance of all that he is liable for, becomes invested with all the rights which the creditor had against the principal debtor.
- The general rule of equity expounded by Sir Samuel Romilly and accepted by the Court of Chancery in *Crythorne v. Swinburne* [(1807) 14 Ves. 160], that the surety will be entitled to every remedy which the creditor has against the principal debtor, including the enforcement of every security stands statutorily recognised and incorporated in section 141 of the Contract Act.
- A promise by the principal debtor to indemnify the surety is deemed to be implicit in a contract of guarantee and as such, the surety is entitled to recover, from the principal debtor, all such sums which he has rightfully paid under the guarantee.

LETTER OF COMFORT AND OTHER EVOLVING CONCEPTS:

Could your letter of comfort be a contract of guarantee?

- A letter of comfort is a document which is provided by a person (typically an affiliate such as the holding/parent company of the borrower) to the financial institution assuring the financial soundness of the borrower to repay the debt(s). Ordinarily, a letter of comfort does not create any payment/financial obligation on the person giving the letter of comfort. However, under certain circumstances, a letter of comfort may be regarded as a contract of guarantee depending upon the usage of the language in the letter of comfort.



Other evolving concepts:

- In today's commercial era new instruments such as letter of awareness, standby letter of credit, etc. are constantly emerging. The question whether such instruments would be construed as a contract of guarantee depends upon case to case basis as also upon the language used in such instruments. The legal status and enforceability of these letters have been the source of much debate in many jurisdictions.

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