Advanced Contracts, Tendering and Public Procurement
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Special Contract: Guarantee - Part 01

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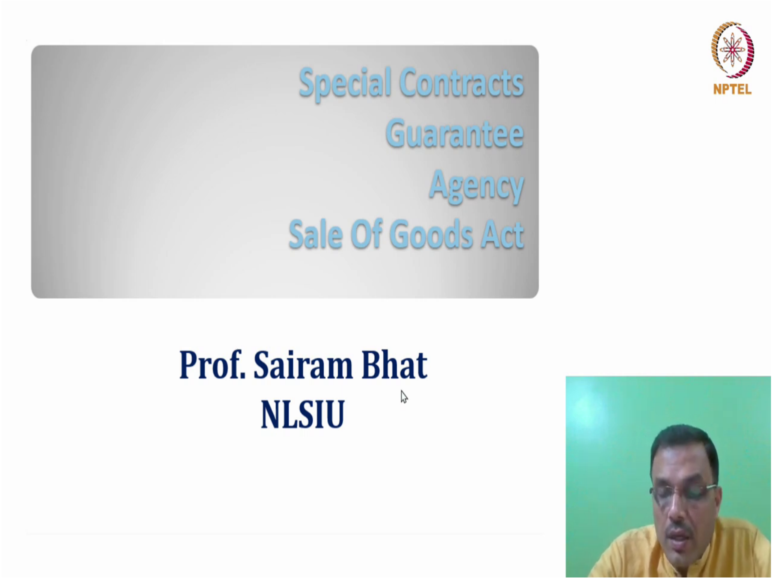

The contracts of guarantee, as a special contract and followed with agency and sale goods, which is covered under a law called the sale goods act of 1930 will be further discussed. Now all these kinds of contracts are very important and relevant for multiple reasons that these define the contractual rights and, liabilities of the parties in this contract.

Furthermore, it is important to acknowledge that this approach narrows down the scope of the freedom of contract theory and establishes a distinct type of contract. Under ordinary circumstances, contracts typically involve two parties and are referred to as bilateral contracts. However, a contract of guarantee introduces a tripartite contract, involving three parties. This distinction highlights the unique nature of such contracts.

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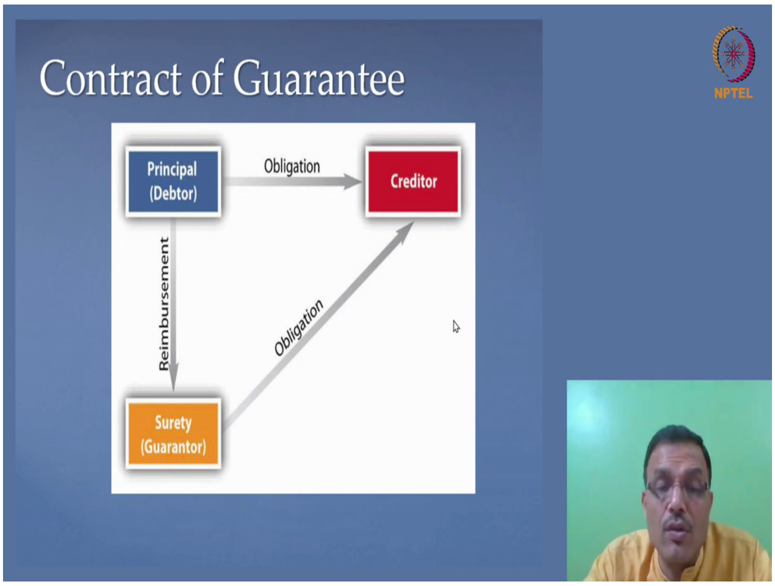

And who are these three parties? You will notice that, there is one debtor, who is the debtor who wants to take a debt and he is a borrower. And in the contract of guarantee, he is called the principal debtor who is called principal debtor, but he is the primary person who is intending to probably take a loan, or he wants certain performance of an obligation.

He goes to a creditor who is willing to give credit, usually a bank or a financial institution. And you will notice that, when you look at creditors, the creditors want to secure their loan as there is a risk in contracts, the risk in loan agreements that the debtor will not repay the loan back.

And hence, what does the creditor do? He would take a security. Now, if the security is movable property, we call it pledge. If it is immovable property, we call it mortgage. There are other forms of security like charge, hypothecation, and others. Property is kept as security, it is kept as some kind of a bond, that if the debtor fails to pay the debt, the creditor can deal with that security and recover the debt.

Normally this kind of a transaction, if it involves a movable property, we call it, it just the contract of pledge. In pledge, you pledge a good, and you want loan because you want liquidity, you want cash and the gold is kept as security, the creditors want kind of a plan B in place.

So, they tell the debtor they are willing to give you loan. You should keep something as security, be it movable property or immovable property, but we also want a person to stand as a guarantor for you. So, this could be an additional condition, that the creditor should have to recover his loan. So, what does the creditor do? He imposes this condition saying that unless the guarantor or a surety, who is supposed to be a person in the eye of law comes in, we will not give you this credit.

Now surety or the guarantor comes into this contract, to support the debtor. The surety does not get anything in this contract. The law on consideration here says that the consideration to the debtor is the consideration for the surety. So, no separate consideration needs to be proved. Why? Because this is a trilateral contract.

So, the consideration between the creditor and the debtor is sufficient consideration for the surety to come into the contract. So, the guarantor or the surety steps in, he supports the contract, he is an important person in this contract because he supports this contract. And in case the principal debtor defaults or fails to pay, I will pay

The debtor and the surety are in some kind of pre-existing understanding or relationship because surety or guarantors do not stand as guarantors for A, B and C person. They must know the person, they have to, have some previous obligation towards that person. So, it is the debtor usually who approaches, this person called the surety and says, I need a loan will you stand as my guarantor.

However, once the surety agrees to be a guarantor, he is obligation is directly to the creditor. He says to the creditor, look, go ahead, give the loan to the debtor and I will step in and I will support this contract. So, obviously if the surety is asked to pay and this could be chances where the debtor defaults or fails to pay, or he is unable to pay or refuses to pay. Then when the debtor does not fulfil his obligation towards the creditor, it is the surety or guarantor who must fulfil his obligation towards the creditor.

And if the surety goes ahead and does the same, he can claim reimbursement from the debtor. Obviously, that is something that, the law will have to come into place. Now, hence you will notice that the contract of guarantee chapter in the Indian contract law does not talk about the obligations of the creditor and the debtor, because that is already covered in the contract pledge.

Pawnor and pawnee is the word that is used in a loan agreement, but the chapter on guarantee is all about the surety, what is the rights of the surety? What are the liabilities of the surety and what are the duties and obligation of the surety, when comes the contract is laid down under this chapter.

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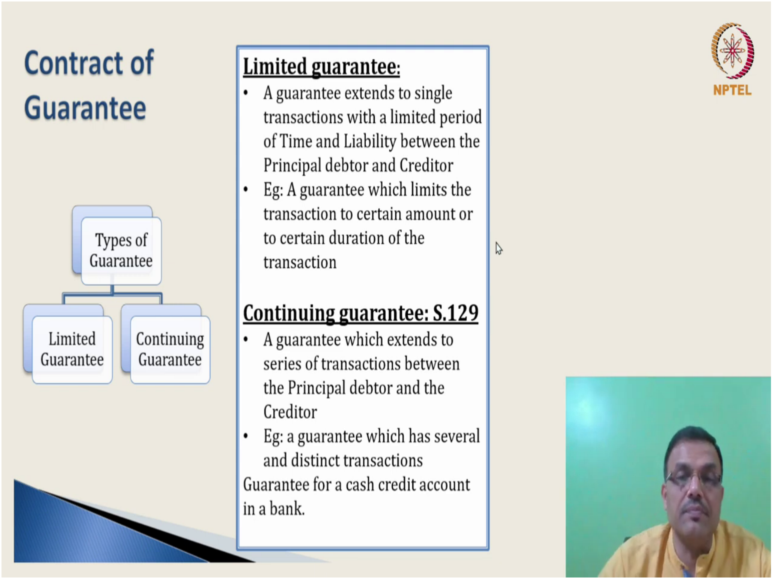

Ordinarily there are two types of guarantees, and we should understand this because there are several kinds and types of guarantees. One of the most popular kinds is a bank guarantee. In terms of the nature of the surety entering the contract, I think guarantees can be divided into two categories. One is limited guarantee. Now limited guarantee is for a single transaction and it is for a limited period, where it is limited by time and by liability.

The surety possesses the discretion to stipulate that they will participate in the contract on the condition that their liability is restricted. What does this imply? It means that although the loan amount may be 1 lakh rupees, the surety declares that they will only act as a guarantee for 50 thousand rupees. This limitation of liability enables the surety to define the extent of their commitment and minimize their exposure to risk. They have the freedom to exercise their right to opt for a limited guarantee, where they can specify the maximum amount, they are willing to stand as a guarantee, which in this case is 50 thousand rupees.

Secondly, the surety can also impose a time limitation on their guarantee, stating that they will act as a guarantor for a specific duration, such as one or two years, but not beyond that. This approach allows the surety to safeguard themselves from prolonged exposure to risk. They may decide that if the debtor fails to repay the debt to the creditor within the agreed timeframe, they will no longer be liable and will exit the contract accordingly. Limiting liability in this manner is a choice available to the surety. It is important to note that the surety's consent in the contract must be explicit, voluntary, and free from any misrepresentation or fraud. Any misconduct in obtaining the surety's consent or misrepresentation of information can render the contract voidable at the surety's discretion.

Now quite different from limited guarantees, continuing guarantee under section 129, there are certain kinds of distinctive factors of defining what this continuing guarantee is. It is a guarantee that can extend to a series of transactions between, the principal debtor and the creditor. So, it is not a onetime transaction it is for a series of transaction.

For example, there is supposed to be supply of coal to a thermal plan for the next three years. And, to assure, the contractors, promise to supply this coal, there may be a surety who is brought in to support such a contract. He says, look, I will stand as a guarantor, for the supply of coal for the next three years.

That is a continuing guarantee because each consignment of coal that is delivered is a transaction, and you continue to be the guarantor for the next three years, as a contracting party continues to exchange, goods and services. That is what continuing guarantee means. And this can also be something that you can extend to what we call as an overdraft facility.

Now banks give overdraft facilities. So, when they give an overdraft facility, it is like you have a lump sum amount but you can withdraw it in instalments. So, again, that could be a continuing guarantee regarding the same. Now, one of the aspects of continuing guarantee is that you must notice that this kind of a guarantee can be revoked unlike a limited guarantee or a onetime guarantee. Why? Because, once you enter a contract of guarantee, you should be able to reconsider your decision, but that reconsideration of the right to revoke will only start prospective, not retrospective, which means continuing guarantee can be revoked prospectively.

So, from now on for this next series of transaction, I do not want to be a surety. But in one time guarantee, once you give your consent you cannot revoke it back. And those are what we call it as irrevocable guarantees. Second the law also says that a continuing guarantee, terminates on the death of the surety or the guarantor, because a contract of guarantee is a personal character of promise.

It is based on that kind of trust between debtor and surety. So, if the surety dies, then the guarantee must stop. So, you cannot expect the obligation of surety to be inherited to the next of kin of to the legal heirs. So, death amounts to termination of the continuing guarantee. And that is also making continuing guarantee slightly different from, limited and other forms of normal guarantee as well. What you to understand at this part of time is that, there can be different other types of guarantees which we may come across. For example, we can talk about what is known as personal guarantee.

The best example to explain what is personal guarantee is the job of a cashier in a bank. Now during early days, the cashier's job was quite a risky job, there would be some kind of risk of he or she, embezzling the cash or misappropriating the cash or running away with the cash. And hence the cashier's job would expect a guarantor or a surety to be brought into the employment contract.

So, your contract or your employment is subject to a guarantor joining the contract. Now you will be there for two years or three years, that is a point of for possibility and for those two or three years of or lifetime, there is a surety of the guarantor who comes in place and says, look, if he does something, I will compensate you and this is the promise that I have for you.

So, in those cases, you will notice that it is a continuing employment or personal guarantee that is given for this cashier’s job and again, you can revoke it, but it is only prospective so far, whatever is the liability or whatever fraud has been committed, you will be responsible. So, it is only prospective and it stands to that extent as well.

But in such kinds of guarantee, you notice that you can have a combination of continuing guarantee and limited guarantee because there can be a case where I will stand for the next three years or five years, but my exposure should not be more than two times his salary, that is something that you can probably limit and it is up to the bank or the employer to accept it or further say, one surety wants to limit his guarantee, so you get another co-surety.

So, the concept of co-surety is also existing in the contract law and you will notice that when one or more sureties join the contract of guarantee, the co-surety have, what is termed as joint and several liability. This could be a possibility. Now in co-surety, for example, directors stand as guarantors for a loan to be given to the company.

Now why should only one director stand? Here, all the directors or two or more directors may come together and state that look they will stand as guarantors and when the company defaults, we will pay. So, the directors in themselves will become co-sureties. They have joint responsibility to discharge the default of the debt. And several in terms of whatever is there b contribution or equally, they will have to come into that kind of a transaction.

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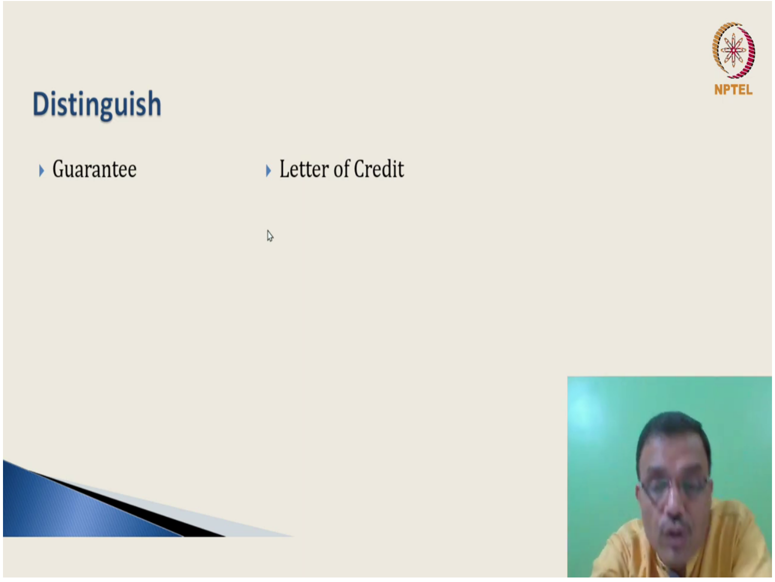

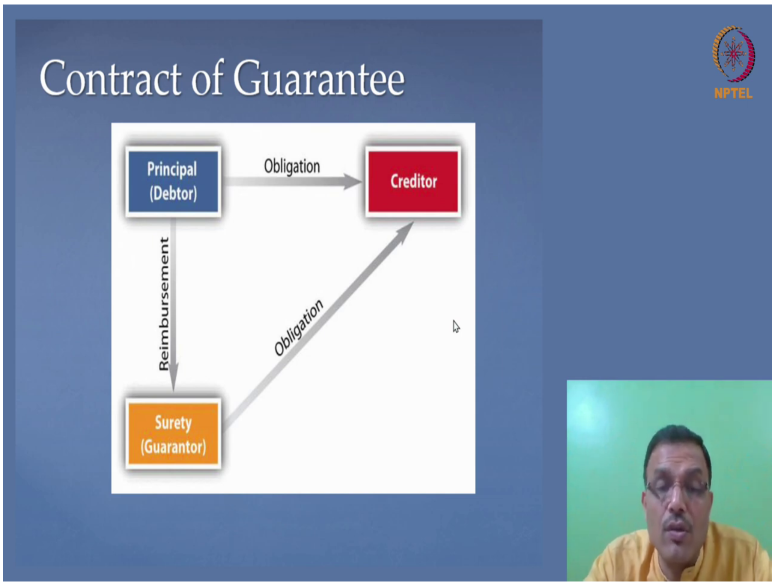

It is quite pertinent to understand the different instruments that are used in economic transactions, both nationally and internationally. It is important for us to understand the distinction between what we call as the contract of guarantee and instruments like letter of credit, or a letter of comfort.

Now let us start with letter of comfort. This letter of comfort is generally issued when a parent company wants to support a subsidiary company to get a contract from the government, it is like letter of support.

Sometimes we say letter of comfort is like a recommendation letter. You need it because without that, people will not trust you, as you are new into the market, so you need those kinds of support. Where do you see letter of comfort? You can also see it in terms of a contractor trying to submit a bid. And the government insists that the suppliers or the component manufacturers should also support that bid through this letter of comfort.

letters of comfort are also bringing in a third party to the contract. So, you it is the government and the contractor. Then you have the third party who comes and gives the letter of comfort. But letters of comfort are supporting documents and they can either be binding, or non-binding. So that is the advantage of letter of comfort.

So, a non-binding letter of comfort is not enforceable by law, but a binding letter of comfort will depend upon what are the wordings of that letter of comfort and how you can make it enforceable or binding. So, that is what is the purpose of letter of comfort and it is used quite widely, say a parent, gives a letter of comfort, on behalf of the subsidiary to a bank saying that you can lend to the subsidy and reassure the bank stating We will come and support this kind of a contract.

Now, if they word the letter of comfort in a binding character, it can amount to a guarantee. So, there are multiple use of these kinds of a instrument in contracts, because they are supporting documents, they are sometimes contractual documents in itself and hence we must clearly understand where these applications come to.

Coming to letter of credits, you will notice that letter of credit is used for international transaction, whereas bank credit or bank guarantees are used for domestic transaction. How does letter of credit operate? The infamous case of Neerav Modi should tell us the kind of challenges that letters of credit have in the international transactions. So, the Neerav Modi case can be a case where, people who are interested in contracts and corruption and criminal law can look forward to reading. but what does letter of credit do?

It gives the seller a comfort or an assurance saying that, please go ahead and sell goods to the buyer, we will ensure that you shall be paid. So, it is a credit letter of the bank saying that, look, we hope the buyer will pay, but if he does not, you already have this letter of credit. And we as the bank who has issued this letter of credit, we will ensure that you, the seller will be paid.

So, it is a credit line that a buyer takes. But it is not like taking money or loan or cash. It is like a letter. So, normally when the seller sells, he goes to the buyer, what happens in contract is that the buyer will pay the price. What does letter of credit do? It is just an assurance that if the buyer fails, then the bank will pay the seller. So, the seller will be assured that he will get this payment once he has dispatched the goods or when he has sent the goods to the buyer.

So, in international transaction, without a letter of credit, why will seller send goods? Because, he is in a different jurisdiction, the buyer is in different jurisdiction, the courts are a problem and enforceability become a challenge. So, I think letter of credit supports such kind of transaction. And the sellers are assured through a letter of credit that they would be receiving payment and that is some kind a guarantee, in one form, but mostly in international transactions.

Finally, coming to guarantee what is important for you to understand is bank guarantee. Because in this type of guarantee the bank is usually the creditor in our traditional kind of example, but in a letter of credit you will notice that the bank is the guarantor. In bank guarantee the bank is the guarantor. So, this is where the bank becomes a surety into the contract.

Now, the bank becomes surety in the contract for whom? It is usually to the government, which is floating the tender. So, here we have creditor, which is a government agency, which floats a tender, which invites bids. And it tells all these bidders who are the debtors look, we will give you the contract provided you, give us a bank guarantee. Now why does government take bank guarantee?

It is because there is always this risk that the contractor or the debtor, may not complete the job. And, he may create a loss to the government. So, the government needs a risk assurance saying that if the contractor fails to perform or, makes a deficient performance, then the bank guarantee will compensate the government. At least to an immediate extent, finally, going to the court to the arbitrator and get the final remedy will take some more time, but this is an immediate, kind of a compensation that can come through the surety of the guarantor or the bank guarantee that is issued in favour of the government.

So, in bank guarantee, the bank is the surety. It gives an assurance to the government department or the government organization that we will pay in case the contractor fails to perform. Interestingly, some of the bank guarantees are called as performance bank guarantee, which means it is based on a condition that lack of performance will entitle the government to encash the bank guarantee.