

Contract of Guarantee

Section 126 defines a contract of guarantee as under :-

"A" contract of guarantee, is a contract to perform the promise or discharge the liability, of a third person in case of his default". The section further provides that :-

"The person who gives the guarantee is called the "Surety", the person in respect of whose default the guarantee is given is called "Principal debtor" and the person to whom the guarantee is given is called the "creditor".

A guarantee may be either oral or written".

For example : A take a loan from a bank. A promises to the bank to repay the loan. B also makes a promise to the bank saying that if A does not repay the loan, "then I will pay". In this case, A is the principal debtor, who undertake to repay the loan. B is the surety, whose liability is secondary because he promises to perform the same duty if there is default on the part of A. The bank in whose favour the promise has been made is the creditor.

The object of a contract of guarantee is to provide additional security to the creditor in the form of a promise by the surety to fulfill a certain obligation, in case the principal debtor fails to do that.

In every contract of guarantee, there are three parties, the creditor, the principal and the surety. There are three contracts in a contract of guarantee. Firstly, the principal debtor himself makes a promise in favour of the creditor to perform a promise etc. Secondly, surety undertakes to be liable towards the creditor if the principal debtor makes a default. Thirdly, an implied promise by the principal debtor in favour of the surety that in case the surety has to discharge the liability on the default of the principal debtor, the principal debtor shall indemnify the surety for the same when a borrower and guarantor both sign an agreement in favour of a bank, they are jointly and severally liable under that contract.

The contract of guarantee is no doubt tripartite in nature but it is not necessary or essential that the principal debtor must expressly be a party to the contract by implication. Thus there is possibility that a person may become a surety without the knowledge and consent of the principal debtor.

Performance Guarantee by Banks :

Some times bank give "performance guarantee (or performance bond) on behalf of the a party to a contract. The bank giving such a guarantee is bound by the obligation undertaken by it. The performance guarantee is an "autonomous" contract and imposes an "absolute obligation" on the bank in its terms. A bank guarantee; for all purpose, should be taken to be a credit- note issued by the bank in favour of the person in whose favour the bank guarantee has been issued,

and it should be encashable just like a credit note ordinarily unless the intention of the parties is other wise.

If a bank has unconditionally guaranteed the payment of price on the supply of goods by the seller to the buyer, the bank is bound to honour this obligation and in the event of any dispute between the seller and the buyer, the buyer cannot obtain an injunction to prevent the bank from honouring the guarantee.

Main Features of a Contract Of Guarantee :

(1) **The Contract may be either oral or in writing** : According to Section 126, a guarantee may be either oral or written. On this point, the position of India is different from that in England. According to English Law, for a valid contract of guarantee, it is necessary that it should be in writing and signed by the party to be charged therewith.

(2) **There should be a principal debt** : A contract of guarantee pre- supposes a principle debt or an obligation to discharged by the principle debtor. The surety undertakes to be liable only if the principle debtor fails to discharge his obligation. If there is no such principle debt, but there is a promise by all one party in favour of the another for compensating in a certain situation, and the performance of this promise is not dependent upon the default of somebody else, it is a contract of indemnity. Thus, when A and B go to a shop. A purchases goods and B tells the seller "If A does not pay you, I will", it is a contract of guarantee. On the other hand, if A is not the principle debtor but only B makes a promise to the shopkeeper to pay, for instance, B tells the shopkeeper, "Let him (A) have the goods. I will be your paymaster. It is a contract of indemnity.

(3) **Benefit to the principle debtor is sufficient consideration** : As in any other contract, the consideration is also needed for a contract of guarantee. For the surety's promise, it is not necessary that there should be direct consideration between the creditor and the surety, it is enough that the creditor had done something for the benefit of the principle debtor. Benefit to the principle debtor constitutes a sufficient consideration to the surety for giving the guarantee. This is clear from Section 127 which reads as under :

"Anything done, or any promise made for the benefit of the principle debt may be a sufficient consideration to the surety for giving the guarantee".

Illustration : B requests A to sell and deliver to him goods on credit. A agrees to do so, provided C will guarantee the payment of the price of the goods. C promises the guarantee the payment in consideration of A's promise to deliver the goods. This is sufficient consideration for C's promise.

(4) **Consent if obtained by misrepresentation or concealment** : The creditor should not obtain guarantee either by any misrepresentation or concealment or any material facts concerning the transaction. If the guarantee has been obtained that way, the guarantee is invalid. The position is explained by sections 142 and 143 which read under :-

Section 142 : "Guarantee obtained by misrepresentation invalid. Any guarantee which has been obtained by means of misrepresentation made by the creditor, or with his knowledge and assent, concerning a material part of the transaction, is invalid".

Section 143 : "Guarantee obtained by concealment invalid. Any guarantee which the creditor has obtained by means of keeping silence as to material circumstances is invalid".

Illustration : A engages B as clerk to collect money for him. B fails to account for some of his receipts and A in consequences calls upon him to furnish security for his duly accounting. C gives his guarantee for B's duly accounting. A does not acquaint C with B's previous conduct. B afterwards makes default. The guarantee is invalid.

References :

- 1) Business Law (6th edition) : MC Kuchhal and Vivek Kuchhal (Vikas Publishing House, Noida)
- 2) Indian Contract Act (12th edition) : RK Bangia (Allahabad Law Agency, Faridabad)
- 3) Indian Contract Act (12th edition) : Avtar Singh (Eastern Law Agency, Noida)