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Giving of Guarantee under FEMA - A Brief Note

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The FEMA Guarantee Regulations is an important regulation applicable to transactions with non-residents. The scope of the prohibition contained in the Regulations is wider than commonly perceived. This Note provides a quick overview of the Guarantee Regulations.

Background of regulation of guarantees

The cardinal principle underlying the transactions covered under FEMA is that all current account transactions are permitted other than those prohibited by law and all, capital account transactions are prohibited other than those expressly permitted by law. Under Section 3 of FEMA a capital account transaction is defined as under:

"Capital account transaction" means a transaction which alters the assets or liabilities, including contingent liabilities, outside India of persons resident in India or assets or liabilities in India of persons resident outside India"

Therefore, all those transactions which are undertaken by an Indian resident or a non resident that alters (either increases or decreases) his/her assets or liabilities shall be covered under this section. Subject to such permissible class of transactions and limit of forex as shall be notified by the RBI under Section 6 (2), the Act provides for a general permission that **any person may sell or draw foreign exchange to or from an authorised person for a capital account transaction**. In exercise of the powers conferred upon the Reserve Bank of India under the Section 6 (3)(j)¹ read with Section 47² of the FEMA, RBI has issued Foreign Exchange Management (Guarantees) Regulations,2000 and the Foreign Exchange Management (Permissible capital account transactions) Regulations,2000 to regulate giving of guarantee.

¹6 (3) "Without prejudice to the generality of the provisions of sub-section (2), the Reserve Bank may, by regulations, prohibit, restrict

or

regulate the following—

(j) giving of a guarantee or surety in respect of any debt, obligation or other liability incurred—

(i) by a person resident in India and owed to a person resident outside India; or

(ii) by a person resident outside India.

² 47 "Power to make regulations.

The Reserve Bank of India may, by notification, make regulations to carry out the provisions of this Act and the Regulations made there under.

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The provisions of Regulation 3 of the Foreign Exchange Management (Guarantees) Regulation, 2000 provides for giving of a guarantee by an Indian resident in favour of a non-resident *only* when expressly permitted and notified or under a general or special permission by the RBI.

Prohibition in the Regulations:

Regulation 3 of the Foreign Exchange Management (Guarantees) Regulation, 2000 puts a blanket restriction, except in accordance with a general or special permission of the RBI on giving of the following:

- Giving of any guarantee
- Provision of any surety
- Any other transaction that has the effect of guaranteeing, a debt, obligation or other liability owed by a person resident in India, or incurred, by a person resident outside India.

The above are prohibited when given by a resident, to a non resident. That is to say, if the person giving the guarantee is a resident, and the person receiving the guarantee is a non-resident, the Regulations are applicable. In other words, the Regulations will apply irrespective of whether the person in respect of whom the guarantee is given is a resident or not.

Meaning of Guarantee

The term guarantee has been defined under Section 126 of the Indian Contract Act, 1872. The relevant extract of the said section is defined as hereunder:

*“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 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". A guarantee may be either oral or written.”*

In *Punjab National Bank v. Sri Vikram Cotton Mills*,³ it was held by the Apex Court that “Guarantees are usually taken to provide a second pocket to pay if the first should be empty.” In the old case of *Birkmyr v. Darnell*,⁴ the Court had held as follows:

³ (1970) 1 SCC 60

⁴ (1704) 91 ER 27

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“If two come to a shop and one buys, and the other to give him credit, promises the seller, ‘If he doesnot pay you I will”

This type of collateral undertaking to be liable for the default of another is called a “contract of guarantee”. In English Law guarantee is defined as “a promise to answer for the debt, default or miscarriage of another.”

Meaning of Surety

From the definition of guarantee under section 126 as adumbrated *supra*, it can be said that **surety** is a person who gives the guarantee, or in simple terms the guarantor. But there is a thin line difference between a guarantor and a surety.

A surety, as a general rule, is a party to the original contract of the principal debtor, he signs his name to the original agreement at the same time the principal signs, and the consideration for the principal's contract is the consideration for the agreement of the surety's. The surety is therefore bound on his contract from the very beginning, and he is bound also to inform himself of the defaults of the principal debtor, and he is not in any part relieved from his obligations under the contract by the creditor's failure to inform him of the principal debtor's default in the contract, for which contract the surety has become the security for.

A guarantor, on the other hand, usually does not make his agreement to answer for the principal debtor's debt or default, contemporaneously with the principal debtor or by the same agreement, but his obligation is entered into subsequently to the making of the original agreement, and his agreement is not the contract that the principal makes, and hence a new consideration is required to support it. The contract of the principal debtor's, not being the one the guarantor makes; he is not bound to inform himself of default, or failure of principal to perform his contract. The creditor is also under the obligation to inform the guarantor of the principal's default, not strictly in the sense of being obliged to give notice immediately after demand on the day the obligation matures, as in the case of an endorser, but if a failure to give notice materially prejudices the rights of the guarantor, the guarantor can claim a discharge on the obligation to the extent of the injury suffered.⁵ The contract of the guarantor is not only collateral, but it is secondary; the surety's contract is primary and direct.⁶

The guarantor is liable only after the default of the principal; the liability is established by the default of the principal, and by showing performance of the conditions of the contract.⁷ But on discussing the distinctions between the surety and the guarantor in respect to the liability assumed, we must remember that guaranties are of two kinds, the conditional guaranty, and the

⁵ *Graff vs. Simms*, 45 Ind., 262;

⁶ *Milroy vs. Quinn et al.*, 69 Ind..

⁷ *Atwood vs. Lester*, 20 R. I., 660

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absolute guaranty. In the former the guarantor is only liable after the condition of the guarantor's contract is fulfilled. So, then, where "A" guarantees the collectability of a certain sum for another person, his obligation matures when the creditor makes the showing that the debt is not collectible; this usually requires the exhausting of all the legal remedies to collect, as by securing a judgment against the principal debtor, and having execution issue on the judgment, together with the sheriff's return showing that the execution cannot be made, because the principal has no goods or property, that may be sold when levied on, to satisfy the execution. An absolute guaranty is one that arises where the guarantor fixes the time to pay, as of some date certain; in this kind of guaranty it is not necessary that the creditor first take steps against the principal to charge the guarantor, as, for instance, where the guaranty is for the payment of a bond according to its terms,⁸ or a guaranty for the payment of a promissory note at its maturity.⁹ It has also been held that an absolute guarantor is not discharged by the creditor's delay in enforcing payment from the principal. It may be said, further, that it makes little difference whether the promissor calls himself a surety or guarantor, the terms of the agreement will control, in determining whether it is to be considered a contract of a surety or of a guarantor.

Further in the United States in the case of *Ross v. Jones, Brown & Co.*, 89 U.S. (Wall) 576 (1875), it was held by the Court that "*the endorser of a note was not a "person bound as security" for purposes of an Arkansas statute similar to the Sureties Act*". Further the Illinois Supreme Court in the recent case of *J.P.Morgan Chase Bank, N.A. v. Earth Foods, Inc.*¹⁰, has held as hereunder:

" a suretyship differs from a guaranty in that a suretyship is a primary obligation to see that the debt is paid, while a guaranty is a collateral undertaking, an obligation in the alternative to pay the debt if the principal does not."

The Illinois Supreme Court thus, held that the legislature did not intend to include guarantors within the scope of the Sureties Act. Therefore, in substance, although under the Indian Statutes, the contract of Surety and guarantee are the same, there is a sharp difference as the obligation attached to the different forms of contract. Thus, the FEMA **Guarantee** Regulations, Regulation 3 expressly mentions "*surety" and all other forms of "guarantee"*.

Simply speaking, a guarantee is an irrevocable undertaking by the guarantor to take responsibility of the debt obligation on behalf of the debtor in the event of default or non-performance. Under the abovementioned parent regulations guarantee can be broadly classified into two groups on the basis of who facilitates or provides such a guarantee, namely, guarantee issued by Authorized Dealers and guarantee issued by person other than other than the Authorized Dealers. The

⁸ *Roberts vs. Ridle*, 79 Pa. St., 468

⁹ *Campbell v. Baker*, 46 Pa St. 243

¹⁰ 740 ILCS 155/1 (West 2000)

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Foreign Exchange Management (Guarantees) Regulations, 2000 under Regulation 4 provides for guarantees to be given by Authorised Dealers while Regulation 5 deals with the latter.

Giving of Guarantees by persons other than an authorised dealer:

The Foreign Exchange Management (Guarantees) Regulations, 2000 prohibits residents in India to furnish any guarantee (Regulation 3) other than as expressed under the parent regulation and also directions issued by the RBI in such regard from time to time. As per regulation 5 of the regulation, **persons other than Authorised Dealers**, are allowed to give a guarantee of performance for:

- (a) A resident exporting company may give a guarantee for performance of an approved project outside India, or for availing of fund based or non-fund based credit facilities, from a bank or a financial institution outside India in connection with the execution of such approved project. A pre condition has been imposed by the RBI in such case wherein previous approval of the approving authority before undertaking such a project.
- (b) a person resident in India being an exporter company may give guarantee in lieu of Bid Bond Guarantee, for bidding for a contract outside India without the approval of the Approving Authority provided that the amount of such guarantee shall not exceed 5% of the contract value.
- (c) An agent in India of a shipping or airline company incorporated outside India may give a guarantee on behalf of such company in connection with its obligation or liability owed to any statutory or Government authority in India.
- (d) a company in India promoting or setting up outside India, a joint venture company or a wholly-owned subsidiary, may give a guarantee to or on behalf of the latter in connection with its business
- (e) a person resident in India with the prior permission of a bank (acting under the directions issued by the RBI to the authorised dealer) can issue guarantee in favour of an overseas lender or security trustee to secure an external commercial borrowing availed under the provisions of the Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000

Apart from the above, giving of any other guarantee will require the prior approval of the RBI.

Giving of guarantees by Authorised dealers:

Authorised dealers have been given a general permission under Regulation 4 of the Foreign Exchange Management (Guarantees) Regulations, 2000, to issue guarantee to the following:



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- Persons resident in India : The Authorised Dealer may give a guarantee in respect of any debt, obligation or other liability incurred by a person resident in India and owed to a person resident outside India the following:
 - an exporter, on account of exports from India;
 - an importer, in respect of import on deferred payment basis
- Persons resident outside India: The Authorised Dealer can issue guarantee in respect of any debt, obligation, or other liability incurred by person resident outside India under the following:

where such debt, obligation or liability is owed to a person resident in India in connection with a bonafide trade transaction however, the RBI subjects such giving of guarantee to be covered by a counter-guarantee of a bank of international repute.

As a counter-guarantee, to cover guarantee issued by the authorized dealer’s branch or correspondent outside India, on behalf of Indian exporter in cases where guarantees of only resident banks are acceptable to overseas buyers.

An authorised dealer can also, in the ordinary course of his business, give a guarantee in the following other cases, namely:

- i) on behalf of his customer or branch or correspondent outside India in respect of missing or defective documents, or authenticity of signatures;
- (ii) in favour of organizations outside India issuing travellers cheques stocked for sale in India by the authorised dealer or by his constituents who are authorised persons.
- iii) in favour of foreign airlines/International Air Transport Association (IATA), on behalf of IATA approved travel agents.
- (iv) in favour of an non-resident service provider, on behalf of a resident customer who is a service importer, for an amount upto USD 100,000 or its equivalent.

Lastly, The Reserve Bank of India subsequently has issued various amendment regulations to the parent regulation (Foreign Exchange Management (Guarantees) Regulations, 2000), which are tabulated hereunder:

Sr.No.	Notification No.	Subject	Effective	Amended	Description
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	and date		Date	Regulation	
1	FEMA.206/2010-RB 01.06.2010	Foreign Exchange Management(Guarantees)(Amendment) Regulations, 2010	20/04/2009	Regulation 5 amended whereby new clause (e) is inserted	<i>“(e) a bank which is an authorised dealer may permit a person resident in India to issue corporate guarantee in favour of an overseas lessor for financing imports through operating lease effected”</i>
2	FEMA.189/2009-RB 27.02.2009	Foreign Exchange Management (Guarantees) (Second Amendment) Regulations, 2009	10/11/2008	Regulation 4 amended whereby new clause 4 (1B) is inserted	<i>“(1B). An authorised dealer may give guarantee or standby Letter of Credit in respect of an obligation incurred by a person resident in India and owed to a person resident outside India in connection with payment of margin money in respect of approved commodity hedging transaction of such person residing in India”</i>
3	FEMA.187/2009-RB 03.02.2009	Foreign Exchange Management (Guarantees) (Amendment) Regulations, 2009	11/07/2008	Regulation 5 amended whereby new clause (d) is inserted	<i>“(d) a bank which is an authorised dealer may (subject to the directions issued by the Reserve Bank in this behalf) permit a person resident in India or on behalf such person to issue guarantee in favour of an overseas lender or security trustee to secure an external</i>



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					<i>commercial borrowing availed under the provisions of the Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000”</i>
4	FEMA.151/2007-RB04.01.2007	Foreign Exchange Management (Guarantees) (Amendment) Regulations, 2007	17/11/2006	Regulation 4 amended whereby new clause 4 (3) (iv) is inserted	<i>(iv) in favour of an non-resident service provider, on behalf of a resident customer who is a service importer, for an amount upto USD 100,000 or its equivalent.”</i>
5	FEMA.129/2005-RB20.01.2005	Foreign Exchange Management (Guarantees) (Amendment) Regulations, 2005	01/11/2004	Regulation 4 amended whereby new sub regulation (1A) is inserted	<i>(1A) "An Authorised Dealer may give guarantee, Letter of Undertaking or Letter of Comfort in respect of any debt, obligation or other liability incurred by a person resident in India and owed to a person resident outside India (being an overseas supplier of goods, bank or a financial institution), for import of goods, as permitted under the Foreign Trade Policy."</i>



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6	FEMA.124/2004-RB16.10.2004	Foreign Exchange Management (Guarantees) (Amendment) Regulations, 2004	16/10/2004	Regulation 4 sub regulation 3 amended whereby new item (iii) is inserted	<i>'(iii) in favour of foreign airlines/International Air Transport Association (IATA), on behalf of IATA approved travel agents'</i>
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