

# **1 (M) Indemnity and Guarantee**

**Subject : Commerce**

**Lesson : Indemnity and Guarantee**

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# 1 (M) Indemnity and Guarantee

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# 1 (M) Indemnity and Guarantee

The scope of the Unit is given below:

- 13.1 What is a Contract of Indemnity?
- 13.2 Essentials of Valid Contracts of Indemnity
- 13.3 Rights of Indemnity Holder
- 13.4 Rights of Indemnifier
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# 1 (M) Indemnity and Guarantee

## 13.1 What is a Contract of Indemnity?

The Indian Contract Act 1872 provides for certain special types of contracts. These are contracts of (1) indemnity, (2) guarantee, (3) bailment and (4) agency. The meaning of indemnity is to make good the loss that another has suffered or, in other words, to compensate the party who has suffered a loss. Section 124 of the Act defines a contract of indemnity as "A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any other person".

### Illustration

Neelam takes a loan of rupees two lakhs from Atul. Akshay makes a contract with Neelam to indemnify her against any proceedings with respect to the loan which Atul may take against her. This is a contract of indemnity. .

In this illustration Akshay is the indemnifier and Neelam is the indemnified. A person who makes a promise to make good the loss is called the promisor or the indemnifier and the promisee or the person whose loss is to be recovered is the indemnity holder or the person who is indemnified. According to this illustration it can be said that the contract of indemnity is made to protect the promisee from any future losses.

This definition is restrictive as it is limited to the conduct of the promisor or of another person but it does not cover losses by accidents or events that are not caused by human conduct. Also, indemnity under Section 124 of the Act covers only express indemnity and not implied promise of indemnity. According to this contracts of insurance would not be within the purview of contracts of indemnity. The law makers however did not have any intention to exclude insurance from the contracts of indemnity. Recently, this issue came up before the Gujarat High Court in *New India Assurance Co Ltd. V State Trading Corporation of India* (A.I.R 2007 Fur 517 (Noc)<sup>34</sup>. In a landmark judgement the Court observed, "almost all insurances other than life and personal accident insurance are contracts of indemnity. The insurer's promise to indemnify is an absolute one. A suit can be filed immediately upon failure of performance, irrespective of actual loss. Of the indemnity holder, incurred liability was absolute, he would be entitled to call upon the indemnifier to save him from that liability by paying it off."

English Law and Indian Law both define indemnity. English Law covers contracts of indemnity by human conduct as well as losses by accidents or other events like death, disability, and destruction by fire, floods, earthquakes and cyclones. The Indian law is narrow in scope when compared to the English law but the law courts in India have followed the English law. The general law on contracts of indemnity in India covers losses that arise out of accidents and events that are not dependent only on the conduct of human beings. It also covers express and implied promises of indemnity.<sup>35</sup>

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## 13.2 Essentials of Valid Contracts of Indemnity

The following are the essentials of valid contracts of indemnity:

1. Contracts of indemnity must be between two parties, the indemnifier and the indemnity holder or indemnified.
2. A contract of indemnity should contain an offer, a consideration, the free consent between parties, the competency of both parties and legality of object to become a valid contract.
3. There should be a promise between two parties whereby one party promises another to save him from any losses suffered by him.
4. The losses may be due to the conduct of the promisor himself or any other person.
5. Contracts of indemnity can be express or implied. In an express contract of indemnity, a promise is made by a person to compensate the other person in express terms but in an implied contract, it is the intention of the promisor to indemnify the other party from losses.



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## 13.3. Rights of the Indemnity Holder

Section 125 has provided the rights of the indemnity holder. According to it the indemnity holder has a right to recover from the indemnifier some of the amounts that he has paid on behalf him, if he has acted within the scope of his authority:

- Damages in respect of a promise to indemnify the other in case of a law suit.
- Costs paid by the indemnity holder to defend a suit that was authorized by the promisor.
- Any amount paid for compromising in a suit authorized by the promisor, if the amount has been authorized by the promisor.



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## 13.4 Rights of the Indemnifier

The Act does not provide any rights to the indemnifier. However, it is taken as a silent acceptance of the rights of the promisor. Therefore, it is made equivalent to the rights of a surety under Section 141 of the Indian Contract Act. With this explanation of the Act the rights of the indemnifier are the same as those of a surety in a contract of guarantee.

## 13.5 Commencement of the Indemnifier's Liability

There are several judgements which have decided upon the liability of the indemnity holder but the Indian Contract Act of 1872 is silent on the time when the liability of the indemnifier commences. The liability of the indemnifier begins as soon as he indemnifies the other person. Some high courts have been of the view that the indemnifier becomes liable only when the indemnity holder actually suffers some loss. Some other high courts have held that the indemnifier is liable before the actual loss. This is considered to be the correct version of indemnity.

### Case Law 1

#### **Gajanan Moreshwar v Moreshwar Madan AIR 1942 BOMBAY 302**

In this case the Bombay High Court came to the conclusion that if the indemnifier is not liable until the loss has occurred it will be a burden on the indemnity holder. The Court held that the indemnifier has to pay as soon as his liability becomes absolute. If the indemnified has incurred an absolute liability, he is entitled to ask the indemnifier to pay off his liability.

### Case Law 2

#### **Osman Jamal & Sons Ltd. v Gopal Purshottam 1928 I.L.R. 56 CAL 262**

In this case a company acted as a commission agent for another firm and purchased goods on behalf of the firm. The firm failed to take the goods. The supplier of the goods was entitled to recover from the firm damages relating to breach of contract. However, before the claim was paid the company went into liquidation. The court held that the official liquidator was entitled to recover the damages from the firm though the company had not paid any amount to the supplier.

## 13.6 What is a Contract of Guarantee?

A contract of guarantee according to Section 126 of the Indian Contract Act I"s a contract to perform the promise or discharge the liability of a third person in case of default. The contract of guarantee consists of three parties. These are the surety, the principal debtor and the creditor".

1. **Surety:** A surety is a person who gives the guarantee to pay in case of default.
2. **Principal Debtor:** The person for whom the guarantee has been taken by the surety is the principal debtors.
3. **Creditor:** A promise of guarantee is given to the creditor to whom the payment has to be made.

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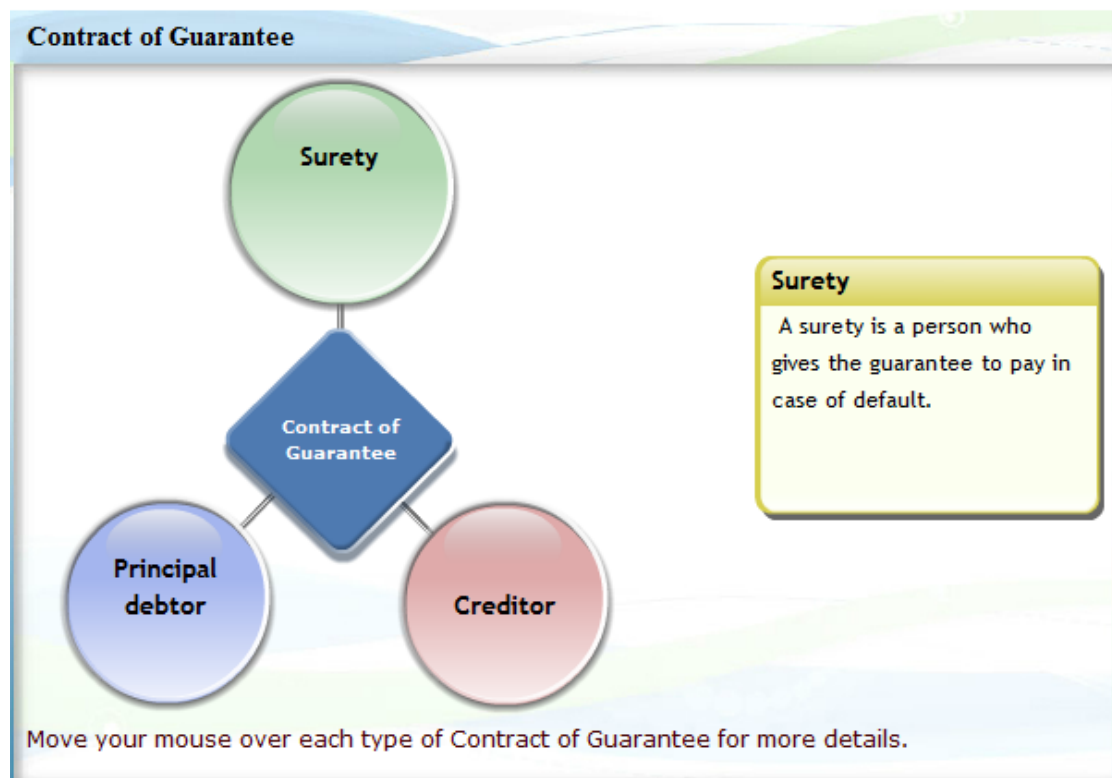
**Figure 13.2 Creditor, Debtor, Surety**

## Illustration

Seema gives a loan of Rs. 50,000 to Aditi on the promise that Atul will repay the loan to Seema if Aditi defaults in her payment. This is a contract of guarantee. Seema is the creditor. Aditi is the principal debtor and Atul is the surety or guarantor.

English law defines guarantee "as a promise that is made by one person to another to be collaterally answerable for a debt in case of default by a third person. The promise must be made in writing". In Indian Law a contract of guarantee can be implied or inferred by the conduct of the parties. It is not necessary for it to be in a written form.

## Check your Progress





# 1 (M) Indemnity and Guarantee

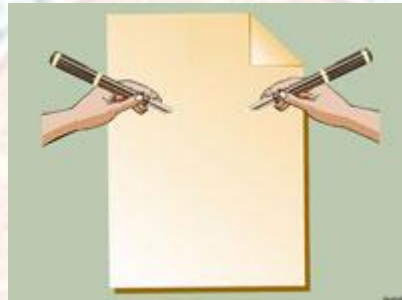
## 13.7 Essentials of Contract of Guarantee

### 13.7.1 Essential Features of a Valid Contract of Guarantee

A contract of guarantee can be performed only when certain essential elements of the contract are fulfilled. The following are the essential requirements of a contract of guarantee.

**a. Valid Contract:** A contract of guarantee must have all the essentials of a valid contract like competence of parties, free consent and consideration to make the contract valid. But there are certain exceptions:

- a. The principal debtor may not be competent to contract. If he is not competent the surety will become the principal debtor and will be liable personally to make the payment.
- b. A surety that makes a promise for the benefit of the principal debtor need not be given consideration. Any promise that a surety makes is sufficient consideration for giving a guarantee.



**Figure 13.3 Three Contracts**

#### **Illustration**

Bhanu asks Billu to deliver 50 watches to him on credit. Billu agrees and Braj guarantees the payment for the goods. Braj states that he would stand guarantee for the payment in consideration of Billu's promise to deliver the 50 watches.

#### **Illustration**

Akriti sells 100 pens to Abhimanyu. Sanjay requests Akriti not to sue Abhimanyu for at least a year if he cannot pay. He also promises that in case of default he would be responsible and would make the payment to Akriti. Akriti agrees not to go to court for payment. This is sufficient consideration for Sanjay's promise.

#### **Illustration**

Tunnu promises to deliver his old car to Munnu at a fixed price. Later Janu without any consideration agrees to pay for the car if Munnu does not pay. This is a void agreement.

- c. Tripartite Agreement: In a contract of guarantee there is the involvement of three contracts.

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- a. **Contract 1:** It is a contract between the principal debtor and the creditor on the basis of which a guarantee for the debt arises.
- b. **Contract 2:** It is an agreement between the principal debtor and the surety in which the principal debtor accepts the responsibility to indemnify the surety if the payment is required to be made by the surety.
- c. **Contract 3:** It is a contract between the creditor and the surety in which the surety promises to undertake the payment of the debt of the principal debtor in case the principal debtor defaults on his payments.

**Check your Progress**

**Essentials of Contract of Guarantee**

- Contract may be oral or in writing
- No misrepresentation of facts
- Consent
- Tripartite agreement
- Valid contract
- There should be a principal debt

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**c. Consent:** Since the contract of guarantee involves the creditor, principal debtor and the surety, it is necessary that all the three parties agree to the contract.



**Figure 13.4 Consent**

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## Illustration

Abu sells 5 air-conditioners to Sara. He later requests Sonu to pay if Sara defaults in her payment. Sonu cannot become a surety without the consent of Sara.

**d. There Should be no Misrepresentation of Facts:** A guarantee should be obtained after disclosing all the material facts that may affect the degree of responsibility of the surety. The surety must know all the facts of the case because if he neglects to do his duty he is responsible for the consequences. Any guarantee that is obtained by misrepresentation or concealment of facts by the creditor becomes an invalid contract of guarantee.

**e. Contract may be Oral or in Writing:** A contract of guarantee may be either oral or written as given in section 126 of the Act. The position as per English Law is different from that the Indian Law. Under English Law the contract must be in writing but Indian Law does not specify this. Hence in India both oral and written contracts are acceptable.

**f. There Should be a Principal Debt:** There has to be a primary liability of a person who is other than the surety to the contract of guarantee. The surety becomes liable only if the principal debtor is unable to discharge his obligation. If there is no principal debtor, there cannot be a contract of guarantee. In situations where there is a promise by one of the parties for compensating another without involving a third party, the contract becomes a contract of indemnity.

## Case Law 3

**Birkmyr V Darnell**  
**1704 91 ER 27 1 Salk, 27 & 28**

In this case the following were distinguished as contracts of indemnity and contracts of guarantee.

When A person says to a shopkeeper, "give your goods to a certain person and I will pay you," it is a contract of indemnity, and when a person goes with another to a shop and tell the shop keeper: "If my friend does not pay for the goods you are giving him I will pay for it," it becomes a contract of guarantee.

To summarize:

1. According to Section 142 of the Indian Contract Act "an invalid guarantee is one which is obtained by the creditor through misrepresentation regarding a material part of the transaction".
2. Section 143 states "that any guarantee in which he creditor maintains silence as to the material facts of the case also makes the contract of guarantee invalid".
3. Under Section 144 "when a co-surety does not give guarantee though it is necessary for him to give guarantee along with the surety, the contract of guarantee will not be valid".
4. If there is no consideration between the creditor and the principal debtor, the surety will be discharged from his liability as the contract will not be valid.

## Illustration

Malti employ Meena to make collections of money on credit sales. Meena collects Rs. 3,00,000 but does not account for all the receipts. Meena's friend account for Malti's

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misappropriation of the funds of her employer. Malti agree to retain Meena but expects a guarantee from her friend Atul. Malti does not let Atul know of Meena's earlier dishonesty. Atul gives the guarantee. However, this guarantee cannot be enforced because she does not disclose Meena's misappropriation of funds.

## Is a Contract of a Guarantee a Contract of Uberrimae Fidei?

Uberrimae fidei means a contract 'of absolute good faith.' A contract of guarantee cannot be called a contract uberrimae fidei. Due to this reason the principal debtor or the creditor may not disclose material facts to a surety before making a contract. If a guarantee is given to a bank, the bank may not inform the surety of the matters that pertain to the credit of the principal debtor.

Section 142 and 143 protect the surety by making a guarantee invalid if it is obtained by misrepresentation or concealment of material facts.

However, if it is a contract of guarantee concerning insurance in a fidelity guarantee, then all material facts should be disclosed, otherwise the surety can rescind the contract.

## 13.8 Distinction between Contracts of Indemnity & Contracts of Guarantee

Contracts of indemnity can be distinguished from contracts of guarantee in the following matter:

**(i) Parties to the Contract:** Contracts of indemnity comprise two parties. These are the indemnifier and the indemnity holder. Contracts of guarantee are made with three parties. These are the principal debtor, the creditor and the surety.



**Figure 13.5 Distinction – Indemnity & Guarantee**

**(ii) Number of Contracts:** Contracts of indemnity are between the indemnifier and the indemnity holder. Only one contract is made between them. However, contracts of guarantee are made out of free contracts. One contract is between the principal debtor and creditor. The second contract is between the surety and the creditor and the third is between the surety and the principal debtor.

**(iii) Nature of Liability:** The indemnifier is independent and has primary liability in contracts of indemnity, but in contracts of guarantee the surety has collateral or secondary liability whereas the primary liability is of the principal debtor.

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**(iv) Purpose of Contract:** Contracts of indemnity provide security against losses whereas contracts of guarantee provide security to creditors against default of the principal debtors.

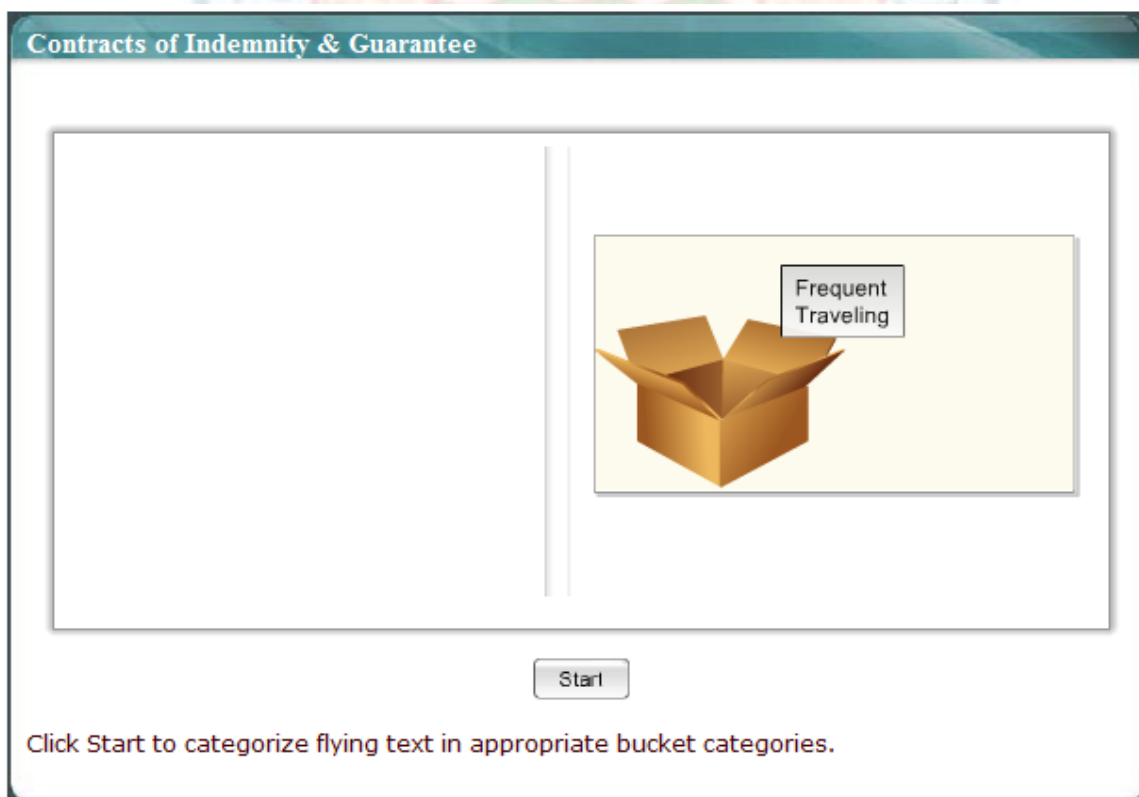
**(v) Request:** In an indemnity contract the indemnifier does not have to act at the request of the indemnity holder. In contracts of guarantee the surety can act only when the principal debtor requests him to do so.

**(vi) Occurrence of Liability:** In contracts of indemnity liability will arise on the happening of the contingency but in contracts of guarantee liability will arise when an existing promise of payment of a debt is not performed.

**(vii) Interest in the Contract:** In indemnity contracts the promisor usually has his own interest in the contract, but in a contract of guarantee the surety does not have any interest in the transaction.

**(viii) Right to Sue Third Parties:** The indemnifier does not have any right to sue a third party in his own name because he does not have any privity of contract. Only in transactions where there is an assignment in his favour may he sue third parties in contracts of indemnity. In contracts of guarantee the surety has the right to sue the principal debtor in his own name after he discharges his debt.

Check your Progress



**Contracts of Indemnity & Guarantee**

Frequent Traveling

Start

Click Start to categorize flying text in appropriate bucket categories.

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Differences between Contracts of Indemnity & Contracts of Guarantee	
Contracts of Indemnity	Contracts of Guarantee
<ul style="list-style-type: none"><li>● Contracts of indemnity comprise two parties. These are the indemnifier and the indemnity holder.</li></ul>	<ul style="list-style-type: none"><li>● Contracts of guarantee are made with three parties. These are the principal debtor, the creditor and the surety.</li></ul>
<ul style="list-style-type: none"><li>● Contracts of indemnity are between the indemnifier and the indemnity holder. Only one contract is made between them.</li></ul>	<ul style="list-style-type: none"><li>● Contracts of guarantee are made out of three contracts. One contract is between the principal debtor and creditor. The second contract is between the surety and the creditor and the third is between the surety and the principal debtor.</li></ul>
<ul style="list-style-type: none"><li>● The indemnifier is independent and has primary liability in contracts of indemnity.</li></ul>	<ul style="list-style-type: none"><li>● In contracts of guarantee the surety has collateral or secondary liability whereas the primary liability is of the principal debtor.</li></ul>
<ul style="list-style-type: none"><li>● Contracts of indemnity provide security against losses.</li></ul>	<ul style="list-style-type: none"><li>● Contracts of guarantee provide security to creditors against default of the principal debtors.</li></ul>
<ul style="list-style-type: none"><li>● In an indemnity contract the indemnifier does not have to act at the request of the indemnity holder.</li></ul>	<ul style="list-style-type: none"><li>● In contracts of guarantee the surety can act only when the principal debtor requests him to do so.</li></ul>

## 13.9 Kinds of Guarantee

There are two categories of guarantees. These are called specific guarantees and continuing guarantees.

### 1. Specific Guarantee

A specific guarantee pertains to a single debt or a single transaction. It is a simple guarantee or a specific guarantee when the debt is discharged, then the duty is performed and the contract of guarantee comes to an end. In a specific guarantee if a new transaction has to be made between two parties a fresh guarantee will have to be taken as the guarantee on the single debt is completed. Guarantee can be for an existing debt or for a prospective debt or a future transaction.

#### Illustration

Purva guarantees the payment for 5 computers to Ali. The computers are to be delivered to Khan in March. Ali delivers the computers to Khan and payment is made to him. Purva's contract of guarantee ends on the payment. He is not liable for any further contracts because it is a specific contract pertaining to only five computers. If Khan paid for the computers then Purva would have been liable to make the payment to Ali.

### 2. Continuing Guarantee

According to Section 129 a continuing guarantee extends to a series of transactions. The surety is liable for all the transactions as his guarantee extends to all of them until the guarantee is removed.

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## Illustration

Raju was employed as a driver by Mr. Tiwari on the recommendation of Shiv for collection of credit payments from Delhi. Shiv guaranteed Raju's honesty and promised to pay in case of any default in payments collected by him (Raju). This is a contract of continuing guarantee.

## Illustration

Alok guaranteed that he would pay Amod Rs. 5,000 for continuously supplying his friend Asif a special cleaning powder every three months. Amod supplies Asif with cleaning powder for Rs. 4,000 and 5,000 which Asif pays. Then Amod supplies cleaning powder for Rs. 6,000 which Asif does not pay. Alok is under continuing guarantee and is liable to pay Amod upto Rs. 5,000 under the continuing guarantee contract.

### 13.9.1 Revocation of Continuing Guarantee

When a guarantee is cancelled it is called revocation of a guarantee. If the guarantee is cancelled then the surety's liability is discharged. A continuing guarantee can be revoked in the following way:

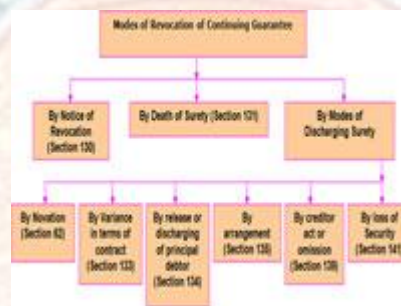


Figure 13.6 Revocation of Continuing Guarantee

**(i) By Notice of Revocation:** A surety can give a notice of revocation to the creditor. After the notice is given the surety does not have any future liability but he continues to be liable under Section 130 for any transactions that have already been entered into by him.

## Illustration

Dharam guarantees to Marram an amount of Rs. 50,000 that Moti will pay his debt in 30 days time. Marram agrees and the contract of guarantee is formed. Before the debt is cleared Dharam gives a notice of revocation. Moti defaults in making his payment on the due date. Dharam is liable to pay as it is an existing debt guaranteed by him.

**(ii) By Death of Surety:** In case of a continuing guarantee if the surety dies the contract is automatically revoked even if no notice of death of surety is given. But, under Section 131 of the Act the surety is liable for the existing transactions to which he had given a guarantee before his death.

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## Illustration

Mulla guarantees the payment of Rs. 500 to Asraf a book seller for any book that he supplies to Braj from time to time. Asraf supplies to Braj a book whose price is Rs. 200. After this transaction Mulla dies. After the death of Mulla, Asraf supplies another book priced at Rs. 100. Mulla's representative is liable only for the payment for the book of Rs. 200 to Asraf and not for the book of Rs. 100 because that book was supplied after his death.

**(iii) Other Reasons:** A continuing guarantee can also be revoked in the following conditions.

1. When there is a variance in the terms of a contract. (Section 133)
2. When the principal debtor is discharged or released. (Section 134)
3. When there is an agreed arrangement with the principal debtor. (Section 135)
4. When the creditor is responsible for an act or its omission which impairs the remedy of a surety. (Section 139)
5. When there is a loss of security.

## 13.10 Rights of Surety

A surety also has certain rights against the principal debtor, the creditor and the co-sureties. Each of these is explained below:

### 13.10.1 Rights Against the Principal Debtor

The surety has the right of subrogation and the right to claim indemnity from the principal debtor.

**(i) Rights of Subrogation:** When a surety makes a payment to a creditor on behalf of the principal debtor in case of a default, he acquires the rights of a creditor against the principal debtor. He can recover the entire amount that he has paid to the creditor. This is called the right of subrogation.



**Figure 13.7 Rights of Surety**

Section 140 of the Contract Act states that when a surety has performed the duty or made a payment on behalf of the principal debtor he acquires the rights of the creditor.



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He is entitled to claim all the sums he has rightfully paid to the creditor. He also gets the benefits of security that were given to the creditor when the contract was entered into.

**(ii) Rights of Indemnity:** When a contract of guarantee is entered into there is an implied promise that the principal debtor will indemnify the surety for all the payments rightfully made by him. If he has made any payments wrongfully he will not be able to recover any amounts. This has been stated in section 145.

### Illustration

Rahul has to pay Rs. 2,00,000 to Mahesh. Venkat is the surety for the debt. Mahesh demands the payment from Rahul on the due date. Rahul fails to pay the amount. Venkat who is the surety is compelled to make the payment on behalf of Rahul. Venkat has the right to recover the amount from Rahul with all the benefits promised to Mahesh as he has now acquired the right of a creditor.

### Illustration

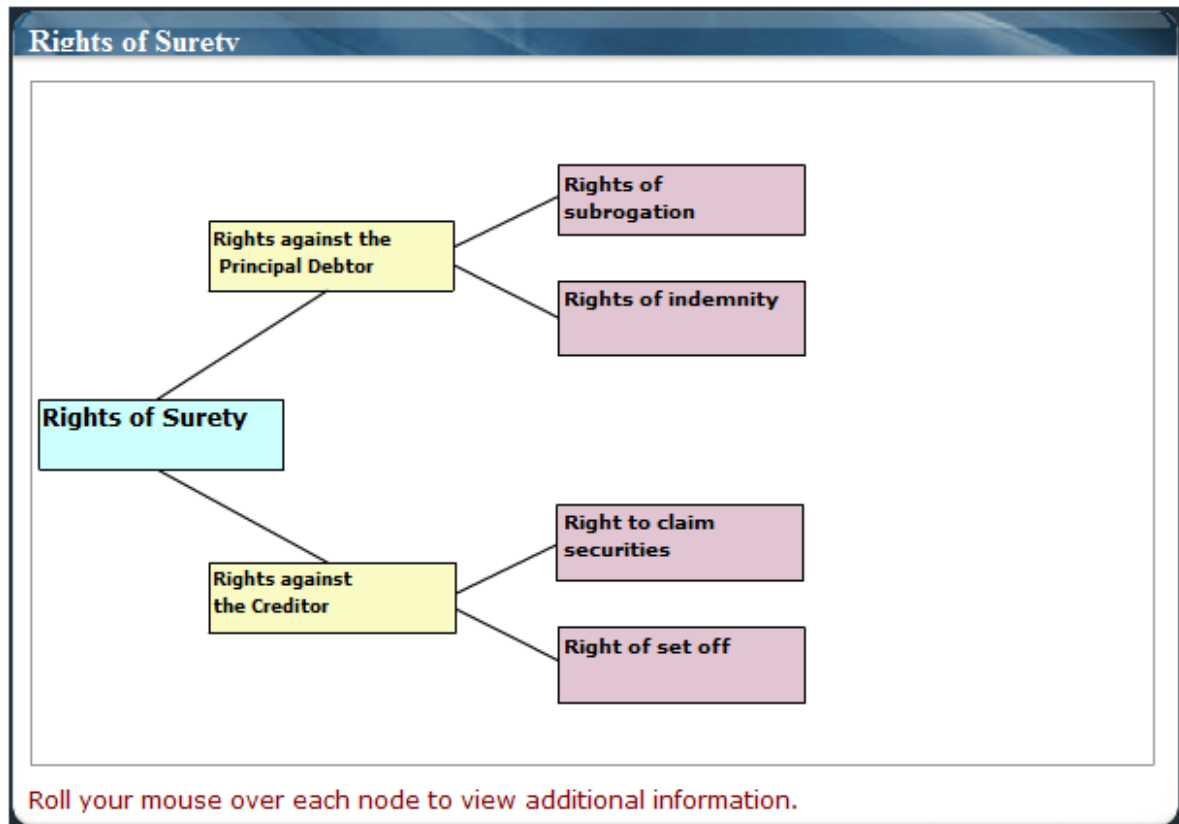
Sonu promises to supply 5 computers to Khursheed for Rs. 1,50,000. Kamal is surety for the amount to be paid by Khursheed on delivery. On the due date the computers are delivered but Khursheed fails to pay. Kamal who is the surety is compelled to make the payment. Kamal wrongly begins to defend Khursheed and incurs certain costs. Kamal incurs an extra expenditure of Rs 8,000. Kamal makes the payment finally on behalf of Khursheed. He later asks Khursheed to pay him 1,58,000. Since Kamal incurs an expenditure of Rs. 8,000 wrongly and without Khursheed's consent he cannot compel the principal debtor to reimburse the amount to him. He can only claim Rs 1,50,000

### Is Surety a Favoured Debtor?

1. The surety's liability is secondary. If he becomes insolvent he will not have to pay for the debts of the principal debtor. However, if the principal debtor becomes insolvent he will have to pay to the creditor.
2. The surety is discharged from his liabilities if there is a variance in the contract but the principal debtor has the liability to pay to the creditor if he defaults.
3. In case securities are offered, a surety has the right to demand a share. However, the principal debtor cannot claim a share if his claim is not satisfied.
4. The surety has to pay for the principal debtor only when there is a default by the principal debtor. However, the principal debtor will have to pay the amount either to the creditor on the due date or to the surety in case of default.

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## Check your Progress



### 13.10.2 Rights Against the Creditor

The surety has the following rights against the creditor:

**(i) Right to Claim Securities:** According to section 141 of the Act, the surety has the right of subrogation after performing his duty or making a payment to the creditor. All the rights of the creditor are passed on to the surety. Accordingly the surety



**Figure13.8 Right Against Security**

gets the right to the benefit of every security, which the creditor has against the principal debtor even if the surety he has no knowledge of the existence of such securities. If the creditor loses the security the surety is discharged of his responsibilities limited to the value of his security.

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## Illustration

Sunny gives Manju Rs 10,000 on the guarantee of Prem. Sunny has a further security of Manju's office table which is made of teak and is of the value of Rs.4000. Sunny cancels the security. Manju becomes insolvent and cannot pay his dues. Sunny sues Prem on his guarantee. Prem is discharged of his responsibility for the value of the office teak table.

**(ii) Right of Set off:** If the creditor sues the surety, he can claim set-off or counter claim, which the debtor had against the creditor.

## Illustration

Deepak took a loan from Sohan for Rs. 8,50,000. Somu guaranteed the loan. Somu also had a claim on Sohan for Rs. 3,00,000. In case of Deepak defaulting in repayment of the loan, Somu is liable to pay Rs. 5,50,000 to Sohan. Somu will also claim the benefit of this set-off although he does not have any personal claim on Sohan.

**(iii) Right to Share Reduction:** If the surety has paid the amount to the creditor on behalf of the principal debtor and the debtor becomes insolvent the amount has to be recovered from him, then the surety can claim from the creditor a reduction in his liability to the extent of the amount of dividend that is claimed by the creditor from the official receiver of the debtor.

## Case law 4

### In Hobson V Bass 1971 6 CRA 772

J gave a guarantee to B for payment of the goods sold by him to another person A up to an amount of Rs 1,000. B supplied goods for Rs 2,000. To A. A became insolvent and B supplied the goods. He asked J to pay. J paid him Rs 1000. B received from the official receiver 25% of Rs 2,000 as dividend in insolvency. It was held that J was entitled to receive a part of the dividend out of the whole received that is 50% of Rs 1000. This is Rs. 500

**(iv) Right to ask the Creditor to Terminate the Debtor's Services:** When a person gives a guarantee for the honest performance of another employee and the employee defaults, the surety has a right to demand that the employee be dismissed. Such dismissals are usually in the case of fidelity contracts, for example contracts relating to insurance.

## 13.10.3 Rights Against Co-sureties

When there is more than one surety to guarantee a debt they are called co-sureties. In case of default all the sureties become liable towards the contribution of the guarantee amount.

The following are the rights of the surety against co-sureties:

**(i) Right to Contribution:** Under Section 146 of the Indian Contract Act wherever there are co-sureties for the same amount, they are liable to share an equal amount of the debt which remains unpaid by the principal debtor. If a surety pays more than his share he has the right to ask the other sureties to participate in contributing an equal amount towards the debt.

# 1 (M) Indemnity and Guarantee

## Illustration

Rohit, Monty and Shiva are sureties to Kajal for Rs. 6,00,000 that is given as a loan to Randhir. On the date of payment Randhir defaults. Rohit, Monty and Shiva are liable between themselves to pay Rs. 2,00,000 each to clear the date.

**(ii) Bound in Different Sums:** If co-sureties are bound in different sums their liability will be shared equally, subject to the maximum amount guaranteed by each of them.

## Illustration

Manu, Pappu and Abhi are sureties for Dhara. They enter into a contract that Manu will pay Rs. 1,00,000, Pappu will pay Rs. 2,00,000 and Abhi will pay to the extent of Rs. 4,00,000 if Dhara makes a default in payment of an amount of Rs. 6,00,000 to Prakash. Manu is liable to pay Rs. 1,00,000, Pappu Rs. 2,00,000 and Abhi Rs. 3,00,000.

## 13.11 Surety's Liabilities

The surety has several liabilities since he has guaranteed the debt. These are discussed below:

**Co-extensive:** The nature and extent of a surety's liability is co-extensive with that of the principal debtor according to section 128 of the Indian Contract Act. "This means that the surety has the same liability as the principal debtor. If the principal debtor does not pay on time, the surety will be required to pay to the creditor".



Figure 13.9 Reduction in Liability

## Illustration

Amit has taken a loan of Rs 1,00,000 from Shamit and Sanjeev has guaranteed it. If Amit fails to pay the amount to Shamit on the due date, Sanjeev will have to pay the amount to the creditor. If an interest rate has been fixed, Sanjeev is also liable to pay the amount of interest.

**Reduction in Liability:** When the principal debtor's liability is reduced, the liability of the surety will also be reduced.

**Secondary Liability:** A surety's liability is secondary and comes into force only when the principal debtor defaults in his payment. If the surety himself becomes insolvent

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before the principal debtor defaults on his payment he will not be liable to pay any amount guaranteed by him.

**Check your Progress**

**Surety's Liabilities**

Liability for default by principal debtor

Contract between creditor & debtor is void

Liability restricted to valid contract

Secondary liability

Reduction in liability

Co-extensive

Click your mouse on each step to view its description.

**Liability restricted**

If a contract of guarantee is valid the surety will be liable. If the creditor makes a contract with representation or fraud, then the surety has the

**Liability Restricted to Valid Contract:** If a contract of guarantee is valid the surety will be liable. If the creditor makes a contract with representation or fraud, then the surety has the right to treat it as a voidable contract at his option.

**Liability When the Original Contract between Creditor and Principal Debtor is Void or Voidable:** The surety and the creditor have a contract that is independent from the principal debtor. Sometimes the original contract between the creditor and the principal debtor is not valid, but the surety is still liable for the principal debtor. In the event of the principal debtor being a minor, the surety does not get absolved of his liability. The surety is liable like a principal debtor.

When the contract between the creditor and the principal debtor is voidable the surety can still be liable. Moreover the liability of the surety continues to exist in the event of the creditor not making his claim during the period of limitation of 3 years of a debt. The surety is not discharged if the limitation period against the surety exists. But a surety who guarantees a time barred debt is not liable because according to the contract of guarantee he is not liable beyond the period of the guarantee contract. If the principal debtor is discharged from his liability or dies, the surety is discharged from his liability.

**Liability for Default by Principal Debtor:** The surety becomes liable immediately on default by the principal debtor. Before the default the surety does not have to pay as his

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liability only begins if the principal debtor does not pay. At the same time, the principal debtor does not have to send any notice of default to the surety. The creditor can sue the surety for the amount immediately on default. Procedurally, he is not required to sue the principal debtor first. He can immediately sue the surety for the amount owed to him.

## 13.12 Discharge of Surety

The surety and the co-surety are discharged from their liabilities in the following circumstances:

- (a) Revocation of Contract by Surety
- (b) By Act or Conduct of Creditor
- (c) By Invalidation of the Contract of Guarantee



Figure 13.10 Revocation of Contract by Surety

### 13.12.1 Revocation of Contract by Surety

A contract can be revoked by a surety either by

- (i) Giving Notice of Revocation or
- (ii) By Death of the Surety or
- (iii) By Novation.

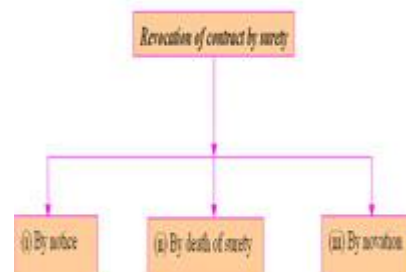


Figure 13.11 Revocation of Contract by Surety

**(i) By Notice:** A specific guarantee can be revoked by the surety by giving notice to the creditor. However, this is possible only before the liability of the surety accrues. If action has already been taken, the guarantee can be revoked. A continuing guarantee can be

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revoked for future transactions but the surety cannot be relieved of his liabilities from transactions that have already taken place (Section 130).

**(ii) By Death of Surety:** In the event of death, the surety is not liable to pay for any transactions entered into by the principal debtor and the creditor after his death. He is however liable for the past transactions. After his death his property cannot be attached for any new contracts made by the creditor and the principal debtor. His liability ceases after his death even though notice is not given. As already stated, in a continuing guarantee the same rule will apply. (Section 131)

**(iii) By Novation:** When a new contract of guarantee is made and it replaces the old contract either between the same parties of the contract or a continuation between at least one of the old parties with a new party, the old contract is discharged. The contract of guarantee made originally is also discharged. (Section 62)

## 13.12.2 By Act or Conduct of Creditor

The surety is discharged from his liabilities due to certain acts or the conduct of the creditor.



**Figure 13.12 By Act or Conduct of Creditor**

(a) Variance in Contract Terms: The liability of the surety extends to the terms of the contract between the three parties i.e., creditor, principal debtor and the surety. Any variation in terms and conditions

must be approved by the parties concerned. If any changes take place without the consent of the surety, he will be discharged from his liability after such changes are made (Section 133).

If the contract of guarantee consists of several distinct different duties and obligations the surety will be discharged from only those duties where there is a variance in the contract terms.

In a continuing guarantee the surety need not perform his duties subsequent to the variance in the contract as it will discharge him from his liabilities.

### **Illustration**

Madhwi is a distributor for consumer products. She employs Munish to sell the goods on commission. Raju is the surety for Munish to Madhwi for giving the correct amount of money collected from the sale of goods on which the commission becomes due. After Munish is employed on his request Madhwi changes the terms of the contract and begins to pay a salary to him without giving any information to Raju. The surety (Raju) is discharged from his liabilities.

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**(b) Release of Principal Debtor:** If the principal debtor is released in a contract by the creditor or by any act or omission of the creditor which has the effect of discharging the principal debtor from his debt, then the surety is automatically released from his liabilities.

## Illustration

Rani makes a contract with Tinu to furnish her office for Rs. 5,00,000 within one month. Rani promises to supply the furnishing material for the office. Minu guarantees the performance of Tinu. Rani does not supply the furnishing material. Minu is discharged from her liabilities as a surety.

**(c) Compounding by Creditor with Principal Debtor:** When the principal debtor and the creditor make a composition with each other without the knowledge of the surety. This applies to a situation in which a variation takes place from the original contract. In such a situation the surety is discharged from his liability.

## Illustration

Akhil borrows a sum of Rs. 50,000 from Shobha. Nirma is a surety for the payment by Akhil. Before the date of payment Akhil and Shobha change the terms of the contract by agreeing that Akhil may pay Rs. 30,000 instead of the whole amount. Nirma is discharged from his liability.

**(d) Act or Omission Impairing Surety's Eventual Remedy:** The surety's liability is discharged when the creditor acts or fails to act in a certain way. This action or its omission becomes inconsistent with the rights of the surety impairing his eventual remedy against the principal debtor, (section 139). If the creditor does not do his duty required towards the surety in the contract of guarantee, the surety can be discharged from his liability.

## Illustration

Ahluwalia contracts to build a hotel in Kohima for Rajender & Co. with certain specifications and a fixed date of completion. Sugani guarantees the completion and quality of the work to be done by Ahluwalia. Rajender & Co. promised to pay Ahluwalia in installments and according to the stages of work completed. The last installment was to be paid on the completion and inspection of the hotel by the competent authorities. Before the work is completed Rajender & Co. pay the complete amount to Ahluwalia. The contractor stops his work after receiving the full payment without completing the construction of the hotel. Sugani is not responsible as surety because Rajender & Co. have paid early and impaired the surety's eventual remedy.

**(e) Loss of Security:** The surety is discharged from his liability if the creditor loses the security given to him by the principal debtor. The surety will be also discharged if the creditor parts with his security without his consent. However he will not be discharged if the security of the creditor is lost due to natural calamities, or an act of an enemy of the country.

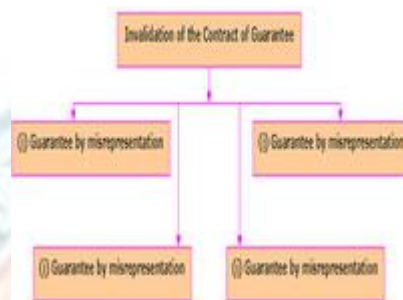


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## 13.12.3 By Invalidation of the Contract of Guarantee

The surety will be discharged from his liabilities by invalidation of the contract of guarantee in the following cases:

1. Guarantee obtained by misrepresentation
2. Guarantee obtained by concealment
3. Contract of guarantee without consideration
4. Contract of guarantee where co-surety fails to join the surety



**Figure 13.13 By Invalidation of the Contract of Guarantee**

**1 Guarantee Obtained by Misrepresentation:** According to section 142 “if a guarantee is received by misrepresentation made by the creditor or with his knowledge and a major part has been misrepresented, the surety will be discharged from his liability”.

**2 Guarantee Obtained by Concealment:** According to section 143 of the contract Act, “if the creditor has remained silent on certain important and material facts and obtained a guarantee, the surety will be discharged from his liability”. The surety will be relieved from his liability as such a guarantee will be obtained by concealment

**3 Contract of Guarantee without Consideration:** In a contract of guarantee there must be consideration between the creditor and the principal debtor. If there is no consideration the surety will be discharged from his liability.

**4 Contract of Guarantee where Co-surety does not Join the Surety:** According to section 144, “in a contract of guarantee involving co-sureties and making it necessary for the contract to be completed by more than one surety, the guarantee is invalid if the co-surety does not join the surety in the contract”.

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