The Law of Guarantees: The Rights & Liabilities of the Guarantor

Maurya Vijay Chandra
INDIA’S FDI POLICY LIBERALISED: WILL THE INFLOWS INCREASE?

THE QUESTION OF WHO IS BETTER—’COMPARATIVE ADVERTISING LAWS IN INDIA’

THE LAW OF GUARANTEES: THE RIGHTS & LIABILITIES OF THE GUARANTOR

LEGALISING EUTHANASIA IN THE LIGHT OF ARUNA SHANBAUG CASE

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Dear Friends,

If I may use the clichéd expression “liberalization, privatization and globalization” of the economy in early 1990’s by successive Indian governments have launched us on the course of economic prosperity in the country. And in last twenty years or so we have witnessed a lot of heartening sights in terms of India’s emerging stature in the global arena. The policy shift primarily involved attracting foreign capital and technology to the country which necessitated a lot of economic and legal reforms in the country. Of these reforms one of the most important features has been the liberalization of the exchange control regime in the country which involved legislation of FEMA and formulation of policy on foreign direct investment. And it is a common knowledge that India has been able to attract a lot of foreign investment in the country because of which we are witnessing a lot development in the country especially in infrastructure sector.

In that larger context Lex Witness studies the effects of Consolidation of Foreign Direct Investment Policy of April 2011 by the Department of Industrial Policy and Promotion, in its cover story titled “FDI Policy liberalized: Will the inflows increase?” In that Witness is assessing the impact of this consolidation on the inflow of investments in the country. On the other hand this issue also explores the good and bad effects of comparative advertising in the country through an article titled “The question of who is better—‘comparative advertising laws in India’” in the context of its impact on the interests of the consumers. Besides we are also trying to understand the impact of hon’ble supreme court on the issue of legalising euthanasia titled “Legalising Euthanasia in the Light of Aruna Shanbaug case”.

Our last issue was appreciated by a lot of our readers who found it informative, insightful and enriching. Especially the cover story “India’s Merger Control Regime Arrives” was liked by lot of readers besides the Article on “Internet Frauds And The Indian Cyberlaw” got us a lot of delightful feedback from our valuable readers.

We believe in a constructive dialogue so as to contribute to the discourse on legal issues of national importance and therefore always await the views and opinions of our readers on the issues explored, studied and investigated by our magazine so as to enrich ourselves to keep on improving in our effort.

Your Witness please!

PBA Srinivasan
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Dear Friends

We are living in momentous times. These are the times wherein we can sniff our tryst with the items on top of our nation's 'wish list'. At times, we witness despairing moments like unfolding of scams one after another, yet along with that there is the heartening sight of 'change mascots' like Anna Hazare who have the ability to galvanize and inspire the confidence in the civil society to keep striving towards our cherished national dreams.

Lokpal bill, to be drafted by the committee constituted, has generated a lot of hope amongst the people of a corruption free polity. Yet the bill to be drafted is no cake walk as it involves several serious and contentious issues like whom to include and whom to exclude from its jurisdiction as there is a clamour for much wider mandate than originally planned and to include Politicians, Bureaucrats and Judges therein. Besides it is also been debated as to how to enable it to be an effective watchdog, as is the desire of the civil society to vest it with powers to investigate and prosecute the persons complained against. But the issue of frivolous and motivated complaints is also an issue of critical importance as honest and sincere public servants may be subjected to harassment by unscrupulous elements in society. Therefore harmonizing such conflicting issues into a single draft is going to be a herculean task for the drafting committee.

Imbued with the missionary zeal to support knowledge based events in the legal services industry, Lex Witness continues to partner with legal forums and events of national and international importance.

Noticeable amongst them are The Legal Counsel Congress India 2011, our second round of partnership with them and Annual Intellectual Property Awards-2011, one of the major arms of the CII IPR Initiative 2011 organised by CII with the Government of India, wherein Lex Witness has an year's commitment as an Official Media Partner.

After the successful event in London in March this year, the Global LPO Conference travels to USA this June titled “International Domain - aggressive steps” and Lex Witness is pleased to be partnering with this vital conference in the LPO space yet again.

Also, I take this opportunity to thank all of you for yur continuous support to a initoatove called Lex Witness!

Your Witness please!

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The Law of Guarantees:  
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Sayanhya Roy

INTRODUCTION

Guarantee is defined under section 126 of the Indian Contract Act 1872 to mean a contract to perform the promise, or discharge the liability, of a third person in the case of the default of such third person. It also provides that a contract of guarantee can be made either orally or in writing. A contract of guarantee is characterised by the presence of three parties - the creditor, to whom the guarantee is given; the guarantor or surety, who gives the guarantee; and the debtor on whose behalf the guarantee is given. The main purpose for a contract of guarantee is to provide the creditor with an additional security in the form of a promise to discharge an obligation by the guarantor in the event of a default by the debtor. The second contract is an implied contract between the debtor and the guarantor whereby the debtor undertakes to indemnify the guarantor wherein, due to the default of the debtor, the guarantor has to pay the sum owed by the debtor to the creditor. Section 145 of the Indian Contract Act provides that in every contract of guarantee, there is an implied promise by the debtor to indemnify the guarantor, and the guarantor is entitled to recover from the debtor whatever sum he has rightfully paid under the guarantee, but no sums which he has paid wrongfully.

GUARANTEE AND INDEMNITY: DISTINCTION

The guarantor’s right to recover the payment made under the guarantee from the debtor is one of the aspects of a contract of guarantee that differentiates it from a contract of indemnity. Indemnity is defined in the Oxford English Dictionary as a security or protection promised against a loss or other financial burden. To indemnify has been defined therein to mean to compensate someone for harm or loss and to secure someone against legal responsibility for their actions. Section 124 of the Indian Contract Act defines a contract of indemnity to be a contract by which one party promises to save the other from loss caused to him by the conduct of the indemnifier himself or by the conduct of any other person. A contract of indemnity, therefore, is a single contract between two persons - the indemnifier and the indemnity holder. Unlike a guarantor who has certain rights against the debtor towards recovery of the amount paid to the creditor, once the indemnifier has indemnified the indemnity holder, the former cannot recover the amount so paid. Also, unlike the indemnifier, the liability of a guarantor is only secondary to the liability of the
A contract of guarantee requires meeting of minds of three players - the principal debtor, the surety and the creditor. The surety (usually a bank) undertakes an obligation at the request express or implied of the principal debtor (usually the bank’s customer). It is an independent contract between the bank and the beneficiary. It is this very autonomy that makes a contract of guarantee an instrument for growth of business and economy.

The principal that a surety is a favoured debtor dates back to the late 18th Century era of global trading by the East India Company. Over the four centuries this rule has withstand the test of time and still enforced in the contemporary world. There are a plethora of judgments in this connection; the notable ones being Law vs. East Indian Co.; Winston vs. Rives; Blest vs. Brown, amongst others. Further, it is well-settled that the liability of the Surety/Guarantor is co-extensive with that of the principal debtor, unless it is otherwise provided in the agreement itself. If a contract neglects to limit the liability of the guarantor towards the creditor, the guarantor risks being liable for the whole of the debt. In view of this position, guarantees are drafted in such a way that guarantor and the principal debtor are jointly and severally liable in the ordinary course of all times.

The liability of the guarantor arises only when the debtor makes a default. An indemnifier, on the other hand, has a primary liability which arises immediately upon the happening of the contemplated event.

**CONTRACT OF GUARANTEE: SALIENT FEATURES**

The main features of a contract of guarantee are that the contract may be oral or in writing; that there should be a principal debt owed by the debtor to the creditor; that there must be a sufficient consideration benefiting the debtor; and that the consent of the guarantor must not have been obtained by fraud or misrepresentation. Unlike the English law, a contract of guarantee in India may be made either orally or in writing. It is however always advisable to have the contract in writing, and also specify the extent to and the conditions under which the guarantor will be liable towards the debt owned by the debtor to the creditor. In the absence of a limit, the guarantor is deemed to be wholly responsible towards the entire amount or part thereof remaining unpaid by the debtor under the relevant principal transaction. A limit may further ensure that additional losses and expenses incurred by the creditor will not be recoverable by the creditor from the guarantor.

A contact of guarantee pre-supposes the existence of a principal debt owed by the debtor to a creditor. In the absence of a principal debt, where the promise is simply towards compensating another for a loss caused due to the happening of certain events or under certain circumstances, the contract is not one of guarantee, but is a contract of indemnity. The principal debt owed by the debtor must constitute a sufficient consideration to the guarantor to provide the guarantee. Section 127 of the Indian Contract Act provides that anything done, or any promise made for the benefit of the debtor may be sufficient consideration to the guarantor for giving the guarantee. Section 127 of the Indian Contract Act provides that anything done, or any promise made for the benefit of the debtor may be sufficient consideration to the guarantor for giving the guarantee. In the absence of the requisite consideration, a guarantor cannot provide a valid guarantee.

Furthermore, sections 142 and 143 of the Indian Contract Act provide that a contract of guarantee is vitiated if the consent of the guarantor is obtained by fraud or misrepresentation of facts. The free consent of a party entering into a contract has been defined in section 14 of the Indian Contract Act to include those not caused by fraud or misrepresentation of facts. However, while the explanation to section 17 of the Indian Contract Act provides that mere silence as to the facts likely to affect the willingness of a person to enter into a contract may not constitute a fraud, section 143 of the Act mandates that obtaining a person’s consent to act as a guarantor either by misrepresentation, or keeping silent as to a material
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(Q) What are the defining features of Contract of Guarantee?
The contract of guarantee has been defined in section 126 of the Indian Contract Act, 1872 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". A contract of guarantee is executed to give assurance to the creditor in lieu for his money. Hence, there have to be three parties (in case the contract is between two parties). The liability of the surety/guarantor is secondary and arises when principal debtor fails to fulfill his commitments under the agreement.

(Q) Is a Guarantor a "favoured debtor" in the eyes of law?
The liability of a surety/guarantor will be equal to that of the principal debtor where the liability of the surety/guarantor is not specifically provided in the contract. Further, where the contract of guarantee is unconditional, no condition can be put to it afterwards either by the surety, creditor or court. Hence, the surety/guarantor is sometimes called a favoured debtor. The surety/guarantor as a favoured debtor can insist on a strict adherence to the terms of his obligations. The surety's/guarantor's liability is limited to the amount which he has undertaken to pay. He cannot be made liable for more than he has undertaken on the default of the principal debtor.

(Q) The extent of the liability undertaken by the guarantor, unless limited by the contract, is deemed to be co-extensive with the liability of the debtor. Please comment
It is obvious that in case of failure on the part of the debtor to discharge his liability, the surety/guarantor will be asked to discharge the liability. Section 128 of the Indian Contract Act, 1872 says that the liability of the surety is co-extensive with that of the principal debtor, unless it is otherwise provided by the contract. The Rajasthan High Court in the case of Narayan Singh vs. Chhatar Singh [AIR 1973 Raj 347] has opined that the liability of the guarantor is co-extensive with that of the principal debtor and if the latter's liability is scaled down in an amended decree or otherwise extinguished in whole or in part by a statute, the liability of the guarantor would also pro tanto be reduced or extinguished. The Supreme Court in the case of M.S.E.B., Bombay vs. Official Liquidator [AIR 1982 SC 1497] has further clarified that a guarantor is no doubt discharged under section 134 of the Indian Contract Act by any contract between the creditor and the principal debtor by which the principal debtor is released or by any act or omission of the creditor, but a discharge which a principal debtor may secure by operation of law in bankruptcy/liquidation proceedings does not absolve the guarantor of its liability.

Furthermore, it was observed in the case of Lachhma Joharimal vs. Bapu Khandu [(1869) 6 Bom HCR 241] that a creditor is

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not bound to exhaust his remedy against the principal debtor before suing the guarantor and that when a decree is obtained against the guarantor, it may be enforced in the same manner as a decree for any other debt. Thus the rule of law states that a creditor cannot be restrained from action against the guarantor on the ground that the debtor is solvent or that the creditor may have relief against the debtor in other proceedings. In Bank of Bihar Ltd. vs. Damodar Prasad [AIR 1969 SC 297] the court has held that the creditor is not required to exhaust all his remedies available against the debtor before enforcing his claim against the guarantor.

The extent of the liability undertaken by the guarantor, unless limited by the contract, is deemed to be co-extensive with the liability of the debtor. A guarantor cannot be made liable for more than what he has undertaken in the contract. However, in the absence of the limiting factors in a contract, the guarantor who guarantees the payment of a bill will be liable for all that the debtor will be liable for. The Allahabad High Court in Zaki Hussain vs. Dy. Commr. Gonda [AIR 1929 All 687] has said that the liability of the guarantor extends not only to the debt undertaken by the debtor, but also the interest recoverable by the creditor on that debt. It is generally understood that in the absence of a limit, the guarantor is also liable to pay for the reasonable expenses incurred by the creditor for recovering the sums due from the debtor and the guarantor. However, in the absence of a contract to the contrary, a guarantor is not liable for a liability of the debtor incurred prior to the contract of guarantee.

A guarantor is not discharged from his liability if the creditor terminates his contract with the debtor. There is, however, a difference of opinion on the enforceability of the contract between the creditor and the guarantor in case where the original contract between the creditor and the debtor is rendered void. In Kashiba vs. Shripat Narshiv [(1885) 19 Bom. 697] and Sohal Lal vs. Puran Singh [(1916) 54 P.R. 1916] it has been held that a bond passed by a minor, or in cases wherein the original contract between the debtor and the creditor was void, the guarantor was still liable despite the original contract being void. The same has been reiterated in Chhaju Singh vs. Emperor AIR 1921 Lah 79. However, in Edaven Kavungal Kelappan Nambiar vs. Moolakal Kunhi Raman AIR 1957 Mad 164, the Madras High Court has held that if a guarantor guaranteed a debt by a minor (an agreement that will be considered void; vide sections 10 and 11 of the Indian Contract Act), he incurred no liability as his liability was co-extensive with that of the principal debtor, whose contract was void.

**LIMITS IMPOSED BY CONTRACT**

It is pertinent to note that the contract of guarantee may provide for conditions that limit not only the sum recoverable from the guarantor, but also state the explicit conditions under which the guarantee can be invoked.

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Section 145 of the Indian Contract Act contemplates an implied contract of indemnity between the guarantor and the principal debtor. It provides that the guarantor is entitled to recover only such sums from the debtor as has been rightfully paid by the guarantor and not such amounts as have been paid otherwise.

Chittaranjan Banerjee vs. Dy. Commr. Of Lakhimpur [AIR'1980 Gau 62] held that a guarantor in the eye of law is a “favoured debtor” and the surety bonds are to be construed strictly. A guarantor can only be held to be bound if the condition of the liability has been fulfilled. Being a “favoured debtor”, a guarantor is entitled to insist upon a rigid adherence to the term of his obligation by the creditor and cannot be made liable for more than he has undertaken. The nature of the contract cannot be equated with that of an insurer or uberrima fides. It is one of strictissimi juris.

The contract may also mention the procedure of invoking the guarantee, and if it is provided therein that the creditor must first extinguish all available remedies against the debtor before invoking the guarantee, then fulfilment of such a condition is mandatory before invoking the guarantee. The same principle is applicable in the case of co-guarantors. In the absence of a definite limit in the contract the creditor has the right to sue all the parties together or any party or combination thereof. Section 146 of the Indian Contract Act provides that in the absence of a contract between the co-guarantors, the co-guarantors are liable, as between themselves, to pay an equal share of the whole debt, or of that part which remains unpaid by the principal debtor.

**RIGHTS OF THE GUARANTOR AGAINST THE DEBTOR AND CREDITOR**

The guarantor, having discharged the guarantee in favour of the creditor upon the default of the debtor, is entitled to the guarantor’s right of subrogation. That is to say, where a guaranteed debt has become due, or default of the principal debtor to perform a guaranteed duty has taken place, the guarantor, upon payment and performance of all that he is liable for, is invested with all the rights which the creditor had against the debtor. These rights also include a right to the benefit of every security that the creditor has against the debtor at the time when the contract of guarantee was entered into (pursuant to sections 140 and 141 of the Indian Contract Act). Thereafter, section 145 of the Indian Contract Act contemplates an implied contract of indemnity between the guarantor and the principal debtor. It provides that the guarantor is entitled to recover only such sums from the debtor as has been rightfully paid by the guarantor and not such amounts as have been paid otherwise.

**CONCLUSION**

In a contract of guarantee, it is, therefore, important to carefully set the limits of liability of the guarantor towards the creditor. The rights of the guarantor towards the debtor and the creditor are statutorily provided, and serve to enhance the position of the guarantor only once he has discharged his liabilities. The liability to discharge the full extent of the liabilities of the debtor may not be palatable for most guarantors since the said liabilities not only take into account the principal sum, but also other amounts such as interest and costs that may inflate the net guarantee payable. By limiting the guarantee payable, the contingencies under which such guarantee shall be payable, and by directing the procedure applicable for the creditor to seek a relief in case of a default by the debtor, the guarantor will ensure a greater level of clarity for the parties to the arrangement. The aim of a contract of guarantee is to facilitate a receipt of benefit by a debtor which may not have been possible otherwise. For the guarantor, it is important to remember that while he may be willing to display his generosity by placing his assets at stake, at the end of the day, he must not bite more than he is willing to chew!

**ABOUT THE AUTHOR:**

Sayonhya Roy holds an LLB from Faculty of Law, University of Delhi. He worked as a business and legal correspondent with The Business Standard in New Delhi before turning to law practice. Currently, Roy is practising as an advocate at M/s Agarwal Jetley & Co., Advocates. He has been involved in Corporate and Commercial law practice, particularly in the areas of Company laws, Foreign Direct Investments, Joint ventures, and Commercial & Contract Laws.