

Chapter 1. The Indian Contract Act, 1872

Unit 1.

Contract of Indemnity and Guarantee

1.1 WHAT IS A CONTRACT OF INDEMNITY?

Indemnity: (dict. meaning) - Security or protection against a loss or other financial burden.

Definition: Section 124 of the Contract Act defines a contract of indemnity as under:

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, is called a "contract of indemnity".

There are two parties in this form of contract. The party who promises to indemnify/save the other party from loss is known as 'indemnifier', whereas the party who is promised to be saved against the loss is known as 'indemnified or indemnity holder'.

Illustration: P contracts to indemnify Q, against the consequences of any proceeding, which R may take against Q in respect of a certain sum of ₹ 2000. This is a contract of Indemnity. P is called the Indemnifier and Q the Indemnity-holder.

Definition is not exhaustive: In an indemnity contract, loss must be caused by some human agency. Thus, the definition of indemnity under the Indian Contract Act, is very narrow. It is restricted to such cases only where:

- 1) Loss is caused by the **conduct of promisor** or
- 2) Loss is caused by **conduct of any other person.**

Thus, the loss caused by events or accidents like fire or perils of the sea, which do not depend on the conduct of any person, are not covered under a contract of indemnity.

However the Indian courts have liberally interpreted the term and have recognised the wide definition of indemnity as given in English law to cover the loss caused even by events or accidents which may not be based on person's conduct.

Under the English law contract of indemnity is:

A promise to save a person harmless from the consequences of an act. Such a promise can be express or implied from the circumstances of the case.

So the Law Commission of India in its 13th Report has recommended that the scope of section 124 be extended to include cases where:

- 1) not necessary that the indemnity holder should first discharge his liability and then claim reimbursement. The Indemnity holder can compel payment from the indemnifier even before he has met his liability.
- 2) *loss is not caused by the conduct of any person.*

1.2 WHAT ARE THE RIGHTS OF INDEMNITY-HOLDER?

Rights of the Indemnity-holder: Section 125 of the Contract Act lays down that the indemnity-holder is entitled to get from the indemnifier:

1. all **damages** which he may be compelled to pay in any suit in respect of any matter to which the promise to indemnify applies;
2. all **costs** which he may be compelled to pay in such suits (provided he acted prudently or with the authority of the indemnifier).
3. all **sums** which he may have paid upon **compromise of suit** (provided the compromise was prudent or was authorised by the indemnifier).

The indemnity holder has other rights besides those mentioned above. If he has incurred a liability and that liability is absolute, he is entitled to call upon his indemnifier to save him from the liability and to pay it off. (*Gajan Moreshwar vs. Moreshwar Madan 1942 Bom. 302*)

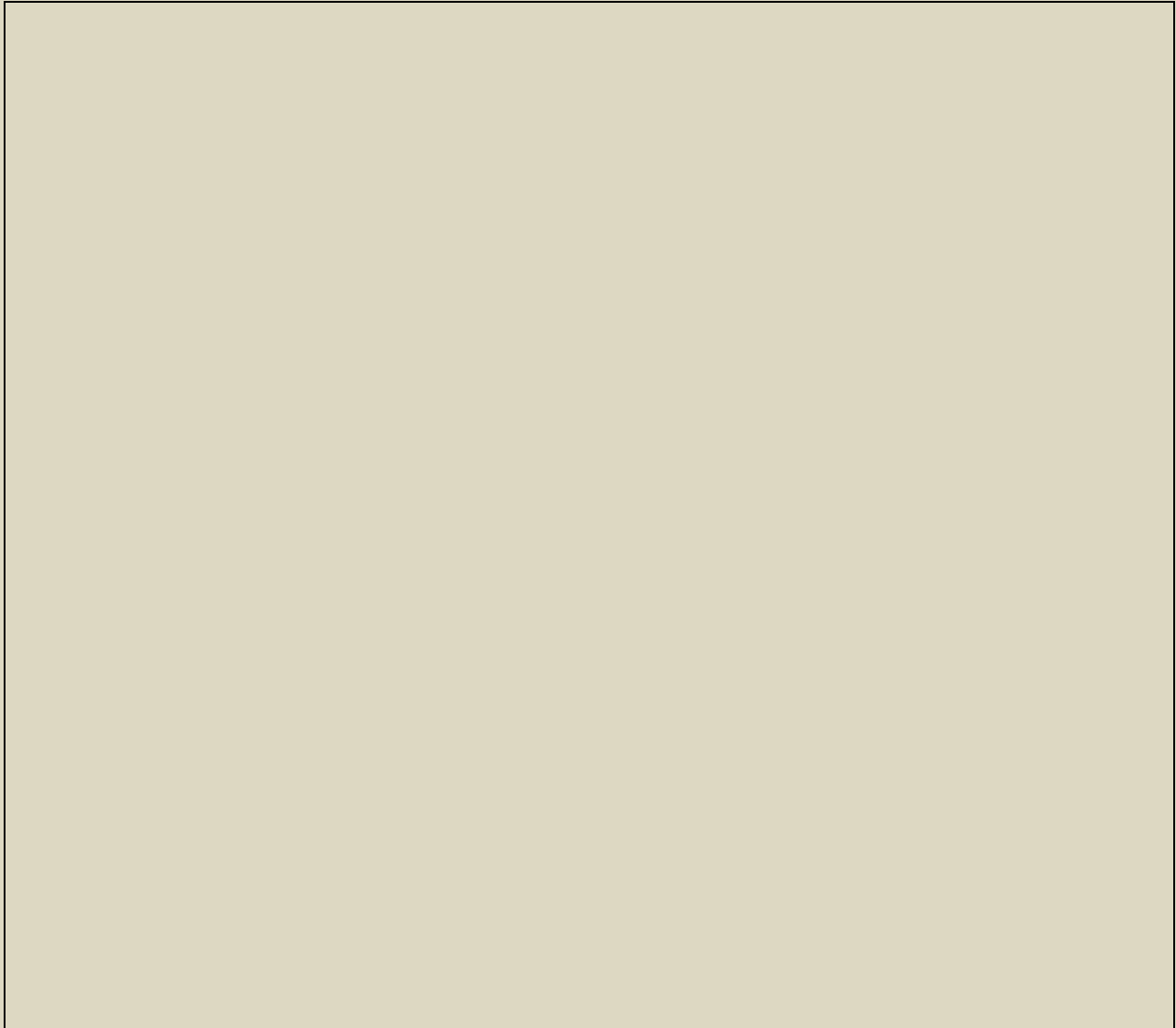
Examples:

(1) A may contract to indemnify B against the consequences of any proceedings which C may take against B in respect of a sum of ₹ 5000/- advanced by C to B. In consequence, when B who is called upon to pay the sum of money to C fails to do so, C would be able to recover the amount from A as provided in Section 124.

(2) X, a shareholder of a company lost his share certificate. He applied for the duplicate. The company agreed to issue the same on the term that X will compensate the company against the loss where any holder produces the original certificate. Here there is contract of indemnity between X and the company.

1.3 WHAT IS A CONTRACT OF GUARANTEE?

Definition: A contract of guarantee is a contract to perform the promise or discharge the liability, of a third person in case of his default (Sec 126).



Essentials of a valid Guarantee:

(1) Essential Elements of a Contract: A contract of guarantee must satisfy all the essential elements of a contract. [For eg: the object must be lawful; there must be free consent etc. (Sec 10)]

Exception:

- (a) Consideration received by principal debtor is a sufficient consideration to the surety for giving the guarantee (Sec. 127)
- (b) If principal debtor is incompetent to contract the guarantee is valid but it is not the case with surety. *(We will discuss the effect of minor as surety in detail in the succeeding topics)*

- (2) **Form of Contract:** A contract of guarantee may be either oral or written; Sec 126. Under the English Law a contract of guarantee has to be in writing.
- (3) **Parties to Guarantee:** In a contract of guarantee there are three parties i.e., the creditor, the principal debtor and the surety. **All the parties must join the contract.**
- (4) **Existence of a Principal Debt:** The existence of a principal debt due by the debtor to the creditor for the payment of which guarantee is to be given is necessary. If there is no principal debt due and payable there is no valid guarantee.
- (5) **Primary Liability of Debtor:** In a contract of guarantee, the primary liability is that of principal debtor. The liability of surety arises only when there is a default of the principal debtor. Therefore, the liability of the surety is secondary.
- (6) **Liability of Principal Debtor to Indemnify the Surety:** In every contract of guarantee there is an implied promise by the principal debtor to indemnify the surety; and the surety is entitled to recover from the principal debtor whatever sum he has rightfully paid under the guarantee, but no sums which he has paid wrongfully (Sec. 145).

Illustration: B is indebted to C, and A is surety for the debt. On refusal by B to pay the amount, C demands payment from A, and on his refusal sues him for the amount. A is compelled to pay the amount of the debt with costs. He can recover from B the amount paid by him for costs, as well as the principal debt.

- (7) **Consideration:** In a contract of guarantee, the consideration received by the principal debtor is taken to be sufficient consideration for the surety. *"Anything done, or any promise made, for the benefit of the principal debtor may be sufficient consideration to the surety for giving the guarantee"* (Sec. 127)

Illustrations:

(a) 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 to guarantee the payment in consideration of A's promise to deliver the goods. This is a sufficient consideration for C's promise.

(b) A sells and delivers goods to B. C afterwards requests A to forbear to sue B for the debt for a year, and promises that if he does so, C will pay for them in default of payment by B. A agrees to forbear as requested. This is a sufficient consideration for C's promise.

(c) A sells and delivers goods to B. C afterwards, without consideration, agrees to pay for them in default of B. The agreement is void.

Reasons:

1. At the time of delivering goods, contract was between A & B. As mentioned in 'essential to a valid guarantee' - "All the parties must join the contract".
2. C agrees afterwards to guarantee. However at this time he is not getting anything in return as consideration, as for this fresh contract A is not offering/doing anything in return either for B or C.

Note: As compared to case (b) above, A agrees to forbear to sue B for debt for a year for the fresh promise by C.

Check yourself: 'A' had advanced money to 'B' on a bond hypothecating B's property stating that C is the surety for any balance that might remain due after realization of B's property. C was not a party to the bond. He, however signed a separate surety bond two days Subsequent to the advance of the money. Whether it constitutes a valid guarantee?

(8) Misrepresentation and concealment affecting guarantee: A guarantee obtained by way of misrepresentation concealment of material fact is invalid (Secs. 142 & 143).

Classification of Contracts of Guarantee:

Contracts of guarantee may be of three types:

- (1) for payment to the Creditor or the Principal Debtor by the Guarantor;
- (2) for payment of price for goods sold, and
- (3) for the good conduct or honesty of a person employed in a particular office. This is called as "fidelity Guarantee". (fidelity- faithfulness to obligations /duties).

A guarantee can also be classified as:

- (1) Simple Guarantee: A guarantee which extends to a single transaction or debt is called a simple guarantee, or
- (2) Continuing Guarantee (Sec. 129)

1.4 WHAT IS THE DISTINCTION BETWEEN CONTRACT OF INDEMNITY AND GUARANTEE?

Sr. No	Points of Differences	CONTRACT OF INDEMNITY	CONTRACT OF GUARANTEE
1.	Parties	In a contract of indemnity, there are two parties: the indemnifier and the indemnity holder.	In a contract of guarantee there are three parties: creditor, the principal debtor, and the surety.
2.	Ability to Contract	The parties must be all capable of contracting.	The principal debtor may be a minor, in which case the surety will be primarily liable.

3.	Objective	The contract of indemnity is for the reimbursement of the loss.	Whereas the contract of guarantee is for the security of the creditor.
4.	Contract	It is necessary to have only one contract, i.e. between the indemnity-holder indemnifier.	It is necessary to have three contracts between each of the parties.
5.	Nature of Liability	Liability of the indemnifier is primary.	Liability of surety is secondary i.e., the surety is liable only if the principal debtor fails to perform his obligations.
6.	Liability Arises	The liability of the indemnifier arises only on the happening of a contingency.	There is an existing debt or duty, the performance of which is guaranteed by surety. Thus the liability of surety arises only in case of default by the Principal Debtor.
7.	Recovery	After discharging his liability the indemnifier cannot recover the loss from anyone.	The surety, after he discharges the debt owing to the creditor, can proceed against the principal debtor.

10.5 WHAT IS CONTINUING GUARANTEE? WHEN CAN IT BE REVOKED?

A guarantee which extends to a series of transactions is called a Continuing Guarantee (Sec. 129):

Illustrations:

- (a) A, in consideration that B will employ C in collecting the rents of B's zamindari, promises B to be responsible, to the amount of 5,000 rupees, for due collection and payment by C of those rents. This is a continuing guarantee.
- (b) A guarantees payment to B, a tea-dealer, to the amount of ₹ 100, for any tea he may from time to time supply to C. B supplies C with tea to the value of ₹ 100, and C pays B for it. Afterwards B supplies C with tea to the value of ₹ 200. C fails to pay. The guarantee given by A was a continuing guarantee, and he is accordingly liable to B to the extent of ₹ 100.
- (c) A guarantees payment to B of the price of particular five bags of flour to be delivered by B to C and to be *paid* for in a month. B delivers five bags to C. C pays for them. Afterwards B delivers four bags to C, which C does not pay for. The guarantee given by A was not a continuing guarantee, and accordingly he is not liable for the price of the four bags.

HOW A CONTINUING GUARANTEE IS REVOKED?

- (1) **By notice of revocation by the surety:** The notice operates to revoke the surety's liabilities as regards transactions entered into after the notice. He continues to be liable for transactions entered into prior to the notice (Sec 130)

Illustration: B agrees to discount, at A's request, bills of exchange for C, and A thus gives guarantee to B, for twelve months, the due payment of all such bills to the extent of 5,000 rupees. B discounts bills for C to the extent of 2,000 rupees. Afterwards, at the end of three months, A revokes the guarantee. This revocation discharges A from all liability to B for any subsequent discount. But A is liable to B for the 2,000 rupees, on default of C.

- (2) **By the death of the surety:** "The death of the surety operates, in the absence of a contract to the contrary, as a revocation of a continuing guarantee, so far as regards future transactions" (Sec. 131)
- (3) **By discharge of surety in various circumstances:** A continuing guarantee is also revoked under all circumstances under which a surety is discharged from his liability, such as by :
- (i) Variance in terms of contract (Section 133)
 - (ii) Agreement with the principal debtor (Section 135)
 - (iii) Loss of Security (Section 141)
 - (iv) Invalidation of contract (Section 142, 143, 144)
 - (v) Release or discharge of principal debtor (Section 134)
 - (vi) Novation (Section 62)
 - (vii) Creditor's act or Omission impairing surety's eventual remedy (Section 135)

CONTRACT OF GUARANTEE, WHEN INVALID?

- i) Contract of guarantee is invalid when the essentials of a valid contract are not fulfilled.
- ii) U/s 142 to 144 a contract of guarantee will be invalid in the following cases-

- (a) **Guarantee obtained by misrepresentation:** 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. - Sec. 142
- (b) **Guarantee obtained by concealment:** Any guarantee which the creditor has obtained by means of keeping silence as to material circumstances is invalid. – 143

Illustrations

- (a) A engages B as a clerk to collect money for him, B fails to account for some of his receipts, and A in consequence 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.
- (b) A guarantees to C payment for iron to be supplied by him to B to the amount of 2,000 tons.

B and C have privately agreed that B should pay five rupees per ton beyond the market price, such excess to be applied in liquidation of an old debt. This agreement is concealed from A. A is not liable as a surety.

(c) **Guarantee on contract that creditor shall not act on it until co-surety joins:** Where a person gives a guarantee upon a contract that a creditor shall not act upon it until another person has joined in it as co-surety, the guarantee is not valid if that other person does not join. - Sec.144

1.6 WHAT IS THE EXTENT OF THE LIABILITY OF THE SURETY?

Surety's Liability: The liability of the surety is **co-extensive** (having the same scope) with that of the principal debtor, unless it is otherwise provided by the contract -Sec. 128. Thus it can be seen:

- (i) The liability of surety is the same as that of principal debtor
- (ii) Where a debtor cannot be held liable on account of any defect in the document, the liability of the surety also ceases.
- (iii) Surety's liability continues & can be sued even if the principal debtor has not been sued or is omitted or not made a co- defendant. This is for the reason that **the liability of the surety is separate on the guarantee.**

Exception: However, by an **express** agreement the surety may place a limit on his liability,

e.g. a surety may declare that his guarantee is limited to a fixed amount say ₹ 1,00,000 then the surety cannot be held liable for any amount exceeding ₹ 1,00,000 though the principal debtor may be liable to pay ₹ 1,50,000 but in no case the surety's liability will be greater than that of the principal debtor.

Illustration: A guarantees to B the payment of a bill of exchange by C, the acceptor. The bill is dishonoured by C. A is liable not only for the amount of the bill but also for any interest and charges which may have become due on it.

When the principal debtor is a minor, the surety alone is liable to the creditor.

Position of surety in case of a minor principal debtor:

According to the decision of the Bombay High Court in *Kashiba v. Shripat* I.L.R. 10 Bom. 1927 the surety can be held liable, though a minor debtor is not liable. But the later decisions of the Bombay High Court have taken a contrary view. In *Manju Mahadeo v. Shivappa Manju* and in *Pestonji Mody v. Meherbai* it was held that as under section 128, the liability of the **surety is co-extensive with that of the principal debtor**, it can be no more than that of the principal debtor and that the surety therefore cannot be held liable on a guarantee given for default by a minor. If a minor could not default, the liability of the guarantor being secondary liability, does not arise at all. The same view has been endorsed by the Madras High Court in the case of *Edavan Nambiar v. Moolaki Raman* (A.I.R. 1957 Mad.164). It was held that **unless the contract otherwise provides, a guarantor for a minor cannot be held liable.**

SURETY IS ALWAYS CONSIDERED "FAVOURED DEBTOR"

Surety is liable only when principal debtor does not pay, i.e., his liability is of secondary nature. He is considered with favour both at law and equity.

- (a) Surety is liable only for the unpaid balance.
- (b) His liability is co-extensive with that of the principal debtor. His liability cannot be more than that of principal debtor.
- (c) He is not bound by admission and acknowledgement made by the principal debtor before the creditor nor is he liable for judgments obtained against the principal debtor. The reason being that all contracts between each party are exclusively separate to one another.
- (d) He is not liable until the creditor has discharged his part of the promise.
- (e) He is not liable where the creditor has obtained guarantee by misrepresenting a material fact relating to the contract or by keeping silence as to material circumstances, e.g., obtaining a guarantee for the good conduct of an employee without disclosing to the surety his previous dishonesty. (i.e.; false information & acts - misrepresentation, concealment.)

1.7 WHEN IS A SURETY DISCHARGED FROM LIABILITY?

The liability of a surety under a contract of guarantee comes to an end under the following circumstances:

- A. By revocation of the contract of suretyship.
- B. By the conduct of the creditor.
- C. By invalidation of contract.

A. By revocation of the contract of suretyship:

- 1) **Notice of revocation:** In the case of a continuing guarantee a notice by the surety to the creditor stating that he will not be responsible, will revoke his liability as regards all future transaction. He will remain liable for all transaction entered into prior to the date of the notice (Sec. 130).
- 2) **Death of surety:** In the case of a continuing guarantee the death of a surety discharges him from all liabilities as regards transaction after his death unless there is a contract to the contrary (Sec. 131).

B. By the conduct of the creditor:

- 1) **Variation of contract:** Any variance, made without the surety's consent in the terms of the contract between the principal debtors and the creditor, discharges the surety as to transactions subsequent to the variance (Sec. 133).

Illustrations:

- (a) A becomes surety to C for B's conduct as a manager in C's bank. Afterwards, B and C contract, without A's consent, that B's salary shall be raised, and that he shall become liable for one-fourth of the losses on overdrafts. B allows a customer to overdraw, and the bank loses a sum of money. A is discharged from his suretyship by the variance made without his consent, and

is not liable to make good this loss.

- (b) A guarantees C against the misconduct of B in an office to which B is appointed by C, and of which the duties are defined by an Act of the Legislature. By a subsequent Act, the nature of the office is materially altered. Afterwards, B misconducts himself. A is discharged by the change from future liability under his guarantee, though the misconduct of B is in respect of a duty not affected by the later Act.
- (c) C agrees to appoint B as his clerk to sell goods at a yearly salary, upon A's becoming surety to C for B's duly accounting for moneys received by him as such clerk. Afterwards, without A's knowledge or consent, C and B agree that B should be paid by a commission on the goods sold by him and not by a fixed salary. A is not liable for subsequent misconduct of B.
- (d) A gives to C a continuing guarantee to the extent of 3,000 rupees for any oil supplied by C to B on credit. Afterwards B becomes embarrassed, and, without the knowledge of A, B and C contract that C shall continue to supply B with oil for ready money, and that the payments shall be applied to the then existing debts between B and C. A is not liable on his guarantee for any goods supplied after this new arrangement.

- 2) Release or discharge of principal debtor:** The surety is discharged 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, the legal consequence of which is the discharge of the principal debtor (Sec. 134).

Illustrations:

- (a) A gives a guarantee to C for goods to be supplied by C to B. C supplies goods to B, and afterwards B becomes embarrassed and contracts with his creditors (including C) to assign to them his property in consideration of their releasing him from their demands. Here B is released from his debt by the contract with C, and A is discharged from his suretyship.
- (b) A contracts with B to grow a crop of indigo on A's land and to deliver it to B at a fixed rate, and C guarantees A's performance of this contract. B diverts a stream of water which is necessary for irrigation of A's land and thereby prevents him from raising the indigo. C is no longer liable on his guarantee.

- 3) Arrangement with principal debtor:** A contract between the creditor and the principal debtor, by which the creditor makes a composition with, or promises to give time to, or not to sue the principal debtor, discharge the surety, unless the surety assents to such contract (Sec. 135)
- 4) Act or omission impairing surety's eventual remedy:** If the creditor does any act which is inconsistent with the rights of the surety's or omits to do any act which his duty to the surety requires him to do and the eventual remedy of the surety himself against the principal debtor is thereby impaired, the surety is discharged (Sec. 139).

Illustrations

- (a) B contracts to build a ship for C for a given sum, to be paid by instalments as the work reaches certain stages. S becomes surety to C for B's due performance of the contract. C, without

the knowledge of S, prepays to B the last two instalments. S is discharged by the prepayment.

(b) X puts M as apprentice to Y, and gives a guarantee to Y for M's fidelity. Y promises on his part that he will, at least once a month see M make up the cash. Y omits to see this done, as promised, and M embezzles. X is not liable to Y on his guarantee.

- 5) **Loss of security:** If the creditor loses or parts with any security given to him by the principal debtor at the time the contract of guarantee was entered into, the surety is discharged to the extent of the value of the security, unless the surety consented to the release of such security (Sec. 141).

Illustrations

- (a) C advances to B, his tenant, 2,000 rupees on the guarantee of A. C has also a further security for the 2,000 rupees by a mortgage of B's furniture. C cancels the mortgage. B becomes insolvent, and C sues A on his guarantee. A is discharged from liability to the amount of the value of the furniture.
- (b) C, a creditor, whose advance to B is secured by a decree, receives also a guarantee for that advance from A. C afterwards takes B's goods in execution under the decree, and then, without the knowledge of A, withdraws the execution. A is discharged.
- (c) A, as surety for B, makes a bond jointly with B to C, to secure a loan from C to B. Afterwards, C obtains from B a further security for the same debt. Subsequently, C gives up the further security. A is not discharged.

C. By invalidation of contract: A contract of guarantee is invalid if it is obtained

- by means of misrepresentation (Sec.142). or
- by keeping silence on material circumstances (Sec. 143), or
- if a co-surety fails to join according to the terms of the contract (Sec. 144).

Exceptions to the above rules of discharge of surety:

- (a) A mere forbearance on the part of a creditor to sue the debtor or to enforce any other remedy would not discharge the surety in the absence of any specific provision.
- (b) Even where the claim is barred by limitation, surety is still responsible. In *Krishto Kishore vs. Radha Romun I.L.R. 12 Cal.330*, the plaintiff sued the principal debtor and the surety for arrears of rent. The plaintiff also made the legal representatives of the principal debtor a party after knowing about the death of the principal debtor and the debt became barred by limitation. It was held that even if debt is barred by limitation on account of death of principal debtor, the surety is still liable. The same view was confirmed by Privy Council in *Mahant Singh vs U Ba Yi A.I.R 1939 P.C 110* where it was held that omission of the creditor to sue within the period of limitation does not discharge the surety.
- (c) Where the principal debtor compounds [settles] with the creditor regarding the amount or promises not to sue, the surety will be discharged. But a contract for giving time to a debtor is entered into with a third party, the surety will not be discharged. Where there are co-sureties release of one co-surety would not automatically discharge the other co-sureties. Further in

between other co-sureties, the released co-surety is not absolved of his liability vis a vis other co-sureties.

1.8 WHAT ARE RIGHTS OF THE SURETY?

After making the payment and discharging the liability of the principal debtor, the surety gets various rights. Such rights are of three types as follows: (i) rights against the principal, (ii) rights against the creditor, and (iii) rights against the co-sureties.

I. RIGHTS AGAINST THE PRINCIPAL DEBTOR

The surety has the following rights against the principal debtors:

- 1) **Rights of subrogation:** 'Subrogation' means substitution of one party for another as creditor so that the new creditor succeeds to the former's rights. Section 140 of the Contract Act lays down that when the principal debtor has defaulted in making the payments or in performing the guaranteed duty, and the surety has paid the debt or performed the duty, then **the surety is invested with all the rights which the creditor had against the principal debtor. This right of surety is called 'the rule of subrogation'**. It means that the surety steps into the shoes of the creditor.

The Supreme Court has observed about this right as follows: "The surety will be entitled to every remedy which the creditor has against the principal debtor to enforce every security and all means of payment; to stand in the place of the creditor. (*Amrit Lal Vs State Bank of Travancore*, AIR 1968 SC 1432).

- 2) **Right of indemnity:** Section 145 of the Contract Act lays down that in every contract of guarantee there is an implied promise by the principal debtor to indemnify (to pay back) the surety, and the surety is entitled to recover from the principal debtor whatever amount he has rightfully paid under the guarantee, but no amount which he has paid wrongfully.

For example, S guarantees to C to the extent of Rs, 3,000 payment for sugar to be supplied by C to D. Then C supplies to D sugar for ₹ 2,000 but obtains from S payment of ₹ 3,000 in respect of sugar supplied. S cannot recover from D more than ₹ 2,000, the actual amount of the sugar supplied.

In this connection the following principles were laid down:

- (i) the claim of the surety is restricted to that smaller amount which he may have paid under the principle of "accord and satisfaction". Surety is not entitled for higher amount than what he has paid.
- (ii) surety can also claim indemnity for any special damages which he has suffered while discharging his duties
- (iii) surety can claim even if he has paid a time barred debt as it is a rightful payment though there are contrary views on this issue.

In all the above instances surety can claim reimbursements only if **actual payments have been made** and **not where he has merely executed promissory notes**. [*Panth Narayana Murthy vs. Marimuthu* (1902) 26 Mad. 322, 328]

II. RIGHTS AGAINST THE CREDITOR

1) Rights to securities: According to Section 141 of the contract Act, a surety, after paying the liability of the principal debtor, is entitled to the benefit of every security which the creditor has against the principal debtor at the time when the contract of suretyship is entered into, whether the surety knows of the existence of such security or not.

2) Right to claim set-off: 'Set-off' means a counter claim or deduction from the amount of loan. When the creditor sues the surety for payment of principal debtor's liabilities, the surety is entitled to claim set-off, if any, which the principal debtor had against the creditor.

For example, D borrows ₹ 10,000 from C and S gave a guarantee for repayment of loan. D had a claim of ₹ 2,000 against C on some earlier transaction. On due date D fails to pay the loan. Here, S is entitled to deduct, ₹ 2,000, which C owed to D and thus his liability is only for ₹ 8,000.

3) Right to sue: Surety has a right to require the creditor to sue for and recover the guaranteed debt. This right of surety is known as right to file a '**Quia timet action**' against the debtor. There is of course an inherent risk of having to indemnify the creditor for delay and expense

4) Right to dismiss: Surety has a right to call upon the creditor to dismiss the person from service if the person whose fidelity is guaranteed by surety is persistently dishonest.

5) Right to claim no-liability: Surety can claim that he is not liable on the guarantee to the creditor, if it can be proved that principal debtor was incapable of entering into a contract, say because he was a minor. This is on the **principle that the liability of the surety is co-extensive with that of the principal debtor.**

III. RIGHTS AGAINST THE CO-SURETIES

Surety's rights against co-sureties - Where a debt is guaranteed by more than one sureties, they are called co-sureties. In such a case all the co-sureties are liable to contribute towards the payment of the guaranteed debt as per agreement among them. But in the absence of any agreement, if one of the co-sureties is compelled to pay the entire debt, he has a right of contribution from the other co-surety or co-sureties. The rules of contribution are laid down in Sec. 146 - 147 which are as follows;

1. Equal contribution: Where there are sureties for the same debt for similar amount (i. e., for one and the same amount) the co-sureties are liable to contribute equally, and are entitled to share the benefit of securities, if any, held by any one of the co-sureties, equally. To sum up the principle it may be said, "**As between co-sureties, there is equality of burden and benefit**".

Illustrations

(a) A, B and C are sureties to D for the sum of 3,000 rupees lent to E. E makes default in

payment. A, B and C are liable, as between themselves, to pay 1,000 rupees each.

(b) A, B and C are sureties to D for the sum of 1,000 rupees lent to E, and there is a contract between A, B and C that A is to be responsible to the extent of one-quarter, B to the extent of one-quarter, and C to the extent of one-half. E makes default in payment. As between the sureties, A is liable to pay 250 rupees, B 250 rupees, and C 500 rupees.

- 2. Liability of co-sureties bound in different sums:** Where there are sureties for the same debt for different sums, the rule is that "subject to the limit fixed by his guarantee, each surety is to contribute equally, (and not proportionately to the liability undertaken).

Illustrations

(a) A, B and C are sureties to D for the sum of 3,000 rupees lent to E. E makes default in payment. A, B and C are liable, as between themselves, to pay 1,000 rupees each.

(b) A, B and C are sureties to D for the sum of 1,000 rupees lent to E, and there is a contract between A, B and C that A is to be responsible to the extent of one-quarter, B to the extent of one-quarter, and C to the extent of one-half. E makes default in payment. As between the sureties, A is liable to pay 250 rupees, B 250 rupees, and C 500 rupees.

- 3. Right to share benefit of securities.**

Liability of two sureties is not affected by mutual arrangements : As per section 132 of the Act "where two persons contract with a third person to undertake a certain liability and also contract with each other that one of them shall be liable only on the default of the other, third person not being a party to such contract, the liability of each of such two persons to the third person under the first contract is not affected by the existence of the second contract, although such third person may have been aware of its existence"

Test Your Understanding



Q.I State with reasons whether the following statements are correct or incorrect

1. For default in the repayment of loan on the agreed date, interest can be increased retrospectively from the date of lending.
2. The quantum of obligation of a surety may be made more or less than that of the principal debtor by a special contract.
3. In a contract of guarantee, the surety is entitled to recover from the principal debtor, whatever sums he has paid under guarantee.
4. A contract of indemnity is not a contingent contract.
5. An oral guarantee is not a guarantee at all.
6. In a contract of guarantee, the surety assumes a primary liability.
7. A continuing guarantee can never be revoked. Anything done or any promise made for the benefit of the principal debtor may be sufficient consideration to the surety for giving guarantee.
8. The creditor may at his will release any of the co-sureties from his liability.
9. Release of one co-surety automatically discharges the other co-sureties.
10. Right of subrogation means that the surety steps into the shoes of the creditor.
11. Continuing guarantee is revoked by the death of the surety.
12. A fidelity guarantee is not a continuing guarantee.
13. Co-sureties who have given guarantee for different amounts are liable to contribute proportionately.
14. A fire insurance contract is not a contract of indemnity.
15. A simple guarantee cannot be revoked.
16. The liability of a surety is primary and independent.
17. Unless there is an express agreement, the surety cannot be indemnified by the principal debtor.
18. As per the Indian Law, a contract of guarantee must be in writing.
19. Life Insurance contract are covered under contract s of indemnity.
20. Any variance made without the surety's consent in the terms of the contract discharges the surety as to transactions subsequent to variation.

Answers:

[1 – False (penalty not allowed), 2- False (only less allowed, as coextensive with principal debtor), 3 – False (only rightful amount), 4 - False, 5 - False, 6 - False, 7 – False (can be revoked for future transaction), 8 - True, 9 -False , 10 - False, 11 - True, 12 - True, 13 - False, 14 – False (explanation to be given to justify), 15 - false, 16 - False, 17 – False (implied), 18 - False, 19 - False, 20 - False. 21.- True.]

Q.II Comment

1. "The liability of surety is co extensive with that of the principal debtor".
2. "Surety is favoured debtor"
3. A contract of indemnity is contingent contract
4. A surety is discharged from his liabilities only when he is dead". Comment.
5. The liability of two sureties is not affected by mutual arrangements.
6. "The liability of a surety is co-extensive with that of the principal-debtor".
7. "A surety's liability is independent of the liability of the principal-debtor."
8. In contract of gurantee there are three contracts. **(Nov 2013)**

Q.III Short/ Long Answer Questions.

1. What is a contract of indemnity? Whether a contract of insurance is covered by the definition.
2. When is surety discharged from liability?
3. Explain contract of indemnity and state the rights of an indemnity-holder
4. Point out the circumstances in which a surety is discharged from liability, by the conduct of the creditor.
5. Discuss the term continuing guarantee. How can it be revoked?
6. When does guarantee become invalid?
7. What is a fidelity guarantee?
8. Under what circumstances a guarantee may be treated invalid?
9. What are the rights of a surety against the principal debtor and against co-sureties.
10. Distinguish between a contract of indemnity and guarantee.
11. Explain with examples the circumstances under which a surety is discharged from his liability.
12. What is a contract of guarantee? Under what circumstances a surety is discharged from his liability?
13. Explain the rights of the surety against the (a) principal-debtor, and (b) creditor.
14. What is a contract of guarantee? Explain the rights of the surety.
15. What is a continuing guarantee? How can it be revoked?
16. Whether failure of the creditor to sue the principal-debtor within the period of limitation discharges the surety.
17. Explain the rights of the surety against the co-surety.
18. What is the nature of surety's liability? What are his rights?



CASE STUDIES

1. A gives to C a continuing guarantee to the extent of ₹ 5000 for the vegetables to be supplied by C to B from time to time on credit. Afterwards, B became embarrassed, and without the knowledge of A, B and C contract that C shall continue to supply B with vegetables for ready money, and that the payments shall be applied to the then existing debts between B and C. Examining the provision of the Indian Contract Act, 1872, decide whether A is liable on his guarantee given to C. **(Nov. 2008)**

Ans: A is not liable to C – for the transactions that place after variation between B and C; since a surety is discharged if any variation is made in a contract of guarantee without the consent of the surety.

2. B owes C a debt guaranteed by A. C does not sue B for a year after the debt has become payable. In the meantime, B becomes insolvent. Is A discharged? Decide with reference to the provisions of the Indian Contract Act, 1872. **(Nov. 2008)**

Ans: A is not discharged – since mere forbearance on the part of the creditor to sue the principal debtor does not discharge the Surety.

3. Ravi becomes guarantor for Ashok for the amount which may be given to him by Nalin within six months. The maximum limit of the said amount is ₹ 1 lakh. After two months Ravi withdraws his guarantee. Upto the time of revocation of guarantee, Nalin had given to Ashok ₹ 20,000.

Referring to the provisions of the Indian Contract Act, 1872 decide -

- (i) Whether Ravi is discharged from his liabilities to Nalin for any subsequent loan?
- (ii) Whether Ravi is liable if Ashok fails to pay the amount of ₹ 20,000 to Nalin? **(May 2006)**

Ans: Ravi is discharged - from all the liabilities in respect of any loan given by Nalin to Ashok after the date of revocation of continuing guarantee. **Ravi is not discharged** - for the loan of ₹ 20,000 already given by Nalin to Ashok,

4. C, the holder of an overdue bill of exchange drawn by A as surety for B, and accepted by B, contracts with X to give time to B. Is A discharged from his liability? **(Nov. 2006)** **Ans: A is not discharged from his liability** - since, where a contract to give time to the principal debtor is made by the creditor with a third person, and not with the principal debtor, the surety is not discharged (Sec. 130).

5. A contracts with B for a fixed price to construct a house for B within a stipulated time. B would supply the necessary material to be used in the construction, C guarantees A's performance of the contract. B does not supply the material as per the agreement. Is C discharged from his liability? **(Nov. 2006)** **Ans: C is discharged from liability** - since the surety is discharged by any act or omission of the creditor, the legal consequence of which is the discharge of the principal debtor (Sec. 134); since failure to supply the necessary material by B (i.e., the creditor) amounts to an omission on the part of the creditor resulting in discharge of A (i.e., the principal debtor), and consequently, discharging C (i.e., the surety).

6. A borrows ₹ 4,000 from B. C stands surety only for ₹ 2,000. A becomes insolvent and a dividend of 50 paise is received from his estate. How much amount the creditor will get from (i) the debtor, and (ii) the surety? **Ans:** ₹ 2,000 from the debtor. In this case the surety will also receive ₹ 1,000 being 50 paise dividend for the amount of ₹ 2,000 paid by him on behalf of the debtor.
7. A sells and delivers goods to B. C afterwards requests A not to sue B for the debt for a year and promises that, if he does so, C will pay for them in default of payment by B. A agrees not to sue B as requested. Can A recover the amount from C if B does not pay the amount? **Ans:** Yes, it is a contract of guarantee.
8. A becomes surety to C for B's conduct as a manager in C's bank. Afterwards, B and C contract, without A's consent, that B's salary shall be raised and that he shall become liable for one-fourth of the losses on overdrafts. B allows a customer to overdraw, and the bank loses a sum of money. Is A discharged? **Ans:** Yes, Variation in terms of the contract of guarantee without surety's consent discharges him.
9. C agrees to appoint B as his clerk to sell goods at a monthly salary on the guarantee of A for B's duly accounting for money's received by him as such clerk. Later on, without A's consent or knowledge, C and B agree that B should be paid by a commission on the goods sold by him and not by a fixed salary. B misconducts himself after the change. Is A liable? **Ans:** No.
10. A agree to build a house for B within an agreed time, B supplying the necessary timber. C guarantees A's performance. B fails to supply the timber. Is C discharged from his liability? **Ans:** Yes, surety is discharged by discharge of the principal-debtor.
11. B contracts to build a ship for C for a given sum, to be paid in instalments as the work reaches certain stages. A guarantee B's due performance. C without the knowledge of A makes advance payment of the last two instalments. Is A discharged? **Ans:** Yes, Creditor's omission discharges the surety.
12. C advances to B, his tenant, ₹ 2,000 on the guarantee of A. C has also a further security for ₹ 2,000 by a mortgage of B's furniture. C cancels the mortgage of B's furniture. B becomes insolvent, and C sues A on his guarantee. Is A liable? **Ans:** No, surety is discharged to the extent of the value of the furniture
13. A engages B as a clerk to collect money for him. B fails to account for some of his receipts. Thereupon C gives his guarantee for B's duly accounting. A does not disclose to C, B's previous conduct. B afterwards makes default. Is C liable? **Ans:** No, the guarantee is invalid.
14. A, B and C as sureties for D, enter into three several bonds, each in a different penalty, namely, A ₹ 10,000, B ₹ 20,000 and C ₹ 40,000 conditioned for D's duly accounting to E. D makes a default to the extent of ₹ 40,000 and ₹ 60,000? **Ans:** A, B and C each have to pay ₹ 10,000. In case the default

is to the extent of ₹ 40,000. A will pay ₹ 10,000 and B and C ₹ 15,000 each. In case the default is to the extent of ₹ 60,000, A will pay ₹ 10,000, B ₹ 20,000 and C ₹ 30,000.

15. 'A' stands surety for 'B' for any amount which 'C' may lend to B from time to time during the next three months subject to a maximum of Rs. 50,000. One month later A revokes the guarantee, when C had lent to B Rs. 5,000. Referring to the provisions of the Indian Contract Act, 1872 decide whether 'A' is discharged from all the liabilities to 'C' for any subsequent loan. What would be your answer in case 'b' makes a default in paying back to 'C' the money already borrowed i.e. Rs. 5,000? **(Nov. 2002)** *Ans: A is discharged – from all the liabilities in respect of any loan given by C to B after the date of revocation of continuing guarantee. A is not discharged – for the loan of Rs. 5,000 already given by C to B.*
16. M advances to N ₹ 5,000 on the guarantee of P. The loan carries interest at ten percent per annum. Subsequently, N becomes financially embarrassed. On N's request, M reduces the interest to six per cent per annum and does not sue N for one year after the loan becomes due. N becomes insolvent. Can M sue P? **Ans:** M cannot sue P, because a surety is discharged from liability when, without his consent, the creditor makes any change in the terms of his contract with the principal debtor, no matter whether the variation is beneficial to the surety or does not materially affect the position of the surety (Sec.133, Indian Contract Act, 1872).
17. 'Amit' stands surety for 'Bikram' for any amount which 'Chandar' may lend to 'Bikram' from time to time during the next three months subject to a maximum amount of ₹ 1,00,000 (one lakh only). One month later 'Amit' revokes the surety, when 'Chandar' had already lent to 'Bikram' ₹ 10,000 (ten thousand). Referring to the provisions of the Indian Contract Act, 1872. Decide:
- (i) Whether 'Amit' is discharged from all the liabilities to 'Chandar' for any subsequent loan given to 'Bikram'?
 - (ii) What would be your answer in case 'Bikram' makes a default in paying back to 'Chandar' the already borrowed amount of ₹ 10,000? **(Nov 2015)**

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