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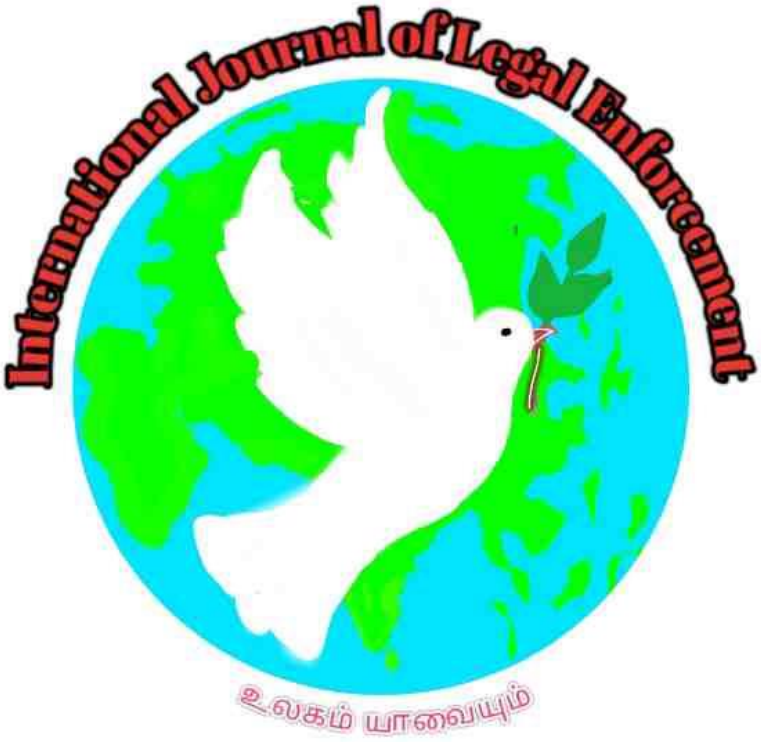

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Article on

GUARANTEE AGREEMENT: HOW FAR IS THE SURETY PROTECTED

– **Arya Sharma**

Student HNLU, Raipur

INTRODUCTION

Indian Contract Act, 1872 is a colonial statue which provides the conditions and a framework under which contracts can be made legally binding on the parties. The Act is broadly divided into two parts; one part from section 1 to 75 talks about formation and basic concepts of contract, while the other part from section 124 to 238 deals with the specific contracts which are categorised into five specific contracts i.e. indemnity, guarantee, pledge, bailment and agency.

The contract of guarantee is specified in sections 126 to 147. In a literal sense, guarantee is an assurance given by a person or an organisation to the other for the work or performance of third individual. These contracts are made in everyday life whether written oral, to discharge a person from his liability in case of default. Some examples of these contracts are seen in the case of obtaining bank guarantees, employment and other things. There are certain essential requirements for entering into enforceable guarantee contracts. On such requirement is surety, a person who gives guarantee on behalf of the third party. The surety has certain liabilities and rights attached to these contracts which are essential to know how far this surety is protected in the contract of guarantee.

CONTRACT OF GUARANTEE

Contract of guarantee is under the tab of Specific contracts because in these cases the remedy is not the monetary damages given by the court but it asks the other person for specifically fulfilling the obligations made under the contract, and in this case, surety is asked to perform the same if there is any default on the part of third person. Also, the contract of guarantee has an independent standing from the other collateral contracts. This contract is defined under Section 126 of Indian Contract Act, 1872 which says that,

"Contract of guarantee", "surety", "principle debtor" and "creditor" – A "contract of guarantee" is a contract to perform the promise, or discharge the liability, of a third person in case of his default. The person who gives the guarantee is called the "surety"; the person in respect of whose default the guarantee is given is called the "principle debtor", and the person to whom the guarantee is given is called the "creditor". A guarantee may be either oral or

written. [1] The main reason why these types of contracts are made is to help the person in need so that he could get a loan, employment on the assurance of the surety, that creditor could ask the surety if the principal debtor is unable to perform.

Independent liability is different from guarantee contracts, which means there conditional clause of 'on the fault of principle debtor' must be there to make it a contract of guarantee. In a landmark case of Taylor v. Lee[2], where a landlord and his tenant went to plaintiff's shop and asks the plaintiff to sell him anything he wants and he would make sure it is paid. Now there is no collateral promise to be liable on the fault of tenant is there, this is his original independent liability to pay him and is not of the nature of guarantee. Instead of that if he would have said that 'if my tenant would not pay you, I will pay you', then it would be contract of guarantee.

Essentials of contract of guarantee

1. There must be three parties i.e.
   1.1 Surety- one who gives the guarantee
   1.2 Creditor – one to whom guarantee is given
   1.3 Principle debtor – one in respect of whose default the guarantee is given. Since there are three parties, there are three contracts between them.
2. There must be a recoverable principle debt upon which contract of guarantee is based. Recoverable means it should not be forbidden by any statue and must be due on the part of principle debtor. In a Scottish case of Swan v Bank of Scotland, 'If there is nothing due, no balance, the obligation to make that nothing good amounts itself to nothing. If no debt is due, if the banker is forbidden from having any claim against his customer, there is no liability incurred by the co-obligors'[3]

   In case where the principle debtor is a minor, although the debt is void but if there is a surety for the same and the minority of the principle debtor is known to all the parties then would the surety be made liable? There is a difference in the view in English and Indian judgement. In Coutts & Co v Browne Lecky[4], court held that in case of a void contract of debt the surety cannot be made liable to pay the creditor since a contract with minor is void ab initio, hence no contract means no default, no default hence no

[1] Indian Contract Act, 1872, § 126, No. 9, Acts of Parliament, 1872 (India).
[2] Taylor v Lee (1924) 121 SE 659; 187 NC 393.
[3] Swan v Bank of Scotland(1836) 10 Bligh NS 627
[4] Coutts & Co v Browne Lecky [1946] 2 All E.R. 207

guarantee. But in Kashiba Bin Narsapa Nikade vs Narshiv Shripat, Bombay High Court held that 'If the debt is void, the contract of the so-called surety isn't collateral, but a principal contract[5]'. In India if a minor enters into a contract of guarantee and the surety is aware about that then he is liable to pay as if the contract is the main contract and a collateral one.

3. Consideration – since guarantee is a contract, consideration becomes the essential part of it. However there is no direct consideration between the surety and creditor. Consideration of guarantee is defined under Section 127 of the contract act, which says; anything done or any promise made, for the benefit of principle debtor, may be sufficient consideration to the surety for giving the guarantee[6]. In Indian 'good consideration' also includes past consideration. The benefit of surety has to be taken into account, it is not necessary that the surety has any profit from the contract or not.

Continuing guarantee

Contract of guarantee is of two types, one is the specific guarantee and the other is continuing guarantee. As per Section 129 of Indian Contract Act, continuing guarantee is a guarantee which extends to a series of transactions. This makes the surety liable for the unpaid balance at the end of the guarantee.

RIGHTS AND LIABILITIES OF SURETY

There can be no contract of guarantee is not surety is present. In various cases the term surety is substituted as guarantor. 'The liability of the surety is co-extensive with that of the principal debtor, unless it is otherwise provided by the contract' as said under Section 128 of ICA, 1872. The expression 'co-extensive' means the liability of the surety extends till the liability of principle debtor, and not more than that. In Zaki Husain v. Deputy Commissioner[7], the court overruled the above judgement, and mentioned that the surety is liable for both the principal amount and the interest. The only illustration under this Section also specifies that the surety is liable not only for the mount of the bill but also for any interest and charges which are due on the principal debtor.

[5] Kashiba Bin Narsapa Nikade vs Narshiv Shripat (1894) I.L.R. 19 Bom. 697
[6] Indian Contract Act, 1872, § 127, No. 9, Acts of Parliament, 1872 (India).
[7] Zaki Husain vs Deputy Commissioner Of Gonda, AIR 1929 All 687

However, there is are some limitations to this section, in case when the debt against the principal debtor is discharged, due to an omission on part of creditor, then the creditor cannot proceed against surety.

A surety is not liable if there is a condition precedent to his liability and is not fulfilled yet. Section 144 is based on the similar principle which says that when a person gives a guarantee to a contract that the creditor shall not act upon it until another person has joined in it as co-surety, the guarantee is not valid if that person does not join. [8]

It is a settled principle that surety becomes liable as soon as principal debtor defaults. The creditor can go against any of them in case of such default. In Bank of Bihar Ltd v Damodar Prasad, Supreme Court held that, 'the very object of the guarantee is defeated if the creditor is asked to postpone his remedies against the surety. The solvency of the principal is not a sufficient ground for restraining execution of the decree against the surety. It is the duty of the surety to pay the decretal amount. On such payment he will be subrogated to the rights of the creditors.[9] Hence here the liability of a surety is same as the principle debtor for the creditor in case of any default and he can proceed against any of them exclusively; mere forbearance by the creditor to sue the principle debtor does not discharge surety.

In case of continuing guarantee, the surety can revoke the contract of guarantee at any time for the future transactions as per Section 130. Also, as per Section 131 in case surety dies in the course of contract, the guarantee would stand revoked and the creditor cannot proceed against his legal heirs. However, in case of specific guarantee if the contract does not say expressly the surety would not be discharged even after his death i.e., his legal heirs would be liable but only to the extent of property of surety.

Surety has certain rights against principle debtor, creditor and co-sureties in order to protect his interest under the contract of guarantee.

1. Right of Subrogation – as per Section 140, surety can sue the principal debtor after he pays or performs the guarantee, or he steps into the shoes of creditor and can recover the amount he would have paid to creditor.

[8] Indian Contract Act, 1872, § 144, No. 9, Acts of Parliament, 1872 (India).
[9] Bank of Bihar Ltd v Damodar Prasad, AIR 1969 SC 297

2. Right of indemnity – under Section 144, the principal debtor is under an implied contract of indemnity with the surety, that the surety is entitled to recover any loss occurred to the surety and the amount he paid rightfully.
3. Variation in terms of contract – when there is a variation made in the contract between principal debtor and creditor, without the consent of surety; he is discharged from the liability. The exception to this rule is that when the variation is of such nature that it benefits the surety or the alteration is immaterial to the contract then the surety is not discharged.
4. Section 135 – according to this section, the surety is discharged in when the creditor and principal debtor is enters into such a contract which, a. Changes the composition or nature of the contract b. Increases the time period of debt repayment c. Allows not to sue the principal debtor in case of default; the consent of surety is not taken.
5. Section 141- in case any security is given to the creditor by the principal debtor; it is immaterial that surety has knowledge of the same or not, he would be discharged to the extent of the value of the security.
6. Right against co-sureties – as per section 146 and 147, when there are two or more sureties, their respective liabilities towards the debt are equal unless they have contracted among themselves regarding their share.

PROTECTION OF SURETY

The contract of guarantee is a very common specific contract one can see in commercial world; without these contracts business and commerce would be impeded. The main player in these contracts is the guarantor or the surety. There are many instances in our country where the surety is either forced to become a surety or had become the surety without knowing the actual consequences of the same. In earlier times, mostly the family members or the close friends of the principal debtor become his surety which cost them a lot of suffering due to just moral emphasis on them.

Now in the modern world where this moral emphasis has converted into legal promise and the principal debtor is legally bound to repay the surety just the way he would have if he was a creditor. But still the liability of a surety is considered as an asset or accessory for the creditor and debtor.

Where the principal debtor has sold all his assets and has left the country, it is the surety would be liable for the repayment of the loan but would not be able to recover the said amount from anyone easily. In this scenario the surety would be in trouble and none of the rights mentioned in this Act would help him because getting everything fixed in the real world is a bit difficult and nearly impossible. The risk which was undertaken by the surety for the betterment of third party has to be controlled by a wise administration with better guarantee laws.

The judiciary must take into consideration the fact that the surety brings a convenience to both the creditor and principle debtor and the consideration to that contract is also for the benefit of principle debtor; hence his interests must be protected in case of any default.

CONCLUSION

Contract of guarantee is a tripartite contract where surety plays an important role as there can be no guarantee without a guarantor. This surety has rights and liabilities defined under Indian Contract Act, 1872, against the debtor and the creditor as well. However in practical world the interest of this surety has to be understood in much proper manner since he is the one who took risk for the debtor. Many a times he has to suffer due to the negligence of principle debtor and strict interpretation of law by the courts. Hence there is a need in the modern legal world to administer these types of contracts with much appropriate laws.

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