CHAPTER 1

THE INDIAN CONTRACT ACT, 1872

UNIT–1 : CONTRACT OF INDEMNITY AND GUARANTEE

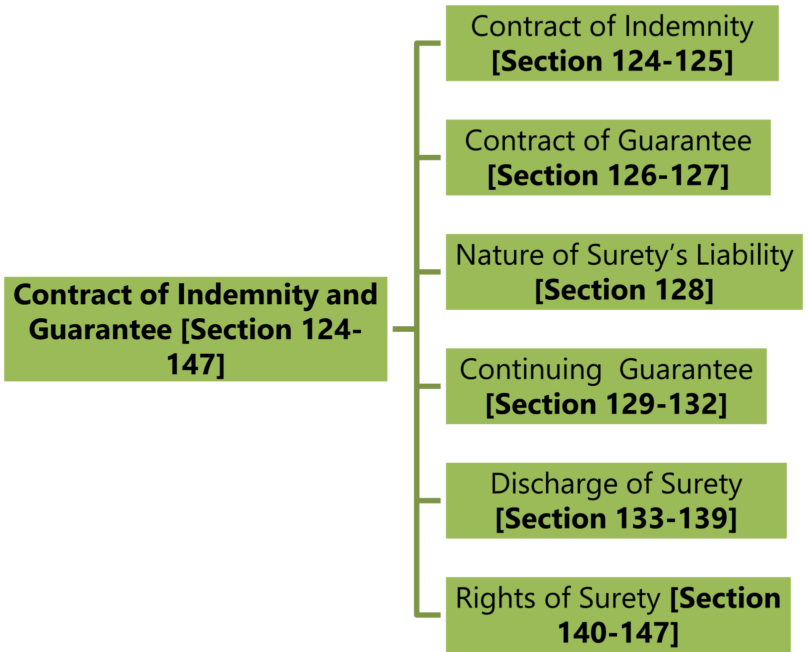
LEARNING OUTCOMES

After studying this unit, you would be able to:

- Identify special type of contracts i.e. Indemnity contracts and Guarantee contracts and also the nature of obligations and rights of each of the parties to the contracts.
- Explain distinction between these contracts.

© The Institute of Chartered Accountants of India

UNIT OVERVIEW



1. INTRODUCTION

Contract of Indemnity and Guarantee are the **specific types of contracts** given under sections 124 to 147 of the Indian Contract Act, 1872. Along with the specific provisions (Section 124 to Section 147 of the Indian Contract Act, 1872), the general principles of contracts are also applicable to such specific contracts. Both the contracts are modes of compensation based on certain similar principles. However, both differs from each other on several issues.

In this unit, the law relating to indemnity and guarantee are discussed in detail.

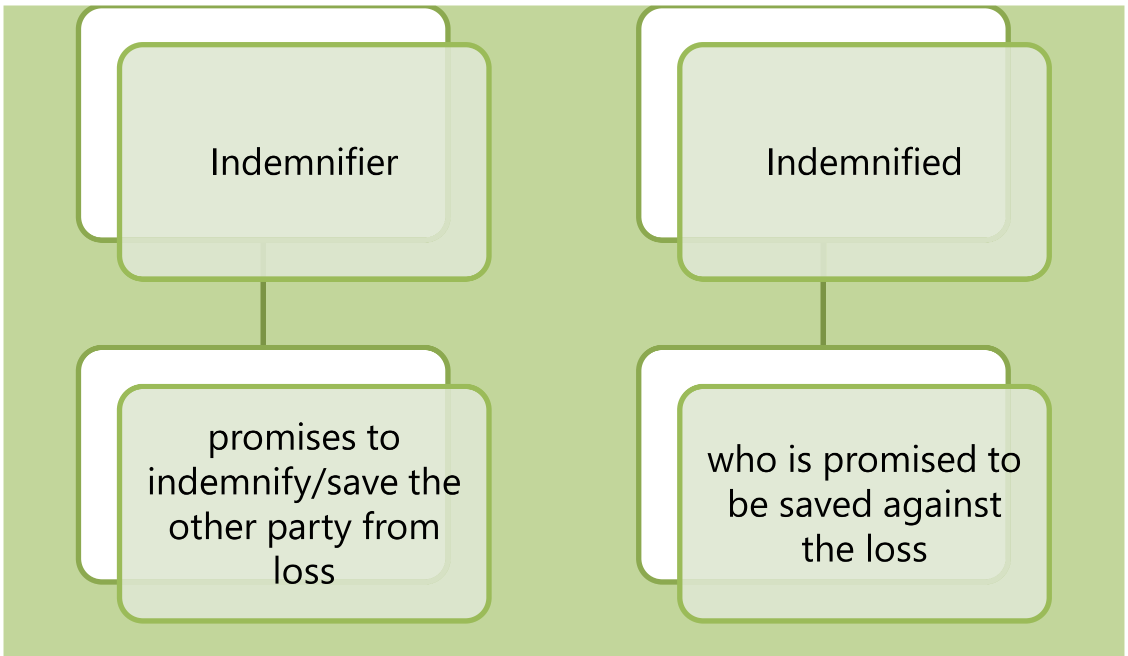
2. CONTRACT OF INDEMNITY

The term **"Indemnity"** means to make good the loss or to compensate the party who has suffered some loss**.** The term **"Contract of Indemnity"** is defined under **Section 124** of the Indian Contract Act, 1872. It is "*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*."

© The Institute of Chartered Accountants of India

Example: Mr. X contracts with the Government to return to India after completing his studies at University of Cambridge and serve the Government for a period of 5 years. If Mr. X fails to return to India, he will have to reimburse the Government. It is 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'**, where as the party who is promised to be saved against the loss is known as **"indemnified" or "indemnity holder".**



Example 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.

Example 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.

© The Institute of Chartered Accountants of India

Example 3: X may agree to indemnify Y for any loss or damage that may occur if a tree on Y's neighbouring property blows over. If the tree then blows over and damages Y's fence, X will be liable for the cost of fixing the fence.

Analysis

To indemnify means to compensate or make good the loss. Thus, under a contract of indemnity the "existence of loss" is essential. Unless the promisee has suffered a loss, he cannot hold the promisor liable on the contract of indemnity.

However, the above definition of indemnity restricts the scope of contracts of indemnity in as much as it covers only the loss caused :

(i) By the conduct of the promisor himself, or

(ii) By the conduct of any other person.

Thus, loss occasioned by the conduct of the promise, or accident, or an act of God is not covered.

Mode of contract of indemnity: A contract of indemnity like any other contract may be express or implied.

a. A contract of indemnity is said to be express when a person expressly promises to compensate the other from loss

b. A contract of indemnity is said to be implied when it is to be inferred from the conduct of the parties or from the circumstances of the case

A contract of indemnity is like any other contract and must fulfil all the **essentials of a valid contract** which includes:

a. Offer and acceptance

b. Intention to create legal obligation

c. Consideration

d. Competency to contract

e. Free consent

f. Lawful object

g. The agreement must not be expressly declared to be void- eg: an agreement in restraint of trade/ marriage etc.

h. The terms of the agreement must not be vague or uncertain

© The Institute of Chartered Accountants of India

i. The agreement must be capable of performance- An agreement to do an impossible act is void.

j. Legal formalities

Example: A asks B to beat C promising to indemnify him against the consequences. The promise of A cannot be enforced. Suppose, B beats C and is fined ₹ 1000, B cannot claim this amount from A because the object of the agreement is unlawful.

A contract of Fire Insurance or Marine Insurance is always a contract of indemnity. But there is no contract of indemnity in case of contract of Life Insurance.

Rights of Indemnity—holder when sued (Section 125) : The promisee in a contract of indemnity, acting within the scope of his authority, is entitled to recover from the promisor/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 any such suit if, in bringing or defending it, he did not contravene the orders of the promisor, and acted as it would have been prudent for him to act in the absence of any contract of indemnity, or if the promisor authorised him to bring or defend the suit;

(3) **all sums** which he may have paid under the terms of any compromise of any such suit, if the compromise was not contrary to the orders of the promisor, and was one which it would have been prudent for the promisee to make in the absence of any contract of indemnity, or if the promisor authorised him to compromise the suit.

Analysis :

We can understand from the above provisions that, in a contract of indemnity, the promisee i.e., indemnity- holder acting within the scope of his authority is entitled to recover from the promisor i.e., indemnifier the following rights:

(a) **all damages** which he may be compelled to pay in any suit

(b) **all costs** which he may have been compelled to pay in bringing/ defending the suit and

(c) **all sums** which he may have paid under the terms of any compromise of suit.

It may be understood that the rights contemplated under section 125 are **not exhaustive**. The indemnity holder/ indemnified has other rights besides those

© The Institute of Chartered Accountants of India

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.

Please note that the Indian Contract Act is silent about the rights which the Indemnifier has on carrying out his promise to indemnify. But they are similar to the rights of a surety under section 141 of the Indian Contract Act.

When does the liability of an indemnifier commence?

Although the Indian Contract Act, 1872, is silent on the time of commencement of liability of indemnifier, however, on the basis of judicial pronouncements it can be stated that the liability of an indemnifier commences **as soon as the liability of the indemnity-holder becomes absolute and certain.** This principle has been followed by the courts in several cases.

Example: A promises to compensate X for any loss that he may suffer by filling a suit against Y. The court orders X to pay Y damages of Rs 10000 . As the loss has become certain, X may claim the amount of loss from A and pass it to Y.

3. CONTRACT OF GUARANTEE

"Contract of guarantee", "surety", "principal debtor" and "creditor" [Section 126]

Contract of guarantee : A contract of guarantee is a contract **to perform** the **promise** made or **discharge the liability**, of a **third person** in case of **his default**.

Three parties are involved in a contract of guarantee	
	Surety- person who gives the guarantee,
	Principal debtor- person in respect of whose default the guarantee is given,
	Creditor- person to whom the gurantee is given

Example 1 : When A requests B to lend ` 10,000 to C and guarantees that C will repay the amount within the agreed time and that on C falling to do so, he (A) will himself pay to B, there is a contract of guarantee.

© The Institute of Chartered Accountants of India

Here, B is the creditor, C the principal debtor and A the surety.

Example 2 : Where 'A' obtains housing loan from LIC Housing and if 'B' promises to pay LIC Housing in the event of 'A' failing to repay, it is a contract of guarantee.

Example 3 : X and Y go into a car showroom where X says to the dealer to supply latest model of Wagon R to Y. In case of Y's failure to pay, X will be paying for it. This is a contract of guarantee because X promises to discharge the liability of Y in case of his defaults.

Analysis

From the definition, it can be analysed that, Guarantee is a **promise to pay a debt owed by a third person** in case the latter does not pay.

Any guarantee given may be **oral** or **written**.

From the above definition, it is clear that in a contract of guarantee is **a tripartite agreement between principal debtor, creditor and surety**. There are, in effect three contracts

(i) A **principal contract** between the principal debtor and the creditor

(ii) A **secondary contract** between the creditor ad the surety.

(iii) A **implied contract** between the surety and the principal debtor whereby principal debtor is under an obligation to indemnify the surety; if the surety is made to pay or perform.

The right of surety is not affected by the fact that the creditor has refused to sue the principal debtor or that he has not demanded the sum due from him.

ESSENTIAL FEATURES OF A GUARANTEE

The following are the requisites of a valid guarantee

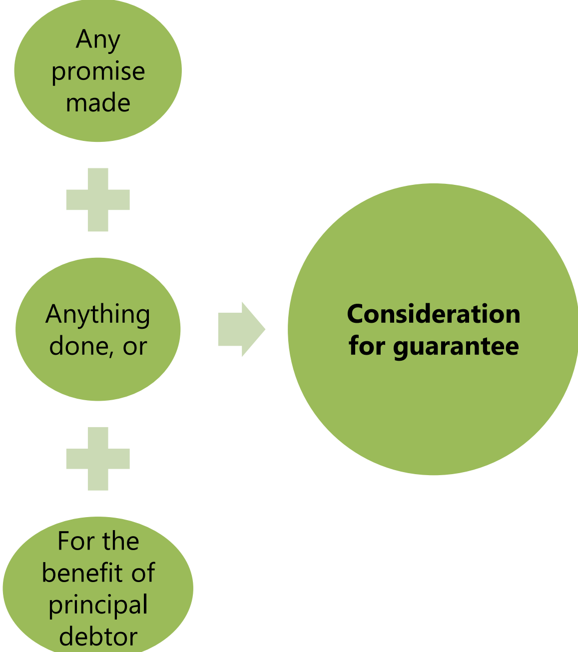
1. **Principal Debt**: The purpose of a guarantee being to **secure** the **payment of a debt**, the existence of recoverable debt is necessary. It is of the essence of a guarantee that there should be someone liable as a principal debtor and the surety undertakes to be liable on his default. If there is no principal debt, there can be no valid guarantee.

2. **Consideration:** Like every other contract, a contract of guarantee should also be supported by some consideration. A guarantee without consideration is void, but there need be no direct consideration between the surety and the creditor. As per Section

127 consideration received by the principal debtor is sufficient consideration to the surety for giving the guarantee, but past consideration is no consideration for the contract of guarantee. Even if the principal debtor is incompetent to contract, the guarantee is valid. But, if surety is incompetent to contract, the guarantee is void.

Example 1: 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. As per Section 127, there is a sufficient consideration for C's promise. Therefore the guarantee is valid.

Example 2 : A sell 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.



Example 3: A sells and delivers goods to B. C afterwards, without consideration, agrees to pay for them in default of B. The agreement is void.

© The Institute of Chartered Accountants of India

3. **Existence of a liability**: There must be an **existing liability or a promise** whose performance is guaranteed. Such liability or promise must be enforceable by law. The liability must be legally enforceable and not time barred.

4. **No misrepresentation or concealment (section 142 and 143)**: Any guarantee which has been obtained by the means of **misrepresentation** made by the creditor, or **with his knowledge and assent**, concerning a material part of the transaction, is invalid (section 142)

   Any guarantee which the creditor has obtained by means of **keeping silence** as to material circumstances, is invalid (section 143)

   Example 1: A engages B as 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 his previous conduct. B afterwards make default. The guarantee is invalid.

5. **Writing not necessary**: **Section 126** expressly declares that a guarantee may be either oral or written.

6. **Joining of the other co-sureties (Section 144):** Where a person gives a guarantee upon 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 other person does not join. That implies, the guarantee by a surety is not valid if a condition is imposed by a surety that some other person must also join as a co-surety, but such other person does not join as a co-surety.

4. TYPES OF GUARANTEE

Guarantee may be classified under two categories:

A. **Specific Guarantee**- A guarantee which **extends to a single debt/ specific transaction** is called a specific guarantee. The surety's liability comes to an end when the guaranteed debt is duly discharged or the promise is duly performed.

Example: A guarantees payment to B of the price of the five bags of rice 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. This is a contract for specific

© The Institute of Chartered Accountants of India

guarantee because A intended to guarantee only for the payment of price of the first five bags of rice to be delivered one time [*Kay v Groves*]

B. Continuing Guarantee [Section 129]- A guarantee which extends to a **series of transaction** is called a continuing guarantee. A surety's liability continues until the revocation of the guarantee.

Example: On A's recommendation B, a wealthy landlord employs C as his estate manager. It was the duty of C to collect rent on 1st of every month from the tenant of B and remit the same to B before 5th of every month. A, guarantee this arrangement and promises to make good any default made by C. This is a contract of continuing guarantee.

5. DISTINCTION BETWEEN A CONTRACT OF INDEMNITY AND A CONTRACT OF GUARANTEE

Point of distinction	Contract of Indemnity	Contract of Guarantee
Number of party/Parties to the contract	there are **only two parties** namely the indemnifier [promisor] and the indemnified [promisee]	there are **three parties** creditor, principal debtor and surety.
Nature of liability	The liability of the indemnifier is **primary** and **unconditional**	The liability of the surety is **secondary** and **conditional** as the primary liability is that of the principal debtor.
Time of liability	The liability of the indemnifier arises only on the happening of a contingency.	The liability arises only on the non performance of an existing promise or non paymemnt of an existing debt.
Time to Act	The indemnifier need not act at the request of	The surety acts at the request of principal

© The Institute of Chartered Accountants of India

	indemnity holder	debtor.
Right to sue third party	indemnifier cannot sue a third party for loss in his own name as there is no privity of contract. Such a right would arise only if there is an assignment in his favour.	surety can proceed against principal debtor in his own right because he gets all the right of a creditor after discharging the debts.
Purpose	Reimbursement of loss	For the security of the creditor
Competency to contract	All parties must be competent to contract	In the case of a contract of guarantee, where a minor is a principal debtor, the contract is still valid.

6. NATURE AND EXTENT OF SURETY'S LIABILITY [SECTION 128]

The liability of the surety is **co-extensive with that of the principal debtor** unless it is otherwise provided by the contract. [Section 128]

Analysis :

(i) The term "**co-extensive with that of principal debtor**" means that the surety is liable for what the principal debtor is liable. However, the liability of the surety may be made less than that of the principal debtor by an express contract to that effect.

(ii) The **liability** of a **surety** arises **only on default by the principal debtor**. But as soon as the principal debtor defaults, the liability of the surety begins and runs co-extensive with the liability of the principal debtor, in the sense that the surety will be liable for all those sums for which the principal debtor is liable. If there is a condition precedent for surety's liability, the surety would be liable only when such condition is fulfilled. A partial recognition of this principal is found in Section 144 (Joining of co surety)

(iii) Where a debtor **cannot be held liable** on account of any defect in the document, the **liability** of the **surety also ceases**.

© The Institute of Chartered Accountants of India

(iv) **Surety's liability continues** even if the principal debtor has not been sued or is omitted from being sued. In other words, a creditor may choose to proceed against a surety first, unless there is an agreement to the contrary.

Example : 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.

Nature of Surety's liability can be summed up as (a) Liability of surety is of secondary nature as he is liable only on default of principal debtor. (b) his liability arises immediately on the default by the principal debtor (c) The Creditor has a right to sue the surety directly without first proceeding against principal debtor.

7. CONTINUING GUARANTEE

Continuing guarantee (Section 129): A guarantee which extends to a series of transactions is called a "**continuing guarantee**". The essence of continuing guarantee is that it applies not to a specific number of transactions but to any number of transactions and makes the surety liable for the unpaid balance at the end of the guarantee.

Example 1 : 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.

Example 2 : 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 above 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.

Example 3 : A guarantees payment to B of the price of five sacks of flour to be delivered by B to C and to be paid for in a month. B delivers five sacks to C. C pays for them. Afterwards B delivers four sacks 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 sacks.

In the continuing guarantee, the **liability of surety continues** till the **performance** or the **discharge** of all the transactions entered into or the **guarantee is withdrawn**.

© The Institute of Chartered Accountants of India

8. LIABILITY OF TWO PERSONS, PRIMARILY LIABLE, NOT AFFECTED BY ARRANGEMENT BETWEEN THEM THAT ONE SHALL BE SURETY ON OTHER'S DEFAULT.

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, the 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. (Section 132)

Example : A and B make a joint and several promissory note to C. A makes it, in fact, as surety for B, and C knows this at the time when the note is made. The fact that A, to the knowledge of C, made the note as surety for B, is no answer to a suit by C against A upon the note.

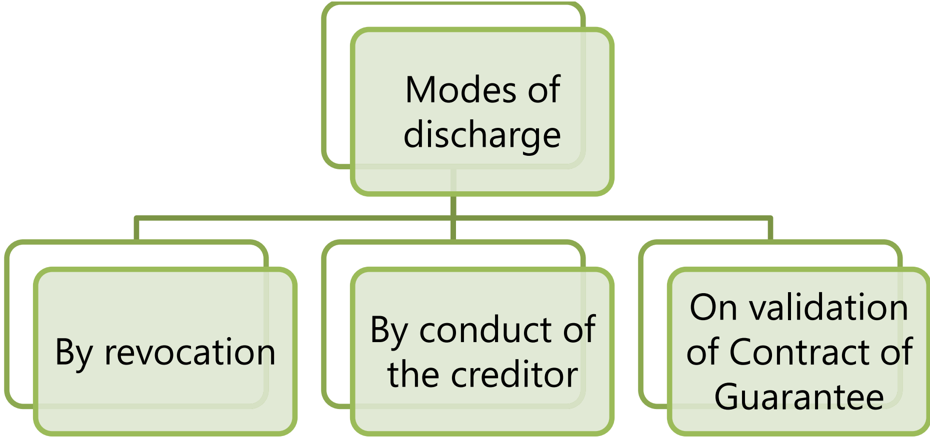
9. DISCHARGE OF A SURETY

A surety is said to be discharged when his liability as surety comes to an end. The various modes of discharge of surety are discussed below:

(i) By revocation of the contract of guarantee.

(ii) By the conduct of the creditor, or

(iii) By the invalidation of the contract of guarantee.



By revocation of the Contract of Guarantee

(a) Revocation of continuing guarantee by Notice (Section 130): The continuing guarantee may at any time be revoked by the surety as to future transactions by notice to the creditors. A specific guarantee can be revoked only if liability to principal debtor has not accrued.

Example 1: A, in consideration of B's discounting, at A's request, bills of exchange for C, guarantees to B, for twelve months, the due payment of all such bills to the extent of 50,000 rupees. B discounts bills for C to the extent of 20,000 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 20,000 rupees, on default of C.

Example 2: A guarantees to B, to the extent of 100,000 rupees, that C shall pay all the bills that B shall draw upon him. B draws upon C. C accepts the bill. A gives notice of revocation. C dishonors the bill at maturity. A is liable upon his guarantee.

Example 3: X gives guarantee to the extent of ₹ 50,000 for the loans given from time to time by A to B. A gave a loan of ₹ 10,000 to B. Afterwards, X gives notice of revocation. X is discharged from all liability to A for any loan granted after the revocation of guarantee but he is liable to A for ₹ 10,000 on default of B.

(b) Revocation of continuing guarantee by surety's death (Section 131): In the absence of any contract to the contrary, the death of surety operates as a revocation of a continuing guarantee as to the future transactions taking place after the death of surety. However, the surety's estate remains liable for the past transactions which have already taken place before the death of the surety.

(c) By novation [Section 62]: The surety under original contract is discharged if a **fresh contract is entered** into either between the same parties or between the other parties, the consideration being the mutual discharge of the old contract.

By conduct of the creditor

(a) By variance in terms of contract (Section 133): Where there is any variance in the terms of contract between the principal debtor and creditor **without surety's consent**, it would discharge the surety in respect of all transactions taking place subsequent to such variance.

© The Institute of Chartered Accountants of India

Example 1: 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.

Example 2: 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.

Example 3: 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.

Example 4: A gives to C a continuing guarantee to the extent of ₹ 3,00,000 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.

Example 5: C contracts to lend B ₹ 5,00,000 on the 1st March. A guarantees repayment. C pays the ₹ 5,00,000 to B on the 1st January. A is discharged from his liability, as the contract has been varied, in as much as C might sue B for the money before the 1st March.

Variation which is not substantial or material or which is beneficial to the surety will not discharge him of his liability. In *M.S Anirudhan v Thomco's Bank Ltd. AIR 1963 SC 746,* the surety guaranteed the repayment of loan provided by the bank to the principal debtor of only upto ₹ 25,000. Subsequently, since the bank was willing to provide loan only upto ₹ 20,000, the principal debtor reduced the amount to ₹ 20,000 in the guarantee form and without intimation to the surety gave it to the bank which was then accepted. On default by the principal debtor, the court held that the surety's

© The Institute of Chartered Accountants of India

liability was not discharged as the alteration was beneficial to him and not substantial.

(b) By release or discharge of principal debtor (Section 134): The surety is discharged if the creditor:

i. enters into a fresh/ new contract with principal debtor; by which the principal debtor is released, or

ii. does any act or omission, the legal consequence of which is the discharge of the principal debtor.

Example: A contracts with B for a fixed price to build a house for B within a stipulated time, B supplying the necessary timber. C guarantees A's performance of the contract. B omits to supply the timber. C is discharged from his suretyship.

(c) Discharge of surety when creditor compounds with, gives time to, or agrees not to sue, principal debtor [Sector 135]: A contract between the creditor and the principal debtor, by which the creditor makes a **composition** with, or **promises to give time** to, or **promises not to sue**, the principal debtor, discharges the surety, unless the surety assents to such contract.

i. *Composition:* If the creditor makes a composition with the principal debtor, without consulting the surety, the latter is discharged. Composition inevitably involves variation of the original contract, and, therefore, the surety is discharged.

ii. *Promise to give time:* When the time for the payment of the guaranteed debt comes, the surety has the right to require the principal debtor to pay off the debt. Accordingly, it is one of the duties of the creditor towards the surety not to allow the principal debtor more time for payment.

iii. *Promise not to sue:* If the creditor under an agreement with the principal debtor promises not to sue him, the surety is discharged. The main reason is that the surety is entitled at any time to require the creditor to call upon the principal debtor to pay off the debt when it is due and this right is positively violated when the creditor promises not to sue the principal debtor. This is, however, subject to two important qualifications. In the first place, the promise not to sue should be distinguished from a mere "forbearance to sue."" A promise not to sue is an engagement which ties the hand of the creditor". It is not

© The Institute of Chartered Accountants of India

negatively refraining; not exacting the money at the time, but it is the act of the creditor depriving himself the power of suing. Section 137 incorporates this principal.

Cases where surety not discharged

i. **Surety not discharged when agreement made with third person to give time to principal debtor [Section 136]:** 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.

   Example: C, the holder of an overdue bill of exchange drawn by A as surety for B, and accepted by B, contracts with M to give time to B. A is not discharged.

ii. **Creditor's forbearance to sue does not discharge surety [Section 137]:** Mere forbearance on the part of the creditor to sue the principal debtor or to enforce any other remedy against him does not in the absence of any provision in the guarantee to the contrary, discharge the surety.

   Example: B owes to C a debt guaranteed by A. The debt becomes payable. C does not sue B for a year after the debt has become payable. A is not discharged from his suretyship.

(d) **Discharge of surety by creditor's act or omission impairing surety's eventual remedy [Section 139]:** If the creditor does any act which is inconsistent with the rights of the surety, 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. It is the plain duty of the creditor not to do anything inconsistent with the rights of the surety. A surety is entitled after paying off the creditor, to his indemnity from the principal debtor. If the creditors act or omission deprives the surety of the benefit of this remedy, the surety is discharged.

In a case before the Supreme Court of India, "A bank granted a loan on the security of the stock in the godown. The loan was also guaranteed by the surety. The goods were lost from the godown on account of the negligence of the bank officials. The surety was discharged to the extent of the value of the stock so lost." *[State bank of Saurashtra V Chitranjan Rangnath Raja (1980) 4 SCC 516]*

© The Institute of Chartered Accountants of India

Example 1: B contracts to build a ship for C for a given sum, to be paid by instalments as the work reaches certain stages. A becomes surety to C for B's due performance of the contract. C, without the knowledge of A, prepays to B the last two instalments. A is discharged by this prepayment.

Example 2: A puts M as apprentice to B, and gives a guarantee to B for M's fidelity. B promises on his part that he will, at least once a month, see that M make up the cash. B omits to see this done as promised, and M embezzles. A is not liable to B on his guarantee.

By the invalidation of the contract of guarantee

(a) **Guarantee obtained by misrepresentation invalid [Section 142]:** 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.

(b) **Guarantee obtained by concealment invalid [Section 143]:** Any guarantee which the creditor has obtained by means of keeping silence as to material circumstances is invalid.

Example 1: 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.

Example 2: A guarantees to C payment for iron to be supplied by him to B for the amount of ₹ 2,00,000 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 (Section 144):** Where a person gives a guarantee upon 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 other person does not join.

10. RIGHTS OF A SURETY

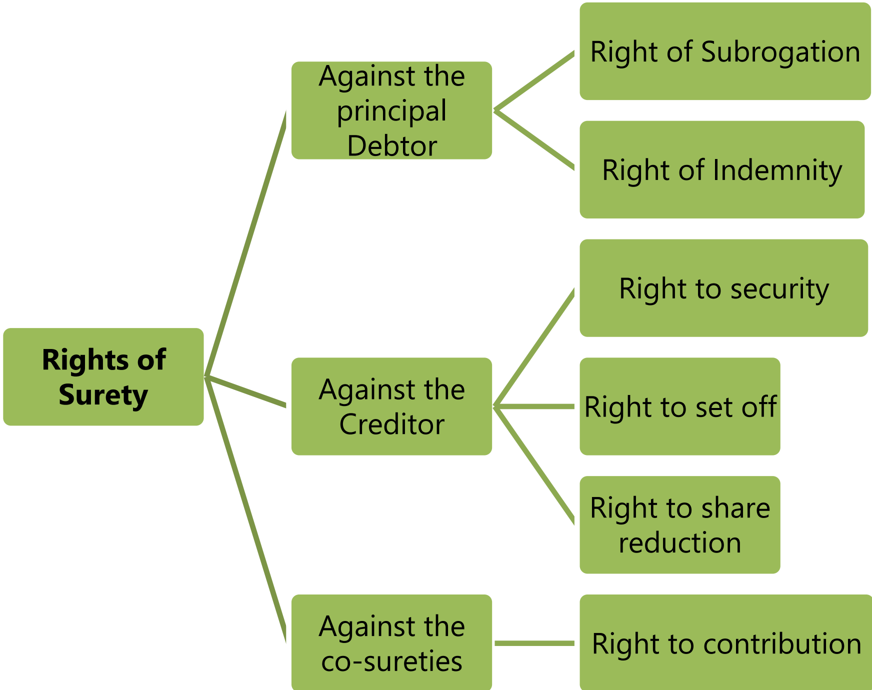
The surety enjoys the following rights against the creditor:

(a) Rights against the creditor,

© The Institute of Chartered Accountants of India

(b) Rights against the principal debtor,

(c) Rights against co-sureties.



Right against the principal debtor

(a) Rights of subrogation [Section 140]: Where, a guaranteed debt has become due, or default of the principal debtor to perform a guaranteed duty has taken place, the surety, upon payment or performance of all that he is liable for, is invested with all the rights which the creditor had against the principal debtor.

This right is known as right of subrogation. It means that on payment of the guaranteed debt, or performance of the guaranteed duty, the surety steps into the shoes of the creditor.

(b) Implied promise to indemnify surety [Section 145]: In every contract of guarantee there is an implied promise by the principal debtor to indemnify the surety. The surety is entitled to recover from the principal debtor whatever sum he has rightfully paid under the guarantee, but not sums which he paid wrongfully.

Example 1: B is indebted to C, and A is surety for the debt. C demands payment from A, and on his refusal sues him for the amount. A

© The Institute of Chartered Accountants of India

defends the suit, having reasonable grounds for doing so, but 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.

Example 2: C lends B a sum of money, and A, at the request of B, accepts a bill of exchange drawn by B upon A to secure the amount. C, the holder of the bill, demands payment of it from A, and, on A's refusal to pay, sues him upon the bill. A, not having reasonable grounds for so doing, defends the suit, and has to pay the amount of the bill and costs. He can recover from B the amount of the bill, but not the sum paid for costs, as there was no real ground for defending the action.

Example 3: A guarantees to C, to the extent of 2,00,000 rupees, payment for rice to be supplied by C to B. C supplies to B rice to a less amount than 2,00,000 rupees, but obtains from A payment of the sum of 2,00,000 rupees in respect of the rice supplied. A cannot recover from B more than the price of the rice actually supplied.

Right against the Creditor

Surety's right to benefit of creditor's securities [Section 141]: A surety 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; and, if the creditor loses, or, without the consent of the surety, parts with such security, the surety is discharged to the extent of the value of the security.

Example 1: C advances to B, his tenant, 2,00,000 rupees on the guarantee of A. C has also a further security for the 2,00,000 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.

Example 2: 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.

Example 3: 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 the up the further security, A is not discharged.

Right to set off: If the creditor sues the surety, for payment of principal debtor's liability, the surety may have the benefit of the set off, if any, that the principal debtor had against the creditor.

© The Institute of Chartered Accountants of India

Right to share reduction: The surety has right to claim proportionate reduction in his liability if the principal debtor becomes insolvent.

Rights against co-sureties

"Co-sureties (meaning)- When the same debt or duty is guaranteed by two or more persons, such persons are called co-sureties"

(a) Co-sureties liable to contribute equally (Section 146): Equality of burden is the basis of Co-suretyship. This is contained in section 146 which states that "when two or more persons **are co-sureties** for the **same debt**, or duty, **either jointly, or severally** and **whether under the same or different contracts** and **whether with or without the knowledge of each other**, the co-sureties in the absence of any contract to the contrary, are **liable**, as between themselves, **to pay each an equal share of the whole debt**, or of that part of it which remains unpaid by the principal debtor".

Example 1: A, B and C are sureties to D for the sum of 3,00,000 rupees lent to E. E makes default in payment. A, B and C are liable, as between themselves, to pay 1,00,000 rupees each.

Example 2: A, B and C are sureties to D for the sum of 1,00,000 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 25,000 rupees, B 25,000 rupees, and C 50,000 rupees.

(b) Liability of co-sureties bound in different sums (Section 147): The principal of equal contribution is, however, subject to the maximum limit fixed by a surety to his liability. Co-sureties who are bound in different sums are liable to pay equally as far as the limits of their respective obligations permit.

Example 1: A, B and C, as sureties for D, enter into three several bonds, each in a different penalty, namely, A in the penalty of 1,00,000 rupees, B in that of 2,00,000 rupees, C in that of 4,00,000 rupees, conditioned for D's duly accounting to E. D makes default to the extent of 3,00,000 rupees. A, B and C are each liable to pay 1,00,000 rupees.

Example 2: A, B and C, as sureties for D, enter into three several bonds, each in a different penalty, namely, A in the penalty of 1,00,000 rupees, B in that of 2,00,000 rupees, C in that of 4,00,000 rupees, conditioned for D's duly accounting to E. D makes default to the extent of 4,00,000 rupees; A is liable to pay 1,00,000 rupees, and B and C 1,50,000 rupees each.

© The Institute of Chartered Accountants of India

Example 3: A, B and C, as sureties for D, enter into three several bonds, each in a different penalty, namely, A in the penalty of 1,00,000 rupees, B in that of 2,00,000 rupees, C in that of 4,00,000 rupees, conditioned for D's duly accounting to E. D makes default to the extent of 7,00,000 rupees. A, B and C have to pay each the full penalty of his bond.

SUMMARY

- **A contract of indemnity-**A contract where one, party promises to indemnify the other from loss caused to him by the conduct of the promisor or by the conduct of any other person.
- **A contract of guarantee-**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 for whom the guarantee is given is called the Principal Debtor, and the person to whom the guarantee is given is called the Creditor.
- Contract of guarantee must be supported by consideration. The consideration received by the principal debtor may be sufficient consideration to the surety for giving guarantee.
- The liability of surety is co-extensive with that of principle debtor. In certain cases surety will be liable though principal debtor is not liable-(i) principal debtor is incompetent to contract. (ii) Principal debtor is adjudged insolvent. (iii) The debts become time-barred. The rights of a surety can be divided into 3 heads: (i) Right against the principal debtor; (ii) Right against the creditor; (iii) Right against the co- sureties.
- The surety is discharged from its liability (i) By revocation of the contract of guarantee. (ii) By the conduct of the creditor, or (iii) By the invalidation of the contract of guarantee.
- **Specific/simple guarantee:** Guarantee for single debt/particular transaction.
- **Continuing guarantee:** Guarantee that extends to a series of transactions.

© The Institute of Chartered Accountants of India

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. A contract of indemnity is a
   - (a) Contingent Contract
   - (b) Wagering contract
   - (c) Quasi Contract
   - (d) Void agreement
2. A contracts to save B against the consequences of any proceedings, which C may take against B in respect of a certain sum of 500 rupees. This is a:
   - (a) Contract of guarantee
   - (b) Quasi contract
   - (c) Contract of indemnity
   - (d) Void contract
3. In a Contract of Guarantee there is/are :
   - (a) One contract
   - (b) Two contracts
   - (c) Three contracts
   - (d) Four contracts.
4. S and P go into a shop. S says to the shopkeeper, C, "Let P have the goods, and if he does not pay you, I will." This is a
   - (a) Contract of Guarantee
   - (b) Contract of Indemnity
   - (c) Wagering agreement
   - (d) Quasi-contract
5. A guarantee obtained by a creditor by keeping silence as to material circumstances is :
   - (a) valid
   - (b) voidable

© The Institute of Chartered Accountants of India

(c) unenforceable

(d) invalid

6. In a contract of guarantee, a person, who promises to discharge another's liability is called:

(a) Principal debtor

(b) Creditor

(c) Indemnifier

(d) Surety

Answer to MCQs

1.	(a)	**2.**	(c)	**3.**	(c)	**4.**	(a)	**5.**	(d)	**6.**	(d)

QUESTION AND ANSWER

Question 1

M advances to N ₹ 5,000 on the guarantee of P. The loan carries interest at the rate 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?

Answer

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 (Section 133, Indian Contract Act, 1872).

Question 2

What are the rights of the indemnity-holder when sued?

Answer

Rights of Indemnity- holder when sued (Section 125): The promisee in a contract of indemnity, acting within the scope of his authority, is entitled to recover from the promisor—

(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;

© The Institute of Chartered Accountants of India

(2) all costs which he may be compelled to pay in any such suit if, in bringing or defending it, he did not contravene the orders of the promisor, and acted as it would have been prudent for him to act in the absence of any contract of indemnity, or if the promisor authorised him to bring or defend the suit;

(3) all sums which he may have paid under the terms of any compromise of any such suit, if the compromise was not contrary to the orders of the promisor, and was one which it would have been prudent for the promisee to make in the absence of any contract of indemnity, or if the promisor authorised him to compromise the suit.

It may be understood that the rights contemplated under section 125 are not exhaustive. The indemnity holder/ indemnified 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.

Question 3

Define contract of indemnity and contract of guarantee and state the conditions when guarantee is considered invalid?

Answer

Section 124 of the Indian Contract Act,1872 states that "A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or the conduct of any person", is called a "contract of indemnity".

Section 126 of the Indian Contract Act, 1872 states that "A contract to perform the promise made or discharge liability incurred by a third person in case of his default." is called as "contract of guarantee".

The conditions under which the guarantee is invalid or void are stated in section 142,143 and 144 of the Indian Contract Act are:

(i) Guarantee obtained by means of misrepresentation.

(ii) creditor obtained any guarantee by means of keeping silence as to material circumstances.

(iii) When contract of guarantee is entered into on the condition that the creditor shall not act upon it until another person has joined in it as co-surety and that other party fails to join as such.

© The Institute of Chartered Accountants of India

Question 4

Mr. X, is employed as a cashier on a monthly salary of ₹ 2,000 by ABC bank for a period of three years. Y gave surety for X's good conduct. After nine months, the financial position of the bank deteriorates. Then X agrees to accept a lower salary of ₹ 1,500/- per month from Bank. Two months later, it was found that X has misappropriated cash since the time of his appointment. What is the liability of Y ?

Answer

If the creditor makes any variance (i.e. change in terms) without the consent of the surety, then surety is discharged as to the transactions subsequent to the change. In the instant case Y is liable as a surety for the loss suffered by the bank due to misappropriation of cash by X during the first nine months but not for misappropriations committed after the reduction in salary. [Section 133, Indian Contract Act, 1872].

Question 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.

Answer

According to Section 134 of the Indian Contract Act, 1872, 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 for the creditor, the legal consequence of which is the discharge of the principal debtor. In the given case the B omits to supply the necessary construction material. Hence C is discharged from his liability.

Question 6

Mr. D was in urgent need of money amounting ₹ 5,00,000. He asked Mr. K for the money. Mr. K lent the money on the sureties of A, B and N without any contract between them in case of default in repayment of money by D to K. D makes default in payment. B refused to contribute, examine whether B can escape liability?

Answer

Co-sureties liable to contribute equally (Section 146 of the Indian Contract act, 1872): Equality of burden is the basis of Co-suretyship. This is contained in section 146 which states that "when two or more persons are co-sureties for the same

© The Institute of Chartered Accountants of India

debt, or duty, either jointly, or severally and whether under the same or different contracts and whether with or without the knowledge of each other, the co-sureties in the absence of any contract to the contrary, are liable, as between themselves, to pay each an equal share of the whole debt, or of that part of it which remains unpaid by the principal debtor".

Accordingly, on the default of D in payment, B cannot escape from his liability. All the three sureties A, B and N are liable to pay equally, in absence of any contract between them.

Question 7

Mr. Chetan was appointed as Site Manager of ABC Constructions Company on a two years contract at a monthly salary of ₹ 50,000. Mr. Pawan gave a surety in respect of Mr. Chetan's conduct. After six months the company was not in position to pay ₹ 50,000 to Mr. Chetan because of financial constraints. Chetan agreed for a lower salary of ₹ 30,000 from the company. This was not communicated to Mr. Pawan. Three months afterwards it was discovered that Chetan had been doing fraud since the time of his appointment. What is the liability of Mr. Pawan during the whole duration of Chetan's Appointment.

Answer

As per the provisions of Section 133 of the Indian Contract Act, 1872, if the creditor makes any variance (i.e. change in terms) without the consent of the surety, then surety is discharged as to the transactions subsequent to the change.

In the instant case, Mr. Pawan is liable as a surety for the loss suffered by ABC Constructions company due to misappropriation of cash by Mr. Chetan during the first six months but not for misappropriations committed after the reduction in salary.

Hence, Mr. Pawan, will be liable as a surety for the act of Mr. Chetan before the change in the terms of the contract i.e., during the first six months. Variation in the terms of the contract (as to the reduction of salary) without consent of Mr. Pawan, will discharge Mr. Pawan from all the liabilities towards the act of the Mr. Chetan after such variation.

Question 8

A agrees to sell goods to B on the guarantee of C for the payment of the price of goods in default of B. Is the agreement of guarantee valid in each of the following alternate cases:

Case 1. If A is a Minor

© The Institute of Chartered Accountants of India

Case 2: If B is a Minor

Case 3: If C is a minor.

Answer

Case 1: The agreement of guarantee is void because the creditor is incompetent to contract.

Case 2: The agreement of guarantee is valid because the capability of the principal debtor does not affect the validity of the agreement of the guarantee.

Case 3: The agreement of guarantee is void because the surety is incompetent to contract.

Question 9

S asks R to beat T and promises to indemnify R against the consequences. R beats T and is fined ₹ 50,000. Can R claim ₹ 50,000 from S.

Answer

R cannot claim ₹ 50,000 from S because the object of the agreement was unlawful. A contract of indemnity to be valid must fulfil all the **essentials of a valid contract** which includes:

a. Offer and acceptance

b. Intention to create legal obligation

c. Consideration

d. Competency to contract

e. Free consent

f. Lawful object

g. The agreement must not be expressly declared to be void- eg: an agreement in restraint of trade/ marriage etc.

h. The terms of the agreement must not be vague or uncertain

i. The agreement must be capable of performance- An agreement to do an impossible act is void.

j. Legal formalities

© The Institute of Chartered Accountants of India