

UNIT – 7: CONTRACT OF INDEMNITY AND GUARANTEE

LEARNING OUTCOMES

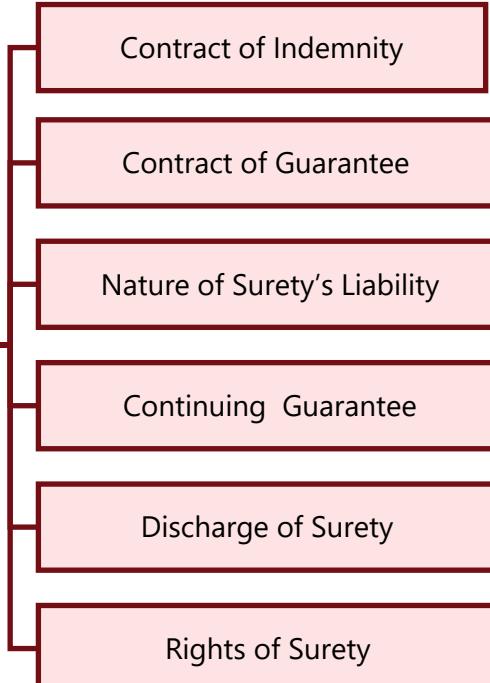
After studying this Chapter, you will be able to understand:

- ◆ 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.
- ◆ Distinction between contract of indemnity and contract of guarantee.
- ◆ Mode of discharge of contract of guarantee in various circumstances.

UNIT OVERVIEW



Contract of Indemnity and Guarantee



Contract of Indemnity and Guarantee are the specific types of contracts provided under sections 124 to 147 of the Indian Contract Act, 1872. In addition to the specific provisions (i.e. Section 124 to Section 147 of the Indian Contract Act, 1872), the general principles of contracts are also applicable to such contracts. Even though both the contracts are modes of compensation based on similar principles, they differ considerably in several aspects.

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



7.1

CONTRACT OF INDEMNITY

The term "Indemnity" literally means "Security against loss" or "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."

Example 1: Mr. X contracts with the Government to return to India after completing his studies (which were funded by the Government) at University of Cambridge and to 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.

Parties:

- The party who promises to indemnify/ save the other party from loss- "indemnifier",
- The party who is promised to be saved against the loss- "indemnified" or "indemnity holder".

Example 2: 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 3: X may agree to indemnify Y for any loss or damage that may occur if a tree on Y's neighboring 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.

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

- the conduct of the promisor himself, or
- the conduct of any other person.

Thus, loss occasioned by an accident not caused by any person, or an act of God/ natural event, is not covered.

In case of **Gajanan Moreshwar v/s Moreshwar Madan (1942)**, decision is taken on the basis of English Law. As per English Law, Indemnity means promise to save another harmless from the loss. Here it covers every loss whether due to negligence of promisee or by natural calamity or by accident.

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.

Example 4: 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—

- (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.

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



7.2 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 guarantee is given

Example 6: 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 failing to do so, he (A) will himself pay to B, there is a contract of guarantee.

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

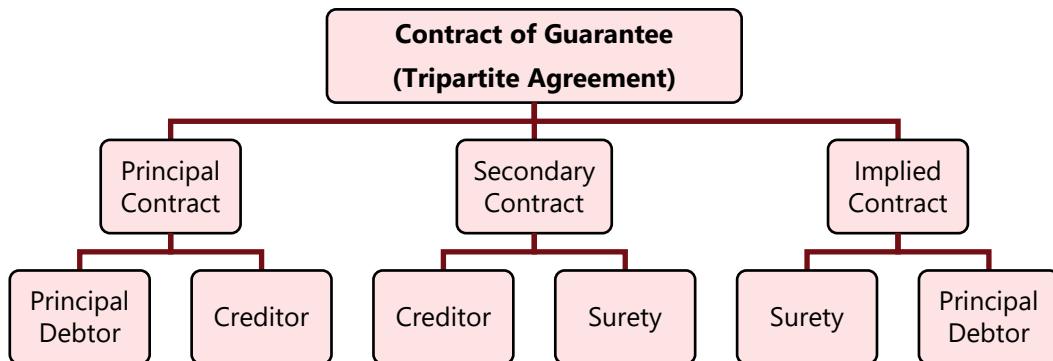
Example 7: X and Y go into a car showroom where X says to the dealer to supply latest model of Wagon R to Y, and agrees that if Y fails to pay he will. In case of Y's failure to pay, the car showroom will recover its money from X.

This is a contract of guarantee because X promises to discharge the liability of Y in case of his defaults.

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 and the surety.
- (iii) An 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. **Purpose:** The purpose of a guarantee being to secure the payment of a debt, the existence of recoverable debt is necessary. 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 is no need for a 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 8: 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 9: A sells and delivers goods to B. C afterwards, without consideration, agrees to pay for them in default of B. The agreement is void.

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 10: 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.

Example 11: 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 rupee five 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.

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.



7.3 TYPES OF GUARANTEES

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 12: 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 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.

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 13: 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.

Example 14: A guarantees payment to B, a tea-dealer, to the amount of ₹ 10,000, for any tea he may from time-to-time supply to C. B supplies C with tea to above the value of ₹ 10,000, and C pays B for it. Afterwards B supplies C with tea to the value of ₹ 20,000. C fails to pay. The guarantee given by A was a continuing guarantee, and he is accordingly liable to B to the extent of ₹ 10,000.



7.4 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-payment of an existing debt.
Time to Act	The indemnifier need not act at the request of indemnity holder.	The surety acts at the request of principal 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.



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

- (i) The liability of the surety is co-extensive with that of the principal debtor unless it is otherwise provided by the contract. [Section 128]
- (ii) Liability of surety is of secondary nature as he is liable only on default of principal debtor.
- (iii) Where a debtor cannot be held liable on account of any defect in the document, the liability of the surety also ceases.
- (iv) A creditor may choose to proceed against a surety first, unless there is an agreement to the contrary.

Example 15: 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.



7.6 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)

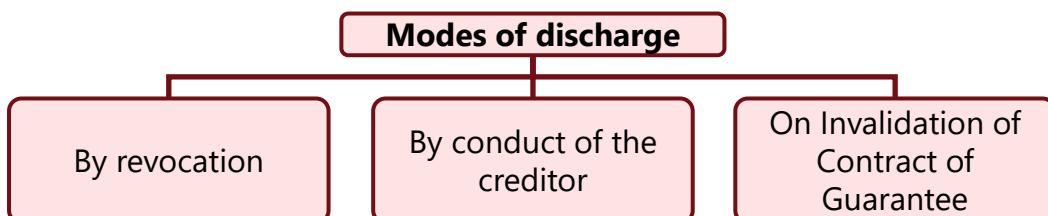
Example 16: A and B make a joint and several promissory note to C. A makes it, in fact, as surety for B, and C knows this at the time when the note is made. The fact that A, to the knowledge of C, made the note as surety for B, is no answer to a suit by C against A upon the note.



7.7 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. Once the guarantee is revoked, the surety is not liable for any future transaction however he is liable for all the transactions that happened before the notice was given.

A specific guarantee can be revoked only if liability to principal debtor has not accrued.

Example 17: Arun promises to pay Rama for all groceries bought by Carol for a period of 12 months if Carol fails to pay. In the next three months, Carol buys ₹ 2000/- worth of groceries. After 3 months, Arun revokes the guarantee by giving a notice to Rama. Carol further purchases ₹ 1000 of groceries. Carol fails to pay. Arun is not liable for ₹ 1000/- of purchase that was made after the notice but he is liable for ₹ 2000/- of purchase made before the notice.

- (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.

Example 18: 'S' guarantees 'C' for the transaction to be done between 'C' & 'P' for next month. After 5 days 'S' died. Now guarantee is revoked for future transactions but 'S's estate is still liable for transactions done during previous five days.

- (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.

Example 19: 'S' guarantees 'C' for the payment of the supply of wheat to be done by 'C' & 'P' for next month. After 5 days, the contract is changed. Now 'S' guarantees 'C' for the payment of the supply of rice to be done by 'C' & 'P' for rest of next month. Here, guarantee is revoked for supply of wheat. But 'S' is still liable for supply of wheat done during previous five days.

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.

Example 20: 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) **By release or discharge of principal debtor (Section 134):** The surety is discharged if the creditor:
- enters into a fresh/ new contract with principal debtor; by which the principal debtor is released, or
 - does any act or omission, the legal consequence of which is the discharge of the principal debtor.

Example 21: 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.

Example 22: A gives a guarantee to C for goods to be delivered to B. Later on, B contracts with C to assign his property to C in lieu of the debt. B is discharged of his liability and A is discharged of his liability.

- (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.

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 23: 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 24: 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.

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 Chitrangan Rangnath Raja (1980) 4 SCC 516]*

Example 25: 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 [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.

Example 26: 'C' sells AC to 'P' on misrepresenting that it is made of copper while it is made of aluminum. 'S' guarantees for the same as surety without the knowledge of fact that it is made of aluminum. Here, 'S' will not be liable.

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

Example 27: 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 28: 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.

Example 29: 'S1' guarantees 'C' for payment to be done by 'P' to 'C' on the condition that 'S1' will be liable only if 'S2' joins him for such guarantee. 'S2' does not give his consent. Here, 'S1' will not be liable.



7.8 RIGHTS OF A SURETY

The surety enjoys the following rights against the creditor:

- (a) Rights against the creditor,
- (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.

Example 30: 'Raju' has taken a housing loan from Canara Bank. 'Pappu' has given guarantee for repayment of such loan. Besides, there was a condition that if 'Raju' does not repay the loan within time, the bank can auction his property by giving 15 days notice to 'Raju'. On due date 'Raju' does not repay, hence Pappu being a surety has to repay the loan. Now 'Pappu' can take the house from bank and has a right to auction the house by giving 15 days notice to 'Raju'.

(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 31: B is indebted to C and A is surety for the debt. Upon default, C sues A. A defends the suit on reasonable grounds but is compelled to pay the amount. A is entitled to recover from B the cost as well as the principal debt.

In the same case above, if A did not have reasonable grounds for defence, A would still be entitled to recover principal debt from B but not any other costs.

Right against the Creditor

- (a) **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 32: 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.

- (b) **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

Example 33: 'X' took a loan of ₹ 50,000 from 'Y' which was guaranteed by 'Z'. There was one another contract between 'X' and 'Y' in which 'Y' had to pay ₹ 10,000 to 'X'. On default by 'X', 'Y' filed suit against 'Z'. Now 'Z' is liable to pay ₹ 40,000 (₹ 50,000 – ₹ 10,000).

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

Example 34: 'X' took a loan of ₹ 50,000 from 'Y' which was Guaranteed by 'Z'. 'X' became insolvent and only 25% is realised from his property against liabilities. Now 'Y' will receive ₹ 12,500 from 'X' and Now 'Z' is liable to pay ₹ 37,500 (₹ 50,000 – ₹ 12,500).

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):** Unless otherwise agreed, each surety is liable to contribute equally for discharge of whole debt or part of the debt remains unpaid by debtor.

Example 35: 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 36: 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 principle 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 37: 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.

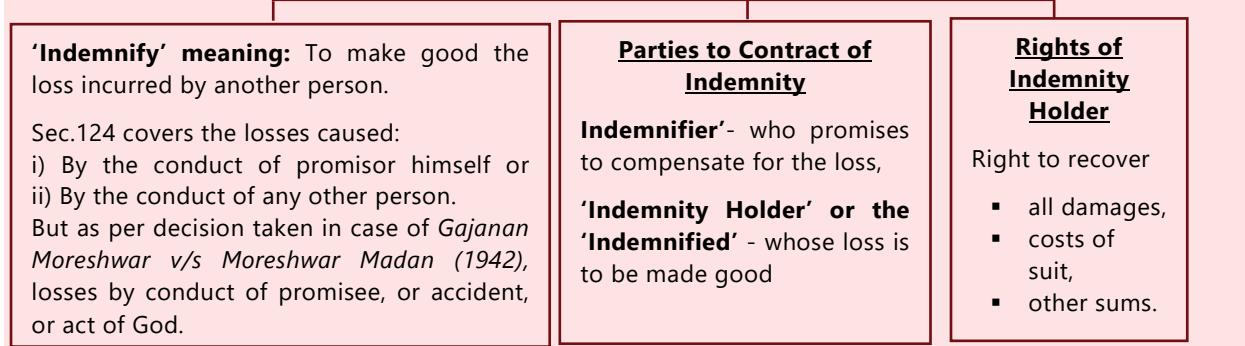
Example 38: A, B and C, as sureties for D, enter into three several bonds, each in a different penalty, namely, A in the penalty of 1,00,000 rupees, B in that of 2,00,000 rupees, C in that of 4,00,000 rupees, conditioned for D's duly accounting to E. D makes default to the extent of 4,00,000 rupees; A is liable to pay 1,00,000 rupees, and B and C 1,50,000 rupees each.

Example 39: 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 even though the 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.

CONTRACT OF INDEMNITY



CONTRACT OF GUARANTEE

'Guarantee'
meaning:

Contract to perform the promise; or discharge the liability, of a third person in case of his default.

Parties to Contract of Guarantee

Surety: Who gives the guarantee,

Principal Debtor: In respect of whose default the guarantee is given,

Creditor: To whom the guarantee is given

Essential Features

1. **Purpose:** To secure the payment of a debt.
2. **Consideration:** Must be there, may be direct or indirect.
3. **Existence of liability:** Liability must be legally enforceable, not time barred.
4. No misrepresentation or concealment
5. May be oral or written.
6. Joining of co-sureties must be if provided in contract.

Types of Guarantee

**Specific
Guarantee**

1. Guarantee which extends to a single debt/specific transaction,
2. Surety's liability comes to an end when guaranteed debt is duly discharged.

**Continue
Guarantee**

1. Guarantee which extends to a series of transaction,
2. Surety's liability continues until the revocation of the guarantee,

Modes of Discharge of Surety

**By
Revocation**

1. By Notice,
2. By surety's death,
3. By Novation,

**By Conduct of
Creditors**

1. By variance in terms,
2. By release or discharge of PD,
3. Composition with PD,
4. Impairing surety's remedy,

**On Invalidations of
Contract of
Guarantee**

1. Guarantee obtained by misrepresentation,
2. Guarantee obtained by concealment,
3. Guarantee on contract that creditor shall not act on it until co-surety joins

Rights of Surety

**Against Principal
Debtor**

1. Right of Subrogation,
2. Right of Indemnity,

Against Creditor

1. Right to Security
2. Right to Set Off
3. Right to share reduction

Against Co-Surtees

1. Right to claim contribution equally,
2. Right to claim contribution only agreed sum

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. 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) Surety contract
 - (b) Simple contract
 - (c) Contract of indemnity
 - (d) None of above
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. This is called:
 - (a) Contract of indemnity
 - (b) Contract of Guarantee
 - (c) Quasi Contract
 - (d) None of the above
3. Section 124 to 125, of the Contract Act, deals with:
 - (a) Contracts of indemnity
 - (b) Contracts of guarantee
 - (c) Both (a) and (b)
 - (d) None of above
4. 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-
 - (a) Indemnity
 - (b) Guarantee
 - (c) Wagering
 - (d) None of the above

5. 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. Whether-
- (a) A is liable for the price of the four sacks.
 - (b) A is not liable for the price of the four sacks.
 - (c) A is liable for the price of the two sacks only.
 - (d) A is liable for the price of the one sack only.
6. 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. Which is the correct option?
- (a) X is discharged from all liability to A for any loan granted.
 - (b) X is liable to A for ₹ 10,000 on default of B.
 - (c) X is liable to A for ₹ 50,000 on default of B.
 - (d) X is liable to A for ₹ 40,000 on default of B.
7. The guarantee is valid even if ___ is incompetent to contract:
- (a) Principal Debtor
 - (b) Surety
 - (c) Both a & b
 - (d) None of these
8. Section 143 of the Contract Act 1872 deals with
- (a) Guarantee obtained by free consent
 - (b) Guarantee obtained by fraud
 - (c) Guarantee obtained by concealment
 - (d) None of above
9. A surety has a right of indemnity and right of subrogation against _____
- (a) Principal Debtor
 - (b) Creditor
 - (c) Co-Sureties
 - (d) All of these

10. In contract of guarantee for whom guarantee given is called
- Surety holder
 - Principal debtor
 - Both (a) and (b)
 - None of above

Descriptive Questions

- What are the rights of the indemnity-holder when sued?
- Define contract of indemnity and contract of guarantee and state the conditions when guarantee is considered invalid?
- Mr. X, is employed as a cashier on a monthly salary of ₹ 12,000 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 ₹ 10,500/- 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?
- 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.
- Mr. D was in urgent need of money amounting to ₹ 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?
- 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.

7. 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

Case 2: If B is a Minor

Case 3: If C is a minor.

8. 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.
9. Manoj guarantees for Ranjan, a retail textile merchant, for an amount of ₹1,00,000, for which Sharma, the supplier may from time to time supply goods on credit basis to Ranjan during the next 3 months.

After 1 month, Manoj revokes the guarantee, when Sharma had supplied goods on credit for ₹40,000. Referring to the provisions of the Indian Contract Act, 1872, decide whether Manoj is discharged from all the liabilities to Sharma for any subsequent credit supply. What would be your answer in case Ranjan makes default in paying back Sharma for the goods already supplied on credit i.e. ₹40,000?

10. 'C' advances to 'B', ₹2,00,000 on the guarantee of 'A'. 'C' has also taken a further security for the same borrowing by mortgage of B's furniture worth ₹2,00,000 without knowledge of 'A'. 'C' cancels the mortgage. After 6 months 'B' becomes insolvent and 'C' sues 'A' his guarantee. Decide the liability of 'A' if the market value of furniture is worth ₹80,000, under the Indian Contract Act, 1872.

ANSWERS/HINTS

Answers to MCQs

1.	(c)	2.	(a)	3.	(a)	4.	(b)	5.	(b)	6.	(b)
7.	(a)	8.	(c)	9.	(a)	10.	(b)				

Answers to the Descriptive Questions

1. **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—
- (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 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.

2. 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 a "contract of guarantee".

The conditions under which the guarantee is invalid or void is provided in section 142, 143 and 144 of the Indian Contract Act. These include:

- (i) Guarantee obtained by means of misrepresentation.
- (ii) Guarantee obtained 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.

3. According to section 133 of the Indian Contract Act, 1872, 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.

In the instant case, the creditor has made variance (i.e. change in terms) without the consent of surety. Thus, surety is discharged as to the transactions subsequent to the change.

Hence, 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.

4. 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 discharged 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, B omits to supply the necessary construction material. Hence, C is discharged from his liability.

- 5. 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 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.

- 6.** 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.

- 7.** **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.

- 8.** 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.

- 9. Discharge of Surety by Revocation:** As per section 130 of the Indian Contract Act, 1872, a continuing guarantee may, at any time, be revoked by the surety, as to future

transactions, by notice to the creditor, but the surety remains liable for transactions already entered into.

As per the above provisions, liability of Manoj is discharged with relation to all subsequent credit supplies made by Sharma after revocation of guarantee, because it is a case of continuing guarantee.

However, liability of Manoj for previous transactions (before revocation) i.e. for ₹ 40,000 remains. He is liable for payment of ₹ 40,000 to Sharma because the transaction was already entered into before revocation of guarantee.

- 10. Surety's right to benefit of creditor's securities:** According to section 141 of the Indian Contract Act, 1872, 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.

In the instant case, C advances to B, ₹ 2,00,000 rupees on the guarantee of A. C has also taken a further security for ₹ 2,00,000 by mortgage of B's furniture without knowledge of A. 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 i.e. ₹ 80,000 and will remain liable for balance ₹ 1,20,000.