

IN THE SUPREME COURT OF THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

In the matter of an appeal in terms of Section 5 (2) of the High Court of the Provinces (Special Provisions) Act No. 10 of 1996 as amended by High Court of the Provinces (Special Provisions) (Amendment) Act No. 54 of 2006.

People's Bank,
No. 75, Chiththampalam A. Gardiner Mawatha,
Colombo 02.

S.C. Appeal (CHC) No. 05/2007

Plaintiff

H.C. (Civil) No. 139/2001

Vs.

1. Fawziya Nizam,
No. 07, Mosque Lane, Watarappala Road,
Mount Lavinia.
2. Tuan Furkan Buhary,
No. 11/D/2, National Housing Scheme,
Raddolugama.
3. Abdul Jabar Ifthikar Hussein,
No. 47/5, Main Street,
Moratuwa.
4. Noor Mohamed Mohamy Nizam,
No. 07, Mosque Lane, Watarappala Road,
Mount Lavinia.

Defendants

AND NOW BETWEEN

People's Bank,
No. 75, Chiththampalam A. Gardiner Mawatha,
Colombo 02.

Plaintiff-Appellant

Vs.

1. Fawziya Nizam,
No. 07, Mosque Lane, Watarappala Road,
Mount Lavinia.
2. Tuan Furkan Buhary,
No. 11/D/2, National Housing Scheme,
Raddolugama.
3. Abdul Jabar Ifthikar Hussein,
No. 47/5, Main Street,
Moratuwa.
4. Noor Mohamed Mohamy Nizam,
No. 07, Mosque Lane, Watarappala Road,
Mount Lavinia.

Defendant-Respondents

Before: Hon. Vijith K. Malalgoda, P.C., J.

Hon. A. H. M. D. Nawaz, J.

Hon. Janak De Silva, J.

Counsel:

Kushan De Alwis, P.C. with Prasanna de Silva and S. Mudannayake for Plaintiff-Appellant

Geoffrey Alagaratnam, P.C. with Bushan Illeperuma for the 2nd and 3rd Defendant-Respondents

Written Submissions:

04.11.2014 and 19.06.2012 by the Plaintiff-Appellant

03.11.2014 and 31.07.2012 by the Defendant-Respondents

Argued on: 25.03.2022

Decided on: 02.08.2024

Janak De Silva, J.

The Plaintiff-Appellant Bank (“Appellant”) instituted this action in the Provincial High Court of the Western Province (Exercising Civil Jurisdiction) Holden in Colombo (“Commercial High Court”) against the 1st to 4th Defendants-Respondents (“Respondents”) seeking, *inter alia*, judgment and decree jointly and severally in a sum of Rs. 13,000,000 together with legal interest from 06.06.2001 until date of decree and thereafter legal interest on the aggregate amount of the decree until payment in full.

The Appellant provided banking facilities to International Fashions (Pvt) Ltd. (“Company”), which maintained a current account with the Appellant. On or about 11.03.1993, an application was made by the Company to the Appellant for an overdraft facility in a sum of Rs. 6,500,000/=. The Appellant granted the facility on the condition that the amount be repaid within a period of 180 days (A3 and A4).

The 1st to 4th Respondents executed what is termed as a “Guarantee” (A5) (“Guarantee”) in favour of the Appellant as security for the repayment of the said overdraft facility.

On 11.08.1997 the Appellant demanded the repayment of the outstanding sum due on the overdraft facility. The Company failed and neglected to pay the amount due.

On or about 11.08.1997, the Appellant made a demand on the 1st to 4th Respondents for a sum of Rs. 5,980,847/05 due on the Guarantee given by them (P12 to P15). This action was instituted as they failed to pay on the demand.

Having considered the evidence lead at the trial, the learned trial judge delivered judgment dismissing the action with costs although he answered all issues pertaining to the overdraft facility in favour of the Appellant. The application was dismissed on the basis that it was prescribed in law.

The learned trial judge concluded that any action for the recovery of the amount due on the overdraft facility should have, in terms of Section 10 of the Prescription Ordinance, been filed within 3 years from the final overdrawn date. He went on to hold that the Respondents, as sureties, are entitled to rely on any defenses which may be available to the Company in an action for the recovery of the amount due on the overdraft facility. As any such action was prescribed by the time this action was instituted on 06.06.2001, the learned trial judge held that this action was prescribed.

Before proceeding to consider the merits of the arguments made before us, I must clarify that the principal debt, amount due from the Company to the Appellant on the overdraft facilities, is not extinguished by the operation of Section 10 of the Prescription Ordinance. For reasons more fully explained by me in **S. Albert and Others v. S. Sivakumar [S.C. (C.H.C) Appeal No. 04/2007, S.C.M. 23.01.2023 at page 13]**, the common phrase “*no action shall be maintainable*” in Sections 5 to 10 indicate “*that these sections are not intended to extinguish an obligation*” but to “*prevent an action being maintained on an obligation after the lapse of a specified period*”.

Weeramantry [*The Law of Contracts*, Lawman (India)(Pvt.)Ltd. (1969 Reprint in 1999), Vol. II, page 857] confirms this at footnote 14 in stating:

"It would not be strictly correct to relate the rule as is often done to the extinction of the accessory obligation upon the extinction of the principal, for the debt is not in our law extinguished but only rendered unenforceable."

There are two issues that arise for determination in this appeal. One is determining the applicable section in the Prescription Ordinance for the purposes of an action on the Guarantee. The other is, even if the action on the Guarantee is not prescribed, whether the Respondents are entitled to rely on any defense of prescription which could have been raised by the Company against the Appellant.

I will first consider the applicable section in the Prescription Ordinance. Prior to doing so, it is important to clear a misconception on the part of the learned trial judge who held that this action is based on the overdraft facility provided to the Company. Upon an examination of the plaint, it is clear that the cause of action relied on by the Appellant is the failure on the part of the Respondents to pay on demand as agreed in the Guarantee.

In ***Hatton National Bank Ltd. v. Sellers Sports (Pvt) Ltd. and Others*** [(2000) 3 Sri.L.R. 326] it was held that as regards the guarantee in issue, Section 6 of the Prescription Ordinance which relates to amounts due on a written promise or other written security is the applicable section and the period of prescription is 6 years. It was further held that the period should be computed not from the date of the default on the principal obligation, but from the date on which the payment upon the Guarantee became due namely, 10 days after demand in writing was made.

I am of the view that the relevant principle has been correctly expounded in ***Hatton National Bank Ltd. v. Sellers Sports (Pvt) Ltd. and Others*** [ibid.]. Section 6 of the Prescription Ordinance is applicable in determining whether the cause of action on the

Guarantee is prescribed. The demand was made on 11.08.1997 and this action was filed on 06.06.2001. Hence, this action is not prescribed.

Nevertheless, the Respondents submit that an action on the overdraft facility was prescribed as at the date this action was instituted. Therefore, it is contended that the Respondents can rely on that as a defense in this action against them.

On this point, parties took opposing positions. The Appellants contend that the Respondents tendered the Guarantee to the Appellant whereby they bound themselves as principal debtor. Thus, even where the debt of the Company to the Appellant is prescribed, the guarantor is not discharged from their liability to the Appellant.

The Respondents countered that the Guarantee is collateral to the contract already in existence between the Appellant and the Company. Where the transaction between the Appellant and Company is void or unenforceable by the Appellant, the guarantors are not bound. The cause of action on the overdraft facility was prescribed by the time this action was instituted against the Respondents. Therefore, this action cannot be maintained.

I must begin examining these competing and intricate positions by addressing an interesting conflicts of law question. The common law of Ceylon being the Roman-Dutch law, the general law of contracts in Ceylon is the Roman-Dutch law [Weeramantry (*supra*.), page 37].

However, in terms of Section 3 of the Civil Law Ordinance, in all questions or issues with respect to the law of banks and banking, the law to be administered shall be the same as would be administered in England in the like case [Weeramantry (*supra*.), page 45].

As the Respondents are private parties, it is arguable that the governing law is the Roman-Dutch law. Nevertheless, the Guarantee was given as part of a banking transaction and arguably English law will govern the issue. Which of these laws should be applied in determining whether the guarantors are not bound where the transaction between the Appellant and Company is void or unenforceable?

After considering the respective positions in both the Roman-Dutch law and English law, I am of the view that no determination on this issue need be made, as upon a consideration of the facts in this matter the position in both these laws are the same on this issue. In the event a firm position needs to be taken, I am inclined to hold that the governing law is the English law for the reason set out above.

In examining the position in Roman-Dutch law, Weeramantry [supra. pages 856-857] states as follows:

"The general principle would be that where the debt of the principal debtor is barred by limitation, the remedy against the surety is also barred for the reason that by the Roman-Dutch law the surety undertakes to pay the debt of the principal debtor only so long as the debt is enforceable in law and has not in fact been paid by the debtor. On the same principle, if there is interruption of prescription in respect of the principal debtor, such interruption operates also as an interruption against the surety, contrary to the general rule that interruption of prescription is operative only in respect of the person by whom the acknowledgement is made." (emphasis added)

The first case in South Africa in which this issue arose was **Cronin v. Meerholz (1920 TPD 403)**. The plaintiff took judgment against the principal debtor and thereafter sued the surety. At the time there was no prescription in respect of a judgment and what had to be decided was whether the claim against the surety had similarly become 'imprescribable'. The Court held that it had.

Wessels JP in his judgement relied on Voet 46.1.36 which reads as follows:

"If in sooth the making of a demand on one of two joint debtors interrupts prescription in respect of the other also, when each of them was bound as a principal debtor, far more must we say that an obligation against a surety is prolonged by a demand which was made on the principal debtor. It is more in accord with nature for an accessory to go with its principal, than for one principal thing to be assessed on another." (Gane's Translation)

In **Union Government v. Van der Merwe** [1921 TPD 318 at 321], one of the authorities relied on by Weeramantry for his statement, Wessels J.P. held:

"The contract of suretyship presupposes a principal obligation which has the same object, in the sense used by Continental jurists, as the contract of the surety. This is expressed by the maxim una eadem res vertitur in obligatione. Troplong, Cautionnement, sec.22.

The legal scope of the surety's contract is identical with that of the principal debtor --- accessorium sui principalis naturam sequitur. The surety undertakes the same obligation as the debtor, and undertakes to perform this same obligation so soon as the debtor, when called upon, fails to perform it. Troplong, caut:46. It is true there are two contracts, the one between the creditor and the debtor and the other between the creditor and the surety. But the contract between the creditor and the surety is not an independent contract with an obligation of its own but an accessory contract with the very same obligation that exists between the principal debtor and the creditor.

Although it is true that the suretyship contract may be entered into by an agreement different to that of the principal contract, yet immediately the surety agrees to become such, whether by a written or a verbal agreement, then his contract with the creditor is of the same nature as that of the principal debtor,

because it becomes accessory to it, or is, as it were, absorbed by it.” (emphasis added)

The position in Roman-Dutch law as expounded in the authorities cited above was challenged in ***Rand Bank Ltd. v. De Jager [1982(3) SA 418(C)]*** where Baker J. held that Voet had incorrectly extended the principal that applied only to co-debtors to sureties. It was held that Cod. 8.39(40).4(5) refers to co-debtors *in solidum* and not to sureties and that Justinian did not apply it to sureties, nor did he intend to and that sureties were a species apart and were governed by their own rules.

However, this debate has now been laid to rest by the Supreme Court of Appeal of South Africa in ***Shirley Joyce Jans v. Nedcor Bank Limited (86/02) [(2003) ZASCA 15, (2003) 2 All SA 11 (SCA) (24 March 2003)]*** where the decision in ***Rand Bank Ltd. v. De Jager*** (*supra*) was overruled. The position now is that the contract between the creditor and the surety is not an independent contract with an obligation of its own but an accessory contract with the very same obligation that exists between the principal debtor and the creditor and hence sureties are entitled to raise any defense that may be raised by the principal debtor against the creditor which makes the principal debt unenforceable.

Nevertheless, there is another aspect to the issue. Weeramantry relies on Caney's *Novation* [L.R. Caney, *A Treatise on the Law Relating to Novation* (Cape Town, 1938), page 140] for the first part of the statement quoted above. Nevertheless, according to Caney's *The Law of Suretyship* [Forsyth & Pretorius (eds.), 5th edition (Juta & Co. Ltd., 2002), page 32], Roman-Dutch law appears to recognize a difference in the position between the creditor and surety or guarantor when the principal debt is invalid or prescribed. It reads as follows:

“What then is the difference between a guarantee that a debtor will perform and suretyship? Lubbe makes one point of distinction clear : the guarantor’s obligation, as an obligation independent of that of the debtor, is to indemnify

the creditor in respect of losses suffered through the debtor's non-performance, whereas the surety, as we have seen, is only liable for losses resulting from the debtor's breach of contract. Thus if the creditor suffers grave losses when it turns out that debtor's contract is invalid, the guarantor's obligation remains in force and he will have to pay those losses but the surety's obligation falls away and he will not have to pay a penny. A second point of distinction is this: as we have seen, suretyship is an undertaking, in the first instance, that the debtor himself will perform, and only secondarily that if he fails to perform that the surety will do so. With guarantee, on the other hand, the guarantor undertakes to pay on the happening of a certain event but does not promise that that event will not happen." (emphasis added)

In so far as English law is concerned, contracts of suretyship can take two main forms. They are either contracts of guarantee or contracts of indemnity.

Halsbury's Laws of England, (5th ed., 2008), para. 1013 states that:

"A guarantee is an accessory contract by which the promisor undertakes to be answerable to the promise for the debt, default or miscarriage of another person, whose primary liability to the promise must exists or be contemplated."

According to Geraldine Andrews and Richard Millet in *Law of Guarantees* [6th ed. (Thomson Reuters, 2011), at page 3], the essential distinguishing feature of a contract of guarantee is that the liability of the guarantor is always ancillary, or secondary, to that of the principal, who remains primarily liable to the creditor. There is no liability on the guarantor unless and until the principal has failed to perform his obligations.

It follows from the secondary nature of the obligation, that the guarantor is generally only liable to the same extent that the principal is liable to the creditor, and that there is usually no liability on the part of the guarantor if the underlying obligation is void or unenforceable, or if that obligation ceases to exist. This is known as "the principle of co-extensiveness" [ibid., pages 5, 272].

Hence, if the principal debtor's obligation turns out not to exist, or is void, diminished or discharged, so is the guarantor's obligation in respect of it [*Lakeman v. Mountstephen* (1874) LR 7 HL 17 at 24-25]. In *Vossloh Aktiengesellschaft v. Alpha Trains (UK) Ltd.* [(2011) 2 All ER (Comm) 307 at para. 24] this co-extensiveness between the principal debtor's and the guarantor's obligation has been identified as an 'essential distinguishing feature of a true contract of guarantee'.

Nevertheless, not all guarantees have the principle of co-extensiveness. The true nature of the relationship and the respective rights and obligations between the guarantor and the creditor depends on the true construction of the instrument. In *Page's Law of Banking*, Ali Malek QC and John Odgers (eds.), 14th ed., (LexisNexis, 2014, page 466] it is stated as follows:

"This must be contrasted with the situation where, on the true construction of the promise, a primary or direct undertaking has been given by the guarantor to perform the principal debtor's obligation. If the obligation is of this nature, then the promise: (a) will be enforceable whether or not the principal debtor's obligation is enforceable; and (b) will not be a true contract of guarantee, because the promise will have a primary rather than a secondary liability to the creditor." (emphasis added)

Accordingly, the true nature of the relationship between the Appellant and the Respondents and their respective rights and liabilities must be determined by an examination of the Guarantee. In construing the Guarantee, we must not apply to it merely technical rules but must interpret it so as to reflect what may fairly be inferred to be the parties' real intention and understanding as expressed by them in the agreement [*Peerylease Ltd. v. Imecar AG* [(1988) 1 WLR 463 at 469H-470A]. It must be construed by looking at it as a whole without preconceptions as to what it is.

Nevertheless, English courts have identified certain types of documents as creating either primary and secondary obligations. In particular, it has been recognized that an “**on demand**” instrument, taking effect as an independent instrument creates a primary obligation [See *Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.* [(1978) 1 All ER 976; *Esal (Commodities) Ltd. and Reltor Ltd. v. Oriental Credit Ltd. and Wells Fargo Bank NA* (1985) 2 Lloyd’s Rep. 546; *IIG Capital LLC v. Van Der Merwe and another* (2008) EWCA Civ 542] whereas a **true guarantee** creates a secondary or accessory liability which is predicated on the default of the principal [See *Paddington Churches Housing Association v. Technical and General Guarantee Co. Ltd.* (1999) BLR 244; *Marubeni Hong Kong and South China Ltd. v. Government of Mongolia* (2005) EWCA Civ. 395].

Moreover, it has been held that performance bonds given by banks are almost invariably construed as imposing a liability on the bank to pay, whatever dispute there may be on liability under the underlying contract while instruments which are not banking instruments and formed part of a transaction outside the banking context and which was not described either on its face or in the supporting legal opinion in terms “appropriate to a demand bond or something having equivalent legal effect” created a “strong presumption against” interpretation as a demand bond [*IIG Capital LLC v. Van Der Merwe and another* (supra.) at para. 8].

The Guarantee was issued by the Respondents and not the Appellant Bank. Hence it is possible to claim that it was not part of a banking transaction. Nevertheless, the beneficiary is the Appellant bank and the Guarantee was given as security for a banking transaction, namely overdraft facility. Let me now construe the Guarantee to identify its true legal effect.

It is true, that the Guarantee is titled “Guarantee”. Nevertheless, the answer is not so straightforward as the body contains several references to “guarantee” as well as to “surety”. Moreover, the Guarantee must not be construed based purely on internal linguistic considerations. In *Wijewardene v. Jayawardene* (26 N.L.R. 193) the Privy

Council held that the words “this guarantee shall be a continuing guarantee” did not change the character of the obligation created by paragraph 1 into one of suretyship. The mere use of a descriptive term cannot affect the reality of the transaction. The agreement must be construed as a whole.

In this examination, Clause (ix) of the Guarantee (A5) offers an important insight of the intention of the parties. It reads:

“(ix) Any money herein mentioned shall be deemed to be owing notwithstanding any incapacity of or limitation upon the debtor or any person acting or purporting to act on behalf or in the name of the debtor with respect to borrowing or of or upon the Bank or any person acting or purporting to act on behalf or in the name of the Bank with respect to lending, or any defect or insufficient in the borrowing powers to the debtor or any such person aforesaid or in the lending powers of the Bank or any such person aforesaid, or in the exercise thereof respectively, which might be a defence as between the debtor and the Bank...” (emphasis added)

Accordingly, defenses touching on capacity or authority which may be available to the Company against the Appellant, in an action based on the overdraft facility, is not available to the Respondents. No doubt, this has not excluded defenses such as prescription. Nevertheless, this provides a vital indication that the obligations between the Appellant and the Respondents were intended to be independent of the obligations between the Appellant and the Company at a minimum on these matters.

By virtue of Clause 2 of the Guarantee (A5), the Respondents have bound themselves to:

“[...] pay to the Bank in (COLOMBO – Corporate) the moneys herein mentioned ten days after demand (PROVIDED ALWAYS that the total liability including all interest from the date of demand, and such further sums by way of Banker’s charges, Legal costs and expenses in accordance with the Bank’s usual course of

business shall not exceed the sum of Rupees Thirteen Million only (Rs. 13,000,000/=)“

This shows that the Guarantee is an on-demand guarantee. As Carnwath L.J. held in ***Marubeni Hong Kong and South China Ltd. v. Mongolia*** [supra., at para. 23], “demand bonds” however described are a specialised form of irrevocable instrument developed by the banking world for its commercial customers. They have been accepted by the courts as the equivalent of letters of credit.

In my view, these observations are equally applicable to the Guarantee although it was not given by a bank. It was given by the Respondents to the Appellant bank as security for a banking transaction. A bank when lending on commercial basis will understandably seek to cover the amount loaned with an on-demand guarantee that assures repayment in the absence of any other security such as mortgage of property as in this case.

In ***IIG Capital LLC v. Van Der Merwe and another*** (supra. para 19), Lord Justice Waller held:

“[...] there is no doubt that in a contract of guarantee parties may, if so minded, exclude any one or more of the normal incidents or suretyship. However if they choose to do so clear and unambiguous language must be used to displace the normal legal consequence of the contract [...]” (emphasis added)

The Appellant and the Respondents have sought to do so in Clause 9 of the Guarantee (A5) which reads as follows:

“9. Although my/our ultimate liability hereunder cannot exceed the limit hereinbefore mentioned, yet this present guarantee shall be construed and take effect as a guarantee of the whole and every part of the moneys herein mentioned and accordingly I am/we and each of us are not and is not to be entitled as against the Bank to any right of proof in the insolvency of the

debtor or other right of a surety discharging his liability in respect of the principal debt, unless and until the whole of the moneys herein mentioned including interest and charges as aforesaid shall have first been completely discharged and satisfied." (emphasis added)

This is an unequivocal statement that the Respondents are not entitled to any right of a surety discharging his liability in respect of the principal debt. This includes the right of a surety to be considered discharged from his liability upon the cause of action on the principal debt becoming prescribed. This exclusion further fortifies the position that it is an "on demand" guarantee creating a primary obligation between the Respondents and the Appellant.

The matter is put beyond doubt in Clause 14 of the Guarantee (A5) which reads as follows:

*"14. I/we and each of us specially agree that the Bank shall be at liberty, either in one action to sue the debtor and me/us and each or any of us jointly and severally, or to proceed in the first instance against me/us and each or any of us only, and further that I/we and each of us hereby renounce the right to claim that the debtor should be excused or proceeded against by action in the first instance, and (where this guarantee is given by more than one person) the right to claim that the Bank should divide its claim against us and bring actions against us, each for his portion pro rata, and the right to claim in any action brought against all of us that the Bank should only recover from each of us a pro rata share of the amount claimed in that action, and all other rights and benefits to which sureties are or may be by law entitled **IT BEING AGREED that I/we and each of us am/are and is liable in all respects hereunder as principal debtor/principal debtors jointly and severally, to the extent aforementioned, including the liability to be sued before recourse is had against the debtor.**"*

(emphasis added)

This is what is generally termed as a “principal debtor” clause. It was at one time held that a self-standing provision of this nature may be construed as preventing a guarantor from claiming that he has been discharged from liability by virtue of a fundamental breach of the contract with the borrower by the bank.

However, the prevailing view is that the inclusion of a “principal debtor” clause will not usually suffice *in itself* to determine the nature of the contract [**Carey Value Added SL v. Grupo Urvasco SA [(2011) 2 All E.R. (Comm) 140 at para.22]**].

Nevertheless, in combination with the other clauses of the Guarantee referred to above, it establishes that the intention of the parties was to create an independent obligation on the part of the Respondents to the Appellant.

In summary, there is a general principle in both the Roman-Dutch law and English law that if the principal debtor’s obligation turns out not to exist, or is void, diminished or discharged, so is the guarantor’s obligation in respect of it. However, parties can by agreement vary such rights and make the obligation under the agreement between them primary rather than a secondary obligation.

The Guarantee when constructed as a whole is an independent undertaking given by the Respondents to the Appellant creating a primary obligation. They undertook to pay on demand, all monies due according to its terms. This undertaking was not a collateral undertaking with that of the Company but an independent and primary obligation to pay on demand. The Respondents are not entitled to rely on any defenses that the Company would have in discharging its obligations in respect of the principal debt, namely the overdraft facility.

The learned Judge of the Commercial High Court erred in failing to consider the true nature of the Guarantee. Instead, he applied the general principle and assumed that any action on the Guarantee will be barred where an action on the failure to make payments on the overdraft facility was barred by Section 10 of the Prescription Ordinance.

The clear terms of the Guarantee, coupled with legal principles and precedents supports the contention of the Appellant that the Guarantee was a primary obligation undertaken by the Respondents. This action is not prescribed even though an action on the overdraft facility is prescribed. It is for this reason that the Appellants, as guarantors, cannot raise prescription based on the principal debt.

For all the foregoing reasons, I answer issue no. 14 in the affirmative and issue nos. 15 (a), 15 (b), and 17 in the negative. The answer to all the other issues shall remain as in the judgment of the Commercial High Court.

Accordingly, the judgment of the Commercial High Court dated 07.12.2006 is set aside. Judgment is entered as prayed for in the plaint dated 06.06.2001.

The learned Commercial High Court Judge is directed to enter decree accordingly.

The Appellant is entitled to costs in both the Commercial High Court and this Court.

Appeal allowed.

JUDGE OF THE SUPREME COURT

Vijith K. Malalgoda, PC, J.

I agree.

JUDGE OF THE SUPREME COURT

A. H. M. D. Nawaz, J.

Only two pivotal questions arise in this appeal from the court *a quo*- the Commercial High Court.

- a) Is the assurance or security document labeled as "**Guarantee**" a combination of a guarantee and an indemnity, or is it merely a true guarantee?

- b) Does the characterization of the so-called guarantee as either a "true guarantee" or a "guarantee and indemnity" affect the Respondent-Defendants' (the guarantors) defense of prescription (time bar) against the principal debt claimed by the Plaintiff-Appellant (Peoples' Bank) in this case?

The appeal also raises the issue of the residual applicability of Roman-Dutch law to matters relating to banks and banking. This question must be clarified due to the transactions between the parties in the case, specifically the Peoples Bank (the lender), the principal debtor (a company), and the Defendant-Respondents (the Directors of the company) who guaranteed the loan. The principal debtor did not figure as a Defendant in this litigation; only the Directors (the guarantors) were sued in the case.

At the outset, I venture to say that though I do not disagree with the essence of the conclusion of Janak de Silva.,J that the appeal of the People's Bank must be allowed, on balance I take the view that some further and different reasons have to be set down to buttress my own conclusions.

The security document that gave rise to the cause of action, as averred, by the People's Bank, is classified as a Guarantee. However, it is well-established in law that the title of the document will not determine whether it is a guarantee and/or an indemnity. Neither will the practice of referring to the guarantor and indemnifier simply as a guarantor, even though this is widespread. For example, there is authority from the English Court of Appeal that a director's obligation under a document described as a guarantee was, by virtue of its wording, a primary obligation payable on demand without recourse to the defenses available to the underlying obligor and that it was, in effect, a performance bond -a type of demand guarantee -see ***Francina Johanna van der Merwe and Gerrit le Roux van der Merwe v IIG Capital LLC.***¹

The guarantee in the instant case shares similarities with the guarantee encountered in the English precedent. In both instances, the principal debtor is a company, while

¹ (2007) EWCA Civ 542.

the guarantors are the company's directors. I will discuss this aspect later in this judgment under the rubric "co-extensiveness." Some English cases suggest that even when the contract between a creditor and a principal debtor is void, it may not vitiate the contract between the creditor and the so-called guarantors of the principal debt. This is particularly so in the case of a guarantor who is a director of a borrowing company.²

Quintessential Issue in the appeal

I will further delve into this matter in the course of the judgment. The resolution of the quintessential issue in this case hinges on whether the guarantee in question is a true guarantee or a combination of a guarantee and an indemnity, a construct that frequently appears in banking transactions.

Factual Template

To understand the crux of the legal questions before this court, it is necessary to narrate the facts. The People's Bank, the Plaintiff-Appellant in this case, advanced financial accommodation by way of an overdraft facility to a company called *International Fashions (Pvt) Ltd*, in the amount of Rs. 6,500,000. This was a temporary overdraft, as International Fashions (Pvt) Ltd promised to repay the amount within 180 days. On March 11, 1993, an application was made for the aforesaid temporary overdraft, which was repayable on demand and secured by a document titled "**Guarantee**" provided by five directors of the principal debtor company, International Fashions (Pvt) Ltd. Additionally, a promissory note dated March 11, 1993, was given to the People's Bank as further assurance for the repayment of the overdraft facility.

² J Steyn, 'Guarantees: The Co-Extensiveness Principle' (1974) 90 LQR 246, 248-251, explaining Gerrard v James [1925] 1 Ch 616 and other cases, but **noting that if the result follows because the 'guarantor agreed to be liable regardless of the company's capacity, then the contract is probably better understood as an indemnity;** Note that clause 1 (ix)- the ultra vires clause of the guarantee in this case renders the guarantee enforceable notwithstanding the incapacity of the corporate borrower,

The document titled "**Guarantee**" is central to this case and gives rise to the legal questions at hand. Before addressing these legal questions, it is important to complete the narrative of the remaining facts in the case.

The evidence provided by a bank officer who testified in the Commercial High Court, along with the statement of accounts he produced, clearly establishes that the principal debtor, International Fashions (Pvt) Ltd, utilized the overdraft facility by drawing cheques on its current account and thereby increasing its indebtedness. Though the repayment was required within 180 days from the date of the overdraft, this obligation was not fulfilled.

Although the application for the overdraft was in writing as stated above, it should be noted that even in the absence of such an application, the drawing of a cheque or the issuance of any other form of payment instruction is typically considered a request for an overdraft.³ Numerous such requests are evident upon examining the statement of accounts, and the People's Bank subsequently honored these cheques.

Long before November 29, 1996, the advances made to the principal debtor had been classified as non-performing advances (NPAs), and as of that date, the liability of the principal borrower had increased to Rs. 5,980,052.89. The evidence shows that demands for repayment were made to International Fashions (Pvt) Ltd, but the company responded with various settlement proposals. Time continued to pass, with the last demand made to the company and respondent-directors on August 23, 1997. *No action was filed against the principal debtor-the company other than this action against the guarantor-directors which was filed only on June 6, 2001.* These dates become essential as the prescriptive plea raised by the guarantors has to be resolved having regard to them.

³ See Paget's Law of Banking, Fifteenth Edition (2018) at p141; also see Lloyds Bank plc v Voller (2000) 2 All ER (Comm.) 978 (CA).

My discussion so far has focused on the principal debtor, which is relevant because the guarantors (the Defendant-Respondents) are relying on the time bar for repayment by the principal debtor. In their answer, the Directors (the Defendant-Respondents) raised the defence of prescription of the principal debt. The crux of their defense is that their own liability has been extinguished due to the principal debt becoming prescribed. Though they provided a guarantee, their promise of repayment is incapable of being acted upon or has become inoperative—so goes the argument of the guarantors.

This argument by the guarantors was accepted by the learned judge of the Commercial High Court in his judgment dated December 7, 2006. As I mentioned earlier, this amounts to an argument of co-extensiveness invoked by the providers of the guarantee. The answer filed by the Defendant-Respondents (the guarantors) in the Commercial High Court brought to the forefront the question of prescription of the principal debt, which was also raised as an issue by the Defendant-Respondents.

Thus, the pith and substance of the defense of the Defendant-Respondents has been a case of co-extensiveness. If the principal debt had become prescribed, it would have extinguished the co-extensive liability of the guarantors. This argument succeeded in the Commercial High Court and the action filed by the People's Bank against the guarantor-directors failed. The dismissal of the plaint on this ground has given rise to this appeal.

Though unsaid in the judgment of the Commercial High Court, it is this principle of co-extensive liability of the sureties that pervaded the spirit of the judgment of the court *a quo*. I now turn to that aspect of the matter.

Co-extensiveness

As guarantees are secondary obligations, the general principle is that the guarantor's liability is co-extensive with that of the principal debtor. Lord Selbourne said in *Lakeman v. Mountstephen* 'until there is a principal debtor, there can be no suretyship. Nor can a man guarantee anyone else's debt unless there is a debt of some other

person to be guaranteed'.⁴ Thus, if there is no enforceable debt, the liability of the guarantors becomes nullified.

The principle of co-extensiveness arises from the very nature of a true guarantee. It is trite law that a guarantee obligation is secondary and accessory to the obligation the performance of which is guaranteed; the guarantor undertakes that the principal debtor will perform his (the principal debtor's) obligation to the creditor and that he (the guarantor) will be liable to the creditor if the principal debtor does not perform.⁵ In a true guarantee the liability of a surety or a guarantor is so bound up with the primary obligation of the principal debtor that the obligation of the guarantors is treated as accessory to the underlying transaction.

Thus, if the principal debt is void or is voidable (and has been rescinded by the principal), no liability will attach to the guarantor.⁶ In *Censura Forensis* Van Leeuwen says in 1.4.17.3 'suretyship is an accessory obligation, by which a person, by means of a stipulation, pledges his credit on another's obligation, the principal debtor still remaining bound.' All this proves the crucial point that a valid principal obligation is essential for suretyship; suretyship has no independent existence.

The description above, which outlines the fundamental characteristics of a suretyship or guarantee, typically applies only to guarantees in the traditional sense. This perspective may not accurately reflect modern obligations undertaken by guarantors. In contemporary banking law, it is common to encounter situations where, based on the true interpretation of the promise, a guarantor provides a primary or independent undertaking to fulfill the principal debtor's obligation. This stands apart from traditional guarantee arrangements, as most standard form guarantees today effectively combine elements of both a guarantee and an indemnity.

⁴ (1864) LR 7 HL at 24-25.

⁵ *Moschi v Lep Air Services Ltd* (1973) AC 331. HL.

⁶ *Heald v O'Connor* (1971) 1 WLR 497.

If this is the case, then the guarantor's obligation would be to fulfil his own primary responsibility according to its specific terms, rather than merely ensuring that the principal debtor's obligation is met. It is important to emphasize this distinction, as the guarantors in this case have argued that their obligation constitutes a true guarantee, which is typically considered secondary and accessory to the underlying transaction.

Is the security document a true guarantee or a guarantee and indemnity?

In particular, this court needs to ascertain whether the document titled "**Guarantee**" in this case is a "true" guarantee (creating a secondary obligation) or some form of indemnity or demand bond (creating a primary obligation). As a matter of English Law and Roman – Dutch law, the form they take makes a difference and the significance of the difference between a guarantee and an indemnity is that in the case of indemnities the guarantor's promise; (a) will be enforceable whether or not the principal debtor's obligation is enforceable; and (b) will not give rise to a true contract of guarantee, because the guarantor will have a primary rather than a secondary liability to the creditor.⁷

As I stated earlier, ascertaining the nature of the promise in any given case depends upon the true construction of the actual words in which the promise is expressed. Regard must be had both to the words of the promise and the context in which it was given. In each case, the ultimate question is whether the person giving the promise has given an independent undertaking to perform the principal debtor's obligation, regardless of whether that obligation has ever been or remains valid and enforceable as between the creditor and the principal debtor.

Before determining the nature of the document titled "Guarantee", I will now proceed to address the guarantors' argument that the prescription of the principal debt has extinguished their liability. According to their claim, their obligation was accessory to

⁷ Paget's Law of Banking, 15th edition at p 511

the underlying principal debt, and thus, its expiration should also terminate their liability.

The key issue is whether the principal debt was time-barred at the time the case was brought against the guarantors. In the case before the Commercial High Court, the guarantors' stance was that since the principal debt was barred by prescription, it could not be recovered in court.

Consequently, they contended that the suretyship or guarantee contract with the Defendant-Respondents should be deemed terminated. The critical question, therefore, is whether the principal debt was indeed time-barred when the legal action was initiated against the guarantors.

Prescription of the principal debt

It must be acknowledged that the learned Commercial High Court judge's finding that the principal debt was prescribed at the time of the institution of the action cannot be faulted. However, the learned judge miscalculated the commencement of the prescriptive period by treating the last date of payment by the principal debtor as the starting point.

The challenge before this court is against the further conclusion of the learned Commercial High Court judge that, due to the invalidity or unenforceability of the principal debt because of the time bar, the liability of the guarantors has ended. Has the liability of the guarantors indeed terminated due to the successful running of prescription against the principal debt?

I would proceed to answer this question after shedding a few thoughts on the facts relating to the time bar of the principal debt. As the evidence clearly shows, the last payment by the principal debtor seems to have been recorded on 29.11.1996. On this particular day, the statement of accounts shows the overdrawn amount as Rs. 5,980,052.89.

The People's bank sent a letter of demand to both the principal debtor and the guarantors on 11.08.1997. Given that the repayment of the temporary overdraft was contingent upon a demand, the limitation period in respect of a claim for repayment of an overdraft would commence from the date on which the demand for repayment is made and not from the date the overdraft was granted. It has to be remembered that a contrary view was taken by the English Court of Appeal in *Parr's Banking Co. Ltd v. Yates*⁸, where a claim against a guarantor was held to be time-barred in respect of advances made more than 6 years before the issue of the writ. Paget's Law of Banking lays down that in modern banking practice, overdrafts are treated as repayable on demand, and it is thought that Parr's case does not represent the law today.⁹

The document titled "Application for a Temporary Overdraft" includes an agreement to repay the amounts on demand. As such, the three-year prescriptive period for overdrafts in this case would commence from the date of the demand, specifically 11.08.1997, rather than from 29.11.1996, which reflects the date of the last overdrawn balance. Hence, the bank's claim against the principal debtor in respect of the outstanding amount on the overdraft facility would be time-barred or prescribed on 11.08.2000. The People's bank in the case never instituted an action against the principal debtor as the principal debt had become prescribed.

Could this prescription of the principal debt extinguish the obligation of the guarantors and release them from their liability?

It repays attention that the action against the guarantors was instituted on 06.06.2001 – nearly 10 months after the principal debt had become time-barred. The question arises as to which law would govern the contract of guarantee on which the guarantors were sued: English law or Roman-Dutch law? Would the governing law allow the guarantors to raise the defence of time-bar of the principal debt?

⁸ (1898) 2 QB 460, CA

⁹ Pagets Law of Banking, 15th edition at p129

Although banking law in Sri Lanka is governed by English law, the law of guarantees is governed by Roman-Dutch law. Consequently, a guarantor in Sri Lanka is entitled to certain defenses or privileges unless they have been expressly renounced. I had the occasion to analyze the defenses or privileges in the case of *Sri Lanka insurance Corporation Ltd v. the Attorney General*¹⁰ in the Court of Appeal.

While English law does not substantially differ from Roman-Dutch law regarding the benefits accorded to sureties, it is important to remember that Roman-Dutch law applies to contracts of guarantee.

I have previously alluded to the legal position under English law on unenforceability of principal debt.¹¹ English law suggests that if the debt becomes extinguished and unenforceable, it goes without saying that since there is no debt to be guaranteed, the liability of a true guarantor would be at an end. What is the position of an indemnity under English law? The obligation to repay the debt to the creditor survives, provided that the promise to pay is embodied in an indemnity. What, then, is the position in Roman-Dutch Law?

Can the guarantor in a transaction governed by Roman-Dutch law use the prescription of the principal debt as a peremptory defence in a suit brought against him by the creditor? It must be recalled that the guarantors contended that their obligation was collateral and accessory, asserting it constituted a true guarantee secondary to the principal debt contract. This point had been contentious under Roman-Dutch law.¹²

In *Jans v Nedcor Bank Ltd*¹³ the South African Supreme Court of Appeal remarked that it wanted to settle an issue 'which ha[d] been the subject of debate for centuries' (at 649). The question that 'occupied the minds of jurists for a long time' (at 651) was whether 'an interruption or delay in the running of prescription in favour of the

¹⁰ CA / LA / 50 / 2007 (decided on 02.08.2019)

¹¹ See *ibid* fn 7.

¹² See Christopher Forsyth, 'Prescription, Suretyship and the Unwelcome Revival of Correality' (1999) 11 S Afr Mercantile LJ 385; C.F. Forsyth, 'Suretyship and Prescription; A New Frontier' (1984) 101 S African LJ 237.

¹³ 2003 (6) SA 646 (SCA).

principal debtor interrupted [or delayed] the running of prescription in favour of a surety'(at 649). After an exhaustive analysis of the fundamental principles applicable to suretyship the court concluded that it did (at 663). The South African Supreme Court concluded that sureties enjoy the benefit of raising defences which are available to the principal debtor.

Scott JA stated (at 661):

' By its very nature a contract of suretyship is burdensome. The surety undertakes responsibility for the fulfilment of another's obligation. No doubt for this reason the law affords protection to a surety in a number of different ways. At common law, for example, a surety will be released if the creditor does something in his dealings with the principal debtor which has the effect of prejudicing the surety... In order to be valid, contracts of suretyship must now also be embodied in a written document signed by or on behalf of the surety .. But a balance must be struck. Sureties do not assume the obligations of others against their wills, but with their free consent. Once having done so they cannot expect to be entitled simply to disabuse their minds of the fortunes of the principal debtor's liability and then require the law to protect them against their ignorance. If prescription in favour of the principal debtor is delayed or interrupted without their knowledge, they generally have themselves to blame.

In **Eley (formally Memmel) v Lynn & Main Inc**¹⁴ the South African Supreme Court of Appeal was called upon to decide whether a claim against a surety who had bound herself as surety in respect of a debt that was confirmed and reinforced by a judgment against the principal debtor, prescribed after three years, or after 30 years as contemplated by the Prescription Act 68 of 1969. (In terms of section 11(a)(ii) of the Prescription Act, the period of prescription in respect of any judgment debt' is 30 years, whereas, under section 11(d), it is three years in respect of 'any other debt'.)

¹⁴ 2008 (2) SA 150 (SCA).

The surety sought to distinguish the decision in *Jans* on the basis that *Jans* concerned the interruption or delay in the running of prescription and not directly whether a judgment against the principal debtor resulted in prescription against the surety being extended to 30 years, in line with section 11(a)(ii) of the Prescription Act. Mthiyane JA rejected this distinction that the surety sought to draw as 'illusory' and affirmed that *Jans* 'set . .] out the fundamental principles applicable to suretyship contracts in general and [was] not confined to the effect of the interruption of the running of prescription against the principal debtor' (at 154).

The judge remarked that this was particularly clear from the judgment in *Jans* where Scott JA observed that to permit the claim against the surety to prescribe before the claim against the principal debtor would be subversive of the whole contract of suretyship (*Jans* at 662).

Mthiyane JA thus concluded that the contention that the claim against the surety had prescribed after three years fell to be rejected.

Thus, the Roman-Dutch law position as clearly spelled out above makes it patently clear that it is in regard to true guarantees that the above proposition applies.

That finally brings us to the quintessential issue to which category of guarantees that the security instrument provided by the defendant- respondents belongs. I have already adumbrated the key differences between true guarantees and indemnities. The tests or guidelines which delineate the distinctions between the two categories have been set out in the course of this judgment.

In a nutshell it is not a matter of label to be attached but a question of substance of the obligations. It is the obligation that the guarantors undertook in the document titled the guarantee a primary, independent obligation. Upon a careful perusal of the component parts of the document, I take the view that the document in question created a primary, independent obligation, so that the principal debtor's defenses are unavailable to the guarantors.

The document in question partakes of the characteristics of a combination of a guarantee and indemnity which has assumed primacy in standard guarantee documents. Bearing in mind that the task is to identify the nature of the obligations assumed by the guarantors under the guarantee, the method of construction of the wording and context of the bond would revolve around the following.

Clauses or features in the guarantee that render the obligation enforceable as an indemnity

Clause 1 (ix) which is generally referred to as the ultra vires clause makes it clear that the guarantors have undertaken to accept primary liability as principal debtor for any sums which cannot be recovered from the company. The clause puts beyond doubt that the guarantor's liability is not affected by the irregular exercise of borrowing powers of the company or even when the indebtedness becomes void or unenforceable by the bank. No legal limitation or lack of contractual capacity on the part of the principal debtor exculpates or exonerates the guarantors from liability and thus, the guarantors have assumed primary liability for all monies they guaranteed under the document of assurance.

Waiver of Legal Privileges

The law relating to *personal guarantees or suretyship* is Roman-Dutch Law which affords several privileges and defences to sureties, such as,

(i) *the beneficium ordinis seu excussionis*, whereby the surety when sued may call upon the creditor to first proceed against the principal debtor and to come against him only if the debtor is unable to pay or satisfy the judgment debt in full.

(ii) *the beneficium divisionis*, whereby when several persons are sureties for the same debt, each of them, may when sued for the whole amount, require the creditor to divide his claim and sue the other co-sureties as well, each for his share *pro rata* insofar as the others are not insolvent.

(iii) *the beneficium cedendarum actionum*, whereby if a surety pays the creditor the debt due, he is entitled to demand from the creditor a cession of action not only as against the principal debtor but also against all other persons who may be liable.¹⁵

The defense *Beneficium ordinis seu excussionis* or simply “benefit of excussion” allows a surety to resist payment to a creditor by insisting that the creditor must first attempt to collect the debt from the principal debtor.

The benefit is procedural in that the surety could raise this defence when litigation is instituted, with the result that the benefit then delays payment by insisting that the creditor must follow a certain procedure—he must excuse the principal debtor before seeking to recover the outstanding debt from the surety. Thus, it is a dilatory plea, not a peremptory defence.

Although the benefit of excussion, one of the ancient protections afforded to sureties under Justinian's legislation (Caney's The Law of Suretyship in South Africa, 5th ed., by CF Forsyth & JT Pretorius (2002), 15ff), is still recognized, sureties often waive or tacitly renounce this benefit by assuming liability as "surety and co-principal debtor."

These special defenses protected sureties against possible collusion between the debtor and the creditor. By way of clause 14, the guarantors have renounced all these privileges and the effect of all this renders each of the guarantors liable in all respects as principal debtors jointly and severally, which includes the liability to be sued before recourse is had against the debtor.

Consequently, I conclude that the guarantors have bound themselves as primary debtors and not as true guarantors who principally assume secondary liability.

I have already alluded to an additional test namely - if the guarantors demonstrate personal interest in the borrowing of the corporate entity, the guarantors must be

¹⁵ See Wijewardene v Jayawardene (1917) 19 N.L.R 449.

treated as having undertaken primary liability.¹⁶ In the circumstances I entertain no doubt that there was no impediment to the People's Bank instituting this action against the guarantors and the prescription of the principal debt cannot be invoked by the guarantors when they have assumed obligations under an indemnity or a combination of guarantee and indemnity. Both English law and Roman-Dutch law converge harmoniously on indemnities and Caney's *the Law of Suretyship* describes such a situation as undertaking liability as surety and co-principal debtor.¹⁷

The indemnities that the guarantors undertook in the deed are "**continuing obligations**" and that gives an indication that **they survive the termination of the principal debt even on prescription, as is evident on the facts.**

Thus, one sees that any link between the liability under the overdraft agreement and liability under the guarantee has been severed. Thus, I take the view that even if People's Bank is unable to enforce the overdraft agreement, the guarantee and indemnity remain enforceable. The combination of all these matters demonstrates a clear and unanswerable case that the obligations of the guarantors under the guarantee are primary, separate and independent.

For the foregoing reasons, I proceed to set aside the judgment of the Commercial High Court dated 07.12.2006 and order that the judgment is entered as prayed for in the plaint dated 06.06.2001. I direct the learned Commercial High Court Judge to enter decree in accordance with this judgment.

The appeal is thus allowed.

JUDGE OF THE SUPREME COURT

¹⁶ Ibid fn1.

¹⁷ See Caney's the Law of Suretyship, 5th Edition at page 55.