Nature and extent of liability of surety

Introduction

According to [Black’s law dictionary](https://www.latestlaws.com/wp-content/uploads/2015/04/Blacks-Law-Dictionery.pdf), the word “*guarantee is used, as a noun, to denote the contract of guarantee or the obligation of a guarantor, and, as a verb, to denote the action of assuming the responsibilities of a guarantor*.”

A contract of guarantee enables an individual to get a loan or buy goods on credit or acquire means of livelihood. A contract of guarantee is a tripartite agreement, that is, it concerns three parties- the principal debtor, the creditor, and the surety.

There must be a principal debtor who has taken debt from the creditor. The surety comes into the picture and pays the debt on behalf of the principal debtor. For example, A, an individual comes up and tells the supplier of certain goods B, that he will pay for the goods bought by C, in case C fails to do so. A promises to guarantee the payment in consideration of B’s promise to deliver the goods. This is sufficient consideration for C’s promise.

# Contract of guarantee

A contract of guarantee is precisely stated under [Section 126](https://indiankanoon.org/doc/53550/) of the [Indian Contract Act, 1872](https://legislative.gov.in/sites/default/files/A1872-09.pdf). According to this section, a contract of guarantee can be understood as a contract that requires an individual or a group of individuals to perform a promise made or to discharge their liability under the contract when the third party to the contract failed to fulfill their part of the promise. This guarantee can be oral or written.

A contract of guarantee requires three parties: the principal debtor, the creditor, and the surety. The individual on whose non-payment the guarantee has to be given is the principal debtor or the borrower, the creditor is the individual who is given the guarantee and the surety is the individual who gives the guarantee.

Surety makes a promise to the creditor that on the principal debtor’s default, they will discharge the third party’s liability or fulfill the promise which was made by the principal debtor. Therefore, the surety gives assurance to the creditor for the principal debtor’s act.

It can be interpreted that the liability of the surety acts as collateral to the principal debtor’s liability. In case the principal debtor defaults, the surety is bound by a conditional promise to be held liable.

There are three essential features of a contract of guarantee:

1. **Consideration-** It is an essential element of a contract of guarantee. The consideration can be monetary, a future act, personal property, etc. that largely benefits the principal debtor.
2. **Not made in good faith-** A contract of guarantee is not an uberrimae fides contract, that is, a contract made in good faith. But there is an obligation to disclose all the material facts to the surety so he can make an informed decision. Therefore, a guarantee obtained by concealment or misrepresentation is invalid.
3. **Either oral or written-** The contract can either be oral or written according to Section 126 of the [Indian Contract Act, 1872.](https://legislative.gov.in/sites/default/files/A1872-09.pdf)

The Act seeks to protect the interest of all the three parties that are involved in a contract of guarantee with emphasis on the interests of the surety.

# Nature of liability of surety

As laid down in [Section 128](https://indiankanoon.org/doc/1377136/) of the Indian Contract Act, 1872, the liability of the surety is coextensive. It has the same extent as that of the principal debtor. It emphasizes the maximum degree as well as the scope of the surety’s liability.

## Coextensive

‘Coextensive’ is an attribute to the word extent and refers to the amount or the quantum of the principal debt. This particular section only explains the ambit of the extent of surety’s obligation when no limit has been stipulated against the validity of the principal debtor’s obligation.

The Section further explains how the surety may, however, in the agreement impose certain limits to the extent of his liability entering into a special contract. They can make a declaration and impose a certain limit or restriction to their liability.

Unless it is expressly mentioned in the terms of the contract, neither can the surety be held liable by the creditor nor can he sue him, till the principal debtor makes a default. Therefore, the surety’s liability is secondary or peripheral in nature.

It is encouraging to take note of the fact that even before the Indian Contract Act, 1872 was enacted the Indian courts perceived the principle of co-extensiveness. In the case of [Lachman Joharimal v. Bapu Khandu and Another (1869)](https://shortnotesonlaw.blogspot.com/2009/09/lachhman-joharimal-v-bapu-khandu-and.html" \t "_blank), the Bombay High Court explained how it is not binding on the creditor to extinguish his remedies before suing the principal debtor. On obtaining a decree against the surety, it may be upheld in a similar way as a pronouncement or a decree for any obligation of the party or any debt which has not been repaid.

## Condition precedent to the surety’s liability

Where there is a condition precedent to the surety’s liability, he will not be liable unless that condition is first fulfilled. [Section 144](https://indiankanoon.org/doc/820639/) is based on this principle to an extent. For example, when an individual gives a guarantee to undertake a task unless another individual joins as a co-surety, the guarantee will be invalid if another co-surety does not join the contract.

In National Provincial Bank of England v. Brackenbury (1906), a guarantee was signed by the defendant. The defendant signed the contract on the condition that three more individuals would also sign the contract, as part of a joint and several guarantee. However, one of the three individuals did not sign the contract of guarantee. The Court held that no agreement took place since there was a condition to the contract that was not fulfilled. Hence, the defendant was held not liable.

# The extent of liability of surety

It is still a critical issue to measure the maximum extent of surety’s liability and to what extent it is being invoked presently. Herein the question is at what time the surety’s liability comes under scrutiny- when the debtor has not fulfilled their part of the promise of all the remedies that have been availed by the creditor against the debtor.

## Is creditor bound to exhaust his remedies before suing the surety

The surety’s liability is not removed in case of the omission of the creditor in suing the borrower. The creditor does have to necessarily exhaust his remedies against the principal debtor before they sue the surety. They can still maintain a suit if no proceedings have been initiated beforehand against the borrower. However, the surety cannot be held liable until the contingency takes place.

Difficulties arise in interpreting the principle of co-extensiveness when the surety has guaranteed performing a contractual liability to make payments by way of installments to the creditor.

### Prominent case laws

The reference point for these difficulties was brought to light and elucidated in [Lep Air v. Moschi (1973)](https://swarb.co.uk/lep-air-services-v-rolloswin-investments-ltd-moschi-v-lep-air-services-hl-1973/). In this particular case, the debtor did not make the payment in installments to the creditor who had performed their end of the contract. The contract was repudiated by the creditor. The issue here was whether the creditor could initiate proceedings against the surety at the time of repudiation for the amount entitled to the creditor under the contract, regardless of the fact that when the repudiation was accepted the debtor now had a secondary and not a primary obligation to pay damages.

The surety had an obligation to observe the debtor’s performance of his contractual obligations, so on his default, the surety was obligated to make a payment to the creditor for the loss incurred to him. However, it was visualized in this case that the obligation of the surety and the debtor would be coextensive and no pronouncement could breach this basic principle.

The principle of co extensiveness was further enforced in the following cases of [Bank of Bihar Ltd v. Damodar Prasad and Another (1968)](https://indiankanoon.org/doc/743049/)wherein the Supreme Court explained how the sole condition required was to demand the payment pertaining to the principal debtor’s liability for the implementation of the bond. On the fulfillment of the condition and despite constant demands, both the principal debtor and the surety did not fulfill their end of the contract.

The liability being co-extensive and immediate in nature made the surety liable to pay the whole sum in question. There was no delay and no anticipation for the remedies to be extinguished by the creditor against the principal debtor.

A similar judgment was held in [State Bank of India v. Indexport Registered (1992)](https://indiankanoon.org/doc/1553951/), wherein the Supreme Court explained how the surety solely because of the creditor’s omission in initiating proceedings against the surety does not become free from their liability to pay the debt. It was reinstated that the creditor is not confined to having his remedies and a suit is still maintainable before suing the principal debtor.

The Supreme Court explained how prima facie there can be proceedings against the surety despite the absence of demand and without proceeding against the principal debtor first. They explained the lack of any such prerequisite for the creditor to request payment from the principal debtor or sue him for not fulfilling his part of the promise and they can directly initiate proceedings against the surety unless it has been expressly stipulated in the contract.

In the case of [Hukumchand Insurance Co Ltd v. Bank of Baroda (1977)](https://indiankanoon.org/doc/1638192/" \t "_blank), the Karnataka High Court observed the nature and the incidents that occurred are the two main factors which decide the liability, the extent, and manner of the enforcement. Although the principal debtor and the surety’s liability arising from the same bargain, the two liabilities are not alike. These principles laid down were further reinforced in a number of cases.

It is the choice of the creditor which remedy they find fit to pursue and neither the defaulter nor the surety can compel the creditor in any manner and advise them to take recourse to a particular remedy. It falls in the exclusive domain of the creditor.

In the case of [St](https://indiankanoon.org/doc/1793495/)[*a*](https://indiankanoon.org/doc/1793495/)[te Bank of India v. G.J. Herman and others (1998)](https://indiankanoon.org/doc/1793495/), the Kerala High Court observed that the surety’s liability being joint and several, would not bind the creditor to initiate proceedings against the principal debtor or the other sureties in the contract. If such a direction would be binding, it would be a direct violation of the principle of co extensiveness.

They are to be liable till the extent to which they stood guarantee and can face proceedings by the creditor. It is solely the discretion and the decision of the creditor against whom he wants to initiate the proceedings- the principal debtors or any of the sureties.

## A suit against principal debtor alone

The creditor can initiate a suit against the principal debtor alone without initiating any proceedings against the surety. In [Union Bank of India v. Noor Dairy Farms (1996)](https://indiankanoon.org/doc/527958/), it was held that such a suit would be maintainable. The liability of the surety in a contract of guarantee is not absolved on the dismissal of a suit against the principal debtor.

## A suit against surety alone

A suit against the surety without initiating proceedings against the principal debtor has been held to be maintainable. In [N.Narasimhaiah v. Karnataka State Financial Corporation (2004)](https://indiankanoon.org/doc/1640422/" \t "_blank), the creditor showed sufficient reasons for not proceeding against the principal debt in his affidavit. A contract of guarantee was made enforceable by the terms stipulated against the guarantors severally and jointly with that of the principal debtor’s company. The Court held that the creditor has the option to sue the company and the surety as co-defendants or the surety alone.

## Proceedings against surety’s mortgaged property

A financial corporation cannot take possession of the surety’s mortgaged property of the guarantor without prior notice. The corporation also cannot issue any public notice to sell the property without informing the surety. This is because the surety’s liability is secondary in nature and would arise only when the principal debtor fails to repay the amount.

The property of the surety which has been offered as a security can be proceeded against without exhausting the available remedies against the principal debtor.

## Death of principal debtor

In case of the death of the principal debtor, any suit against him would be void ab initio. However, the surety would not be discharged of his liability to pay the amount.

In [Orissa Agro Industries Corpn Ltd v. Sarbeswar Guru,(1985)](https://indiankanoon.org/doc/912995/), it was held that the dismissal of the suit against the principal debtor, under [Order 1](https://lawrato.com/indian-kanoon/cpc/order-1) of [Code of Civil Procedure, 1908](https://legislative.gov.in/sites/default/files/A1908-05.pdf) would not automatically absolve the surety of its liability.

## Surety’s right to limit his liability or make it conditional

The surety may put a restriction on the extent of his liability in the agreement. He can expressly declare his guarantee to a fixed amount and in such a case the surety cannot be liable for any amount beyond the fixed amount.

The principal debtor owes a greater amount but it is not the responsibility of the surety to be responsible for even a single rupee more than what was stated in the agreement.  For example, in Hobson v Bass (1871) the surety expressly declared that “my liability under this guarantee shall not at any time exceed the sum of £250“.

# Conclusion

The principle of co-extensiveness cannot be classified as a rigid principle. The exact degree and extent of the surety’s liability would be governed by the provisions mentioned in the guarantee on the actual constructed document and the parties have the freedom to impose certain restrictions towards the surety’s liability without deviating from the actual nature of the contract of guarantee.

The exact and precise extent will always be under the governance of the provisions of guarantee on how the document has been drafted and the parties enjoy the freedom to add restraints if any to the surety’s liability.

There have been conflicting issues regarding the issue of initiating proceedings, without extinguishing the remedies available in opposition to the principal debtor. The Supreme Court had the same stance in the [Damodar Prasad case](https://indiankanoon.org/doc/743049/" \t "_blank) that the surety can be sued before other remedies are used. The Judiciary has restated this basic principle in many judgments and over the years have and continue to remove the pertinent ambiguities and issues regarding the scope of the surety’s liability.

Each case has clarified the interpretation of the principle however, there is still a wide scope of improvement. The courts will continue to ponder and expound on the validity of the principle with respect to the nuances of the period.

References

1. *Avtar Singh, Contract and Specific Relief, 12th Ed, (2020)*
2. *Pollock and Mulla, The Indian Contract Act,1872, 15th Ed,*