

Indemnity and guarantee

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INTRODUCTION

Learning outcomes

The overall objective of the syllabus is to give students an understanding of the legal system and commercial laws; and build a knowledge base of corporate laws.

Indemnity and guarantee

LO	On the successful completion of this paper, candidates will be able to demonstrate knowledge of laws relating to indemnity and guarantee.
LO 2.13.1	Define contract of indemnity and contract of guarantee. Differentiate between contract of guarantee and indemnity
LO 2.13.2	Identify parties in a contract of indemnity and contract of guarantee
LO 2.13.3	Differentiate between contract of guarantee and indemnity
LO 2.13.4	Describe the rights of indemnity holder
LO 2.13.5	Identify the essentials of the contract of guarantee
LO 2.13.6	Understand the kinds of guarantees i.e. specific and continuing, and revocation of continuing guarantee
LO 2.13.7	Describe rights and responsibilities of surety
LO 2.13.8	Explain how surety is discharged
LO 2.13.9	Understand rules relating to indemnity, guarantee and surety.

References to Legal Acts

Section number references embedded in the learning materials refer to the following legal acts unless otherwise stated:

Act	Chapters
Contract Act 1872	3-16
Partnership Act 1932	17
Negotiable Instrument Act 1881	18
Companies Act, 2017	19-27
Securities Act 2015	22

1 CONTRACT OF INDEMNITY

Section overview

- Definition of contract of indemnity
- Parties in a contract of indemnity
- Rights of indemnity holder
- Time of commencement of the indemnifier's liability

1.1 Definition of contract of indemnity



Definition: Contract of indemnity [Section 124]

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.

1.2 Parties in a contract of indemnity

Indemnifier (Promisor)

The indemnifier (or promisor) is the person who promises to make good the loss.

Indemnified / Indemnity holder (Promisee)

The indemnified (also referred to as the indemnity holder or promisee) is the person whose loss is to be made good.



Example: Indemnified / Indemnity holder (Promisee)

A contracts to indemnify B against the consequences of any proceedings which C may take against B in respect of a certain sum of Rs. 200/-. This is a contract of Indemnity.

In the above example A is the indemnifier and B is the indemnity holder.

1.3 Rights of indemnity holder

According to Section 125 of Contract Act, a promisee is entitled to recover the following amounts from the promisor provided that he acts within the scope of his authority:

- All damages which he may be compelled to pay in any suit in respect of any matter to which the promise to indemnify applies;
- All costs which he may be compelled to pay in
 - bringing or
 - defending such suits.

But the indemnified should not acted against the order of the promisor and acted as any prudent man would act under similar circumstances in his own case, or with the authority of the indemnifier and

- All sums which he may have paid under the terms of any compromise of any such suit. The compromise should not be contrary to the orders of the indemnifier and should be a prudent one or authorized by the indemnifier.

1.4 Time of commencement of the indemnifier's liability

The Contract Act is silent on the time of commencement of the indemnifier's liability under the contract of indemnity. On the basis of judicial pronouncement of courts, it can be said that the liability of an indemnifier commences as soon as the liability of the indemnity holder becomes absolute and certain. In other words, if the indemnity holder has incurred an absolute liability even though he has himself paid nothing, he is entitled to ask the indemnifier to indemnify him.



Example: Time of commencement of the indemnifier's liability

A promises to compensate B for any loss that he may suffer by filing a suit against C. The court orders B to pay C damages of Rs. 50,000. As the loss has become certain, B may claim the amount of loss from A and give it to C.

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2 CONTRACT OF GUARANTEE

Section overview

- Definition of contract of guarantee
- Parties in a contract of guarantee
- Essentials of a contract of guarantee
- Kinds of guarantee
- Revocation of a continuing guarantee
- Nature of surety's liability
- Rights of surety
- Discharge of surety
- Circumstances where surety is not discharged
- Difference between contract of indemnity and contract of guarantee

2.1 Definition of contract of guarantee



Definition: Contract of guarantee [Section 126]

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

Consideration received by the principal debtor is sufficient for the surety and it is not necessary to result in some benefit to the surety himself. [Section 127]



Example: Contract of guarantee

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. This is sufficient consideration for C's promise.

2.2 Parties in a contract of guarantee

Principal debtor

The person in respect of whose default the guarantee is given. [Section 126]

Creditor

The person to whom guarantee is given. [Section 126]

Surety

The person who gives guarantee. [Section 126]

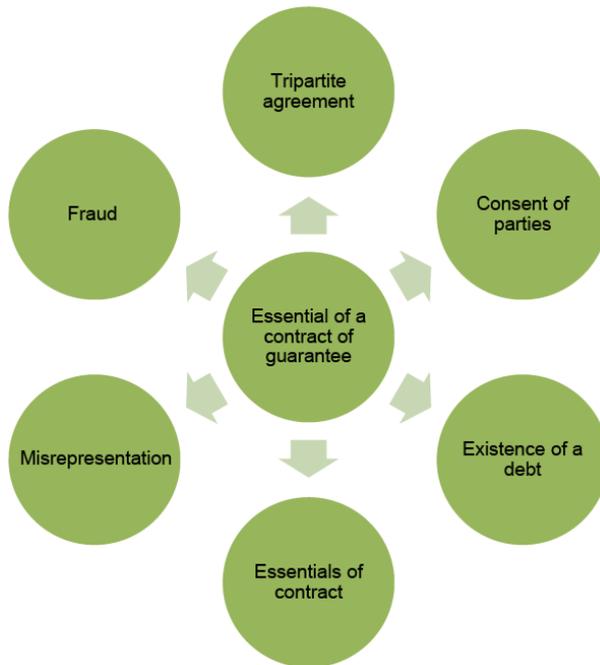


Example: Contract of guarantee

A and his friend B enter a shop and A says to Z "Supply the goods required by B and if he does not pay you, I will." It is a contract of guarantee.

2.3 Essentials of a contract of guarantee

The essentials of a contract of guarantee are shown below:



These essentials are discussed below:

Tripartite agreement

A contract of guarantee is a tripartite agreement between the principal debtor, creditor and surety. There are three contracts in contract of guarantee:

- Contract between creditor and the principal debtor
- Contract between surety and the principal debtor
- Contract between surety and creditor

Consent of parties

Consent is an essential for all the contracts similarly all three must have consented in a contract of guarantee.

Existence of a debt

A contract of guarantee requires an existing debt or a promise whose performance is guaranteed which is enforceable at law. If no such liability exists then there cannot be a contract of guarantee. The principal debtor can be a minor; in this case surety will be liable personally.

Essentials of a contract

All the essentials required in a contract must exist in a contract of guarantee.



Examples: Essentials of a contract

- 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. This is a sufficient consideration for C's promise.
- A sells and delivers goods to B. C afterwards requests A to forbear to sue B for the debt for a year and promises that if he does so, C will pay for them in default of payment by B. A agrees to forbear as requested. This is a sufficient consideration for C's promise.
- A sells and delivers goods to B. C, afterwards, without consideration, agrees to pay for them in default of B. The agreement is void.

Misrepresentation

According to Section 142 of Contract Act, a guarantee must not be obtained by misrepresentation.

Fraud

According to Section 143 of Contract Act, a guarantee must not be obtained by fraud.

2.4 Kinds of guarantee

Guarantee may be classified under the following two categories:

1. Specific guarantee
2. Continuing guarantee

Specific guarantee

When a guarantee extends to a single transaction or debt, it is called a specific or simple guarantee. The liability of the surety comes to an end when the guaranteed debt is duly discharged or the promise is duly performed.

**Examples: Specific guarantee**

A guarantees payment to B of the price of the five bags of flour to be delivered by B to C and to be paid for in 3 months. B delivers five bags to C, C pays for them. This is a contract of specific guarantee.

Continuing guarantee

According to Section 129 of Contract Act, when a guarantee extends to a series of transactions, it is called a continuing guarantee. A surety's liability continues until the revocation of the guarantee.

**Examples: Continuing guarantee**

A, in consideration that B will employ C in collecting the rent of B's zamindari promises B to be responsible, to the amount of Rs. 5,000, for the due collection and payment by C of those rents. This is a continuing guarantee.

2.5 Revocation of a continuing guarantee

A continuing guarantee can be revoked in the following ways:

Notice

A continuing guarantee may at any time be revoked by the surety as to future transactions, by notice to the creditor. [Section 130]

**Examples: Notice**

- A, in consideration of B's discounting, at A's request, bills of exchange for C, guarantees to B, for 12 months, the due payment of all such bills to the extent of Rs. 5,000. B discounts bills for C to the extent of Rs. 2,000. Afterwards at the end of three months. A revokes the guarantee. This revocation discharges A from all the liability to B for any subsequent discount. But A is liable to B for Rs. 2,000 on default of C.
- A guarantees to B to the extent of Rs. 10,000, that C shall pay all the bills that B shall draw upon him. B draws upon C, C accepts the bill. A gives notice of revocation, C dishonours the bill at maturity. A is liable upon his guarantee.

Death of surety

The death of the surety operates, in the absence of any contract to the contrary, as a revocation of a continuing guarantee regarding future transactions. [Section 131]

Other modes of revocation of continuing guarantee

A continuing guarantee is also revoked in following ways:

- novation [Section 62]
- alteration [Section 133]
- release or discharge of the principal debtor by creditor [Section 134]
- compounding of creditor with the principal debtor [Section 135]
- creditor's act or omission impairing surety eventual remedy [Section 139]
- loss of security [Section 141]

2.6 Nature of surety's liability

Nature of surety's liability - it is co-extensive

The liability of a surety is equal to that of the principal debtor unless otherwise agreed. [Section 128]



Examples: Nature of surety's liability – it is co-extensive

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.

Limitation of surety's liability

The liability of surety may be made less than that of the principal debtor by an express contract to that effect.

Initiation surety's liability

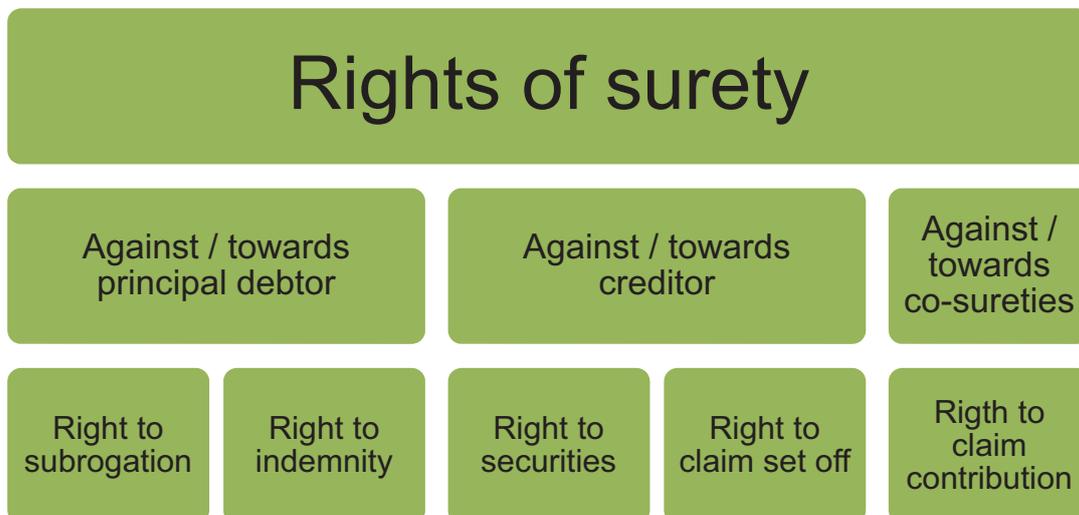
The liability of the surety arises immediately at the time of default by the principal debtor. The creditor can sue the surety without suing the principal debtor.

Condition precedent to surety's liability

Where a person gives a guarantee upon a contract that a creditor shall not act upon it until another person has joined in it as co-surety, the guarantee is not valid if that person does not join.

2.7 Rights of surety

The rights of surety are shown below:



Rights against / towards principal debtor**Right to subrogation**

After making a payment and discharging the liability of the principal debtor, the surety is clothed with all the rights of the creditor, which he can himself exercise against the principal debtor. [Section 140]

Right to indemnity

In every contract of guarantee there is an implied promise by the principal debtor to indemnify the surety; and the surety is entitled to recover from the principal debtor all payments properly made under the guarantee. After the surety makes payment, he is entitled to recover from the principal debtor whatever amount he has paid rightfully including the amount of interest. [Section 145]

**Examples: Right to indemnity**

- B is indebted to C, and A is surety for the debt. C demands payment from A and, on his refusal, sues him for the amount. A defends the suit, having reasonable grounds for doing so, but is compelled to pay the amount of the debt with costs. He can recover from B the amount paid by him for costs, as well as the principal debt.
- C lends B a sum of money, and A at the requests of B accepts a bill of exchange drawn by B upon A to secure the amount. C the holder of the bill demands payment of it from A, and on A's refusal to pay sues him upon the bill. A, not having reasonable grounds for so doing, defends the suit, and has to pay the amount of the bill and costs. He can recover from B the amount of bill, but not the sum paid for costs, as there was no real ground for defending the action.

Rights against / towards creditor**Rights to securities**

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. [Section 141]

**Examples: Right to securities**

- C advances to B, his tenant, Rs. 2,000 on the guarantee of A. C has also a further security for Rs.2,000 by a pledge of B's furniture. C cancels the pledge. B becomes insolvent, and C sues A on his guarantee. A is discharged from liability to the amount of the value of the furniture.
- C, a creditor, whose advance to B is secured by a decree, receives also a guarantee for that advance from A. C afterwards takes B's goods in execution under the decree, and then without the knowledge of A, withdraws the execution. A is discharged.
- A, as surety of B makes a bond jointly with B to C to secure a loan from C to B. Afterwards, C obtains from B a further security for the same debt subsequently C gives up the further security. A is not discharged.

Right to claim set off

The surety has a right to claim set off if any which the principal debtor had against the creditor.

Rights against co-sureties**Right to claim contribution**

When a debt is guaranteed by two or more sureties, they are called co-sureties. The co-sureties are liable to contribute, as agreed, towards the payment of the guaranteed debt. When one of the co-sureties makes payment to the creditor, he has a right to claim contribution from the other co-surety or co-sureties. Following are the rules of contribution between co-sureties: [Section 146 & 147]

- ❑ In the absence of any contract, all co-sureties are liable to contribute equally in case of default by principal debtor.



Examples: Right to claim contribution

- ❑ A, B and C are sureties to D for a sum of Rs.3,000 lent to E. E makes default in payment. A, B and C are liable, as between themselves to pay Rs.1,000 each.
- ❑ A, B and C are sureties to D for a sum of Rs.1,000 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 Rs.250, B Rs.250 and C Rs.500.

- ❑ If co-sureties have agreed to guarantee different sums then co-sureties are liable to contribute equally, subject to the maximum amount guaranteed by each one.



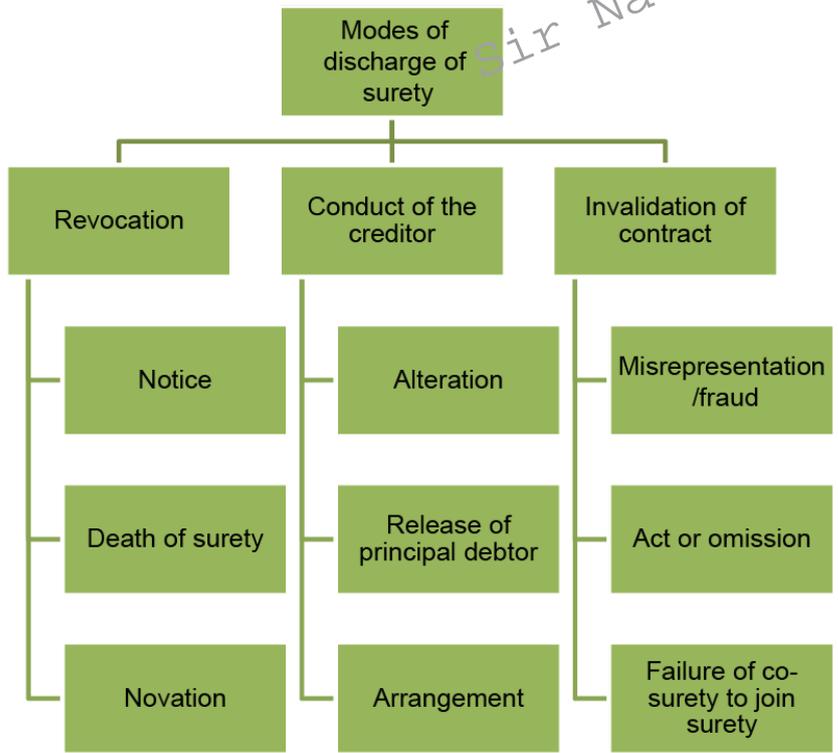
Examples: Guarantee of different sums

- ❑ A, B and C as sureties for D, enter into three separate bonds, of different amounts - A for Rs.10,000, B for Rs.20,000 and C for Rs.40,000, conditioned for D's duly accounting to E.
 - D makes default to the extent of Rs. 30,000 then A, B and C are each liable to pay Rs. 10,000.
 - D makes a default to the extent of Rs. 40,000 then A is liable to pay Rs. 10,000 and B and C are liable to pay Rs. 15,000 each.
 - D makes a default to the extent of Rs. 70,000 then A, B and C are liable to pay full penalty of his bond.

- ❑ Where there are co-sureties, a release by the creditor of one of them does not discharge the others, neither does it free the surety so released from his responsibility to the other sureties. [Section 138]

2.8 Discharge of surety

The ways in which a surety is discharged are shown below:



These modes are discussed below.

Discharge of surety by revocation**Notice**

A surety can be discharged by giving notice to the creditor in case of continuing guarantee, as to future transactions, by notice to the creditor. [Section 130]

Death of surety

The deceased surety's estate will not be liable for any transactions entered into between the creditor and the principal debtor after the death of the surety, even if the creditor has no notice of the death. [Section 131]

Novation

Novation means the substitution of a new contract of guarantee for an old one. The new contract extinguishes the rights and obligations that were in effect under the old contract. [Section 62]

Discharge of surety by the conduct of the creditor**Alteration**

If an alteration is made without the consent of the surety then the surety is discharged as to the transactions, subsequent to the alteration. [Section 133]

**Examples: Alteration**

- 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 surety ship by the variance made without his consent, and is not liable to make good this loss.
- C agrees to appoint B as his clerk to sell goods at a yearly salary, upon A's becoming surety to C for B's duly accounting for money received by him as such clerk. Afterwards, without A's knowledge or consent, C and B agree that B should be paid by a commission on the goods sold by him and not by a fixed salary. A is not liable for subsequent misconduct of B.
- C contracts to lend B Rs. 5,000 on the first March. A guarantees repayment. C pays Rs. 5,000 to B on the first January. A is discharged from his liability as the contract has been varied in as much as C might sue B for the money before the first of March.

Release of principal debtor

The surety is discharged by any contract between the creditor and the principal debtor, by which the principal debtor is released. [Section 134]

**Examples: Release of principal debtor**

- A gives guarantee to C for goods to be supplied by C to B. C supplies goods to B, and afterwards B becomes embarrassed and contracts with his creditors (including C's) to assign to them his property in consideration of their releasing him from their demands. Here, B is released from his debt by the contract with C, and A is discharged from his surety ship.
- A contracts with B to grow a crop of wheat on A's land and to deliver it to B at a fixed rate, and C guarantees A's performance of this contract. B diverts a stream of water which is necessary for irrigation of A's land, and thereby prevents him from raising the wheat. C is no longer liable for his guarantee.
- A contracts with B for a fixed price to build a house for A 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 surety ship.

Arrangement

A contract between the creditor and the principal debtor, by which the creditor makes a composition with, or promises to give time to, or not to sue, the principal debtor, discharges the surety, unless the surety assents to such contract. [Section 135]

Discharge of surety by invalidation of contract

Misrepresentation/ Fraud

Any guarantee which has been obtained by means of misrepresentation made by the creditor or keeping silence as to material circumstances, or with his knowledge and assent, concerning a material part of the transaction, is invalid. [Section 142 & 143]



Examples: Fraud

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 C to furnish security for his duly accounting. C gives guarantee for B's duly account. A does not inform C about B's previous conduct. B, afterwards, makes default. C is not liable because the guarantee was obtained by concealment of facts.

Act or omission

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 impaired, the surety is discharged. [Section 139]



Examples: Act or omission

- B contracts to build a ship for C for a given sum, to be paid by instalments as the work reaches certain stage. A becomes surety to C for B's due performance of the contract. C, without the knowledge of A, pre-pays to B the last two instalments. A is discharged by this prepayment.
- C lends money to B on the security of a joint and several promissory note, made in C's favour by B, and by A as surety for B, together with a bill of sale of B's furniture, which gives power to C to sell the furniture, and apply the proceeds in discharge of the note. Subsequently, C sells the furniture, but, owing to his misconduct and wilful negligence, only a small price is realized. A is discharged from liability on the note.

Failure of co-surety to join surety

Where a person gives a guarantee upon a contract that a 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. [Section 144]

2.9 Circumstances where surety is not discharged

- 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.
- Patience 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.
- Where there are co-sureties, the release by the creditor of one of them does not discharge the other nor does it free the surety so released from his responsibility to the other sureties. [Section 138]

2.10 Difference between contract of indemnity and contract of guarantee

The following table summarises the key differences between the contract of indemnity and contract of guarantee as explored above.

S.no	Contract of indemnity	Contract of guarantee
1	<p>Number of parties</p> <p>There are two parties indemnifier and indemnity holder.</p>	<p>There are three parties principal debtor, creditor and surety.</p>

S.no	Contract of indemnity	Contract of guarantee
2	Number of contracts There is only one contract.	There are three contracts.
3	Object The indemnifier undertakes to save the indemnity holder from any loss.	The surety undertakes for the payment of debts of principal debtor in case of his default.
4	Nature of liability The liability of indemnifier is primary and unconditional.	The liability of surety is secondary and conditional and co-extensive.
5	Commencement of liability The liability 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.
6	Right to sue The indemnifier cannot sue a third party in his own name because of absence of privity of contract between him and third party.	A surety, on discharging the debt of principal debtor, can sue the principal debtor in his own name.

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3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Define a contract of indemnity
- Discuss the rights of indemnity holder
- Define contract of guarantee and its types
- Discuss the nature and extent of surety's liability
- Understand the rights of surety
- Explain the various ways in which the surety is discharged

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