



## INTRODUCTION

The Contract of Guarantee is one of the most important forms of contract which secures the payment of the debt taken by the principal debtor (borrower) from the creditor (lender). Any breach of this contract can broadly result in invoking of (a) specific remedy or (b) substitutional remedy by the creditor against the guarantor, besides remedies available against the principal debtor. While the specific remedy can be in the form of specific performance of the contract<sup>1</sup> for the contractual obligations assumed by the guarantor, the substitutional remedy can be in the form of damages. Likewise, there are certain lesser known and usual provisions that can be invoked by the surety or the principal debtor to protect their interest.

In this article, we discuss a few provisions of the Indian Contract Act from the perspective of the surety, principal debtor, and creditor after understanding the rule of contracting out.

## DOCTRINE OF CONTRACTING OUT

As a general rule, any person can enter into a contract to waive the benefits conferred upon the contracting party under any statute, subject to a few exceptions. These exceptions are waiver of any right which is forbidden by law or is of such a nature that it would defeat the provisions of law or is fraudulent in nature, or is otherwise opposed to public policy<sup>2</sup>.

The Supreme Court of India held<sup>3</sup> that even a statutory right can be waived as long as it does not infringes the rights of the others and is not against the public policy. In the same case, the court referred to another judgement<sup>4</sup> which stated that "...

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<sup>1</sup> Section 10 of the Indian Specific Act, 1963

<sup>2</sup> Section 23 of the Indian Contract Act, 1872

<sup>3</sup> Waman Shrinivas Kini vs Ratilal Bhagwandas & Co., [1959] AIR 689

<sup>4</sup> Bowmakers Limited v. Barnet Instruments Limited [1945] KB 65

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*a waiver in derogation of a statutory right is not favoured, and a waiver will be inoperative and void, if it infringes on the rights of others, or would be against public policy or morals."*

With regard to the provisions dealing with the contract of guarantee under the Indian Contract Act, it was held<sup>5</sup> that these provisions are neither in the nature of inalienable rights nor do those rights have anything to do with public policy. Such rights simply relate to the contracts entered into by individuals and thus the same can be waived<sup>6</sup>. As such, the parties can contractually agree to an understanding which may take away the statutory rights of the relevant party enshrined thereunder.

## **CONTRACTUAL IMPLICATIONS**

Usually, the liability of the surety arises when the principal debtor defaults in repaying the debt. In such a situation, the creditor, at its sole discretion, can either invoke the security or go to the surety for repayment of the debt. In other words, the liability of the surety is co-extensive with that of the principal debtor.

However, this liability of the surety can be restricted through the contractual terms agreed between the relevant parties. Interestingly, for the provision under discussion, the waiver right is provided to the contracting party in the section itself. The relevant section provides that the liability of a surety is co-extensive with that of the principal debtor, unless it is otherwise provided by the contract<sup>7</sup>. Accordingly, the contract of guarantee can be drafted in a manner that can limit or restrict the liability of the surety.

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<sup>5</sup> T. Raju Setty vs Bank of Baroda, [1991] (4) KarLJ 475

<sup>6</sup> T. Raju Setty vs Bank of Baroda, [1991] (4) KarLJ 475

<sup>7</sup> Section 128 of the Indian Contract Act, 1872

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The parties can also contractually agree that in case of default by the principal debtor, the creditor shall be required to exhaust all the remedies against the principal debtor before invoking any rights against the surety.

Similarly, if there are two or more co-sureties who have agreed to discharge the liability of the principal debtor toward the creditor, suitable provisions can be made in the contract to provide the extent of liability to be assumed by the relevant co-surety and the order in which they will be liable to discharge the payment obligations. By way of an example, if there are three co-sureties, A, B and C, then contractually it can be agreed that A and B should be approached only after all the remedies against C are exhausted to recover the outstanding amount owed by the principal debtor or vice versa.

Another important provision that may eventually affect the right of the creditor is in relation to preserving the assets of the principal debtor which are given as security to the creditor for the repayment of debt. Any negligence of the creditor in handling the security will discharge the surety to the extent the security is lost or its value is diminished. Hence, the creditor will have to take measures to ensure that the security is preserved properly since after the discharge of the liability by the surety, the surety has the statutory right to step in the shoes of the creditor to recover the amount of liability discharged by the surety for the principal debtor. While the surety cannot be deprived of his rights of subrogation by an agreement between the creditor and the principal, it can be contracted out under the agreement between the creditor and the surety. As a result of such an agreement, the surety will waive its subrogation right. Such exclusion shall have a two-fold effect, firstly, the creditor will not have contractual obligations to preserve the security in his custody, and secondly, providing of guarantee by the surety will be without any recourse against the principal debtor.

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The Indian Contract Act deals with the provisions of a continuing guarantee<sup>8</sup> where the surety gives a guarantee to the creditor for a series of transactions between the principal debtor and the creditor. In case the creditor is a partnership firm, any change in the status or constitution of the creditor (say, conversion of partnership firm to a company) can affect the validity of the guarantee and can lead to the termination of a continuing guarantee<sup>9</sup>. However, if the contract of guarantee covers an exception for such an eventuality, then the continuing guarantee will not be affected by such a change in the status of the creditor.

You may refer to our last [article](#) on Contract of Guarantee to understand the Rule of Co-extensiveness and the Doctrine of Subrogation

## CONCLUSION

The contract of guarantee is not just a creditor-centric contract as it is usually perceived in general. As far as the principal debtor and the surety are concerned they can also specifically include or exclude provisions in the contract which are essential to protect their rights and interests. Likewise, certain statutory rights can be specifically waived or included for the creditor to achieve the desired commercial understanding between the contracting parties.

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<sup>8</sup> Section 129 of the Indian Contract Act, 1872

<sup>9</sup> Section 38 of the Partnership Act, 1932

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