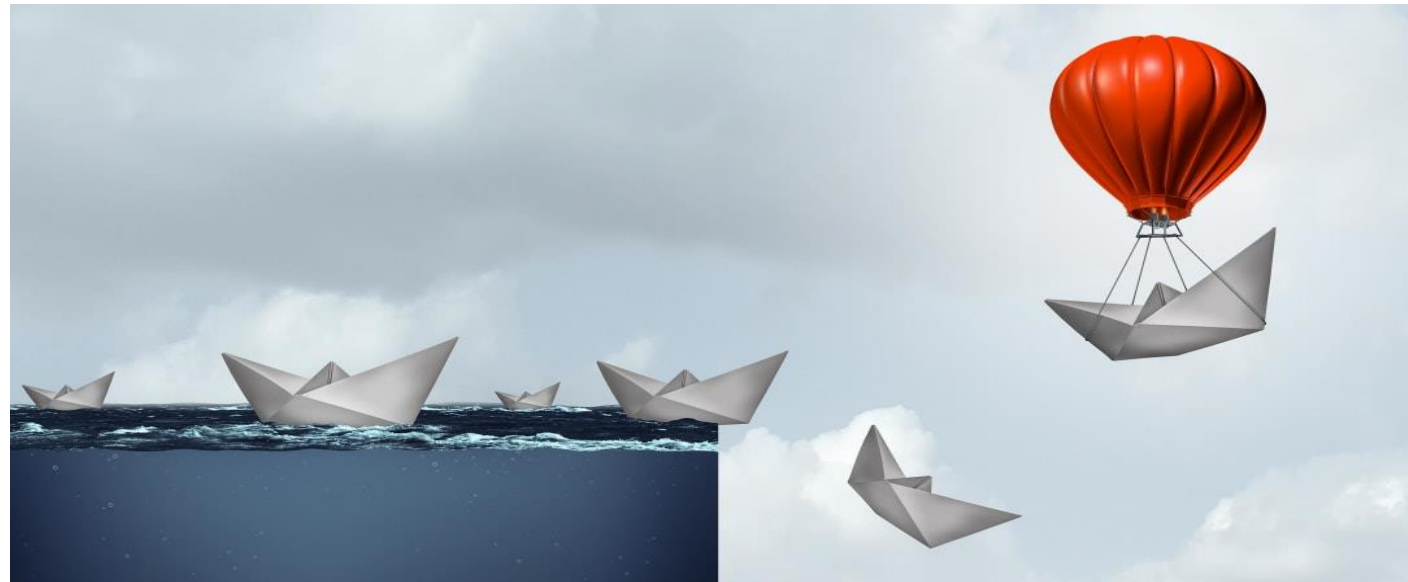


*De Jure*

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## Contract of Guarantee



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## INTRODUCTION

A contract of guarantee is included in Chapter VIII of the Indian Contract Act. With a total of 22 sections dealing with the various aspects of guarantee, it is the second-largest chapter after the chapter dealing with bailment under the Indian Contract Act, which has more than 30 sections.

*"The underlying function of a contract of guarantee is to not just answer for the payment of the debt but also the performance of some duty, in the case of failure of the person who, in the first instance, is obligated to fulfil such obligation".*

The contract of guarantee is a familiar and widely spoken, read and written topic. Some of the commonly discussed topics are the parties to the guarantee, kinds of guarantee, types of guarantee, essentials of the contract of guarantee (which is partly covered under Chapter VIII and the remaining under different sections of the Contract Act), invocation of guarantee, letter of comfort, and other evolving concepts like stand by letter of credit, letter of awareness, etc.

In this article, we are discussing some of the lesser-known provisions dealing with the contract of guarantee such as nature of consideration, the rule of co-extensiveness, the doctrine of subrogation, and contracting-out provisions all of which have a significant bearing on the contractual obligations assumed by the relevant parties to the contract of guarantee.

## NATURE OF CONSIDERATION

The presence of consideration is important for any contract.

Any contract without consideration is *ex nudo pacto actio non oritur*, i.e. it will be considered void. Simply put, an agreement without consideration cannot be held to be binding on the contracting parties.

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In the case of Dwarampudi Nagaratnamba v. Kunuku Ramayya and Another (1968 AIR 253 SC), the Supreme Court of India held that the transfer made by the appellant without any consideration cannot be treated as a valid consideration.

The Contract Act provides that anything done or any promise made for the benefit of the principal debtor may be a sufficient consideration to the guarantor or the surety for giving the guarantee.

Here, it is important to note that the consideration to be given need not necessarily be in monetary terms. Not taking disciplinary actions against the principal debtor, forbearance on the bank's part to initiate adverse action or not triggering an event of default also constitutes good and valid consideration for the guarantee contract. Even not suing, actual suspension of legal proceedings against the principal debtor or an agreement to forbear for a reasonable time will also provide sufficient consideration to support a surety promise.

*"While the presence of consideration is indispensable for any contract, the consideration to be given need not necessarily be in monetary terms."*

Also, the consideration flowing under the contract may or may not be adequate, however, that will essentially not affect the validity of the contract. In other words, there is no 'consideration adequacy test' to be fulfilled. In some agreements, one often comes across the qualifying legend where the parties are made to acknowledge the sufficiency of the consideration under the contract. However, such redundancy can safely be avoided.

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## PRINCIPLES OF CO-EXTENSIVENESS

Another important and interesting but yet less considered provision is the rule of co-extensiveness.

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In terms of the Indian Contract Act, the liability of the surety is co-extensive with that of the principal debtor. This means that the creditor can choose to proceed to recover a debt against the surety independent of the principal debtor or from the securities furnished by the principal debtor. Hence, although the contract of guarantee may originate from the same transaction it is considered an independent contract which creates rights and liabilities separate and distinct from those created by a contract between the principal debtor and the creditor.

A similar principle also holds good for the co-guarantors. A co-guarantor cannot insist that the creditor should proceed against another guarantor before invoking the rights against him, since the liability of guarantors is joint and several.

*"The liability of the guarantor cannot be deferred until the creditor has exhausted his remedies against the principal debtor and the option to seek recourse either against the principal debtor or against the guarantor or any of the guarantors (from the group of co-guarantors) is completely on the creditor."*

It was decided in the case of Ram Sagar Singh v. Yogendra Narain Prasad Singh (AIR 1975 Pat. 239) by the Patna High Court that the liability of the surety is co-extensive with that of the principal debtor and the surety is liable to pay the entire amount without the creditor having required to exhaust his other remedies. This was supported by a decision of the Supreme Court in the case of The Bank of Bihar Limited v. Dr. Damodar Prasad (AIR 1969 SC 297).

As a general rule, the liability of the guarantor remains intact so long as the debt of the principal debtor is not discharged. However, the fact that the obligation of the principal debtor is void or unenforceable will not necessarily release the guarantor from his liability under the guarantee contract. Depending upon the facts and circumstances of the matter, there are judicial pronouncements for and against this point.

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## DOCTRINE OF SUBROGATION

The right of subrogation is defined to mean the right of the guarantor to be placed in the position of the creditor once the obligations of the principal debtor is discharged by the guarantor. In other words, the guarantor has the right to step into the shoes of the creditor and enjoy all the rights that the creditor originally had against the principal debtor to recover the amounts paid by the guarantor.

As an example, if the creditor has a charge over the securities of the principal debtor or if the creditor has the right to sue the principal debtor. The guarantor can therefore have the right over the securities and to sue the principal debtor after principal obligations are discharged by the guarantor.

*"All the rights of the creditor get vested in the guarantor after the guarantor has discharged the obligation of the principal debtor toward the creditor which are the subject of his guarantee. Hence, the fulfilment of the obligations by the guarantor for the principal debtor is not without recourse but with recourse to the guarantor."*

In *Darbari Lal v. Mahbub Ali Mian* (AIR 1927 All 538) it was held that a surety paying off the debt is entitled to all the rights and securities of the creditor as against the principal debtor. In the case of *Parvatneni Bhushayya v. Potluri Suryanarayana And Ors.* (AIR 1944 Mad 195), the Madras High Court held that the language of section 140 of the Contract Act which employs the words "is invested with all the rights which the creditor had against the principal debtor" makes it plain that even without the necessity of a transfer the law vests those rights in the surety.

A surety is entitled to the benefit of every security that the creditor has against the principal debtor, irrespective of whether or not the surety knows of the existence of such security. If the creditor loses or without the consent of the surety, parts with such security, the surety will be discharged to the extent of the value of the security.

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## CONCLUSION

While the Contract Act indicates the liability of the surety, it does not specify the manner of discharge of the debt of the principal debtor. Further, although the liability of the guarantor is absolute and distinct, the provisions of Chapter VIII are not immutable rules and can be contracted out at the drafting stage. At the time of settling the deed of guarantee, the point under consideration will also be whether you are representing a guarantor, principal debtor, or creditor. Hence, one cannot have a "one size fits all" approach. We will in our next rounds of articles separately discuss more on the contracting out provisions, important points to be taken into consideration while settling the contract of guarantee, how the negligence of a creditor or banker can seriously affect the liability of a guarantor, and some key differences between indemnity and guarantee.

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