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PROTECTING THE SURETY IN CONTRACTS OF GUARANTEE – A REVIEW

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Abstract:

In both the global and national economies of the modern world, credit-based transactions occupy a preeminent position in the financial landscape. In turn, most of these credit-based transactions take the shape of contracts of guarantee, involving a guarantor or a surety, who occupies a unique and somewhat vulnerable position in these contracts. With the evolution of these credit-based transactions, the legal protection of the surety becomes necessary to ensure the former's continuity.

As such, this necessitates a review of the law relating to the protection of the rights of the security or guarantor in such contracts. Usually, statutory and common-law rights are the primary medium for enabling such protection, such as the rights granted by the Indian Contract Act, 1872[2] (hereinafter referred to as the 'Act'). This paper principally attempts to analyse the provisions of the Act in protecting the rights of the surety, discussing, among other things, the nature of the surety's liability, his rights, and the role of equity in protecting these rights.

Prior to discussing the rights of the surety, it is imperative to review the concept of a contract of guarantee, also interchangeably called a contract of surety. Broadly speaking, a contract of guarantee is a special form of contract whose primary function is to secure the discharge of liability or payment of debt of a third person in case of his failure to do so. Historically, guarantee contracts in general, and the concept of surety in particular, would find their origins in familial domestic arrangements in ancient times, where it was often common practice for a person to act as a surety or guarantor for their kith and kin. Although this practice has continued till the present day, the contracts of guarantee are now predominantly aimed at securing credit-based transactions in a commercial setting.

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[2] Indian Contract Act, 1872 (Act No. 9 of 1872)

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Introduction:

In India, the Indian Contract Act, 1872, defines the concept of surety as an integral part of a contract of guarantee. Section 126 of the Act defines a contract of guarantee as a contract, either oral or written, to perform a promise, or to discharge the liability of a third person in case of his/her default. The person giving the guarantee is called the 'surety,' the defaulting third person is known as the 'principal debtor' and the person receiving the guarantee is called the 'creditor.'

Surety's Liability:

Section 128 of the Indian Contract Act stipulates that the liability of the surety shall ordinarily be co-extensive with that of the principal debtor, unless otherwise provided for in the terms of the contract. Thus, the liability of the surety is contingent on the default of the principal debtor, although it is ordinarily not necessary for the creditor to exhaust all remedies available against the principal debtor in order to sue the security for the payment of debt. Thus, the surety's liability is only of a secondary nature, and is ancillary or collateral to the primary obligation of the principal debtor, as opposed to the primary nature of the obligation of the indemnifier in a contract of indemnity. Additionally, unlike an indemnifier, the surety is at liberty to reduce the monetary extent his liability, which was recognised in *Hobson v. Bass*[3] and is provided for by Section 128 of the Act.

Rights of surety:

It is clear from the language of Section 127 of the Act that the guarantor usually undertakes the liability despite having no personal interest in the contract of guarantee. Thus, the law will usually look to intervene favourably in his behalf. Consequently, if there arises a dispute with regard to the terms of the contract, the courts will strictly construe such terms in favour of the guarantor and give him the benefit of doubt, a principle known as *strictissimi juris.* Additionally, in keeping with the *contra proferentem* doctrine, ambiguous terms in a contract are usually construed in favour of the surety and against the creditor, since it is the latter which usually drafts the terms of the contract. To this end, the surety enjoys a certain number of rights and protections, which have collectively led the security to be regarded as a 'favoured debtor' in the eyes

[3] Hobson v. Bass (1871) LR 6 Ch. App. 792

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of law.[4] In India, the surety enjoys a multitude of rights, viz. discharge of liability, subrogation of securities, and so on. These rights are statutorily accorded to the surety primarily through Sections 133-145 of the Indian Contract Act.

Discharge of surety:

Section 133 of the Act provides that if there arises any variance regarding the terms of the contract without the surety's consent, the surety is discharged with regard to all transactions taking place subsequent to such variance. In *Holme v. Brunskill*[5] it was held by the majority that any material alteration (without the surety's knowledge and consent) vis-à-vis the terms of the contract had the effect of changing its nature to one different from the one the guarantor had agreed upon, and thus, the surety would be discharged of liability in such cases. The court further held that the surety himself would be the sole judge in assessing the materiality of such alteration. However, in India, the settled position of the law now holds that in cases where the alteration in terms is not proven to be material or substantial, then the surety is not discharged of his liability, as was held by the majority in *M.S. Anirudhan v. The Thomco's Bank.*[6]

Similarly, Section 135 provides that in case where the creditor and the principal debtor enter into any separate contract to provide time to, or refrain from suing, the principal debtor, further releases the surety from his contractual obligations. This was observed in the case of *Rees v. Berrington.*[7] Similarly, in *Annadana Jadaya Goundar vs Konammal*[8], the creditor, on colluding to give time to the principal debtor unbeknownst to the surety, was held to have discharged the surety of liability. It was also held in this case that any act on the part of the creditor which released the principal debtor from liability, would, by extension, also discharge the surety of all liability.

In a similar vein, Section 139 of the Act provides for the discharge of surety if any act or omission on the part of the creditor is prejudicial to or adversely affects the surety's interests. Section 141 also gives the surety the claim over all securities in the creditor's possession against the principal debtor, irrespective of whether the surety was aware of their existence. For example, the surety, in case of negligent loss of securities by the

[4] Madhavi Raje & Kushagra Krishna, *Analysis of Co-extensive Liability of Surety with that of Principal Debtor,* February 22, 2021, available at https://legal60.com/analysis-of-co-extensive-liability-of-surety-with-that-of-principal-debtor/
[5] Holme v Brunskill (1877) 3 QBD 495
[6] M/S Anirudhan v. The Thomco's Bank Ltd 1963 AIR 746
[7] Rees v. Berrington (1795) 30 E.R. 765
[8] Annadana Jadaya Goundar vs Konammal (1933) 64 MLJ 386

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creditor, is discharged *pro tanto* to the value of such lost securities, as was held in the cases of *State Bank of Saurashtra v. Chitranjan Rangnath Raja*[9] and *Amrit Lal Goverdhan Lalan v. State Bank of Travancore*[10].

Lastly, he case of *State of Madhya Pradesh v. Kaluram*[11] broadened the ambit of the word 'security' in Section 141 to include all property rights available with the creditor against the principal debtor, absolving the security of liability because the creditor did not act within its powers to stop the removal of the property vested with it.

Subrogation and Equity:

Immediately after the surety's fulfilment of contractual obligations on default on the part of principal debtor, the surety may request the principal debtor to indemnify him for the debt paid on his behalf. Alternatively, in the event of non-payment of debt, the surety may take into his possession all the securities of the principal debtor which were hitherto in the creditor's possession, along with all the rights enjoyed by the creditor concerning the principal debtor's property. Thus, the surety now effectively steps into the creditor's shoes vis-à-vis the latter's relationship with the principal debtor. This is known as the doctrine of subrogation, and it has its foundations in law as an equitable remedy given to the surety for the protection of his interests. Sir Samuel Romily, on behalf of the plaintiff in *Craythorne v. Swinburne*[12], argued that it would be equitable for the surety to have every remedy of the creditor against the principal debtor so as to enable him to enforce all possible avenues of payment. While the word 'subrogation' is specifically not mentioned in the Act, the concept is enshrined in Sections 140 and 141, which provide for investing with all the rights and securities which the creditor hitherto possessed against the principal debtor. Thus, not only is the surety's right to subrogation a statutory one, it is also an embodiment of the principles of equity and natural justice.

Lastly, there exist further equitable statutory provisions to protect the surety from incurring loss due to dishonest practices. Sections 142 and 143 of the Contract Act provide that any guarantee obtained by misrepresentation or concealment, (via silence as to material facts on the part of creditor) respectively, are invalid. In the case of *Barclays Bank Plc v. O'Brien*[13], it was held that when the surety was inducing into guaranteeing

[9] State Bank of Saurashtra v. Chitranjan Rangnath Raja, AIR 1980 SC 1528
[10] Amrit Lal Goverdhan Lalan v. State Bank of Travancore 1968 SCR (3) 724
[11] State of Madhya Pradesh v. Kaluram 1967 AIR 1105
[12] Craythorne v. Swinburne [1807] All ER Rep 181
[13] Barclays Bank Plc v. O'Brien [1993] UKHL 6

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the liability of the debtor due to misrepresentation or undue influence, the surety would be absolved of all liability, unless the creditor could establish that the surety was aware of all the risks involved. In the case of *Greer v. Kettle*[14], which concerned a set of facts wherein the security entered into a contract to guarantee the payment of a debt which was misrepresented to it by the principal debtor as being legally secured, it was held that the surety would not be liable, because it would be inequitable to impose upon it a liability which it had never undertaken in the first place.

Conclusion:

The law relating to credit-based transactions is an inseparable facet of commercial law, and thus needs to evolve to keep pace with the current global financial landscape. The law relating to contracts of guarantee and the protection afforded to the surety in such contracts by the law is no such exception. In keeping with this ethos, the courts in the country must also adopt a proactive role in cases relating to the rights of the surety, to ensure that the steady development of credit-based transactions, which is a boon to the country's economic and finance ecosystem, can continue unimpeded.

[14] Greer v. Kettle [1938] A.C. 156

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