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RE-DEFINING THE EXHAUSTIVE DEFINITION OF SURETY UNDER SECTION 126 OF INDIAN CONTRACT ACT

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Abstract

A bank loan is approved in the presence of three parties I.e., a contract of guarantee and in case of a huge amount of loan, there are securities for loan recovery. The contract of guarantee is a tripartite contract i.e., there are three contracts involved in a contract of guarantee. Initially, the paper discusses Vijay Mallya's the case of Vijay Mallya, where Bank loan by the principal debtor is Kingfisher airlines, the creditor is state banks (most for the loan taken from IDBI bank) and a surety was United Breweries Holdings Ltd. Vijay Mallya owned more than 50% of the ownership in the companies. Without ignorance of facts that bank employees granted loans to Kingfisher airlines without any calculation of non-performing assets and without verifying the worth of securities kept for the loan, the main problem is the wide ambit of who can be a surety under section 126 of the Indian Contract Act and discusses the law of guarantee and qualifications of surety in Roman, Common and American law with the light on Indian law and introduction of companies act. This paper focuses on the qualifications of surety, who should be surety under guarantee and how this criterion can resolve bank defaults problems and decrease burden on courts.

Introduction

Section 126 of the Indian contract act explains what law of guarantee is with an explanation which three parties are involved in the contract of guarantee, I.e., "principal debtor", "creditor", and "surety".

"A contract of guarantee is a contract to perform the promise, or discharge the liability, of a third person in case of his default. The person who gives the guarantee is called the surety; the person in respect of whose default the guarantee is given is called the principal debtor, and the

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person to whom the guarantee is given is called the creditor. A guarantee may be either oral or written"[2]

Since the beginning of time, trade and the availability of credit have been associated with the necessity to protect the creditor or ensure the repayment of the taken sum. "The contract of suretyship" - both in corporate and personal situations - has grown in prominence in recent years as a tool for reducing loss exposure. For its economic purpose acknowledgement of the security is necessary for the completion of commercial activities. For example- encouraging investment and job creation. Credit for commerce and industry increases output and encourages initiative while also assisting individuals and enterprises through complicated economic times[3].

Regrettably, despite the evident benefits, the rise of surety has also been associated with typical "social and economic" hazards, particularly for the surety. Unfair suretyship is such agreement that have socio economic repercussion especially for the creditor. It is not only influenced by emotional connection but also interfere with the rational analysis of financial risks where the suretyship governed by the presence of commercial and economic benefits that surety might receive on completion of transaction between principal debtor and the creditor. This debt is transferred emotionally or for personal benefits and effects the guarantee contract resulting in non payment of loans and frauds[4]

As a result, there has been a call for caution in situations where there is evidence of a relationship connection. This has mostly been the case due to the notion that agreement to suretyship is linked to or includes deferential trust. This type of trust is said to as deferential:

In the case of the Vijay Mallya, where Bank loan by the principal debtor is Kingfisher airlines, the creditor is state banks (most for the loan taken from IDBI bank) and a surety was United Breweries Holdings Ltd. It is important to note that Vijay Mallya owned more than 50% of the ownership in the companies. Without ignorance of facts that bank employees granted loans to Kingfisher airlines without any calculation of non-performing assets and without verifying the worth of securities kept for the loan, the main problem is the wide ambit of who can be a surety under section 126 of the Indian Contract Act.[5]

HISTORICAL PURPOSE OF SURETY

On a Mesopotamian tablet, the first documented suretyship contract was recorded.in the era

[2] S. 126, The Indian contract act, 1872

[3] Willis D. Morgan, History and Economics of Suretyship , 12 Cornell L. Rev. 153 (1927)

[4] H Kawadza, Reconsidering 'emotionally transmitted debt' in Zimbabwe and proposals for the reform of surety law based on English and South African experiences, De Jure law journal.

[5] STORY, CONTRACTS, (2d Ed. 1874) P. 39, note I; William H. Lloyd, The Surety (1918) 66 U. PA. L. REv., 40; Earl C. Arnold, The Compensated Surety (1926) 26 COL. L. REv. 171.

farmer sometimes could not take care of the crop's property. This was the time when suretyship came in picture I.e., on failure of one farmer to grow crops other farmers by oral contract came in and did labor on farmer's behalf. The profit would be distributed equally between the two of them. By ensuring that the second farmer would follow his promise, a local merchant became the world's first known surety[6].

Suretyship was handled for the first time in a written legal system, Hammurabi's Code.Only 5oo years after Sargon I, the code of Hammurabi (approximately 2250 B. C.) established a system of state fidelity insurance that was more akin to the 19th century than the year 225o B. C. This code's sections 22 and 23 state: "If a guy has been found committing highway robbery, he shall be put to death[7]." "If the brigand is not caught, the robbed man shall submit an itemised declaration of his loss in the face of God, and the city and governor, whose province and jurisdiction the robbery occurred, shall pay him for whatever was lost."[8]

The city and the governor were both designated as sureties under this provision. More than that, the section applies the insurance idea to suretyship contracts, substituting group liability for individual obligation. The city guaranteed the faithfulness of everybody who came under its control, and everyone who came under the city's authority was insured against the dishonesty of others.

A special sort of suretyship arose from the norm of Roman law that a Roman's obligations went to his heirs in proportion to their shares in his estate upon his death. In many circumstances, the inheritance would be inadequate to cover the obligations, and the heirs would be required to make up the difference[9]. They were therefore responsible to all the responsibilities of a guarantor, but if they had a claim of reimbursement, they would gain nothing by using it.

REFERENCE TO VIJAY MALLYA CASE

The section is very exhaustive in nature because state banks have suffered a lot of bank loan defaults and have lost a vast amount of money. To understand how the exhaustive definition of surety is problematic we look at the case of the fugitive former liquor barren also called the "king of good times" Vijay Mallya bank loan contract. He owned two companies, formula-1 teams, and cricket teams but his main company, United Breweries Holdings Ltd. made the most

[6] (2017) The history of surety and suretyship. Weblog. [online] Availaible from: https://surety1.com/history-of-surety/

[7] C.H.W. Johns, Babylonian and Assyrian laws, contracts and letters (library of ancient inscriptions) 46. For a history of this inscription see page 5 of the above.

[8] Botsford, source book of ancient history, 29.

[9] Willis D. Morgan, History and Economics of Suretyship , 12 Cornell L. Rev. 153 (1927)

famous Kingfisher beer and brought pub culture to India starting from Bengaluru. He wanted to take over the airline industry and launched Kingfisher Airlines. With the increasing price of oil, competition from low fare airlines and the economic depression of 2007-08 Vijay Mallya took multiple loans for his malnourished company Kingfisher Airlines from 17 different state-owned banks of over 90000 crores.[10] In this bank loan, there were three parties which were the principal debtor as Kingfisher airlines, creditor state banks (IDBI, State Bank of India and others) and surety as UB Holdings Pvt.[11]

COMMON LAW AND SURETYSHIP

India is a common law country and has taken inspiration from UK. The contract of guarantee in the UK is the same as a contract of guarantee, but it clearly defines that the law of guarantee is between a principal debtor, creditor, and surety, that is a third party. Third-party can be further explained as a person or a group besides the two of the parties primarily involved in a situation, dispute, or contract[12]. As one can observe in Vijay Mallya's case, where he held most of the shares of both companies and was the chairperson, he is not the third party to the contract of guarantee.

In the UK case of 1893, *Sutton v Gray*[13] There was a contract of guarantee between stockbrokers and the plaintiff. Then they will introduce him to the business and share profit and in case of any loss's defendant will be liable for the payment of half of them. The court ruled put an important aspect of the contract of guarantee is defining who cannot be a Surety. The consideration for surety should be only the transaction that is happening between the principal debtor and creditor. Any other benefit surety is receiving from the transaction is not the contract of guarantee but in that case, indemnity will come in places was done for the protection of the creditor that surety should pay on the default of the creditor. The same as stated in section 127 of the Indian Contract Act where the only consideration for the guarantee is anything done for the benefit of the principal debtor. When both principal debtor and surety are fitted or share the same interest as in the Vijay Mallya's where surety does not comply with regulations of guaranteed contract and the contract is not drawn up with the intention to pay back at the default of another party.

[10] Bad boy billionaires (2020) directed by Dylan mohan gray. Available at Netflix.
[11] Vishwanath, S R and Prasad, Durga and Singh, Kulbir (2013) Kingfisher Airlines Limited: A Pie in the Sky. TAPMI, Manipal
[12] https://www.merriam-webster.com/dictionary/third-party.
[13] Sutton v Gray: CA 28 Nov 1893

ZIMBABWE AND SURETY IN GUARANTEE CONTRACT

The possibility of injustice arising, which has warranted the review, renegotiation, and redefining of the borders, as well as the nature, structure, and principles that support the suretyship contract in most European nations.

This remark, tries to emphasize England's response on this issue. "England" and "South Africa" were picked for a simple reason: they have devised more effective techniques for dealing with this issue.

In "*FBC Bank Ltd v Dunleth Enterprises (Pvt) Ltd* the principal debtor and the surety were related and had written an unlimited guarantee in favour of the plaintiff, FBC Bank Limited, a Zimbabwean commercial bank[14]" (hence referred to as 'FBC'). "The guarantor did this by granting FBC access to her immovable property via a hypothecation and guarantee deed. When the principal debtor defaulted, FBC filed a claim against the defendants. Despite the fact that she confessed signing the instrument of suretyship, the surety contended that she was not accountable for the entire sum borrowed by the primary debtor"[15].

According to the surety's argument, she was approached by her relative (the major debtor) who offered to use her property as collateral for the loan he needed from FBC. She went on to say that he offered her a total loan sum of USD 150 000.

The surety pinned the guilt fully and solely on her relative, the principal debtor, to the extent she was deceived. The Zimbabwean High Court held in its decision that she had taken obligation by signing the deed of suretyship due to the caveat subscriptor concept. As a result, the court ruled in favour of FBC.

The case of "*FBC Bank Ltd v Dunleth Enterprises (Pvt) Ltd*" establishes two aspects in the Zimbabwean approach to suretyship. "It demonstrates, first, that the concept of suretyship does not categorize or differentiate such transactions in terms of 'unfairness,' and, second, it demonstrates a regime that is unconcerned about whether the contract was the culmination, or not, of an underlying relational proximity between the principal debtor and the surety. As a result, situations such as FBC Bank Ltd v Dunleth Enterprises (Pvt) Ltd are fairly rare Comparable instances of FBC Bank Ltd v Dunleth Enterprises (Pvt) Ltd have caused a

[14] FBC Bank Ltd v Dunleth Enterprises (Pvt) Ltd & Ors (HC 8753 of 2011) [2014] ZWHHC 568 (21 October 2014)

[15] H Kawadza, Reconsidering 'emotionally transmitted debt' in Zimbabwe and proposals for the reform of surety law based on English and South African experiences, De Jure law journal.

reconsideration of the enforcement of suretyship contracts in other jurisdictions"[16].

There are connections that shows one have influence on the other person. For example, in some cases a principle debtor requests a relative to become surety for his bank loan and one can say that the contract is formed under undue influence by means of emotional pressure or blackmailing or love or affection. In such cases, surety might know the risk involves about such transactions but still contracts in it. This will result in exploiting surety's faith in principle debtor as well as in creditor's faith in trade and commerce and the desire to aid the close relative in his or her undertakings may drive this individual to act 'unfairly' in accepting the risk.

A regulation might be devised to put the burden on the creditor to guarantee that the suretyship is fair.

"The court rightly noted that the suretyship contract was between the FBC and the surety, it did not thoroughly investigate this risk and instead relied on the caveat subcriptor doctrine to declare in favour of the bank. Furthermore, although noting that the guarantor and primary debtor were related, the High Court did not address the reasons that led to the surety's consent".

"Given the challenge that the surety faces in rationalizing themselves, it has been argued that, on public policy grounds, the onus should be on the creditor to demonstrate, first, that the suretyship was the result of an independent act, and second, that the decision to become surety was based on full information that the debtor was privy to. More particularly, the presumption should be whether the parties were in a special relationship at the time of transactional agreement that provided the creditor some potential to influence or control the surety's decision making".

SURETY IN GUARANTEE CONTRACT IN CALIFORNIA

Suretyship is defined as any sort of third-party intercession in its fullest definition.

California's civil code has a section called guarantee, which is separated into two chapters: guaranty in general and suretyship. This clearly suggests a separation between the words, and if categorization justify interferes in any way, it should also imply that suretyship is the narrower term inside the broader expression of guarantee[17].

It is necessary to note that the code acknowledges the distinction and grants it statutory power.

"Section 2787". "Guaranty, what. A guaranty is a promise to answer for the debt, default, or

[16] H Kawadza, Reconsidering 'emotionally transmitted debt' in Zimbabwe and proposals for the reform of surety law based on English and South African experiences, De Jure law journal.

[17] Radin, Max. "Guaranty and Suretyship (Concluded)." California Law Review 18, no. 1 (1929): 21–30. https://doi.org/10.2307/3474995.

miscarriage of another person[18]"

"Section 2831". "Surety, what. A surety is one who at the request of another, and for the purpose of securing to him a benefit, becomes responsible for the performance by the latter of some act in favor of a third person, or hypothecates property as security therefore[19]"

Except for the fact that "surety" is accurately defined as a person and "guaranty" is correctly defined as a thing, the second definition adds just two sentences. The first is "at the request of another," and the second is the sentence "or — thus." Except for the term "at the request of another," which is omitted since it pertains to a specific type of transaction, the two definitions are identical. In the language of section 2787 and the Statute of Frauds, from which that section is evidently based, a person who "becomes responsible for the performance by... [another] of some act in Favour of a third person" is pledging to answer for another person's debt, default, or miscarriage.

As a result, it is impossible to tell from the definitions what the distinction implied by the statute is, except that in cases where no personal obligation tried to enter but property is hypothecated, we are told that the transaction is always "suretyship" and not "guaranty", a rule that the courts do not always follow.

ROMAN LAW ON GUARANTEE

Suretyship is well recognized in all legal systems, both modern and ancient. Roman law had a strong preference for these types of security transactions (adpromissio). In traditional Roman law, there were three types: sponsio, fidepromissio, and fideiussio. Because of their polished and intricate structure, they became a model for all periods, and the regulations regulating suretyship today are still fundamentally Roman[20].

In Roman law the contract of Guarantee is called "fidepromission"[21]. It is not based on common law but has been drawing attention to the concept of suretyship since the very beginning of Roman law. The guarantee picture is when contracts that are made for trade and commerce are fulfilled with an accessory obligation on the surety[22]. Also, if the principal debtor has become insolvent the surety can pay. Roman law has repeatedly not only focused on the reasons and purposes behind the contract of guarantee but also on why there is a need for surety. Roman law draws attention to grounds that qualify a person to become surety. It states that the principal

[18] CAL. CIv. CODE 8$ 2787-2825
[19] CAL. CIv. CODE 8$ 2831-2866
[20] BOTSFORD, SOURCE BOOK OF ANCIENT HISTORY
[21] IBID
[22] Reinhard Zimmermann. (1996) The law of obligations.London, Oxford University Press.

obligation to pay for someone's liability should be purely natural. The case of Buckland where the concept of natural was further discussed by courts and rationale was drawn immoral obligation may be unenforceable to the principal debtor but are enforceable to surety. What it means is the contract of guarantee is formed out of pure means and not personal advances that may hinder the contract or liability of people in any way. The major concern that section 126 brings in it define surety in an extremely limited sense and does not even define the main reasonability and motive to have such a section in the Indian contract and repeatedly the decision of interpretation is on the courts. In Vijay Mallya's case, calculating the shares and performing assets of the law should make it a qualification that the third party can become the surety.

COMPANIES ACT AND CONTRACT OF GUARANTEE

The Companies' Act of 2013[23] came into effect to impose restrictions on inter-corporate loans. The act has successfully removed this by clarifying where the principal debtor and surety cannot take a loan when the directors and members of the company are the same. However, the new amendment is also very exhaustive and exempts subsidiary companies, parent companies and private limited companies, the following rule does not apply to government companies as well. The motive behind the introduction of the Companies acts in 2013 was to hold companies who never pay back bank debts and do not comply with the terms and conditions of the contract of guarantee. Supreme court case of *Shree Ram Mills Ltd V Commissioner of excess Profit tax aid*[24] said that company should follow the provisions of this act while taking a loan, providing a loan or while becoming surety[25]. The companies act of 2017 was further extended and restricted private limited companies with the same directors and members. However, it allowed them also and the act does not make it obligatory or binding to follow such rules and it does not comply with Indian contract. With addition to that co-companies can take such loans where it is passed by general resolution in a meeting.

RE-DEFINING SURETY UNDER SECTION 126

India is a country with corrupt banking system where granting of loans is not transparent, securities are overvalued on paper to get loans sanctioned and not granted according to the

[23] The Campanies Act 2013
[24] AIR 1953 SC 485, 1953 23 ITR 120 SC
[25] Ibid

performing and non-performing assets of the company, a clear definition of surety can resolve a lot of bank fraud loans in India. Government as well as private individuals who are creditors can be protected, and the interests of creditors can be maintained with fair practices in commerce and trade.

In the Vijay Mallya case, he was the chairperson of both the companies, that is UB Holding limited and Kingfisher Airlines and effected the creditor itself, here were the state banks who suffered the loss and it is not the only case in India of bank loan fraud but in fact thousand crores of money of state banks and other companies is at loss because of the definition of surety or qualification to be surety are not defined as section 126 of Indian contact act simply explain it "surety is someone *who pays at default of principal debtor*."[26] This is not enough. Creditor rights are infringed and therefore it is not a valid contract of guarantee. There should be an exception laid down where the surety benefiting from the contract makes it invalid and both principle and creditor should indemnify the creditor. However, a problem of guarantee as per Vijay Mallya's the case and according to the provision, such contracts of the guarantee are not void according to the Indian Contract Act and it does not even make those contracts of guarantee voidable at the option of the creditor. So, it clearly fails to solve the problem of banking fraud and the inability of parent companies to pay back the debt when they become insolvent.

Qualification for a surety under the contract of guarantee should be :

1. He/she/they should not benefit from the contract that is between principal debtor and the surety
2. With addition to point (1) surety shall not receive any kind of compensation, profits, or personal or commercial benefit from the transaction between principal debtor and creditor.
3. The relationship between surety and principal debtor shall be purely for the purpose of trade and commerce with reference to section 127 of Indian contract[27] act that is only for the benefit of principal debtor.
4. Rules under section 185 of the Companies act of 2013 and 2017[28] shall be followed and non-compliance with such contracts shall be void *ab initio*.

[26] S. 126, The Indian contract act, 1872
[27] S. 127, Indian contract act, 1872
[28] S. 185, Indian companies act 2017

5. In such cases of void agreements both parties shall be liable to pay damages to the creditor under indemnity and shall be declared as defaulter by notification of RBI.
6. Such guarantee just ss in case of Vijay Mallya case should be treated under section 142 of Indian Contract Act[29]. Even the law commission in its 13th report[30] said that commas should be removed after creditors to clearly state that section talks about misrepresentation in case of guarantees.[31]

These changes and qualifications laid down for surety will not lead to such guarantees that are not paid by fugitives like Vijay Mallya. Another observation that was made recently by supreme court order on Vijay Mallya in February 2022, is that instead of company UB Holdings Ltd, Vijay Mallya is individually liable for the bank fraud as he owned 52% of the company. This means that individual ownership of a company is also a matter of concern that needs to be analyzed before the formation of a guaranteed contract. For recovery from such fraud, the intervention of courts becomes very problematic and therefore increases the burden on the courts of India. Changes in section 126 are important. Indian contract which is not updated since 1872 by legislatures and relying solely on the observations of the Honorable Supreme court for recovery of losses and for protection of creditors and fundamental rights of traders are especially important to decrease burden on the Indian courts. However, after so many cases Indian government never initiated any changes in Indian contracts after 150 years of Indian contract act However, it is reasonable to argue such rules may refrain or make businesspersons hesitant in taking loans and making investments but on the other hand, defining the qualifications of surety will also encourage creditors to grant loans more frequently with trust and banking fraud problems can be solved.

CONCLUSION

The scope of suretyship has increased differently in various parts of world. While analyzing Roman law and UK law we could see how they do not fail to explain what a third party is. And clearly states the purposes behind the creditor. If the surety is personally benefitted from the transaction between the principal debtor and creditor in any direct or indirect way should be a obligatory rule to make it voidable at the option of the creditor. Because in such a case the creditor is at loss.

[29] Indian contract act 1872
[30] 13th law commission report
[31] 13th law commission report

It is not until the 18th century that institutions like modern-day guaranteed firms emerge. The first recorded effort to form a surety corporation took place in the year 1720. Even though this initiative failed, it did set the stage for future assurance firms. The Guarantee Society of London, formed in London, England in 1837, was the first successful assurance firm. In the early years of assurance firms, England had greater success than the US. The establishment of guaranteed businesses was not made lawful in New York until 1853.

The definition of a fit individual is not defined or stated elsewhere in the Code. In general, a surety must be a trustworthy individual. The court can determine the sincerity of the sureties. A legitimate address should be provided for a guarantee. He may be requested to provide proof of residency. He should not be a nomad. He needs to figure out who he is. Similarly, a poor guy might be sure if he shows proof of residency

Surety often fails to rationalize themselves according to Indian contract act when the payment is to be made on the default of principle debtor. In contract of guarantee, the creditor should take checks and balances when the contract of guarantee is formed. It should also be make sure that debtor and creditor had the full information about surety and section 185 of companies act is with compliance with the contract.

Furthermore, strategies to reduce the obvious unfavorable contracts deriving from relational variables or influence are required. India might do this by implementing a judicial policy based on vigilance. Similarly, the creditor's due diligence must involve, for example, a requirement that the person wishing to become surety should meet with the creditor where the nature and ramifications of the arrangement may be discussed. Furthermore, the prospective surety must always be compelled to choose a legal representation for the transaction. That legal counsel must give valid documentation indicating that the surety was informed about the complexities of the transaction.