Discharge of Surety's Liabilities under Contract of Guarantee: Comprehensive Study with Cases and Laws

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***Abstract*: A contract of guarantee, under section 126 of the Indian Contract Act refers to a contract to perform a promise or discharge the liability of a third person in case of his default. The functions of a contract of guarantee is to enable a person to get loan, or goods on credit or an employment. There must be a conditional promise to be liable on the default of the principal debtor. A liability incurred independently of the default will not fall within the ambit of guarantee. However, under some circumstances, the surety can be discharged of his liabilities. How a surety can be discharged of his liabilities in a contract of guarantee is discussed in this paper.**

***Keywords*: Liability, Surety, Guarantee, Contractual Obligations**

Introduction

A contract of guarantee, under section 126 of [1]the Indian Contract Act refers to a contract to perform a 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 person to whom the guarantee is given is called the "creditor". A guarantee may be either written or oral. The functions of a contract of guarantee is to enable a person to get loan, or goods on credit or an employment. The aim is to have a second pocket as a back up to shift the burden from the first pocket if the need arises.

In the case of [2]Birkmyre n Darnell, the second defendant had promised, in respect of the lending of a horse, to ensure that the first defendant, English, would return the horse within stipulated period of time to the creditor. It was held by the court that this fell within the Statute of Fraud, being a promise to answer for the debt, default or miscarriage of another person and therefore required writing. The promise must be collateral which means that such other person must himself be and remain under the liability to perform the matter in question.

There must be a conditional promise to be liable on the default of the principal debtor. A liability incurred independently of the default will not fall within the ambit of guarantee. However, under some circumstances, the surety can be discharged of his liabilities and those have been discussed in the main body below.

Research Questions

1. Will the surety be discharged of his liabilities if the contract is that of a minor because the minor's contract is void ab initio?

Ans: This question has been well answered in [3]Coutts and Co vs Brown Lecky. The bank had given a loan to an infant by means of an overdraft which had been guaranteed by the second and third defendants. When there was a default, the bank sued both the sureties for the amount. Justice Oliver observed that according to section 1 of the [4]Infants Relief Act 1874, the minor's contract was void ab initio. Therefore, there was no question of debt, default or miscarriage which could be claimed from the sureties as a liability. Since the contract itself was void, the guarantee or surety to it did not hold any validity as well.

In India, in the case of [5]Kashiba Ben Narsapa Nikade vs Narshiv Sripat, a 17-year-old Hindu widow had entered into a contract that had been guaranteed by the second defendant. The Bombay High Court held that a surety of a bond passed by a minor for money borrowed for purpose of litigation not found to be necessary, is liable to be sued on it whether the contract of minor is considered void or voidable. If the debt is void, the surety is liable not as the guarantor but as the principal debtor himself.

2. If the liability of the principal debtor is reduced by a statute, does the liability of the surety get reduced as well?

Ans: This question has been answered by the Nagpur High Court in 1938 as well as in 1944 as it has been held that the aim of the statute in such a case is to relieve the principal debtor and not the surety. In [6]Aypunny Nani vs Devassy Kochouseph, the Kerala

[1] The Indian Contract Act, 1872
[2] Birkmyr vs Darnell, 1704, I Sm. L.C. 12th ed. p. 335
[3] In Coutts and Co. vs Browne-Lecky and Others (1946), 62 T.L.R. 421
[4] Infants Relief Act 1874
[5] Kashiba Bin Narsapa Nikade vs Shripat Narshiv (1895-1896) ILR Bom 466
[6] Aypunni Mani vs Devassy Kochouseph And Ors. on 14 September, 1965

High Court supported the above statement. Justice Gopalan held that in any other case, the creditor would be open to recover the debt as scaled down from the agriculturalist debtor, and the balance from the surety, and the latter in his turn could seek reimbursement from the principal debtor according to section 144 of the Indian Contract Act. Such a construction would nullify the ameliorate provisions of the indebted agriculturalists. This is the most desirable interpretation of section 128 which makes the liability of the surety co-extensive with that of the principal debtor. Thus, the statutory reduction of the principal debtor's liability will operate as a *pro tanto* reduction of the surety's debt.

Main Body

A surety is said to be discharged of his liabilities when his liability comes to an end. The Act recognizes the following modes of discharge:

1. Section 130: Revocation of continuing guarantee:

A continuing guarantee may at anytime be revoked by the surety as to future transactions by notice to the creditor. [7]Offord vs Davies is a suitable example. The defendants had guaranteed the payment of the discounted bills by the plaintiff for 12 months not exceeding 600 pounds. The guarantee had been revoked by the defendants. The guarantee had been revoked before any bill could be discounted. But the hills had been discounted by the plaintiffs which remained unpaid. The question was whether the surety had the right to revoke. The court held that in case of a continuing guarantee, the right of the surety to revoke his guarantee for the transactions that have not taken place, is undisputed. In a continuing guarantee, every transaction is an independent contract which makes the surety irrevocably liable but he may free himself from the future liability.

2. Section 131: Revocation of continuing guarantee by surety's death:

The death of the surety is the only criteria that works in the absence of any other contract of the same effect. The liability of the deceased can be imposed on his legal heirs depending upon the amount of property inherited by them.

3. Section 133: By Variance:

The interests of the surety have always been taken care of by the court of law. The surety is a favored debtor and his liability is *strict-tissimisisi juris*. Although the contract of surety is not the one of utmost good faith initially, once the contract is formed, the utmost good faith is imposed upon the creditor. The liabilities of the surety are absolved as soon as any alteration is made in the contract without his consent, between the principal debtor and the creditor. In the famous case of [8]Bonar vs Macdonald the conduct of the manager of a bank had been guaranteed by the defendant. The bank then raised his salary on the condition that he would be liable for one-fourth of the losses on discounts advanced by the manager. No information of this new arrangement was made to the surety. The manager allowed a client to overdraw his account and the bank lost a sum. The court observed that the surety could not be held liable because the new arrangement was a substitution of the former which discharged the surety.

The Madhya Pradesh High Court has held that if the surety by his consent has in advance enabled the creditor and the debtor to make changes in the terms of the contract, the provisions of section 133 will not be in effect. The consent of the surety must be taken during the time of the variance or prior to that. The court also said that the provisions of sections 134, 135, 139 and 141 cannot be nullified in advance.

Effect of Decree Against Surety

In a case before the Delhi High Court, the creditor gained a decree against the principal debtor and the surety to pay the amount to the decree-holder. He later entered into an agreement with the principal debtor to take a lesser amount from him and not to enforce the decree against him for the balance. The surety claimed a discharge on this basis. The court denied it. Once the liability is converted into a decree debt, the earlier constrains of the underlying contract seize to be applicable. Thud the dealing with the principal debtor does not operate to discharge the surety of his liability under which he is no longer liable as a surety but under a decree.

4. Section 134: Discharge of surety by release or discharge of the principal debtor:

The surety is relieved of his liabilities if by any contract between the principal debtor and the creditor, the principal debtor is released or by any act or omission pf the creditor, the legal consequence of which is discharge of the principal debtor.

Application of Insolvency Laws

It has been held by the apex court that although under the Section 134 the surety is discharged by release or discharge of the principal debtor, a discharge which the principal debtor may secure by cause of winding up or insolvency does not absolve the surety of the

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[7] Offord vs Davies (1862) 12 CBNS

[8] Bonar vs Macdonald, (1850) 3 HLC 226

liability. The bank guarantee for a sum of 50000 rupees was put forth by the supplier of an electricity board. The bank was obliged under the guarantee to pay the amount within 48 hours of demand by the board. It was tried by the bank to realize the amount out of the securities deposited by the supplier for securing the guarantee. The supplier company went into liquidation. The liquidator sought to restrain the bank from securing the guarantee. But the court held that the bank was a secured creditor and was entitled to the benefit of securities between the company and the electricity board.

Act or Omission

An act or omission of the creditor of the legal consequence is the release of the principal debtor will discharge the surety of his liabilities. For example, if there is a contract of construction the performance of which is guaranteed by a surety. The creditor is under the obligation to supply the building material. Failing to do so will release both, the principal debtor and the surety of their liabilities as it would be an act of omission in his part.

5. Section 135: Discharge of surety when creditor compounds with, gives time to or agrees not to sue the principal debtor:

This section provides for two modes of discharge from liability:

a. Composition

When the creditor has a composition with the principal debtor without consulting the surety, the latter is discharged.

An agreement was entered upon between the principal borrower and a bank for a one-time settlement without informing the guarantor. Court said that this amounted to the novation of the contract. The liability of the guarantor seizes to exist. A compromise in terms of the court decree is different from private composition. That does not discharge of the surety unless the decree is collusive.

b. Promise to Give Time

Upon the time for the payment of the guaranteed debt comes, the surety has the right to require the principal debtor to pay it off. Accordingly, it is the duty of the creditor towards the surety not to allow the principal debtor, more time for the payment. For example, when the principal debtor was to make payment for gas supplied within 14 days and on and occasion having failed to do so, the supplier took a promissory note from him, this amounted to extension of time and thereupon the surety was discharged.

6. Section 136: surety not discharged if agreement made with third party to give extension of time to principal debtor:

Promise to Not Sue

In case the creditor, under a contract with the principal debtor agrees to not use him, the surety is discharged. The reason being so that the surety is entitled to at any time require the creditor to call upon the principal debtor to pay off the debt. When it is due and this right is positively violated, the surety is no more liable.

Forbearance to Sue

This is subject to 2 important qualifications: In the first place, a promise not to sue should be distinguished from a mere forbearance to sue. A promise not to sue is an engagement which ties the hands of the creditor. It is not negatively refraining, not exacting the money at time but deprives the creditor from using his power to sue.

7. Section 137: Creditor’s forbearance to sue won’t discharge surety:

According to section 134, on the act or omission by the creditor, the legal consequence may result in the discharge of the surety which is in conflict with the provisions of section 137. This was resolved in [9]Ranjit Singh vs Naubat. The court held that despite the provisions of section 137, the creditor’s rights against the surety is not preserved unless he sues the principal debtor within the period of limitation.

Section 139: Discharge of the surety by the creditor’s act or omission impairing surety’s eventual remedy:

Surety is entitled, to his indemnity from the principal debtor. If the creditor’s act or omission deprives him of this benefit, he is discharged. [10]Darwin vs Pearce is a suitable example. The principal debtor had been a shareholder in a company. His shares were partly paid and the rest was guaranteed by the surety, the shareholder failed and the company forfeited his shares. Had they not been forfeited, they would have belonged to the surety on payment of the outstanding calls. Thus, the forfeiture deprived the surety of his rights to the shares and he was accordingly discharged.

Conclusion

It therefore follows that the contract of guarantee which is an important commercial instrument, has the essential element of the rights of the surety and the circumstances under which the surety can be discharged of his liabilities. The situations and sections

[9] Ranjit Singh And Anr. vs Naubat And Ors. on 16 June, 1902

[10] Darwin vs Pearce

have been elaborately discussed above. In consideration of various factors like the interests of the surety, those of the creditor, the principal debtor as well as the sanity and integrity of the contract, it has been noticed that the concerned judicial authorities set made important precedents with regards to the discharge of the liabilities of the surety under the contract of guarantee.

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