BUSINESS LAW

UNIT 3:Introduction to Special Contracts

TOPIC- Contracts of Indemnity and Guarantee

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CONTRACTS OF INDEMNITY(Sec.124-125)

A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any other person, is called a contract of indemnity.

A contract of indemnity is a kind of contingent contract as the contingency upon which the whole contract of indemnity depends is the happening of loss.

The person who promises to make good the loss is called the 'indemnifier' and the person whose loss is to be made good is called the 'indemnified' or the 'indemnity-holder'.

- EXAMPLE-A sells his property to B and contracts to indemnify B against the costs of litigation if title to the property is disturbed.
- EXAMPLE- Contracts of Insurance where insurance company is the indemnifier and policy holder is the indemnified.

Just like any other contract, the contract of indemnity must have all the essential elements of a valid contract i.e. capacity of parties to contract, free consent, lawful object etc. It may be express or implied. An indemnity given under coercion or for an illegal object is not valid and so cannot be enforced.

- EXAMPLE- A asks B to beat Z and promises to indemnify B against the consequence. B beats Z and is fined Rs. 1000. B cannot claim this amount from A because the object of the agreement was unlawful.

RIGHTS OF INDEMNITY HOLDER WHEN SUED (Sec.125)

The following rights are available to a indemnified against the indemnifier provided he acted prudently, acted as per the directions of the indemnifier and has acted within the scope of his authority-

- Right to recover costs incurred in defending the suit
- Right to recover damages in a suit
- Right to recover sums paid under compromise

The Indian Contract Act does not provide the time of the commencement of the indemnifier's liability under the contract of indemnity. However, the Indian Courts apply the following rules in this regard-

- Indemnifier is not liable until the indemnified suffered a loss.
- Indemnified can compel the indemnifier to make good his loss even before he has actually discharged his liability, provided the liability has become absolute and final. Indemnity is not necessarily given by repayment after payment. Indemnity requires that the party to be indemnified shall never be called upon to pay.

CONTRACT OF GUARANTEE(SEC.126- SEC.147)

A contract of guarantee is a contract to perform the promise, or discharge the liability of a third person incase of his default.(Sec.126). It is entered into with the object of enabling a person to get a loan or goods on credit or an employment.

EXAMPLE- D requests C to supply him goods on credit. C agrees to do so provided S guarantees the payment of the price of the goods. S promises to guarantee the payment. This is the contract of guarantee

The person who gives guarantee is called 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.

So, in a contract of guarantee there are three separate contracts-

- one between the principal debtor and the creditor (eg .loan contract)
- second between the creditor and the surety and(eg.guarantee)
- third between the surety and the principal debtor where in principal debtor requests the surety to give his guarantee and impliedly promises him to indemnify incase surety incurs a liability.

Just like any other contract, a contract of guarantee must have all the essential elements like free consent, legality of object, competency of parties,etc. It may be oral or written. It should also be supported by some consideration. As such no direct consideration is visible between the surety and the creditor but the consideration/benefit received by the principal debtor is sufficient for the surety for giving guarantee.

Contract of Indemnity vs Contract of Guarantee

CONTRACT OF INDEMNITY	CONTRACT OF GUARANTEE
Covered u/s 124 and 125 of the Indian Contract Act, 1872	Covered u/s 126 to 147 of the Indian Contract Act,1872
There are 2 parties- indemnifier and indemnified	There are 3 parties-creditor, principal debtor and surety
There is only 1 contract between the indemnifier and the indemnified.	There are 3 contracts- between principal debtor and creditor; between creditor and surety and between surety and principal debtor
A contract of indemnity is for the reimbursement of loss.	A contract of guarantee is to enable a person get loan/goods on credit / obtain employment
The liability of the indemnifier is primary in nature.	The liability of surety is secondary, i.e. he will be liable only on default of principal debtor.
Here indemnifier acts independently without any request of the debtor or third party.	Here it is necessary that surety should give the guarantee at the request of the debtor.
There is no existing debt or duty	There is an existing debt or duty ,the performance of which is guaranteed.
The indemnifier cannot sue the third party for loss caused to him.	The surety ,after he discharging the debt of the creditor, can proceed against the principal debtor in his own right

NATURE AND EXTENT OF SURETY'S LIABILITY

- The liability of surety is **co-extensive** (equivalent) with that of principal debtor i.e.- whatever amount the principal debtor is liable to pay eg. interest, damages, cost etc., the surety is liable to pay the same. By a special contract, it may be made less than that of principal debtor ,but never more.
- The liability of surety is **secondary/contingent**- surety is liable only on default of the principal debtor. If principal debtor fulfills his obligation, the question of surety's liability does not arise.
- The liability of the surety **arises immediately on default** of the principal debtor-So the creditor may file a suit against the surety without suing the principal debtor or without even exhausting his remedies against the principal debtor .
- The guarantee given by the surety could be **specific or continuing-** Specific guarantee means guarantee given for a single specific transaction and it comes to an end as soon as the liability under that transaction ends. Continuing guarantee means it extends to a number of transactions over a period of time. It may be revoked at any time by the surety as to future transactions.
- The law does not treat principal debtor and surety as one person and so it is possible that in a particular case one is liable while the other may not be liable. For example-

WHEN SURETY IS NOT LIABLE BUT PRINCIPAL DEBTOR IS	WHEN SURETY IS LIABLE BUT NOT PRINCIPAL DEBTOR
The surety will **not be liable where creditor has obtained guarantee by fraud/**misrepresentation (eg. obtaining guarantee for the conduct of an employee without disclosing to the surety his previous dishonesty.)	The principal debtor ,**on becoming insolvent**, is discharged by operation of law but surety still remains liable for the amount of debt.
If any **variation in the contract is done later** on by the creditor and principal debtor , without surety's consent	When principal debtor is a **minor**, he is not liable on that transaction but surety is liable

RIGHTS OF SURETY

- SURETY' RIGHTS AGAINST CREDITOR

  Right to benefit of creditor's securities-At the time of payment to the creditor, the surety can demand from him all the securities creditor has against the principal debtor. Incase by negligience the creditor loses or misplaces them, the surety is discharged to that extent.

  Right to claim set off, if any- The surety is also entitled to take benefit of any set-off or counter claim which the principal debtor might possess against the creditor in respect of the same transaction.

- SURETY' RIGHTS AGAINST PRINCIPAL DEBTOR

  Right of subrogation- After paying off the debt on default of the principal debtor, the surety steps into the shoes of the creditor and gets entitled to all the remedies which creditor could have enforced against the principal debtor eg. sue the debtor, claim the securities held by creditor, claim dividend in insolvency of the debtor etc.

  Right to claim indemnity- The surety is entitled to recover from principal debtor whatever sum he has 'rightfully paid' under the contract eg. principal sum, interest thereon, noting charges, cost of suit etc.

- SURETY' RIGHTS AGAINST CO-SURETIES

  Right to security(right to share benefit)– If any co-surety obtains the security of principal debtor, the other co-sureties have a right to claim a share in it.

  Right to contribution (right to share burden)- Incase of default by principal debtor, the liability falls on all the co-sureties and they bear it as per the agreement amongst them. If any co-surety pays more than his due share, he can claim contribution from other co-sureties. The following rules will apply in the absence of any agreement among them **-**

  ✓ Co-sureties for same debt and same amount- The co-sureties are liable to contribute equally and also share the benefit of securities equally.

  ✓ **Co-sureties for same debt but different amounts-** Subject to the limit fixed by his guarantee, each surety is to contribute equally (and not proportionately to the liability undertaken)

DISCHARGE OF SURETY (i.e. end of surety's liability)

- **Notice of revocation**-A continuing guarantee can be revoked, at any time, by the surety as to future transactions by giving notice to the creditor. The surety will, however, continue to remain liable for transactions entered prior to the notice. But a specific guarantee cannot be revoked once it is acted upon.
- **Death of surety**-Incase of a continuing guarantee, the death of surety discharges him from liability as regards transactions after his death. However, the estate of surety remains liable for the transactions undertaken prior to his death.
- **Variance in terms of contract-** A surety is discharged from liability when, without his consent, the creditor makes any change in the terms of his contract with the principal debtor (no matter whether variation is beneficial to the surety). The surety is discharged in respect of transactions subsequent to the variance .
- **Loss of security-** If due to his negligience, the creditor loses, or parts with any security given to him, at the time of the contract of guarantee, the surety is discharged from liability to the extent of the value of security. But if the security is lost due to an act of God or unavoidable accident, the surety would not be discharged.

DISCHARGE OF SURETY

- **Release of principal debtor**- The surety is discharged by any contract between the creditor and principal debtor by which the principal debtor is released, or by any act or omission of the creditor, the legal consequence of which is the discharge of the principal debtor.
- **Composition between creditor and principal debtor-**Any contract by which the creditor makes a composition with the principal debtor, or promises not to sue the principal debtor, discharges the surety. Eg. if the a creditor makes a composition with the principal debtor and accepts a lesser amount in full satisfaction of his claim, the surety is discharged. But mere forbearance on part of the creditor to sue the principal debtor does not discharge the surety.
- **Invalidation of the contract of guarantee-** A surety is discharged from liability where the creditor had obtained guarantee from surety by means of fraud/ misrepresentation/ nondisclosure as to material part of the transaction or when the object if the contract is illegal or when any of the essential elements of a valid contract is missing.
- **Creditor's act/omission impairing surety's eventual remedy**- If a creditor does anything which is inconsistent with the rights of the surety, or omits to do something which his duty to the surety requires him to do , and so the eventual remedy of the surety against the principal debtor is impaired, the surety is discharged.

  EXAMPLE- B contracts to build a ship for C for a given sum , to be paid by instalments as the work reaches certain stage. A becomes surety to C for B's due performance of the contract. C, without the knowledge of A, pre-pays to B the last two instalments. A is discharged by this prepayment.