

Contract of Indemnity and Guarantee

⇒ Contract of indemnity

Introduction

- 1, Indemnity is a Special Kind of Contract where One person promises to save another from a loss caused to him by the conduct of promisor himself or by the conduct of any one else.
- 2, It means :-

★1, Special Kind of Contract :-

Indemnity is called a Special Contract because it has its own set of rules. Indemnity definitely follows all rules of contract but in addition to the general rules of contract but in addition to the general rules, it also has certain special rules.

★2, One person promises to save another :-

Indemnity involves 2 parties.

→ One, who promises to another.

He is called indemnifier.

→ Second who receives promises, or who receives advantages of promises.

He is called indemnified.

Indemnified is also called indemnity holder.

Indemnifier promises to indemnified / indemnity holder about saving the economic aspect only. In simple words, indemnifier is ready to compensate economic loss of indemnity holder. Any other kind of promise is not covered in indemnity.

*3, loss caused to him —

→ loss against which protection is being provided by the indemnifier may or may not take place if the loss takes place.

→ If the loss takes place, indemnifier will pay to indemnity-holder.

→ But if there is no loss, there is no liability of indemnifier.

→ So, we can say that liability of indemnifier is contingent liability, which may or may not happen.

Eg -

i) Student fee for foreign education funded by Govt.

ii) Promise for loan default.

iii) Tree falling over neighbouring property.

*4, By the conduct of promisor himself or by the conduct of any other person —

→ loss from which protection is being provided, can arise because of 2 reasons :-

a) Act done by indemnifier, i.e., the person promising himself.

b) Act done by any other person.

→ It means loss arising from any other source or any other reason is not covered and no compensation shall be possible.

Eg:- i) Act of God

ii) Mistake of indemnity holder himself

→ In simple words, uncontrollable reasons of loss are not covered in indemnity.

→ However, when we look at Contract Act of England, Act of God is also covered in indemnity.

Made of Contract of Indemnity

- 1) Contract of indemnity may be expressed or implied.
- 2) Expressed means by words, whether spoken or written.
- 3) Implied means without words, neither spoken nor written.
- 4) Indemnity Contract shall be valid even if it is oral and even if it is implied.

Expressed Indemnity
Promise by Student to Government when Govt. funded his education.

Implied Indemnity
Each partner has a duty to save the firm and compensate to other partner, even if it is not written in the partnership agreement.

Indemnity and Insurance

- 1) Insurance Contract are definitely in the nature of Indemnity.
- 2) However, life insurance is not covered under indemnity because, loss of life is considered beyond human control.

Rights of Indemnity Holder

- 1) First of all we must understand that indemnity holder can claim his rights from indemnifier only in case of loss. It means the rights allowed to indemnity holder are also contingent.
- 2) Following are the 3 rights available to indemnity holder :-
 - a) To claim any loss occurred.
 - b) To claim any cost incurred.
 - c) To claim any expense done.

When does the liability of Indemnifier Starts?

- 1) Liability of Indemnifier to compensate indemnity holder is absolutely contingent.
- 2) This liability will start only when the indemnity holder is certain to have some loss.

Contract of Guarantee

Meaning :-

→ Guarantee is a contract where one person promises to perform or pay for someone else in case of his default.

→ Guarantee basically includes following elements :-

- a) Performance of promise, which means made by one and guaranteed by someone else.
- b) ^{OR} Payment of dues payable by one person but guaranteed by someone else.

Parties in the Contract of Guarantee

There are 3 parties involved in the contract of guarantee :-

a) Principal Debtor :-

Means the person who has main liability to perform promise or make payment.

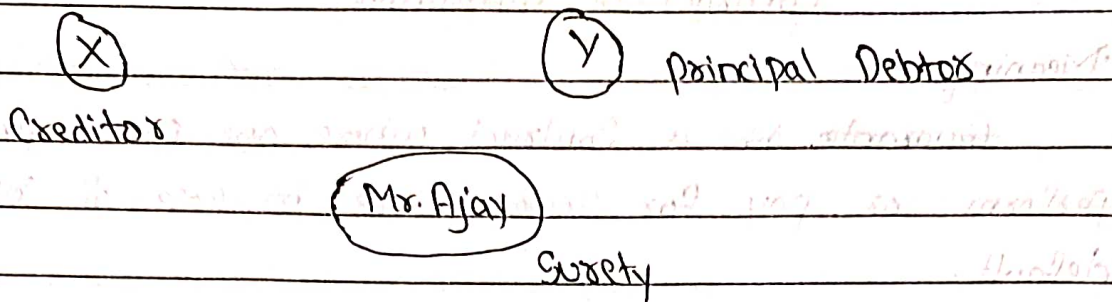
He is the one in favour of whom, Guarantee is being given.

b) Creditor :- Means the person to whom guarantee is given.

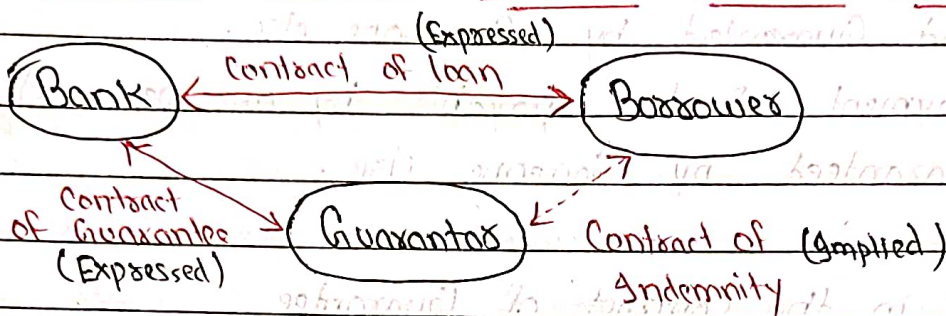
In other words, He is the one to whom the principal debtor is liable to perform or pay.

c) Surety / Guarantor :- Means the person who is giving guarantee to creditor in favour of principal Debtor.

Eg - Mr. X hired Mr. Y and appointed him as Cashier in his (X) office. This appointment was done after the guarantee given by Mr. Ajay Kumar for the conduct of Mr. Y.



Contract of Guarantee includes 3 Contracts :-



1) Guarantee is called Tripartite agreement.

2) It means Contract of guarantee involves 3 contracts among 3 parties.

3) These 3 contracts are as follows :-

a) Contract to perform the promise or make the payment, this contract is done between principal debtor and creditor. This must be expressed.

b) Contract to pay or perform in case of default by principal debtor. This contract is done between guarantor and creditor. This must be expressed.

c) Contract to compensate the loss incurred by guarantor due to the default of principal debtor. This is a contract of indemnity where principal debtor is indemnifier and guarantor is indemnity holder.

This is a contract may be expressed or implied. This is always assumed to be present by default.

Features of Guarantee

Following are the essential features / rules / conditions / elements which must be taken care of while giving guarantee :-

a) Purpose -

To provide assurance that there will be no loss to the creditor. This is the reason due to which, Guarantee is called Surety.

b) Consideration -

It looks like that Guarantor gets nothing when he gives guarantee. This creates an impression that consideration is absent. This is a wrong impression because consideration need not to come directly to Guarantor. The transaction b/w principal debtor and creditor got possible only bec of guarantee and this is sufficient consideration.

c) Existence of liability -

There must be some liability on part of the principal debtor. This liability may belong to payment or some other performance.

d) No misrepresentation or concealment -

Guarantee must be taken / given after having knowledge of all material facts. Any guarantee obtained because of fraud, misrepresentation and concealment shall not be valid.

It is the duty of principal debtor and creditor to inform guarantor about every relevant matter that they know.

e) Writing not necessary -

A contract of guarantee is not dependent on any deed or document. Guarantee must be expressed and this expression may be oral or written, both are allowed.

f) Joining of other Co-Sureties -

Co-Sureties mean more than one guarantor for the same liability. This system of Co-Sureties is absolutely allowed. If a guarantor puts a condition that his guarantee will be valid only if some other Co-Surety also join, then this guarantee shall be valid only after arrival of Co-Surety.

g) Role of Minor -

Guarantor must not be incompetent to contract. However, principal Debtor and creditor may or may not be competent. So, if we specifically talk about minor, minor can be creditor, minor can be principal debtor but minor can not be guarantor.

Types of Guarantees :-

There are 2 Types of Guarantees :-

(a) Specific Guarantee / Stand-alone Guarantee -

This guarantee is applicable on one single transaction only. A fresh guarantee shall be needed for every new transaction.

Eg -

Credit purchase of Machinery from Supplier once in a while.

b) Continuing Guarantee -

This means a guarantee applicable on series of transactions, which means guarantee will remain for multiple transactions. Guarantor will remain liable unless he receives his guarantee.

Eg -

Credit purchase of tea for office for the entire month upon a guarantee from neighbouring office owner.

Nature and Extent of Surety's liability -

→ Liability of Surety is Co-extensive with the principal Debtor.
↳ Equal

Eg -

Loan amount was guaranteed by surety. In case of default, creditor can demand loan amount, interest as well as penalty from Guarantor.

→ liability of Surety is Secondary in nature which means it arises when there is a default by principal debtor.

→ If there is defect in the document, due to which principal debtor gets discharged from liability, guarantor will also get discharged.

* → Creditor can decide to sue Guarantor first. Guarantor will have to pay and then guarantor can recover from the principal debtor.

Liability of 2 persons, primarily liable, not affected by Age Arrangement between them that one shall be Surety on another's default.

- Basically, borrower and guarantor are 2 different roles.
- But if guarantor signs the loan agreement, not as guarantor, but as borrower, he becomes co-applicant in the loan.
- After becoming co-applicant, Bank (creditor) can demand repayment either from original borrower or from the guarantor acting as borrower.
- If Bank demands repayment from original borrower, it is absolutely fine but if bank (creditor) demands repayment from guarantor who is acting as borrower, He will have to pay but he can recover from original borrower.
- There is a mutual understanding b/w original borrower and guarantor acting as borrower that original borrower will compensate to the guarantor.

Discharge of Surety - (Q. 2, 11, 14, 15, 17, 21, 26, 6, 8, 12, 13, 20, 23)

Discharge

Discharge of Surety means that Surety is no more liable.

No more liable means no liability for future transactions.

The liability of Surety for past transaction will

Continue. past transactions mean transactions done before the extent of discharge.

Following are the 3 major reasons of Discharge of Surety :-

1) Revocation of Contract of Guarantee

Revocation means Cancellation of Contract of Guarantee

this Cancellation takes place in any of the following

3 ways :-

1.1) When Guarantor informs through a Notice to Creditor, whether oral or written.

1.2) When Guarantor dies. But his property / estate shall remain liable for past transactions.

1.3) When Guarantor and Creditor themselves Council the old Contract and make a new Contract.

This is called Novation.

2) By Conduct of Creditor

Conduct of Creditor means that Creditor has done something due to which guarantor is getting free from his liability. This can happen in

following 4 ways :-

2.1) When principal debtor and Creditor make variation in their agreement without the Consent of guarantor.

2.2) when Creditor does something which exempts the principal debtor, in this case guarantor also gets exempted.

Eg- A Farmer took loan from bank. It was guaranteed by Mr. Khanna. Bank loans to farmers were written off. which exempted by farmer. when farmer got exempted, Mr. Khanna also get discharged.

2.3) when Creditor makes some Compounding (Settlement) with principal debtor or allows him more time to repay without knowledge of guarantor.

2.4) when Creditor has some duties and he defaulted in his duties.

Eg- Ram was hired by Mr. Sharma upon guarantee of his conduct from Hanuman. Hanuman gave a condition that Mr. Sharma should report to Hanuman about Ram's behaviour every month. If Mr. Sharma fails to report, guarantee of Hanuman gets cancelled.

3) Invalidation of Contract of Guarantee - Invalidation means that due to some reason, guarantee becomes invalid. Following are the 3 reasons due to which guarantee becomes invalid and guarantor gets discharged :-

3.1) Guarantee obtained through misrepresentation:

3.2) Guarantee obtained through concealment:

3.3) When guarantor gave a condition that he will be liable only when co-surety joins, and co-surety does not join:

Rights of Surety

Rights of Surety can be classified into 3 categories. Each categories contains some rights of the Surety. They are as follows :-

1, Rights of Surety against principal Debtor -

a) Right of Subrogation

Subrogation means substituting one person in place of another with respect to rights. When a person receives exactly same rights from some other person, this is called Subrogation.

In case of Guarantee, Surety gets all rights of a creditor if Surety had to pay the liability.

b) Right to receive Indemnity

When guarantor had to pay liability of principal debtor, guarantor gets a right to claim compensation from the principal debtor. Even if principal debtor has not made any such promise in expressed terms, even then principal debtor is liable. This is a right about implied indemnity.

2) Rights of Surety against Creditor

a) Right to receive Collateral Security

Surety will be able to claim Collateral Security from the creditor.

b) Right to claim Set off

If creditor and principal debtor both have some liability to each other, then in case of default, both the receivable and payable shall be adjusted and only the balance can be demanded from the guarantor.

c) Right to Share reduction

When principal debtor make some payment to creditor, this much amount shall be reduced from the liability of guarantor.

3) Right of Co-Surety against each other

a) Co-Surety liable to contribute equally

If Co-Sureties do not decide any ratio of their liabilities, they will be liable in equal ratio. If they decide a ratio, their liability will be as per that ratio.

b) Limit on the liability

This right is also called Fixed Sum Right.

When Co-Sureties decide that they will be equally liable but their equal share of liability should not go beyond a pre-determined fixed limit, then the liability will not go beyond that limit for that guarantor.