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BBA | Semester III | UK3DSCMGT203

Business Laws

Course Code: UK3DSCMGT203 • Module 4 Notes

Module 4: Law of Indemnity and Guarantee

Course: Business Laws (UK3DSCMGT203) • Semester III • BBA FYUGP Kerala University

1. Contract of Indemnity: Definition, Nature, and Scope

The term *Indemnity* literally signifies protection against financial loss, security against anticipated damage, or compensation for injury suffered. Section 124 of the Indian Contract Act 1872 defines a Contract of Indemnity as follows:

"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."

- The party who promises to make good the loss is called the **Indemnifier** (Promisor).
- The party in whose favor the promise is made and who is protected against loss is called the **Indemnity Holder** or **Indemnified** (Promisee).

Narrow Statutory Definition Versus English Common Law Scope

An important academic distinction exists between Section 124 and English common law: Section 124 strictly covers losses caused by human agency (the conduct of the promisor or any third party). It does not explicitly encompass losses caused by natural disasters, accidents, or fire. Consequently, in Indian jurisprudence, contracts of fire insurance and marine insurance are technically classified as *Contingent Contracts* (under Section 31), whereas in English common law, all insurance contracts (except life insurance) are treated as contracts of indemnity.

Rights of the Indemnity Holder (Section 125)

The promisee in a contract of indemnity, acting within the scope of his authority, is entitled to recover from the promisor:

1. All damages which he may be compelled to pay in any suit in respect of any matter to which the promise to indemnify applies.
2. All costs which he may be compelled to pay in any such suit if, in bringing or defending it, he did not contravene the orders of the promisor and acted as it would have been prudent for him to act in the absence of any contract of indemnity, or if the promisor authorized him to bring or defend the suit.
3. All sums which he may have paid under the terms of any compromise of any such suit, if the compromise was not contrary to the orders of the promisor and was one which it would have been prudent for the promisee to make.

Commencement of Indemnifier's Liability: Gajanan Moreshwar v. Moreshwar Madan

Historically under English common law, an indemnity holder could recover only after suffering actual physical financial disbursement ("you must be damnified before you can claim to be indemnified"). However, equity courts recognized this as unjust. In India, Justice Chagla of the Bombay High Court

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settled the legal rule in the landmark case of **Gajanan Moreshwar v. Moreshwar Madan (AIR 1942 Bom 302)**: the court held that an indemnity holder is entitled to call upon the indemnifier to satisfy the debt or pay the claim as soon as the liability becomes absolute and clear, even before the indemnity holder has actually suffered cash disbursement.

2. Contract of Guarantee: Definition, Structure, and Tripartite Framework

Section 126 of the Indian Contract Act 1872 defines a **Contract of Guarantee** as: *"A contract to perform the promise, or discharge the liability, of a third person in case of his default."*

A contract of guarantee involves three distinct parties and three interconnected contracts:

- The person who gives the guarantee is called the **Surety** (Guarantor).
- The person in respect of whose default the guarantee is given is called the **Principal Debtor**.
- The person to whom the guarantee is given is called the **Creditor**.

The Tripartite Contractual Matrix

1. Contract 1: Between Principal Debtor and Creditor (the underlying primary debt or obligation).
2. Contract 2: Between Surety and Creditor (the secondary collateral promise to pay upon debtor's default).
3. Contract 3: Between Principal Debtor and Surety (the implied promise by debtor to indemnify surety under Section 145).

Contract of Indemnity Versus Contract of Guarantee

Comparative Parameter	Contract of Indemnity (Section 124)	Contract of Guarantee (Section 126)
Number of Parties	Two parties: Indemnifier and Indemnity Holder.	Three parties: Creditor, Principal Debtor, and Surety.
Number of Contracts	Single contract between indemnifier and indemnified.	Tripartite: Three contracts operating simultaneously.
Nature of Liability	**Primary and Independent:** Indemnifier's liability is not dependent on default of any other person.	**Secondary and Collateral:** Surety is liable only if the principal debtor defaults on primary debt.
Existence of Prior Debt	No preexisting debt or duty required; risk is future and contingent.	Preexisting debt or legal obligation owed by principal debtor is essential.
Right to Sue Third Parties	Indemnifier cannot sue third parties in their own name (must sue in indemnity holder's name).	Surety, upon discharging debtor's debt, steps into creditor's shoes and sues principal debtor directly.

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3. Nature, Extent, and Rights of the Surety

Section 128 defines the extent of surety liability: *"The liability of the surety is co-extensive with that of the principal debtor, unless it is otherwise provided by the contract."*

- **Co-extensive Liability:** The surety is liable for exactly what the principal debtor is liable for (principal sum, accumulated interest, litigation costs, late penalties).
- **Creditor Not Bound to Sue Debtor First:** The creditor can proceed directly against the surety without first exhausting legal remedies against the principal debtor or liquidating pledged securities, unless specifically agreed otherwise (Bank of Bihar v. Damodar Prasad, 1969).

Comprehensive Rights of the Surety

1. **Rights Against the Principal Debtor:**
   - *Right of Subrogation (Section 140):* Upon payment or performance of all that he is liable for, the surety is invested with all the rights which the creditor had against the principal debtor. The surety literally steps into the legal shoes of the creditor.
   - *Right to Implied Indemnity (Section 145):* In every contract of guarantee there is an implied promise by the principal debtor to indemnify the surety; the surety is entitled to recover from the debtor all payments rightfully made.
2. **Rights Against the Creditor:**
   - *Right to Creditor's Securities (Section 141):* A surety is entitled to the benefit of every security which the creditor has against the principal debtor at the time when the contract of suretyship is entered into, **whether the surety knows of the existence of such security or not**. If the creditor loses or parts with such security without surety consent, the surety is discharged to the value of the security.
   - *Right to Set-Off:* The surety is entitled to claim any set-off or counterclaim which the principal debtor had against the creditor.
3. **Rights Against Co-Sureties (Contribution):** Under Section 146, when two or more persons are co-sureties for the same debt, they are liable to contribute equally in the absence of a contract to the contrary. Under Section 147, co-sureties bound in different sums must pay equally as far as the limits of their respective obligations permit.

4. Discharge of Surety from Liability

The law protects the surety vigorously. A surety is discharged from all future liability under three major statutory categories:

1. Discharge by Revocation

- **Revocation by Notice (Section 130):** A *Continuing Guarantee* (a guarantee extending to a series of transactions under Section 129) may at any time be revoked by the surety as to future

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transactions by notice to the creditor. The surety remains liable for transactions executed prior to notice.

- **Revocation by Death of Surety (Section 131):** The death of the surety operates, in the absence of any contract to the contrary, as a revocation of a continuing guarantee as to future transactions.

2. Discharge by Conduct of the Creditor

- **Variance in Terms of Contract (Section 133):** Any variance made without the surety's consent in the terms of the contract between the principal debtor and creditor discharges the surety as to transactions subsequent to the variance.
- **Release or Discharge of Principal Debtor (Section 134):** The surety is discharged by any contract between the creditor and principal debtor by which the debtor is released, or by any act or omission of the creditor the legal consequence of which is the discharge of the principal debtor.
- **Compounding with, Giving Time to, or Agreeing Not to Sue Debtor (Section 135):** A contract between creditor and debtor by which creditor makes a composition with, or promises to give time to, or not to sue the debtor, discharges the surety unless the surety assents.
- **Impairing Surety's Eventual Remedy (Section 139):** If the creditor does any act which is inconsistent with the rights of the surety, or omits to do any act which his duty to the surety requires him to do, and the eventual remedy of the surety against the debtor is impaired, the surety is discharged.

3. Discharge by Invalidation of Contract of Guarantee

A guarantee is invalid and unenforceable if obtained by means of misrepresentation made by creditor (Section 142), obtained by keeping silence as to material circumstance (Section 143), or if a person agreed to be co-surety fails to join (Section 144).

5. Detailed Legal Regime of Indemnity and Rights of Indemnity Holder

Contracts of indemnity and guarantee constitute essential risk-allocation instruments in commercial transactions, governed by Chapter VIII of the Indian Contract Act 1872. Section 124 defines a contract of indemnity as 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. Notably, the definition under the Indian Contract Act is narrower than that under English common law, as it covers only losses occasioned by human agency (the promisor or a third party) and excludes losses arising from natural perils, accidents, or events beyond human agency. Hence, contracts of fire insurance and marine insurance, which protect against accidental perils and acts of nature, are treated under Indian law as contingent contracts governed by Section 31, rather than contracts of indemnity under Section 124.

The statutory rights of the indemnity holder are codified in Section 125. The promisee in a contract of indemnity, acting within the scope of his authority, is entitled to recover from the promisor:

1. **All Damages:** All damages which he may be compelled to pay in any suit in respect of any matter to which the promise to indemnify applies.
2. **All Costs of Litigation:** All costs which he may be compelled to pay in bringing or defending such suits, provided that in bringing or defending it, he did not contravene the orders of the promisor and acted as it would have been prudent for him to act in the absence of any contract of indemnity, or if the promisor authorized him to bring or defend the suit.
3. **All Compromised Sums:** All sums which he may have paid under the terms of any compromise of any such suit, if the compromise was not contrary to the orders of the promisor, and was one which it would have been prudent for the promisee to make in the absence of any contract of indemnity, or if the promisor authorized him to compromise the suit.

A crucial question in indemnity jurisprudence concerns the exact moment when the indemnifier's liability commences. Under early English common law rules, an indemnity holder was required to first pay out the loss out of pocket before seeking reimbursement from the indemnifier ("you must be damnified before you can claim to be indemnified"). However, equity courts recognized the hardship of this rule, establishing that indemnity is not merely an agreement to repay after payment, but an agreement to protect the promisee from incurring the liability itself. In the landmark Indian ruling Gajanan Moreshwar Parelkar v. Moreshwar Madan Mantri (1942) 44 Bom LR 703, Justice Chagla definitively held that Section 124 and 125 are not exhaustive. Applying equitable principles, the Bombay High Court ruled that if the indemnity holder has incurred an absolute and enforceable liability, he is entitled to call upon the indemnifier to pay off that liability or deposit the amount in court even before the indemnity holder has suffered actual pecuniary disbursement.

6. Analysis of Surety's Rights, Co-Suretyship, and Detailed Grounds of Discharge

A contract of guarantee under Section 126 involves a tripartite arrangement consisting of the principal debtor (who owes the underlying debt), the creditor (to whom the debt is owed), and the surety (who guarantees performance or payment in case of default). Section 128 defines the core nature of the surety's liability: the liability of the surety is co-extensive with that of the principal debtor, unless it is otherwise provided by the contract. This co-extensive nature establishes that the surety's liability is immediate, direct, and equal in magnitude to that of the debtor. As affirmed by the Supreme Court in Bank of Bihar Ltd. v. Damodar Prasad AIR 1969 SC 297, the creditor is not required to exhaust legal remedies against the principal debtor or even sue the debtor first before suing the surety; upon the debtor's default, the creditor can immediately proceed against the surety unless the guarantee agreement explicitly stipulates otherwise.

The law confers extensive protective rights upon the surety against all three parties in the transaction:

1. **Rights Against the Principal Debtor:** Under Section 140, upon payment or performance of all that he is liable for, the surety is invested with all the rights which the creditor had against the principal debtor. This fundamental equitable principle is known as the **Right of Subrogation**, placing the surety directly in the shoes of the creditor. Furthermore, Section 145 establishes an

implied promise by the principal debtor to indemnify the surety for all sums rightfully paid under the guarantee.

2. **Rights Against the Creditor:** Under Section 141, the surety is entitled to the benefit of every security which the creditor has against the principal debtor at the time when the contract of suretyship is entered into, whether the surety knows of the existence of such security or not. If the creditor loses, or without the consent of the surety, parts with such security, the surety is discharged to the extent of the value of the security.
3. **Rights Against Co-Sureties:** Where multiple persons stand as co-sureties for the same debt, Sections 146 and 147 mandate the **Doctrine of Contribution**. Co-sureties are liable to contribute equally to the extent of the default, irrespective of whether they are bound jointly or severally, under the same or different contracts, and with or without knowledge of each other. Where co-sureties are bound in different sums, they are bound to pay equally so far as the limits of their respective obligations permit.

Because the surety assumes an unremunerated contingent burden for another's obligation, equity treats the surety as a favored debtor, discharging him from liability upon any unauthorized alteration of the underlying contract. Sections 130 to 144 enumerate the exhaustive modes of discharge of a surety:

- **Revocation of Continuing Guarantee:** A continuing guarantee may be revoked at any time by the surety as to future transactions by notice to the creditor (Section 130), or automatically by the death of the surety as to future transactions, in the absence of a contract to the contrary (Section 131).
- **Variance in Terms of Contract (Section 133):** Any variance made without the surety's consent in the terms of the contract between the principal debtor and the creditor discharges the surety as to transactions subsequent to the variance, even if the alteration is beneficial to the surety.
- **Release or Discharge of Principal Debtor (Section 134):** The surety is discharged by any contract between the creditor and the principal debtor by which the debtor is released, or by any act or omission of the creditor the legal consequence of which is the discharge of the debtor.
- **Compounding or Giving Time to Debtor (Section 135):** A contract between the creditor and the principal debtor, by which the creditor makes a composition with, or promises to give time to, or not to sue, the principal debtor, discharges the surety unless the surety assents to such contract.
- **Act or Omission Impairing Surety's Eventual Remedy (Section 139):** If the creditor does any act which is inconsistent with the rights of the surety, or omits to do any act which his duty to the surety requires him to do, and the eventual remedy of the surety against the principal debtor is thereby impaired, the surety is completely discharged.
- **Invalidation of Guarantee (Sections 142–144):** Any guarantee obtained by means of misrepresentation made by the creditor, or with his knowledge and assent, concerning a material part of the transaction, or obtained by keeping silence as to material circumstances, is invalid.

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7. Comprehensive Structural Differences: Indemnity vs. Guarantee

The legal distinctions between contracts of indemnity and contracts of guarantee represent fundamental principles of commercial risk governance:

1. **Number of Parties:** A contract of indemnity involves exactly two parties: the indemnifier (promisor) and the indemnity holder (promisee). A contract of guarantee involves three parties: the principal debtor, the creditor, and the surety.
2. **Number of Contracts:** In an indemnity, there is only one original contract between the indemnifier and the indemnity holder. In a guarantee, there are three concurrent contracts: (a) between the principal debtor and creditor (the primary obligation); (b) between the surety and creditor (the guarantee); and (c) an implied contract between the principal debtor and surety (the indemnity).
3. **Nature and Maturity of Liability:** In an indemnity, the liability of the indemnifier is primary, original, and independent; it arises upon the occurrence of a contingent loss. In a guarantee, the liability of the surety is secondary, collateral, and accessory; it matures only upon the default of the principal debtor, whose liability is primary.
4. **Right to Sue Third Parties:** An indemnifier cannot sue third parties in his own name for the loss sustained; he must bring the action in the name of the indemnity holder unless an assignment has taken place. In a guarantee, the surety, upon discharging the debt of the principal debtor, is invested with the statutory Right of Subrogation (Section 140) and can sue the principal debtor directly in his own name.
5. **Request of Debtor:** An indemnifier undertakes liability independently, without any request from the person causing the loss. A surety enters into the guarantee specifically at the request (express or implied) of the principal debtor.

Bank Guarantees and Judicial Restraint

In modern corporate finance and cross-border commercial transactions, Bank Guarantees (including Performance Guarantees, Bid Bonds, and Financial Guarantees) serve as unconditional financial undertakings issued by commercial banks. Under settled commercial jurisprudence, a bank guarantee represents an independent autonomous contract between the issuing bank and the beneficiary, entirely independent of disputes arising under the underlying underlying contract between the seller and buyer.

In *Svenska Handelsbanken v. Indian Charge Chrome* (1994) 1 SCC 502 and *U.P. State Sugar Corporation v. Sumac International Ltd.* (1997) 1 SCC 568, the Supreme Court of India established that civil courts must exercise extreme restraint and should not grant injunctions restraining the encashment of unconditional bank guarantees, except in two rare and extraordinary circumstances:

- **Fraud of an Egregious Nature:** Where fraud in the obtaining or encashment of the bank guarantee is clear and established to the knowledge of the bank.
- **Irretrievable Harm and Injustice:** Where encashment of the guarantee would cause extraordinary, irreversible harm that cannot be compensated through subsequent damages or restitution.

8. Principles of Co-Suretyship and Mathematical Contribution Rules

When multiple sureties guarantee the same primary debt, Sections 146 and 147 of the Indian Contract Act regulate the precise equitable apportionment of liability among co-sureties.

Co-Sureties Bound for Equal Limits (Section 146)

Where two or more persons are co-sureties for the same debt or duty, either jointly or severally, and whether under the same or different contracts, and whether with or without the knowledge of each other, the co-sureties, in the absence of any contract to the contrary, are liable, as between themselves, to pay each an equal share of the whole debt, or of that part of it which remains unpaid by the principal debtor.

Co-Sureties Bound in Different Limits (Section 147)

Section 147 establishes that co-sureties who are bound in different sums are liable to pay equally as far as the limits of their respective obligations permit. The liability does not operate proportionately to their limits; rather, the loss is divided equally up to the maximum liability cap of each surety.

Worked Numerical Example of Co-Suretyship Contribution:
Assume sureties A, B, and C enter into three separate bonds as co-sureties for a loan borrowed by D, but each guarantees up to a different maximum limit:

- Surety A is bound up to a limit of Rs. 10,000.
- Surety B is bound up to a limit of Rs. 20,000.
- Surety C is bound up to a limit of Rs. 40,000.

Scenario 1: Principal Debtor D defaults to the extent of Rs. 30,000.
Under Section 147, the loss of Rs. 30,000 must be divided equally among the three sureties: Rs. 30,000 / 3 = Rs. 10,000 each. Since Rs. 10,000 does not exceed the limit of any surety (A's limit is Rs. 10,000; B's is Rs. 20,000; C's is Rs. 40,000), each surety contributes exactly Rs. 10,000.

Scenario 2: Principal Debtor D defaults to the extent of Rs. 40,000.
If divided equally, each would pay Rs. 13,333.33. However, A's limit is capped at Rs. 10,000. Therefore, A pays his maximum limit of Rs. 10,000. The remaining unpaid balance of Rs. 30,000 is divided equally between B and C: Rs. 30,000 / 2 = Rs. 15,000 each. Both B (limit Rs. 20,000) and C (limit Rs. 40,000) are fully capable of paying Rs. 15,000. Thus, A pays Rs. 10,000, B pays Rs. 15,000, and C pays Rs. 15,000.

Scenario 3: Principal Debtor D defaults to the extent of Rs. 70,000.
Since the default equals the aggregate limit of all sureties (Rs. 10,000 + Rs. 20,000 + Rs. 40,000 = Rs. 70,000), each surety pays their full respective limit: A pays Rs. 10,000, B pays Rs. 20,000, and C pays Rs. 40,000.

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9. Corporate Applications: Bank Guarantees, Indemnity Caps, and Risk Governance

In corporate procurement, major infrastructure projects, and transnational trade, corporate entities utilize bank guarantees to secure contractual performance. When an enterprise undertakes a substantial government tender or industrial turnkey contract, the employer mandates the submission of a Performance Bank Guarantee (PBG) issued by a scheduled commercial bank. Business managers must comprehend that bank guarantees operate as autonomous financial undertakings. Financial executives must carefully monitor validity periods, claim expiry dates, and performance milestones to prevent inadvertent default or sudden financial encashment.

When structuring corporate acquisitions, joint ventures, or vendor agreements, commercial negotiators employ indemnity covenants to allocate operational and historical risks. Unlike ordinary damage claims that require proof of foreseeability under Section 73, an indemnity clause entitles the protected party to full monetary restitution for specified liabilities, environmental claims, or historical tax assessments. Strategic management practices dictate negotiating clear monetary indemnity caps, survival duration limits, and explicit third-party defense procedures to maintain balanced contractual equilibrium.

Strategic Steps in Surety and Guarantee Risk Governance

Enterprises acting as corporate guarantors for subsidiary loans or business partners should implement proactive safeguards:

- **Formal Written Approvals:** Requiring explicit board resolutions and shareholder approvals under Section 186 of the Companies Act 2013 before extending corporate guarantees.
- **Monitoring Principal Debt Movements:** Regularly reviewing the borrower's debt servicing records to anticipate distress before default occurs.
- **Preserving Securities and Subrogation Rights:** Ensuring that the lending institution does not release collateral securities without guarantor consent, safeguarding the right of subrogation under Section 141.
- **Limitation Covenants:** Negotiating explicit financial ceilings and definitive termination timelines within the guarantee instrument.

10. Comparative Analysis: Tripartite Rights and Statutory Protections of Sureties

To provide a clear conceptual summary of the surety's multifaceted statutory protections, the following matrix contrasts the surety's rights across the three relational dimensions:

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Dimension	Statutory Basis	Core Legal Entitlement	Managerial Implication
Against Principal Debtor	Section 140 (Right of Subrogation) Section 145 (Right to Indemnity)	Step into the shoes of the creditor upon debt discharge; recover all sums rightfully paid plus interest.	The surety can initiate debt recovery suits against the borrower without requiring a formal assignment deed.
Against Creditor	Section 141 (Right to Securities) Section 133 (Consent for Variances)	Entitled to all securities held by the creditor; absolute discharge upon unauthorized contract alterations.	Lenders cannot renegotiate repayment terms or release borrower collateral without written guarantor consent.
Against Co-Sureties	Section 146 (Equal Contribution) Section 147 (Contribution in Limits)	Right to demand equal contribution from co-sureties up to their respective agreed liability ceilings.	Guarantors who pay more than their equitable share can enforce immediate recovery against fellow co-sureties.

Checklist for Extending Corporate Guarantees

Prior to executing corporate guarantee instruments, corporate boards and treasury officers must complete rigorous forensic due diligence:

- **Statutory Cap Verification:** Confirming compliance with Section 186 loan and guarantee limits under the Companies Act 2013.
- **Specific vs. Continuing Guarantee:** Explicitly defining whether the undertaking covers a single discrete transaction or continuous credit facilities.
- **Covenant of Variance Notification:** Stipulating that any extension of credit limits or repayment dates requires prior written guarantor consent.
- **Limitation on Time and Amount:** Inserting clear financial caps and sunset clauses to terminate contingent exposure upon facility maturity.

11. Contemporary Jurisprudence on Bank Guarantees and Injunction Standards

In modern corporate practice, invocation of performance bank guarantees is a frequent point of commercial friction between project principals and contractors. Commercial courts in India have repeatedly reaffirmed that an unconditional bank guarantee constitutes an independent contract between the issuing financial institution and the beneficiary. The issuing bank is legally bound to honor the demand without inquiring into any underlying disputes between the contractor and the project owner regarding project delay or alleged contractual breaches.

The two narrowly circumscribed exceptions to this principle—egregious fraud and irretrievable harm—are interpreted with exceptional judicial rigor. To obtain an injunction against encashment, the applicant must establish fraud of an egregious nature that permeates the very foundation of the

guarantee transaction, and demonstrate that honoring the guarantee would cause irreversible financial ruin that cannot be remedied through subsequent arbitral proceedings. Ordinary financial disputes or counterclaims regarding contractual penalties do not qualify as grounds for judicial interference, preserving the absolute commercial reliability of banking instruments in interstate and global commerce.

Corporate risk officers must therefore ensure that all bank guarantee obligations are backed by precise contract milestone definitions and verifiable completion certifications, preventing improper or premature calls while maintaining sound corporate liquidity.

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