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Analysis of Contract of Indemnity and Guarantee

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“Contract of Indemnity” and “Contract of Guarantee” are very important aspects in the “Indian Contract Act, 1872” that made commercial dealings much easier involving minimum risk. In this paper, a comparative analysis of the contract of indemnity and guarantee has been given concerning Sections 124, 125, 126, and 127. It focuses on the importance of indemnity whose main purpose is to save the promisee from all the losses or damage he suffered from the act of promisor or a third party and how the contract of guarantee enables the principal debtor to take a loan from the creditor, who lends the money on the guarantee that surety will repay the loan in case the principal debtor defaults. It highlights essential features of indemnity and guarantee which are required to legally validate a contract. Every aspect of the sections has been analyzed with the help of illustrations which are based on real-life examples along with the judicial interpretation of the landmark cases. Then it also emphasizes on what are the advantages of indemnity over the contract of guarantee by imposing a primary obligation on the promisor.

Keywords: *guarantee, contract, indemnity.*

INTRODUCTION

“Section 124”¹ of the Indian Contract Act, defines the term Contract of Indemnity. It says that “a contract, by which one party promises to save the other from loss caused to him either by the conduct of the promisor himself or by the conduct of a third person, is called a contract of indemnity.”² The word “indemnity” comes from the Latin word “indemnis” which stands for ‘free from a loss’.³ So indemnity acts as a protection against the damage suffered by a party as a consequence of the act. Contract of Indemnity is done between two parties. The two parties are⁴:

- *The person who gives the indemnity is called indemnifier;*
- *The person for whose protection it is given is called indemnity holder or indemnified. The Contract of Indemnity gives assurance to the indemnity holder that in case of any loss he suffers as a consequence of an act he will be protected by the indemnifier and will not have to bear the risk himself.*⁵

It will be clearer with the help of illustrations⁶:

Mr. “A” is a person who is hesitant in buying a plot and Mr. “B” is another person who encourages him to buy the plot and promises him that whatever loss he may suffer from the plot will be indemnified by Mr. B. This is a Contract of Indemnity where Mr. A is indemnity holder and Mr. B is indemnifier.

Mr. Amit is having a well-established sweet shop. Mr. Suman, asks Amit to collaborate his business with him and sell sweets made of brown sugar and if he suffers any losses because of changing the quality of sugar, Mr. Suman will indemnify Mr. Amit for all the losses he suffered from changing the quality of sugar. This is a contract of indemnity where Mr.Suman is the indemnifier and Mr. Amit is the indemnity holder who will be compensated for the loss.

¹ Indian Contract Act 1872, s 124

² *Ibid*

³ Juan Pablo Santopinto, ‘Knock-for-Knock Indemnities and their Application in Oil and Gas Contracts in Argentina’ (2014) 7(28) <<https://www.iiij.net/>> accessed 04 October 2021

⁴ *Ibid*

⁵ Avtar Singh, *Contract & Specific Relief* (12th edn, Eastern Book Company, Lucknow 2017) 593

⁶ *Ibid*

ESSENTIAL OF THE CONTRACT OF INDEMNITY

1. Only two parties are required in the formation of the Contract of Indemnity that is Indemnifier or promisor and indemnity –holder or promisee.⁷
2. The sole purpose of this contract is to protect the promisee from all the losses whatever he faces from the conduct of the promisor or third party.⁸
3. It can either be expressed that is oral or written as the case may be or can be implied depending upon the circumstances of the case.⁹
4. The essentials of a legitimate contract should be fulfilled.¹⁰

JUDICIAL PRONOUNCEMENT OF CONTRACT OF INDEMNITY UNDER ENGLISH LAW

The contract of indemnity is wider in scope under English statute in comparison to India, as the English law includes a promise of indemnity against all types of losses which arise from different causes such as loss caused by fire, by accident along with loss caused by humans¹¹. But Indian law¹² includes only those losses which arise from human agency.¹³ Under English law,¹⁴ the first case dealing with the contract of indemnity was *Adamson vs Jarvis*¹⁵ in which Adamson was the Plaintiff, who was the auctioneer. He put certain cattle on sale as per the directions of the defendant (Jarvis).¹⁶ After some time, it came to the notice that the livestock which was auctioned was not owned by the defendant rather it was owned by another person and that person sued the plaintiff. Then the defendant was sued by the plaintiff, for indemnification as he suffered the loss by following the instruction of the defendant.

⁷ *Ibid*

⁸ Indian Contract Act 1872, s 124

⁹ Wayne Courtney, 'Indemnities And The Indian Contract Act 1872' (2015) 27(1) JStor

¹⁰ *Ibid*

¹¹ Avtar Singh (n 5)

¹² *Ibid*

¹³ *Gajanan Moreswar Parelkar v Moreswar Mdan Mantri* AIR 1942 Bom 302

¹⁴ *Ibid*

¹⁵ *Adamson vs Jarvis* (1827) 4 Bing 66: 29 RR 503

¹⁶ *Ibid*

The Court stated that as the plaintiff followed the instruction of the defendant he was entitled to be indemnified by the defendant because the plaintiff suffers loss from the act of the defendant. Hence it can be inferred from this case that to claim the indemnity, the indemnity holder should act on the promise of the indemnifier. Also, there can either be expressed or implied contract which relies on the facts of the cases. For example in *Dugdale vs Lovering*¹⁷, the plaintiffs were having proprietorship of certain trucks which the defendant and K.P. Co. have made claims. Thereafter the defendant told the plaintiffs to deliver trucks and the plaintiffs agreed to deliver by demanding an indemnity bond, but the defendant did not give any response to it. However, the trucks have been delivered to the defendant. Then K.P. Co. has filed a case against plaintiffs for delivering the trucks to the defendant upon which they had made claims. Thus the court held that defendant was bound to indemnify the plaintiffs as there was an implied promise based on the fact that by demanding the bond of indemnity, the plaintiffs did not intend to deliver it except on indemnity.¹⁸ Considering the above facts and decisions, it can be concluded that even the implied promise can be enforced under an indemnity. This has widened the scope of indemnity.

JUDICIAL PRONOUNCEMENT OF CONTRACT OF INDEMNITY UNDER INDIAN LAW

In India, the first case dealing with the contract of indemnity is *Osman Jamal and Sons Ltd vs Gopal Purshotam*¹⁹. In this case, the defendant and the plaintiff had entered into a contract in which the plaintiff has to buy and sell the goods of the defendant upon which he gets the commission and the defendant give assurance to the plaintiffs that they will indemnify it from all the damages it suffers during the transaction.²⁰ However, when the goods were supplied, the defendant refused to accept delivery of the same due to which the supplier had to resell the goods at a price lower than the market price and ask the plaintiff to compensate him for the losses he has suffered. The plaintiff has become bankrupt and sued the defendant for

¹⁷ *Dugdale v Lovering* (1875) LR 10 CP 196: 44 LJ CP157: 32 LT155

¹⁸ *Ibid*

¹⁹ *Osman Jamal & Sons Ltd v Gopal Purshotam* AIR 1929 Cal 208, 118 Ind Cas 882

²⁰ *Ibid*

indemnity. But defendant contended as the plaintiff had not paid any amount to the supplier, they were not entitled to claim indemnity. Thus the court held in favor of Plaintiff Company and observed that “indemnity is not necessarily given by repayment after payment. Indemnity requires that the party to be indemnified shall never be call upon to pay”. And since the defendant has promised to indemnify him from the losses, he has to pay for the loss.

This section envisaged that indemnity can be expressed or implied. The instance of implied promise has been better explained in the rulings of *Privy Council in Secy of State for India in Council vs Bank of India Ltd*²¹. In this case, the plaintiff (Gangabai) has the endorsement of a promissory note for rs.5000 issued by the government. However, this promissory note was possessed by the broker, which was given by the lady to him and forged the endorsement in his favor and then gives it to the bank which accepted it in bona fide. The bank then applied to the Public Debt office to renew the promissory note in their name. The lady after being aware of fraud committed by the broker sued him for the conversion of her property. The state was then had to compensate the plaintiff who was the real owner and the court held that the state can recover the loss from the bank as there was the implied promise of indemnity.²²

Another milestone case was *Tropical Insurance Company Ltd vs Zenith Life Assurance Company Ltd*²³. In this case the promise given by the indemnifier to protect indemnified from the damage caused by indemnifier or third party act or if the loss caused by an event or accident it may arise from the conduct of a third party or promisor or may not be. So we will not include all kinds of accidents or events in the conduct of indemnity.²⁴

²¹ *Privy Council in Secy of State for India in Council v Bank of India Ltd* AIR 1938 PC 191

²² *Ibid*

²³ *Tropical Insurance Company Ltd v Zenith Life Assurance Company Ltd* AIR1941 Lahore 68

²⁴ *Ibid*

RIGHTS OF INDEMNITY HOLDER

Section 125 deals with the right of indemnity holder. *“It says that if the promisee in the contract of indemnity acts within the scope of his authority and on the direction of the promisor, is entitled to recover from the promisor-²⁵*

- *Damages - loss incurred by the indemnity holder which he was forced to pay in any suit because of conduct of promisor or third party.* For example, A is a stock trader who invests in share markets and makes huge profits. He encourages B to become his partner in the share market and he will share his profit and if he suffers any loss or damage A will indemnify him.
- *Costs - it is a kind of litigation charge that the indemnity holder was forced to pay in any suit.* For example, A has sold the cow in the direction of B who says that in case A suffers any loss B will indemnify him. Later on, it was found that the cow does not belong to B instead it is of C and now C has filed suit against A. So all the costs A has to bear in this suit will be paid by B.
- *Sums - It includes the entire amount which is given in terms of compromise unless it does not against the order of promisor.”²⁶*

ENFORCEABILITY OF CONTRACT OF INDEMNITY

Under the original English rule, it was laid down that the indemnity holder is entitled to indemnity only when he bears the actual loss after paying for the same. The maxim of law was: *“you must be indemnified before you can claim to be indemnified.”²⁷* However,²⁸ in due course of time, the Court Of Equity has reformed the law to give relaxation and in 1911 in the case of *“RE RICHARDSON, EX PARTE THE GOVERNORS OF ST THOMAS HOSPITAL CASE²⁹*, a norm has been established that indemnity holder can claim the indemnity before paying for

²⁵ Indian Contract Act 1872, s 125

²⁶ *Ibid*

²⁷ RK Bangia, *Law of Contract II With Indian Partnership Act And Sale Of Goods Act* (7th edn, Allahabad Law Agency, Faridabad 2017) 4

²⁸ *Ibid*

²⁹ *Re Richardson, Ex Parte The Governors Of St Thomas Hospital Case* [1911] 2 KB

the actual loss suffered as a contract of indemnity would serve the small purpose if indemnity holder has to pay the loss in the first instance."³⁰ Then in India, the Bombay High Court has applied the same principle in the case of *Gajanan Moreswar Parelkar vs Moreswar Madan Mantri*³¹. In this case, the court agreed with the previous rulings that the indemnity holder can claim the amount before the actual loss from the indemnifier. The reasoning given for this judgment was that if the liability was imposed on the indemnity holder in the first instance it might throw an intolerable burden on him and he may not have the capacity to pay for the loss.³²

CONTRACT OF GUARANTEE (SECTION 126 - 127)

SECTION 126 states that 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 his default the guarantee is given is called the principal debtor, and the person to whom the guarantee is given is called a creditor. A guarantee may be either oral or written*".³³

The main function of the contract of guarantee is to undertake the responsibility of paying the arrears of another person in case he defaults. It enables the principal debtor to take a loan from the creditor, who lends the money on the guarantee that surety will repay the loan in case the principal debtor defaults. So, it not only saves the defaulter from the vicious cycle of debt but also the creditor by saving it from loss of non-repayment of the loan. Unlike indemnity, it serves both parties.

Illustrations³⁴:

- A is a person who lends Rs. 4000 to B for six months at an interest of 8 p.c.p.a on the guarantee that C will pay the loan in case B defaults at the end of one year. This is a contract of guarantee.

³⁰ *Ibid*

³¹ *Gajanan Moreswar Parelkar v Moreswar Madan Mantri* AIR 1942 Bom 302

³² *Ibid*

³³ Indian Contract Act 1872, s 126

³⁴ *Ibid*

- A is a shopkeeper who sells and delivers goods to B on the credit upon the condition that if B fails to pay the price of goods at the end of the month C will undertake the responsibility for the payment of the price of goods.³⁵

ESSENTIAL FEATURES OF CONTRACT OF GUARANTEE

The contract may be oral or written: As per section 126,³⁶ a contract of guarantee may be either oral or written. However, under English law, the case is not the same as that of India. To have a valid contract of guarantee, it must be written and signed.³⁷

There should be principal debt: in the contract of guarantee,³⁸ there must be principal debt which is to be discharged by a principal debtor. The surety undertakes the liability when the principal debtor defaults on his obligations. Thus there must be the existence of liability to enforce the contract of guarantee.³⁹

The Benefit to the principal debtor is sufficient consideration: there must be some consideration between the creditor and surety to enforce the contract of guarantee. It is not necessary to have direct consideration between the surety and creditor. So any benefit received by the principal debtor is adequate to bind the surety.⁴⁰

Consent of the surety should not have been obtained by misrepresentation or concealment- any guarantee obtained by the means of misrepresentation or concealment of material fact by the creditor concerning the transaction will be void.⁴¹

SECTION 127

Consideration for guarantee - *"Anything done, or any promise made, for the benefit of the principal debtor, may be sufficient consideration to the surety for giving the guarantee."*⁴²

³⁵ *Ibid*

³⁶ *PJ Rajappan v Associate Industries (p) Ltd* (1990) 1 KLJ 77

³⁷ *Ibid*

³⁸ *Mountstephen v Lakeman* (1872) LR 7QB 196, 202

³⁹ *Ibid*

⁴⁰ Indian Contract Act 1872, s 127

⁴¹ *Ibid*, s 40&41

So, to validate the contract of guarantee, consideration is essential i.e. both the parties must give something and get something in return to bind the contract. And that consideration must be a lawful one

Illustrations⁴³:

1. A, who is a moneylender gives a loan of rs.2000 to M. C then requests A not to sue M for the debt for three months and promises that, if A will forbear to sue, C will guarantee the repayment of the loan if M defaults. A agrees to do so on request. It will be a consideration for C's promise.
2. A, who owns a bakery shop delivers cakes to B on the credit which is to be paid at the end of the month. C then guarantees to pay A the price of cakes if B defaults on the payment but without any consideration. This agreement will be void. Thus, when a loan is given by the creditor to the principal debtor on the guarantee given by surety it will be adequate consideration.

In *Ram Narain vs Lt. Col. Hari Singh's case*⁴⁴, it was held by the court that when there is a contract of guarantee among principal debtor, creditor, and surety without the lawful consideration, it will be void.⁴⁵

In the *State Bank of India vs Premco Saw Mill case*⁴⁶, the Bank issued a legal notice to the principal debtor which stated that they will sue her as she defaults on her payment of a loan. However, her husband becomes the surety and undertook the liability for repayment of the loan, and a promissory note is issued in the favor of the bank and thus bank did not principal debtor. It was held by the court that such forbearance would be sufficient consideration for giving a guarantee.⁴⁷

⁴² *Ibid*, s 21

⁴³ *Ibid*

⁴⁴ *Ram Narain v Lt Col Hari Singh case* AIR 1964 Rajasthan 76

⁴⁵ *Ibid*

⁴⁶ *State Bank of India v Premco Saw Mill case* AIR 1984 Gujarat 93

⁴⁷ *Ibid*

In *Ujjal Transport Agency vs Coal India Ltd case*⁴⁸, two parties enter into a contract to cut down the trees from forests and then take away their timber. To secure the payment for the acting bank has given a guarantee for the same. However, the forest officials did not permit removing forests timber. Thus, consideration there was no consideration between the parties of the contract. So, it can be concluded that whatever benefits received by the principal debtor from the creditor will be adequate consideration for the surety to give a guarantee. The surety only enters into contact so that the principal debtor could avail all the benefits without the risk of indebtedness and if there is no consideration for the same then why a surety will take liability.⁴⁹

DIFFERENCE BETWEEN CONTRACT OF GUARANTEE AND CONTRACT OF INDEMNITY

- Only two parties are required under indemnity i.e. indemnifier and indemnity holder. In guarantee mainly three parties are required i.e. creditor, principal debtor, and surety.⁵⁰
- Under indemnity,⁵¹ there is a single contract between indemnity holders and indemnifier. In guarantee, there are triple contracts, the first contract is between the principal debtor and the creditor for a loan, the second contract is between the creditor and the surety, and the third contract is between the principal debtor and surety.⁵²
- The liability of the promisor in case of indemnity is primary. While in guarantee the liability is secondary.⁵³
- In a contract of indemnity, the loss occurred due to the default of the promisor or third party. In a contract of indemnity, the default is done by the principal debtor.⁵⁴
- Under indemnity, the liability is conditional i.e. it may or may not be any liability. Under guarantee, the liability starts once the contract is entered between parties.⁵⁵

⁴⁸ *Ujjal Transport Agency v Coal India Ltd case* (2011) 1 SCC 117

⁴⁹ *Ibid*

⁵⁰ Avtar Singh (n 5) 669

⁵¹ *Ibid*

⁵² *Ibid*

⁵³ See Cheshire and Fitfoot, *Law of Contract* (9th edn, Furmston 1976) 181

⁵⁴ *Ibid*

WHAT ARE THE ADVANTAGES OF INDEMNITY OVER GUARANTEE?

Indemnities confer more advantages over beneficiaries of the contract:

1. An indemnity confers a primary obligation on the promisor to the promisee i.e. if the promisee suffers from any loss that will be indemnified by the promisor in the first instance.⁵⁶ However, in the case of guarantee, there is a secondary obligation. This means that the primary contract is between the principal debtor and the creditor. So, the liability to act on the terms of the contract will be primarily on the principal debtor not on surety.⁵⁷

For example, Company A is the manufacturer of battery-electric vehicles who contracts with Company B, which is the seller of batteries. Company A wants company B to comply with the terms and conditions of environmental law, as non-compliance could hamper the reputation of Company A in the market.⁵⁸ Thus, to protect the business of company A, company B indemnifies Company A against all the losses including damage to the image and penalties imposed by the agencies on violation of environmental law by Company B. If in near future the contract becomes void, the indemnity remains enforceable as per its terms. However, a guarantee would fail as soon as the contract becomes void, and company A has to pay for the losses if company B infringed the environmental law.⁵⁹

Unlike a guarantee, an indemnity does not have to be in writing and signed to be valid.⁶⁰ The surety is released from his liability if there is any variation in terms of the original contract in the absence of surety's consent, the surety will be discharged from the liability.⁶¹ In the case, *M.S Anirudhan vs Thomcos Bank Ltd*,⁶² the surety has given a guarantee of rs. 25000 but the bank

⁵⁵ *Unity Finance Ltd v Woodcock* (1963) 1 WLR 455 (CA)

⁵⁶ *Ibid*

⁵⁷ 'Advantages of indemnity over guarantee' (*Lawbite*, 17 October 2019) <<http://www.lawbite.co.uk>> accessed 9 October 2021

⁵⁸ *Ibid*

⁵⁹ *Ibid*

⁶⁰ 'Definitions & Conditions of Guarantee' (*Britannica*, 13 April 2018) <<https://www.britannica.com/>> accessed 10 October 2021

⁶¹ *Ibid*

⁶² *MS Anirudhan v Thomcos Bank Ltd* AIR 1963 SC 746

has reduced the liability to 20,000. The court said that the variance is unsustainable and will not discharge the liability of surety. In a contract of guarantee, the liability of the surety is similar to the liability of the principal debtor. For example, if the principal debtor owes a debt of Rs. 1 lakh to the creditor, then surety is also accountable only for that amount. But in the case of indemnity, seeing the example of a manufacturer of electric battery vehicles, an indemnity covers all the loss from reputational damage to regulatory penalties.⁶³

CONCLUSION

Contract of indemnity is that type of contract where the promisor (i.e. the indemnifier) promises to protect the promisee (i.e. the indemnified) from all the damage caused to him either by the act of the promisor or by the act of the third person. It is very helpful in any contractual deals as it indemnifies the promisee against the loss even if the contract is void and thus reduces their risk. It can be inferred from both Indian and English law that the contract of indemnity can be narrow and broad at the same time. The definition of indemnity is wider under English law as it includes all the losses apart from the human agency but under Indian law, the definition is narrower in comparison. Similarly, the contract of guarantee is a special contract whose main purpose is to protect the creditor from loss by undertaking the guarantee of paying the debt of the principal debtor in case he fails to pay it. To enforce the contract of guarantee, it must be supported by lawful consideration between creditor and surety. An indemnity comes into the picture when any loss emerges from the act of the promisor or third party, while a guarantee emerges when the principal debtor defaults in the payment. Various grounds have been discussed above in which both the contract of indemnity and guarantee differ from each other. However, both the contracts are important, the former protects a party from loss, and the latter aid the person to secure a loan or to take goods before the payment without any risk of indebtedness.

⁶³ *Ibid*