Liability of Guarantors and Possible Strategies for Mitigation of Liability

If you have questions or would like additional information on the material covered herein, please contact:

Ms. Seema Jhingan, Partner

(sjhingan@lexcounsel.in)

Ms. Parul Parmar, Associate

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Large unpaid debts and continuing defaults by borrowers require the banks and financial institutions to initiate proceedings for recovery of dues against the principal borrowers as well as the guarantors under various legislations and forums, including the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 for enforcement of security against the guarantors and under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 before the Debt Recovery Tribunals for recovery of debt against the guarantors. The Insolvency and Bankruptcy Code, which came into force on December 1, 2016, as a consolidated legislation to deal with insolvent and bankrupt persons, both natural and artificial, is also assisting the financial institutions to initiate corporate debt resolution process against guarantors.

The concept of guarantee is governed by the Indian Contract Act, 1882 ("**ICA**"), where under the contract of guarantee puts an obligation on a surety to honour the promise of principal debtor by paying the principal debtor's present or future debt, provided to him by a creditor in case of default by the principal debtor. The liability of a guarantor is co-extensive with the liability of the principal debtor and can be invoked without exhausting the remedies against the principal debtor, unless otherwise provided in the contract (of guarantee), i.e. certain exceptions could be created at the time of execution of the contract of guarantee vis-a-vis the obligations of the guarantor. However, limited rights have been provided to the guarantor that may assist him in discharging him from his liabilities in his

(pparmar@lexcounsel.in)

Ms. Swet Shikha,Associate

(sshikha@lexcounsel.in)

LexCounsel, Law Offices C-10, Gulmohar Park New Delhi 110 049, INDIA.
Tel.:+91.11.4166.2861
Fax:+91.11.4166.2862

capacity as a guarantor/surety.

Even the RBI's circular dated September 9, 2014 issued with reference to the Master Circular on Wilful Defaulters DBOD.No.CID.BC.3/20.16.003/2014-15 dated July 1, 2014, clarified that when a payment default is made by the principal debtor, the bank is entitled to proceed against the guarantor/surety even without exhausting the remedies against the principal debtor. In case the said guarantor refuses to comply with the demand made by the creditor/bank, despite having sufficient means to make payment of the dues, such guarantor would also be treated as a *'wilful defaulter'*.

In nutshell, the liability of guarantor is well established and co-extensive with that of the debtor.

Possible Defences Available to Guarantors:

Even though the possible defences available to a guarantor against his liability under the contract of guarantee are limited, the guarantor can take certain defences against his liability in certain cases as discussed below.

A. **By Variance in terms of the Contract:**

Section 133 of the ICA postulates that any variance, made without surety's consent, in terms of the contract between the principal debtor and the creditor, discharges surety as to transactions subsequent to the variance. Thus, in case the guarantor successfully establishes that there have been subsequent variations to the contract of guarantee to which the guarantor was not privy to or had no knowledge of, the guarantor can be excused from performing his obligations under law for all the subsequent transactions post the variance.

The Hon'ble Bombay High Court in the matter of *Keshavlal Hari Lal Setalvad and Ors vs Pratapsingh Moholalbhai Sheth and Ors [ILR1932 56 Bom 101]* elaborated the principles of variation of contract and discharge of the surety and confirmed that if there is a substantial alteration, even if there be no actual prejudice to the surety which can be shown to exist, the surety will be discharged.

B. **Discharge of Guarantor by Release of Principal Debtor:**

Section 134 of the ICA provides that the guarantor shall stand discharged from its liabilities under a contract of guarantee in case of any agreement arrived at between the creditor and the principal debtor, by which the principal debtor is released. Such release of principal debtor could be owing to any act or omission of the creditor, the legal consequence of which is the discharge of the principal debtor. Simply put, if the principal debtor is discharged of his liability to the creditor, the guarantor also stands discharged.

C. **Release of Debtor by Creditor:**

In terms of Section 135 of the ICA, if without the consent of the surety, the creditor and debtor enter into a contract, whereby the creditor agrees to make composition/compromise with or gives time to or agrees not to sue the surety, in such a case, guarantor being the surety stands discharged by law to fulfil his obligations under the contract of guarantee unless the surety assents such contract. The Hon'ble Rajasthan High Court in the matter of *Ramswaroop And Anr. vs State Bank of Bikaner & Jaipur [2002 (3) WLN 430]* held that:

"It is true that in each and every case of compromise surety cannot claim discharge of the liability under the surety bond but when the creditor accepted that the decree be passed against all the defendants and this decree is to be satisfied by defendant No. 1 and when the creditor himself agrees to accept entire decretal amount from only the borrower defendant, then it amounts to voluntarily entering into new contract by the creditor with the debtor. This new compromise (agreement), by necessary implication, discharges the guarantor."

D. **<u>Remedy of Surety impaired by the act or omission of the Creditor</u>:**

Where the creditor either does something, which is inconsistent with the rights of the surety or omits to do his duty towards the surety and because of this, the eventual remedy of the surety that he had against the principal debtor is impaired, the surety/guarantor is discharged from his liability towards the creditor in accordance with section 139 of the ICA.

In the case of *Jose Inacio Lourence vs Syndicate Bank and Another [1989 65 Comp Cas 698 Bom]*, the Hon'ble Bombay High Court held that *"failure in not registering the charge is also an act which is inconsistent with the rights of surety within the meaning of Section 139, ICA and the eventual remedy which the surety may have against the principal debtor is impaired resulting in discharge of the surety*."

E. **<u>Guarantee obtained by Misrepresentation</u>:**

In case where a guarantee has been obtained by means of misrepresentation made by the creditor, or with his knowledge and consent, concerning a material part of the transaction, such a guarantee is invalid. In terms of Section 142 of ICA, any guarantee which has been obtained by means of misrepresentation made by the creditor, or with his knowledge and assent, concerning a material part of the transaction, is invalid.

F. **<u>Guarantee obtained by concealment</u>:**

One additional ground that can be taken by the guarantor is that the guarantee was obtained by the creditor by means of keeping silence as to certain material circumstances and in such circumstances the guarantee can be challenged as invalid.

In the matter of *Krishan Kumar vs. Syndicate bank & Ors. (RFA No. 1/1997 decided on Februray 19, 2009)* before the Hon'ble Delhi High Court, it was argued that the guarantor did not give any guarantee and had not signed any document undertaking to pay any money to the bank in the event of defendant no. 1 (principal borrower) failed to repay the same and the guarantor contended forgery by the bank manager. The Hon'ble Delhi High Court held that the finding of the trial court in holding the guarantor liable as much as the principal borrower was erroneous in light of the fact that the plaintiff bank had miserably failed to prove the authenticity of the guarantee forming the subject matter of the case.

While the liability of the guarantors is co-extensive with the liability of the principal debtor and can be invoked without exhausting the remedies against the principal debtor, the guarantors can assess if any of the above discussed defences are available or applicable to them in light of their specific facts and circumstances in the ongoing proceedings.

Feedback