

5. Indemnity and Guarantee

5.1 Meaning and Definition

To indemnify means to compensate or to make good of the loss and a contract of indemnity means a promise or statement of liability to pay compensation for a loss or for a wrong in a transaction. It is known also bearing the anticipated loss by the party. *Indemnity is a security or protection against a contingent hurt, damage or loss.* According to section 22 of NCA, 2056, "Where any person has concluded a contract relating to indemnity with the provision to pay to any party to a contract or a third person for any loss or damage that may result from his actions, while working under the direction of that party to that contract, he may realize as compensation."

According to ICA, 1872 section 124, "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."

Features of contract of Indemnity:

- It is a special contract as well as the general
- It has also necessary to be the all essential elements of valid contract.
- It is a contingent contract.
- All matter depends on the agreement of the contract.
- A contract of indemnity is a security for an anticipated loss.
- It covers the concerned party as well as the third party.
- It may be made expressly or impliedly.
- It covers only the loss caused by an event mentioned in the agreement of contract.
- It covers only the actual loss.
- It has two parties.

5.2 Right and Duties of Indemnity Holder

The person who promises to make good for contingent damages is called the Indemnity holder. The indemnity holder is entitled to recover any or all of the amounts of compensation under the contract of indemnity.

5.2.1 The rights of Indemnity holder are as follows:

- To recover entire indemnity amount prescribed in the agreement of contract.
- To claim all damages compelled to pay to a third party for loss
- To claim all costs spent in relating to indemnity.
- To claim all the costs of legal actions.

But, except otherwise is mentioned in the contract, the indemnifier will not be liable for the loss in the following circumstances, which are called also the duties of indemnity holder:

- Not to work negligently.
- Work without the intention of causing any loss or damage.
- Not to work against the instruction of the promisor or indemnifier.
- Work in according with agreement of contract.

5.3 Rights and Duties of Indemnifier

Rights of an indemnity holder are the duties of an indemnifier. He must pay all damages, all costs and all sum of money is according to an agreement of contract of Indemnity. Similarly, Duties of indemnity holder are the rights of indemnifier.

Rights of indemnifier

There are not prescribed any specific rights of indemnifier either in Nepalese law or in Indian law.

- (1) If indemnity holder acts negligently.
- (2) If indemnity holder is acting with the intention of causing any loss or damage.
- (3) If he is acting against the instruction of the other party (promisor).

Duties of indemnifier

The duties of an indemnifier arise in the following circumstances.

- (1) There must be a loss in accordance with the contract to make the indemnifier liable.
- (2) There must be an occurrence of the anticipated events.

- (3) Where the right of indemnity is used by the indemnity holder prudently and the instruction of the indemnifier is not contravened or when there is no breach of contract.
- (4) If the costs demanded by the indemnifier are not caused by negligence, haphazard behavior.

5.4 Contract on Guarantee

A "Guarantee" means a contract of a promise to be responsible for something, to perform the promise or to discharge the liability of a third person, in case of his default. In other words, guarantee means a promise to answer debt, default or miscarriage of another. Such a contract involves three parties.

- a. Creditor: The person, to whom the guarantee is given, is called the creditor.
- b. Surety: The person, who gives the guarantee, is called the surety.
- c. Principal Debtor: The person, in respect of whose default is given the guarantee, is called the principal debtor.

A contract relating to guarantee shall be deemed to have been concluded if it provides that, if any person defaults in the repayment of the loan obtained by him or fulfillment of the obligation accepted by him, it will be repaid of fulfilled by a third person. [Sec. 15(1) of NCA 2056]

A contract of guarantee is a contract to perform the promise to discharge the liability of a third person in case of his default. [Sec. 126 of ICA 1872]

On the basis of definitions given above, it can be said that a contract of a guarantee is that contract by which one party promises to discharge the liability or to repay the loan on behalf of the third party if the third party is unable to repay the loan or to discharge the liability promised by him. Example, If 'A' advances a loan of Rs. 5,000/- to 'B' and 'C' promises to 'A' that if 'B' does not repay the loan, 'C' will pay. Here, this is a contract of guarantee.

In Mahabir Shumsher vs. Loyds Bank, the court held that 'A contract of guarantee is a tripartite Agreement which contemplates the principal debtor, the creditor and the surety.¹

5.4.1 Features of Contract of Guarantee

1.1.1 A tripartite (tri-party) contract:

Under the contract of guarantee, there must be the three parties. Principal Debtor, Surety and Creditor are party of contract of guarantee. There should be three different agreements between three parties.

- No direct Consideration between Surety and Creditor:
- Primary liability lies upon the principal debtor and surety seems to be secondary or conditional liability.
- Competency of parties is must essential along with other essential elements of a valid contract.

¹ Mahabir Shumsher vs. Loyds Bank

- Liability of Surety arises after the defaults of the principle debtor.
- It must be concluded in written form.
- Consent all of three parties is essential.
- The contract of guarantee may be express or implied etc.

Besides that, being special types of contract, it must satisfy all the essential elements of valid contract such as offer and acceptance, lawful objective, consideration, free consent, contractual capacity etc.

5.5 Types of Guarantee

5.5.1 Types of Guarantee are as below:

1.1.2 a. Absolute and Conditional Guarantee:

Unconditionally a promise to pay the debt, on the default of the principal debtor, is called absolute guarantee but, if some contingency arises there is a conditional guarantee.

1.1.3 b. General and Special Guarantee:

The guarantee that can be accepted by general people is called general guarantee and accepted by a particular person is called the special guarantee.

1.1.4 c. Limited and unlimited Guarantee:

If there is limitation of time and amount under an agreement is called the limited guarantee, whereas there is not any limitation of time and amount is called the unlimited guarantee.

1.1.5 d. Prospective and Retrospective Guarantee:

Guarantee is given for future transaction is called prospective guarantee and Guarantee is given for past or existing actions is called retrospective guarantee.

1.1.6 e. Specific and Continuing Guarantee:

Guarantee is extended to a single transaction or debt is called a specific guarantee and if a guarantee extends to a series of transactions continuously is called a continuing guarantee.

- **Features of continuing guarantee:**
 - Continuing Guarantee is not ended by the first advance.
 - It is always be revoked by a notice to the creditor.
 - A revocation of continuing Guarantee is possible for future transactions.

- Death of the surety terminates the contract.
- **Revocation of the continuing guarantee:**
 - A Surety may revoke a continuing guarantee at any time by a notice.
 - The death of the surety automatically terminates the contract of guarantee. But except otherwise agreed, the liability of the surety for the previous transactions is not discharged.
 - By the variation in the terms of the contract without the consent of surety.
 - By novation of the contract.
 - By discharge of the principal debtors.
 - By loss of security

5.5.2 Rights and Liability of Surety:

1.1.7 5.5.2.1 Rights of Surety:

a. Rights against the creditor:

- Rights to demand security with creditor.
- Right to claim set-off. Set-off means to counter a claim. If the creditor lost or loss the security the surety can make a counter claim.
- Right of subrogation: It means right to substitution. After the payment of all the guaranteed debt to the creditor, Surety substitutes the status of creditor.
- Right to claim Equities: On the full payment of guaranteed debt, the security is entitled to all equities. (With natural increment and claim)

b. Rights of a surety against the Principal debtor: After the payment of the guaranteed debt, the surety stands against the principal debtor. So, there are some rights for surety against the principal debtor established by law which is as below:

- **Right to be relieved from liability:** Surety may compel to principal debtor to pay the loan and get rid of him from the liability.
- **Right to claim indemnity:** Surety has the right to claim of the legal expenses, eg. loan, interest, cost of suits, etc.
- **Right to subrogation:** Subrogation means to be placed on the seat of the creditor. Such a right of surety can be exercised on the full payment of the guaranteed debt.

c. Rights against co-sureties: If there are more people become the sureties under a single agreement of contract or single transaction of loan all are responsible to pay the loan respectively. Except otherwise, there is different terms and conditions under the agreement, liability of co-sureties is equal. If they bound for different-different sum, they are compelled to pay their respective liabilities. In case one co-surety paid entire liability but other co-sureties do not make payment or fails to pay their respective liability in this situation aggrieved co-surety has the right to sue against the other co-sureties to recover his paid amount.

d. Rights to recover the actual amount paid: Surety has the right to recover the entire payment from the principal debtor. He can recover only the amount actually paid by him but not equal to the guarantee in case surety did not pay total sum of guarantee.

1.1.8 5.5.2.2 Liabilities of Surety

a. Liability co-extensive as the principal debtor: The surety's liabilities is same as that the principal debtor. Hence, in the absence of a contract to the contrary, liability of the surety is co-extensive with or similar to that of the principal debtor and he remains responsible until the principal debtor becomes free from his liability.

b. Secondary liability of surety: Firstly, the principal debtor must be paid his all liability by himself. Where the principal debtor performs his duty by himself nothing remains any liability of surety. If principal debtor does not perform his liability, then after, liability of surety will begin. So, it can be said that surety's liability is secondary.

c. Contingent nature of liability: The contract of guarantee seems conditional or contingent nature of contract. After the failure of principal debtor, the obligations of surety will begin. So, it depends on the future uncertain or collateral event.

d. Limited nature of liability: It limits the liability of the surety.

e. Liability of primary nature:

- If the principal debtor is the minor at that time surety will be liable as the primary nature.
- The principal debtor becomes insolvent.
- Operation of law occurs death, insolvent/ insanity principal debtor can discharge form the liabilities but not surety. But all most depends on the agreement of the contract.

1.1.9 5.5.2.3 Discharge of Surety from the liabilities

- a. By performance
- b. Revocation of Surety
 - By notice
 - Death
 - Novation (Renewal)
- c. Discharge by variation in terms
- d. By discharge of principal debtor

- e. By release of principal debtor
- f. By compromise of creditor and principal debtor
- g. By loss of security
- h. By the discharge of one of the surety
- i. By damaging surety's rights.
- j. By expiry the time etc.

5.5.2.4 Differences between Indemnity and Guarantee

Base of distinction	Indemnity	Guarantee
Purpose	To save indemnifier from loss	To provide necessary security to the creditor.
Numbers of parties	Two parties	Three parties
Number of Contract	One agreement of contract	Three agreement of contract
Nature of liability	Primary liability is of the indemnifier. It arises immediately after loss from the collateral event.	Secondary liability is of the surety and it arises only on the default of the principal debtor.
Consideration	It has consideration.	It has not direct consideration to surety.
Commencement of liability	The liability of indemnifier arises after the happening of the collateral event.	The liability of the surety arises on the defaults of the principal debtor.
Discharge from liabilities	The indemnifier discharges after paying indemnity to the indemnity holder.	The surety discharges when the creditor discharge or he fulfils the debtors' liability.
Nature of contract	It has contingent nature.	It has general nature
Right to reimbursement	The indemnifier has no right of reimbursement of the amount paid to the indemnity holder.	The surety has the right of reimbursement of the amount from the principal debtor, which is paid to the

		creditor.
Number of promisor	Indemnifier is only one promisor	Principal debtor and Surety both are promisor.
Scope	It has limited scope.	It has boarder scope.

1.1.10 Short Answer Questions

1. When does the liability of a surety under a contract of guarantee come to end? Illustrate and explain. [10]
2055
2. Distinguish between a contract of guarantee and a contract of indemnity. [10]
2056
3. Define contract of indemnity. Explain the rights of the indemnity-holder. [4+6]
2057
4. Explain the rights of indemnity holder. [10]
2058
5. Explain continuing guarantee with suitable illustrations. [10]
2059
6. Who is surety? State and explain the circumstances under which surety is discharged. [4+6]
2060
7. Distinguish between promissory note and bills of exchange. [10]
2060
8. When is a surety discharged from his liability under a contract of guarantee? [10]
2061
9. What is a contract of guarantee? When is the surety discharged from his liability? [3+7]
2062
10. Explain the rights and duties of surety under the contract of guarantee. [3+7]
2063
11. What is a contract of indemnity? Describe the rights and duties of indemnifies and indemnity holder. [3+7]
2064

12. State and explain the conditions under which a surety is discharged. [10]
2065
13. Define a contract of indemnity. Explain the rights and duties of indemnifier. [3+7]
2066
14. Define contract of guarantee? Show the difference between a contract of indemnity and a contract of guarantee. [3+7]
2067
15. Who is a surety? Explain the rights and duties of surety under a contract of guarantee. [3+7]
2068

