ENFORCEABILITY OF A GUARANTEE ON THE WINDING UP OF A GUARANTOR-COMPANY

*Swethaa Ballakrishnen**

There is no challenge to the clear legal position that the obligations of the guarantor in a contract of guarantee crystallise only when there has been a breach by the principal debtor. However, this clarity faces serious threat when extended to a case where a company is the guarantor and there is no breach by the principal debtor at the time of winding up of the surety.

In such a situation, is there a subsisting right to proceed against the guarantor? Is the enforcement of a guarantee subject to breach by the principal debtor at the time of the guarantor's winding up? Or can the surety be proceeded against, irrespective of the conduct of the principal debtor?

This paper envisages a situation where the guarantor-company is being wound up, and traces the rights and liabilities of the creditor that can be triggered by virtue of such winding up. It also seeks to look at situations that might arise in case the winding up occurs before and after the breach of the obligation or debt.

I. Contracts of Guarantee and Guarantors' Liability

A surety or a guarantor is one, who in consideration of some act or promise on the part of the creditor, undertakes to perform the promise or to discharge the liability of a third party in the event of a default. The liability of a guarantor presupposes the existence of a separate liability of the principal debtor, and is thus only secondary to that of the principal debtor.[1]

Liability, for the purposes of a contract of guarantee, may cover debts both present and future.[2] However, it is well-settled law that the guarantor may not be liable under

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[1] *Lima Leitao & Co v. Union of India,* AIR 1968 Goa 29.

[2] *EP George v. Bank of India,* AIR 2001 Ker 107.

the terms of the guarantee, if the creditor has not called upon the principal debtor to pay the amount or perform his promise. Thus, the liability of the guarantor commences only when the principal debtor defaults,[3] and it is only at this stage that the creditor can choose to proceed against the surety.[4]

The liability of the guarantor is discharged in cases where the principal debtor is himself discharged[5] or in cases where there has been a material variance in the terms and conditions of the initial contract of guarantee.[6]

Contract law does not provide for the voluntary revocation of the liabilities of the surety. A logical extension of this principle is that, the guarantor cannot choose to discharge himself of the obligations under the contract, unless such a discharge was triggered by the action of the principal debtor (by way of variance, payment, etc). Such voluntary discharge would amount to fundamental breach of the contract.

The only event, in which the guarantor is discharged from the terms of the contract of guarantee without any action on the part of the principal debtor, is in the case of continuing guarantees when the guarantor gives a notice of revocation or, upon his death.[7] When a continuing relationship is constructed on the faith of a guarantee, the guarantor's heirs may, by notice of his death, revoke the guarantee as regards future transactions.[8] As revocations on the guarantors' own account is restricted to the case

[3] *Moschi v. Lep Air Services,* [1973] AC 331; *General Produce Company v. United Bank Ltd,* [1979] 2 Lloyds Rep 255.

[4] The creditor can choose to proceed against the surety without proceeding against the principal debtor, except in cases where the contract of guarantee provides to the contrary. If such a demand or request is made under the terms of the contract, such demand should be a necessary ingredient of the creditors' cause of action against the guarantor. See *Re J Brown's Estate, Brown v. Brown,* [1893] 2 Ch. 300, *MS Fashions Ltd. v. Bank of Credit ans Commerce Intl. SA (in liquidation),* [1993] 2 All ER 769.

[5] Section 128 of The Indian Contract Act, 1872, entails that the liability of the surety is co-extensive with the liability of the principal debtor. Thus unless it can be shown that the contract is one of indemnity, the validity of the sureties' liabilities rests on the validity of the principal debtors' liability.

[6] *M S Anirudhan v. Thomco's Bank Ltd.,* [1963] I Supp SCR 63, AIR 1963 SC 746.

[7] Section 131 of the Indian Contract Act, 1872.

[8] *Courthart v. Clementson,* (1879) 5 QBD 42. However, in cases where the guarantor could not discharge his liability by giving notice, then his death does not relieve the estate from liability. See also *Lloyds v. Harper,* (1880) 16 Ch. D 290.

of continuing guarantees, this cannot be reasonably extended to apply by analogy to the instant situation.

II. Enforceability of a Guarantee in the Case of a Guarantor's Winding Up

Before addressing the issue of enforceability of guarantee where the guarantor is being wound up, it is important to recognise that there are two possible situations that may be envisaged whilst determining the validity of such enforcement. The first is a case where there is a breach committed by the principal debtor before the winding up proceedings against the guarantor are initiated. The second is when there is no breach by the principal debtor and the winding up proceedings are initiated against the guarantor.

Cases where the breach precedes winding up

In cases where there is a breach by the principal debtor and subsequently the guarantor is being wound up, the enforcement is relatively straightforward. It is, by now, an accepted position in contract law that the liability of the guarantor is dependant on the principal debtor. In other words, the enforcement of the guarantee is contingent on the existence of the liability of the principal debtor at the time of enforcement of the guarantee.

Thus, if there is a breach by the principal debtor at any point in time before the guarantor is wound up, the guarantor is instantly liable and the creditor will be recognised as the guarantor's creditor in the winding up proceedings. However, in cases where the guarantor is a Sick Industrial Unit that is being wound up, the creditor cannot proceed against the Company without the consent of the National Company Law Tribunal (NCLT).[9]

[9] Section 424G of The Companies Act, 1956. See also *Patheja Brothers Forgings and Stamping v. ICICI Ltd.*, 2000 CLC 1492 (SC).

Cases where the winding up precedes the breach

The law is virtually silent in cases where the principal debtor has not committed any breach at the point in time when the guarantor is being wound up. It is envisaged that the contract of guarantee has no specifications regarding the possible breach winding up of the guarantor[10] and whether in such an instance the creditor will have a remedy against the guarantor.

In winding up proceedings, there is no liability that gives the lender the right to implead himself into the proceedings. If there is nothing that triggers the liability against the principal debtor, following the already established reasoning that the liability of the guarantor is co-extensive and contingent with the liability of the principal debtor; it follows that the creditor has no right to proceed against the guarantor.

The concerns of the Court in *Bank of Bihar v. Damodar Prasad*,[11] regarding the object of the guarantee seem to be relevant in this case. If such winding up proceedings allowed the guarantor an embargo against the enforcement of a contract of guarantee, the point of the guarantee, which is to allow for a safety net for the creditor in the case of breach by the principal debtor, will be lost.

Further, there is a duty upon the surety to pay the decretal amount and on such payment, he is immediately subrogated to the rights of the creditor.[12] Thus, there is really no loss to the guarantor while making a provision for the creditors, as his right to be indemnified protects him. However, in a situation where the creditor is not allowed to proceed against the guarantor, the purpose of a contract of guarantee is lost.

Having laid down the legal propositions that might govern a fact situation similar to the instant case, there arises the question as to the enforcement of such guarantee and

[10] It is important to note that most contracts of guarantee or loan agreements usually provide for this eventuality by way of 'events of default' and the 'potential events of default' clauses. These clauses almost always target the eventuality of the guarantor's winding up. There is little jurisprudence regarding the enforceability of a guarantee when the guarantor is being wound up, because in most cases the contract provides for proposed breaches and the guarantor is bound by the limitations of the contract.

[11] AIR 1969 SC 297.

[12] Section 145 of The Indian Contract Act, 1872 lays down an implied promise to indemnify the guarantor. Thus, proceeding against the guarantor entails that there will be a corresponding right of the guarantor to proceed against the principal debtor.

the remedies that the creditor might be allowed in such cases. The question that has to be addressed in such a case, is whether a creditor can ask the receiver dealing with the guarantors' winding up to make a provision for him to provide for the eventuality of a breach at a future date.

III. Claim for a Future Eventuality in a Petition for Winding Up

It is the object of winding up to realize the assets and to distribute the surplus among the shareholders and the creditors.[13] The Companies Act, 1956 provides that any person having a claim against a Company - present or future, certain or contingent - must be able to prove such a claim.[14] Thus, all claims against the Company, both present and future shall be admissible in proof against the Company. Although a mere possibility of a future earning will not, in itself, be a contingent debt that can be proved,[15] it is enough if it can be proved that there was an agreement transacted between the parties.[16]

The only requirement whilst making a future claim is that the winding up proceedings must be carried out with reasonable expediency. Claims must be made before all the accounts are written, and once the accounts have been written up, the Official liquidator shall have the right to reject such a claim on the ground of laches.[17]

In the case of a guarantor being wound up, there is a contract of guarantee in existence and any future claim that is made is contingent on this contract. Thus, the creditor's claim will be one that is within the ambit of this provision.

In the event the guarantor is an insolvent company, the aforesaid Act provides that the insolvency rules in place will govern such winding up.[18] The Presidency Towns Insolvency Act, 1909 provides for liquidated damages that arise from a breach of

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[13] AM Chakraborty, "Taxmanns Company Law", Vol.2, 1332 (1994).

[14] Section 528 of The Companies Act, 1956.

[15] *Newman (RS) Ltd., In re Raphel's Claim*, [1916] 2 Ch. 309.

[16] *Pure Milk Supply Co. v. Hari Singh*, [1963] 33 Com Cases 459 (Punj).

[17] *Bherumal Lal Chand v. Official Liquidator*, [1947] 17 Com Cases 166 (Sind).

[18] Section 529 of The Companies Act, 1956 deals with the application of insolvency rules in the winding up of insolvent companies.

trust.[19] These damages - both present and future[20] - will be deemed to be debts provable in insolvency proceedings.[21] Thus, a debt arising out of indemnity will be a provable debt and such claim will be allowed.[22]

In the instant case, there is an apprehension of breach in trust by the principal debtor. As the liability of the guarantor is co-extensive with that of the principal debtor, there is an apprehended breach of trust by the guarantor. Such breach of trust giving rise to damages is one that may well be argued to fall within the definition of a provable debt; and thus, a provision for the creditor may be made while finalising the accounts of the guarantor.

Thus, as per a strict interpretation of the provision and the derived case law, it is reasonable to conclude that a claim for a future amount can be made in a case where there is a contract to substantiate it and the claim is made before the final accounts are written up.[23]

It is important to note, at this stage, that the above enunciation covers a situation wherein the creditor is seeking to make a claim for a future eventuality *during* the course of the winding up proceedings. Thus, it is a case where although the breach has not yet happened, the creditor is seeking to make a provision for the eventuality. However, if the creditor wishes to enforce a guarantee *after* the guarantor is wound up, the above-mentioned remedies will not be available to him, and he would have to use the contractual remedies of breach and repudiation.

IV. Conclusions

Noting the scarcity of jurisprudence on the subject, it is apparent that there is no absolute authority on the law of enforcement of guarantees when a guarantor is being wound up. From the reading of the general law of guarantee and winding up, it is

[19] Section 46(1) of The Presidency Towns Insolvency Act, 1909.

[20] Section 529(1)(b) of The Companies Act, 1956 read with Section 46(3) of The Presidency Towns Insolvency Act, 1909 provides for the valuation of future and contingent liabilities to be observed in accordance with the laws of insolvency prevalent and in force at the time being.

[21] Section 46(3) of The Presidency Towns Insolvency Act, 1909.

[22] AIR 1936 Mad 793.

[23] supra n. 20.

deduced with a fair degree of clarity that the enforcement of such a guarantee is contingent.

The enforcement of a guarantee by a creditor is determined by two exclusive conditions- first, the principal debtors' breach and second, the ability to prove the future debt arising out of the contract of guarantee, before the guarantor is wound up.

In conclusion, and summarizing the above elaborated propositions, the following fictitious case situations could well cover the law of enforcement of a guarantee when the guarantor is being wound up:

- In a case where the principal debtor commits a *breach before the initiation of winding up proceedings*, the breach is co-extensive with the liability of the guarantor, and the creditor can choose to proceed against the guarantor. The same will also be a provable debt to be recovered during the winding up procedure;
- If the *guarantor is a sick unit*, the approval of the NCLT is required before proceeding against the guarantor;
- In a case where the *principal debtor has not committed a breach before the initiation of winding up proceedings*, the creditor can choose to file a claim for a future eventuality under Section 528 of The Companies Act, 1956 before the guarantors' accounts are finalized. If the Official Liquidator is satisfied with the probability of this eventuality, the guarantee may be enforced;
- In a case where the *guarantor company is insolvent*, the rules of the insolvency legislation operate and eventuality of a claim for the eventuality of a future debt must be made in accordance with the rules therein;
- In a case where the *creditor does not claim for the eventuality of future damages, and the guarantor company is wound up, and subsequently, a breach is committed by the principal debtor*, the only possible remedy that might be left with the creditor is the contractual remedy of breach and repudiation.

REFERENCES

1. AM Chakraborty, "Taxmanns Company Law", Vol.2, 1332 (1994).