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DISSERTATION

TOPIC

THE RIGHTS AND LIABILITIES OF THE SURETY IN A CONTRACT OF GUARANTEE UNDER CONTRACTS ACT 1950 AND COMMON LAW

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A. Comparison.

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Bibliography.

ADDENDA

1. At p. 19- line 12, add the word 'not' *after the phrase* 'the court will'.

2. At p. 61- line 1, add the phrase 'the Contracts Act 1950' *after section 29.*

3. At p. 89- line 14, add the word 'that' *between the words* 'in' *and* 'the'.

CHAPTER ONE.

NATURE OF GUARANTEE.

Introduction

Although guarantee is arguably the most commonly used form of security in the commercial world today[1] much remains to be understood as to its application and legal aspects. Even though the parties may be aware of the purpose of a contract of guarantee, particular knowledge as to the rights and liabilities arising from a contract of guarantee remain obscure. Before such rights and liabilities can be expounded, it is material that the nature of a guarantee be properly understood. This chapter deals with the origin, definition and nature of contract of guarantee under the Contracts Act 1950.

Early on, before the contract of guarantee gained its modern function, suretyship was well-known and practised, more frequently in its primitive form[2]. In Egypt, it was used to secure repayments of debts and the performance of a

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[1]Law Kee Yang, The Law of Guarantee in Singapore & Malaysia, Malaysia: Butterworths, 1992, at 24.

[2]WD Morgan, "The History and Economics of Suretyship" (1927) 12 Corn.L.Q. 153, cited in Phillips & O'Donovan, The Modern Contract of Guarantee , Perth: The Law Book Co. Ltd., 1992, at 3.

contract or obligation by means of hostages[3]. In Anglo-Saxon England it was used to enforce criminal law and maintain the peace, also by means of hostages[4]. Further, in that era, every person who wishes to enter into a business or commercial transaction is required to produce a surety[5]. The requirement of furnishing the sureties was part of the substantive law. The sureties were bound primarily to the creditor and the debtor gave the security to the creditor who handed it to the surety as the sign and proof of his primary liability[6].

The growth of commerce enlarged the scope of guarantee as a mean of securing repayments of debts[7]. It became widely and primarily used in business transaction, e.g., securing contractual obligations, by governments to promote sporting bodies, to foster the growth of small businesses or to assist industrial dispute[8], in international trade[9] in the form of tender bonds, performance guarantee and repayment guarantees[10] and even by trustees[11]. Its usage is thus widespread and numerous.

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[3]T.Hewitson, Suretyship: Its Origin and History in Outline (1927) cited in Phillips & O'Donovan, op.cit., at 4.
[4]Ibid.
[5]Phillips & O'Donocvan, op. cit., at 5.
[6]W.Holdsworth, A History of English Law , London: Sweet & Maxwell, 1927, at 83.
[7]Phillips & O'Donovan, op.cit., at 6.
[8]R.Baxt (ed.), "Commercial Law Note" (1979) A.L.J. 224.
[9]The ICC (International Chamber of Commerce) Uniform Rules for Contract Guarantees (1978).
[10]Phillips & O'Donovan, op.cit ,at 16.

A. Definition of Contract of Guarantee.

Technically, a guarantee is an undertaking that a debt shall be paid[12]. It also means an accessory[13] contract whereby one party undertakes to be answerable for a debt, default or miscarriage of another who is primarily liable to a third party[14]. Such an accessory contract is also called a collateral or conditional contract in contrast to original or absolute contract[15].

The Contracts Act 1950 - Revised 1974, which is in pari materia with section 126 of the Indian Contract Act 1872, defines guarantee as:

> "a contract to perform a promise, or discharge the liability, of a third person in case of his default."

The primary concept of suretyship is that it is an undertaking to be liable to the debtor in case the person guaranteed does not perform his obligations[16].

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[11]Guarantees are taken by paid trustees who are usually corporations or companies to guarantee the performance of their duties as trustee. In this context, individual trustees rarely, if ever, are required or need to take any guarantee.

[12]Campbell v. McIsaac (1873) 9 N.S.R 287 (C.A)(Can.)

[13]i.e. Collateral whereby the principal debtor exists or be contemplaed at the time of the contract.

[14]Carlsberg Brewery MalaysiaSdn. Bhd. v. Soon Eng Haw & Sons and Ors. [1989] 1 MLJ 104 at 105.

[15]VG. Ramachandran, The Law of Contract in India , 2nd. ed., Lucknow: Eastern Book Co., 1983, Vol.2 at 1893.

[16]Ibid. at 185.

A suretyship arises from a personal engagement or promise to pay another's debt[17], although it can also be constituted by a charge of property to secure such debt[18]. The person making the promise to be answerable for the debt or who gives the guarantee is the surety. The person in whose favour the contract is entered into or on whose behalf the promise is made is the principal debtor. The creditor is the person to whom the promise is made or the guarantee is given.

In Malaysia, the term used is 'surety'[19], although the two terms, i.e. 'surety' and 'guarantee' can and may be used interchangeably.[20] However, in the United States, different usage is given to the two different words and this is distinguished by statutes[21].

A contract of guarantee may be oral or in writing[22]. The wording, however, must be definite enough to indicate the debtor, the existing liability of the debtor, the creditor and the surety (who will undertake to be liable for the

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[17]Law Kee Yang, op.cit., at 25.
[18]Re Conley [1938] 2 All.E.R 127; Jagjavindas v. King Hamihon (1931) A.I.R Bombay 337 at 339.
[19]Sec. 79.
[20]Law Kee Yang, op. cit., at 24; section 79 of the Contracts Act 1950 refers to the person who gives the guarantee as 'surety' but refers to the contract as 'guarantee'.
[21]Phillips & O'Donovan, op. cit., at 8; Law Kee Yang, supra., n. 20.
[22]Sec. 79.

liability in case the principal debtor defaults in payment) and the consideration[23]. This consideration may pass from the creditor to the surety or between the creditor and the principal debtor[24].

Consideration is an important element of the contract of guarantee particularly so in Malaysia where all contracts must be supported by consideration[25]. The need for consideration is set out in section 26 of the Contracts Act 1950 and section 80, specifically for contracts of guarantee. The consideration may be "anything done or promise made for the benefit of the principal debtor."[26]This means that there must be a benefit to the principal debtor and any benefit to the surety is immaterial. If there is no consideration as stated above, there can be no contract of guarantee[27]. In illustration (a) of section 80, the consideration is A's promise to deliver the goods to B on credit. In illustration (b) of section 80, the consideration is A's forbearance from suing B for the debt of goods delivered to B. The forbearance is for a year. However, in illustration (c) A sells and deliver goods to B. Later, C agrees to be the surety on this agreement. As

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[23]VG. Ramachandran, op.cit., at 1906.
[24]Id., at 1896.
[25]Sec. 26; this section also provides certain exceptional circumstances where a consideration is not necessary to effect a contract.
[26]In pari materia with sec. 127 of the Indian Contract Act 1870.
[27]VG. Ramachandran, op.cit., at 1907.

the guarantee is given when the contract between A and B is concluded, there is no consideration and the contract is void.

It is worth noting that as guarantee is basically a contract , it is also governed by the ordinary rules of contract law. Section 80 postulates that anything done or promise made for the benefit of the debtor is good consideration. This section appears to lend weight to the view that certain past acts may amount to good consideration in contracts of guarantee[28].

This was not the view of the court in Perbadanan Kemajuan Negeri Selangor v. Public Bank Berhad[29] where Azmi J. held that:

> "[A] valid contract of guarantee can only exist if there is something done by the creditor for the benefit of the principal debtor. The benefit must be given either at the time of execution of the guarantee or in the future but not a past benefit."

The court here relied solely on section 80 and held that there must be benefit to the principal debtor and that past benefit is not good consideration. The

[28]Visu Sinnadurai, The Law of Contract in Malaysia & Singapore: Cases and Commentary, 2nd.ed., Singapore: Butterworths, 1987, at 132.
[29][1980] 1 MLJ 172(HC); [1980] 1 MLJ 214 (FC).

court, however, had failed to consider section 2(d) of the Contracts Act 1950. Section 2(d) states that:

> "when, at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing, or promises to do or abstain from doing, something, such act or abstinence or promise is called consideration for the promise."

This definition makes it obvious that certain past acts may be good consideration. Past consideration is good consideration if the act was originally done at the request of the promisor and it was subsequent to the doing of the act that the promise was made. Thus, section 80 should have been read with section 2(d) and past benefit under section 80 would only be valid in relation to section 2(d). It has been suggested that due to this, there was no need to search for the benefit to the principal debtor in order to ascertain the existence of consideration[30]. So long as the consideration exists at the desire of the promisor, the contract is good. Furthermore, there was no requirement that the consideration must move to the principal debtor. Following section 2(d), the consideration may move to the promisor, i.e., the surety. This is also supported by the wording of section 80 itself which says that anything done for the benefit of the debtor is good

[30]Law Kee Yang, op. cit., at 57.

consideration. The section does not state that the consideration must move to the principal debtor.

B. Collateral Liability.

The essential characteristics of a guarantee is that liability of the surety is collateral to that of the principal debtor[31]. The foundation of this collateral liability is the liability of the principal debtor which existed or be contemplated at the time of the contract[32]. The principal debtor's liability is called the primary liability. As the liability of the surety is secondary or collateral to that of the principal debtor, the primary liability must be enforceable at law and if no such liability exist, there can be no contract of guarantee. Consequently, a valid guarantee depends upon the existence of a promise made to a person to whom the debtor is already answerable or is to be answerable[33]. Being collateral, the surety's liability is contingent upon the default of the principal debtor[34]. If the principal debtor is discharged, the surety is also discharged.

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[31]DGM Marks & GS Moss, Rowlatt on the Law of Principal and Surety, 4th.ed., London: Sweet & Maxwell, 1982, at 2.
[32]Law Kee Yang, op.cit., at 25.
[33]VG. Ramachandran, op.cit., at 1898.
[34]Harburg India Rubber Comb Co. v. Martin [1902] 1 K.B 778.

The principle of collateral liability is stated in section 81 as being "co-extensive with that of the principal debtor, unless otherwise provided by the contract". The term co-extensive means that in terms of quantum and circumstances of liability, the surety's liability is the same as the principal debtor's and no less[35]. However, cases in Malaysia has not proceeded on this matter of quantum and scope of liability vide section 81 but through the rules of construction of the contract of guarantee[36]. This may be due to the law as stated in section 81 itself to the effect that the instrument of guarantee itself is primary.

In Oriental Bank of Malaya Ltd. v. N. Subramaniam[37], the court looked at the instrument of guarantee and construed the promise made between the principal debtor and the creditor, also the guarantee itself to arrive at a conclusion that the surety's liability as a guarantor is only up to the amount which the principal debtor had accrued on his overdraft. Therefore, the quantum or scope of a surety's liability is equal to that of the principal debtor and is decided by construing the contract of guarantee[38]. In Carlsberg Brewery Malaysia Sdn. Bhd. v. Soon Beng Aw & Sons Sdn. Bhd. & Ors.[39] the court stated that in some cases, the liability of

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[35]Phillips & O'Donovan, op.cit., at 9.
[36]Id., at 10.
[37](1958) 24 MLJ 35.
[38]Chew Soon Tat v. Malaysian National Insurance [1977] 1 MLJ 241.
[39][1989] 1 MLJ 104.

the surety has been held to be primary and co-extensive with that of the principal debtor, depending upon the intention of the parties which is to be collected from the language and words of the guarantee. Thus, the liability of the surety, although essentially collateral to the principal debtor's liability , can be made primary by the terms of the contract of guarantee and as this is the overriding provision in section 81, the court has, more often than not, construed the contract of guarantee to find the quantum and scope of the surety's liability.The court in Singapore has also arrived at the same conclusion that the liability of the guarantors to pay the loan is in the same manner as it is payable by the principal debtor, through construing the instrument of guarantee[40]. However, the circumstances of liability of a surety is often decided by relying on section 81 and the rule as stated in it that the surety's liability is co-extensive with the of the principal debtor. In Government of Malaysia v. Gucharan Singh,[41] the issue was the liability of an infant under a scholarship contract whereby the court stated expressly that a contract entered by an infant is void. The agreement was guaranteed by two sureties. The relevant point in this case is the liability of the surety where the court held:

> "as the second and third defendants were sureties, their liability was co-extensive with that of the principal

[40]The position in Singapore is different since contracts are governed by the common law.
[41][1971] 1 MLJ 211.

debtor, and as the principal debtor was not liable, the sureties were also not liable."

There are cases where the court has upheld the overriding position of section 81 as to the contract of guarantee itself being the primary instrument to ascertain the liability of the surety. In the situation, the position that the surety's liability is collateral is made ineffective by the provision of section 81 , i.e. the liability of the surety is co-extensive with that of the principal debtor unless it is otherwise provided by the contract.

In Sykt. Perumahan Pegawai Kerajaan Sdn. Bhd. v. Bank Bumiputera Malaysia Bhd.[42], the issue was on the construction of a performance bond. The surety had refused to honour the guarantee of the due performance of a building contract between the contractor and the plaintiff. Judgment was given against the defendant who appealed on the ground that the plaintiff had to prove the default of the contractor. The counsel for the defendant submitted that there are two types of performance bonds i.e. a conditional performance bond where the surety only becomes liable upon proof of default of the performer and the second being an on-demand performance bond, the guarantee in question falls under the first type whereby proof of breach is required.

[42][1991] 2 MLJ 565.

The court held that the reference should be made to section 81 and its effect was:

> "[to] reduce the efficacy of the provision that the liability of the surety is co-extensive with that of the principal debtor in cases where a surety has executed an agreement of guarantee or indemnity with the person indemnified indicating that the surety would pay subject only to the terms of the said agreement."

Reliance should be made to Indian cases rather than English cases, said the court. Upon construing the contract, the court held that as the contract of guarantee made the surety's liability dependent on a claim by the plaintiff and as such a claim was made, the surety was liable to honour the terms of the guarantee.

In the above case, the court had specifically stated its reliance on section 81. However, cases in the past had been decided to the same effect but the basis of the decision being the construction of the guarantee instrument.

In Kwong Yik Bank Bhd. v. Transbuilders Sdn. Bhd.[43], the guarantors refused to honour their guarantee based on the contention that there was no proper demand made. The learned Shankar J. stated that from the construction of the guarantee the liability of the surety is a "primary and parallel obligation". In MBF Finance v. Hasmat[44], the term used to override the collateral liability of the surety is the provision " the surety guarantees as principal debtor and not merely as debtor". The effect of that decision is that the liability of the surety is primary upon the default of the principal. This was against the principle of collateral liability but as the instrument had so provided, the court readily upheld the document[45].

All these cases show that the court had given recognition to the primary importance of the contract of guarantee to ascertain the extent of a surety's liability either through section 81 or through the rules of construction. However, the first thing that should be done is to, ascertain the liability of the principal, because in its absence, the surety can never be held liable. It follows, therefore, that if the

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[43][1989] 2 MLJ 301.
[44][1990] 1 MLJ 180.
[45]See Public Bank Bhd. v. Chan Siok Lee & Ors. [1989] 2 MLJ 305.; Orangkaya v. Kwong Yik Bank [1989] 3 MLJ 155; Malaysian buildiing Society v. Lim [1989] 3 MLJ 175.

contract is void, voidable, illegal or unenforceable, it stays the same for the surety[46].

1. Exception to the rule: Minor's contract.

The principle has been fettered in case of contracts by minors. Generally, a minor is not competent to enter into a contract[47]. If he enters into a contract, the contract is void and unenforceable against him. Unlike the common law which provides that a minor's contract may be valid for necessaries, the Contracts Act 1950 has no definition of necessaries. Therefore, a minor has no capacity to enter into a contract even if it was made for necessaries. However, reimbursement can be claimed on the basis of section 69.

In Government of Malaysia v. Gucharan Singh[48], the court held that the minor's contract is void and as the liability of the surety is co-extensive with the principal's, the surety is held not to be liable. However, the court held that the liability of the minor existed by virtue of section 69 to reimburse the goods supplied. As a result of this, the sureties were held liable to reimburse the goods

[46]Law Kee Yang, op.cit. at 34.
[47]Sec. 10 and 11; see Mohori Bibee v. Dhurmodas Ghouse (1903) 30 I.A 114.
[48](1971) 1 MLJ 211.

supplied. The decision has been criticised[49] on the fact that liability of the principal debtor in this case is statutory and not contractual. Therefore, as the contract of guarantee did not provide for the statutory liability of the surety, the surety should not have been held liable. However, several authors [50]have stated that the principal obligation need not be contractual in nature. The judge in Gucharan's case had also used the term quasi-contractual obligation to signify the liability of the infant. Furthermore, section 81 did not state that the liability of a surety should be contractual. If reliance can be placed on these contentions, then the surety can be held liable to reimburse the goods supplied.

After this case was decided, the Contracts (Amendment) Act 1976 was passed to cater specially to scholarships agreement entered by minors with the appropriate authorities. The appropriate authorities are the Federal government, States Government, any statutory authorities or an approved educational institution gazetted by the Public Gazette[51]. Thus, the Act 1976 provides that scholarship agreements entered into by minors is valid[52]. It also states the liability of a surety which is jointly and severally with the principal debtor.

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[49]Law Kee Yang, op.cit., at 36.
[50]Phillips & O'Donovan, op cit., at 9;
[51] Contracts (Amendment) Act 1976, sec. 5.
[52]Ibid., sec. 4.