The Difference Between a Guarantee and an Indemnity

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Introduction

Proverbs 11:15 reads:

> He is in a bad way who becomes surety for another, but he who hates giving pledges is safe.

Despite this early warning the law of guarantee as part of the law of contract has developed and maintained an important commercial status as a form of security.

Because New Zealand, together with the rest of the Western World, has a credit based economy, the law relating to creditors is extremely important. One of its most important developments has been the use of guarantees and indemnities by creditors attempting to pierce the corporate veil in order to reduce risk of non-payment and to ensure personal commitment from the directors of a fictitious company personality. New Zealand has experienced a significant increase in litigation in this area.

The undertaking of liability for a debt of a third person is a well developed and complex area of contract law. One significant yet often misunderstood distinction is that between guarantees and indemnities. This confusion was highlighted in *Nathan Finance Ltd v Martin Simmons Air Conditioning Services Ltd*:[1]

1 High Court, Auckland, 17 December 1986 (A 1019/85). Wylie J.

> [the confusion] is not to be wondered at. I suspect that not only are there many responsible senior executives of finance companies who are not aware of the distinction, but also that there are many lawyers to whom such a distinction is somewhat of a mystery.

In its broadest meaning an indemnity is an undertaking to perform an obligation or pay a debt of another, and therefore encompasses all contracts of guarantee and many contracts of insurance. For the purposes of this article it is therefore necessary to define indemnity more narrowly. The term "contract of indemnity" will be used to denote an independent promise by a third party to indemnify a creditor against any loss that may be suffered in the course of a transaction with a principal debtor. Primary liability is assumed by the indemnifier by way of security given for the performance of an obligation or the payment of a debt. The liability is therefore wholly independent of any obligation of the principal debtor.

"Contract of guarantee" will refer to the obligation of a third party either to ensure that the principal debtor performs his obligations or to repay the debt herself. The liability of the guarantor may therefore be described as *secondary* as it will arise only upon the default of the principal debtor on his *primary* obligation to the creditor:[2]

> In every case of guaranty there are at least two obligations, a primary and a secondary. The secondary – the guaranty – is based upon the primary, and is enforceable only if the primary default.

The obligation assumed by the guarantor is to answer for the default of another.[3]

"Surety" will be used as a general term to cover both guarantors and indemnifiers.

Both a contract of guarantee and a contract of indemnity must be valid contracts: there must be offer and acceptance, intention to create legal relations, and good consideration. There is, however, a difference in the obligation undertaken:[4]

> An indemnity is a contract by one party to keep the other harmless against loss, but a contract of guarantee is a contract to answer for the debt, default or miscarriage of another who is to be primarily liable to the promise.[5]

There are no hard and fast rules for determining whether a contract is an indemnity or a guarantee. In each case the courts will look at the specific terms of the agreement and in some cases the surrounding circumstances. Thus the central concern is construction, and the courts will base their decision on the *substance* of the agreement as opposed to its *form* or *description*. The fact that a document is described as either a "guarantee" or an "indemnity" is taken as a guide by the courts, but is by no means conclu-

2 *Western Dominion Investment Co Ltd v Macmillan* [1925] 2 DLR 442, 444 per Dysart J.
3 Ibid.
4 *Yeoman Credit Ltd v Latter* [1961] 1 WLR 828, 831 per Holroyd Pearce LJ.
5 Ibid.

sive. Each case is a question of fact.

Factors

Cases in this area point to several broad principles which the courts will consider when determining classification.

Ultimate Object

A document will be construed by the courts in accordance with what is seen to be the "ultimate object"[6] of the agreement. The intention of the parties will be central to interpretation. Therefore, in commercial agreements, for example, the courts will have regard to such factors as how the parties intended to regulate their dealings by way of the agreement, and the commercial benefits arising out of the agreement.

In *Direct Acceptance Finance Ltd v Cumberland Furnishing Pty Ltd*[7] construction was held to be the key to interpretation. Although the ultimate object of the document must govern its interpretation, "[i]t is the method by which that object is attained which decides the class to which the document belongs".[8]

Terms of the Agreement

The court must start by looking at the terms of the agreement. A guarantor's liability is generally taken to be co-extensive with that of the principal debtor, and therefore if the principal debtor defaults on his primary obligation to the creditor, the creditor may recover from the guarantor whatever sum she could have recovered from the principal debtor.[9] The liability of a guarantor must not be different in kind or extent from that of the principal debtor. If it is potentially greater then the contract will be one of indemnity.

The courts must therefore ascertain whether the document was intended to be a mere contract of guarantee by asking what is the extent of the protection that the creditor has been promised by the surety. The courts will consider some of the following factors.

THE EXTENT OF THE PROMISE

What did the surety undertake to pay? For a guarantee there must generally be no liability imposed upon the guarantor by the agreement other than the promise for the debt due from the principal debtor.[10] A contract will

6 Ibid.
7 [1965] NSWR 1504, 1507 per Walsh J.
8 *Yeoman Credit Ltd v Latter*, supra at note 4, at 831 per Holroyd Pearce LJ.
9 *Direct Acceptance Finance v Cumberland Furnishing*, supra at note 7, at 1510.
10 *Coady v J Lewis & Sons Ltd* [1951] 3 DLR 845.

therefore not be a guarantee if the obligation assumed by the surety is not just the money due at the time of the default of the principal debtor, but is the amount that would have become payable if the transaction had run its full course, or the sum required to completely protect the creditor from any loss.[11] In such cases the contract will be an indemnity as the liability of the surety is potentially greater than that of the principal debtor.

WHEN THE SURETY UNDERTAKES TO BECOME LIABLE

Under a contract of guarantee the assumption of secondary liability is an undertaking to become liable upon the default of the principal debtor. The guarantor's obligation is thereby dependent on the default of the principal debtor.[12] Under a contract of indemnity, however, a primary liability falls upon the indemnifier and liability will arise according to the terms of the agreement. A distinction can clearly be drawn between:[13]

> a promise to pay the creditor if the principal debtor makes default in payment, and a promise to keep a person who has entered, or is about to enter, into a contract of liability indemnified against that liability, independently of the question of whether a third person makes default or not.

The agreement will be a contract of indemnity if, for example:

1. the creditor is able to recover a loss on a transaction from the surety even though the principal debtor is not guilty of default;[14]
2. the agreement provides that the surety's liability arises only in the event that the creditor makes a loss on the totality of the principal transaction or a profit less than she should have made. In this situation the surety does not undertake to become liable upon the default of the principal debtor and hence there is no obligation to make good particular defaults. In addition the creditor has no recourse to the surety upon any particular default of the principal debtor. The validity of the surety's promise is independent of the principal debtor's promise; or
3. the agreement provides that the liability of the surety will arise at the request or upon notice from the creditor.[15] An agreement may provide that in the event that the principal transaction becomes unsatisfactory the creditor may demand payment from the surety. Such liability is not dependent upon any default of the principal debtor and must therefore be an indemnity.

11 See *Direct Acceptance Finance v Cumberland Furnishing*, supra at note 7; *Yeoman Credit Ltd v Latter*, supra at note 4; *Cameo Motors Ltd v Portland Holdings Ltd* [1965] NZLR 109.

12 *Unity Finance Ltd v Woodcock* [1963] 1 WLR 455.

13 *Guild & Co v Conrad* [1894] 2 QB 885, 896; affirmed by Davey J in *Harburg India Rubber Combs Co v Martin* [1902] 1 KB 778, 785.

14 *Yeoman Credit Ltd v Latter*, supra at note 4, at 832-833.

15 *Direct Assurance Finance v Cumberland Furnishing*, supra at note 7; *Cameo Motors Ltd v Portland Holdings Ltd*, supra at note 11.

RIGHTS OF SUBROGATION

Upon payment by the surety of the principal debt he is legally entitled to the full rights of subrogation, thereby stepping into the creditor's shoes.[16] This equitable principle was stated in *Craythorne v Swinburne*:[17]

> a surety will be entitled to every remedy, which the creditor has against the principal debtor; to enforce every security and all means of payment; to stand in the place of the creditor; not only through the medium of contract, but even by means of securities, entered into without the knowledge of the surety; having a right to have those securities transferred to him; ... [t]his right of a surety ... stands, not upon contract, but upon a principle of natural justice.

This principle generally applies to both guarantees and indemnities. But if the agreement contains a clause entitling the surety only to such rights as the creditor under his discretion assigns to her upon her payment of the principal debt (as in *Yeoman Credit v Latter*) then the agreement must be an indemnity. A guarantor is by law entitled to full rights of subrogation. An agreement which purports to give completely different rights to the creditor and the surety (upon payment of the principal debt) can therefore only be an indemnity.

CLAUSES RETAINING THE GUARANTOR'S LIABILITY

A guarantee is an accessory or collateral contract based upon the existence of a primary obligation. This secondary obligation relies wholly upon the continuation of the primary obligation in its original form. Therefore any change in the principal agreement without the consent of the guarantor will release her from liability. An indemnity on the other hand is a primary obligation, and thus any changes in the principal transaction between the debtor and creditor will have no effect upon the liability of the indemnifier.

If the agreement contains a clause providing that the surety is to remain liable in the event of a variation in the principal contract (for example, if the creditor grants an extension of time to the principal debtor), it is almost certain to be interpreted as a guarantee; such a provision would be redundant in an indemnity.[18]

Inconsistencies

In some cases different clauses of an agreement will appear to be inconsistent: for example, when what appears to be a contract of guarantee contains a clause purporting to make the guarantor liable as a principal debtor.[19] Such provisions are common in guarantees and are often used to

16 *Western Dominion Inv Co Ltd v MacMillan*, supra at note 2, at 444.

17 (1807) 14 Ves 160, 162; 33 ER 482, 483 per Sir Samuel Romelly.

18 *Western Dominion Inv Co Ltd v Macmillan*, supra at note 2; *Argo Caribbean Group Ltd v Lewis* [1976] 2 Lloyd's Rep 289.

19 *Heald v O'Connor* [1971] 1 WLR 497; *General Produce Co v United Bank Ltd* [1979] 2 Lloyd's Rep 255.

avoid the consequences of variation of the principal transaction. Clauses cannot convert what is in essence a contract of guarantee into a contract of indemnity.[20] The courts will look to the overriding intention of the agreement,[21] and if the circumstances and the intention dominating the agreement are indicative of a guarantee then this must control the interpretation. In *General Produce Co v United Bank*[22] a clause was construed as making the surety liable as a principal debtor only in certain circumstances. The surety was liable as a guarantor at the outset of the document, but became liable as a principal debtor on the release of the original principal debtor's liability.[23] This interpretation by the Court reconciled the apparent inconsistency in the document before them.

There is no conflict between this case and cases where the court has found that such a clause does not convert what is in essence a contract of guarantee into a contract of indemnity: the court will attempt in each case to give effect to the intention of the parties.

Surrounding Circumstances

The courts may look to the surrounding circumstances to determine the intentions of the parties. This has most commonly occurred in cases where all parties knew that the principal transaction might not be enforceable.[24] If the contract is a guarantee the unenforceability of the principal transaction will generally relieve the guarantor from liability. However, in such situations the courts are more likely to find that the contract is an indemnity[25] in order to avoid a situation where the:[26]

> three parties [the creditor, principal, and surety] . . . enter into an arrangement under which money was to be advanced on [a contract] on which no-one was liable at all, there being no-one liable as principal and therefore no-one liable as surety.

Why the Distinction is Important

It is submitted that the real importance of the distinction is the special rights of the parties to a contract of guarantee, in contrast with the conditional but standard two party relationship in a contract of indemnity. The distinctiveness of the guarantee contract is apparent in three main areas:

1. The statutory requirement that a contract of guarantee be in writing;

20 *Heald v O'Connor*, ibid.
21 *Brown Bros Motor Lease Canada Ltd v Ganapathi* (1982) 139 DLR 227.
22 Supra at note 19.
23 See also *Unity Finance Ltd v Woodcock*, supra at note 12.
24 For example, the invalidity of a contract with an infant before s 10 of the Minors Contracts Act 1969.
25 Although this has not always been the case: see *Coutts Co v Browne-Lecky* [1947] KB 104.
26 *Wauthier v Wilson* (1912) 28 TLR 239, 239 per Farwell LJ (CA).

2. A creditor's rights and causes of action; and
3. A guarantor's rights and defences.

Each will be dealt with separately in order to highlight the nature of contracts of guarantee and draw a comparison with standard contractual rights.

Contracts Enforcement Act 1956

Section 2(1) of the Contracts Enforcement Act 1956 applies (inter alia) to "[e]very contract by any person to answer to another person to the debt, default, or liability of a third person." Section 2(2) further provides that:

> No contract to which this section applies shall be enforceable by action unless the contract or some memorandum or note thereof is in writing and is signed by the party to be charged therewith or by some other person lawfully authorised by him.

In other words, in order for a creditor to be able to bring an action on a guarantee, that contract must be in writing and signed by the guarantor. This section only applies to guarantees and not to indemnities.

The importance of compliance is emphasised by recent New Zealand cases. The requirement that all the material terms of a contract of guarantee be contained in the note of memorandum was a successful defence for a guarantor who alleged defects in the signature attestations and in the identification of the parties in *Golden Coast Poultry Industries Ltd v Brown*.[27] In this case the name of the principal debtor had been omitted and the guarantor was released from liability. A guarantor was also successful in *Westpac Banking Corp v Morris*[28] where the alleged insertion of details into a contract after it had been signed supported a defence of invalidity under the Contracts Enforcement Act.

Creditors' Rights

The distinction between a guarantee and an indemnity is important in that the rights of the creditor are governed by the nature of the agreement. A contract of guarantee involves a promise by the guarantor collateral to that of the principal debtor. If the principal debtor then fails to perform his obligation to the creditor, the creditor is entitled to sue the guarantor. The liabilities of the principal debtor and the guarantor are therefore co-extensive, as are the rights available to them pursuant to an action by the creditor. It therefore follows that if the principal obligation cannot be enforced against the principal debtor the guarantor must also be released from liability.

The principle of co-extensiveness historically relates back to the Roman law concept of fide jussio. This was based on the reasoning that the guarantor's obligation is dependent upon that of the principal debtor and therefore

27 High Court, New Plymouth, 6 August 1986 (A 11/86). Gallen J.
28 High Court, Dunedin, 24 April 1987 (CP 110/86). Williamson J.

cannot exist without a valid and subsisting obligation on her part.[29] The relevant rule of law is "[where] the principal is not obliged, neither is the surety, as there can be no accessory without a principal obligation".[30] This rule was affirmed in *Lakeman v Mountstephen*:[31]

> There can be no suretyship unless there be a principal debtor, who of course may be constituted in the course of the transaction by matters ex post facto, and need not be at the time, but until there is a principal debtor there can be suretyship. Nor can a man guarantee anybody else's debt unless there is a debt of some other person to be guaranteed.

With a contract of indemnity on the other hand, primary liability falls upon the indemnifier. The indemnifier's obligation is wholly independent of that of the principal debtor, though default by the principal debtor is the most likely cause of recourse to the indemnifier by the creditor. An indemnifier will remain liable notwithstanding the unenforceability or invalidity of the principal contract. This is because the promise is to keep the creditor harmless against loss, not to answer for the debt of the principal.[32] The indemnifier owes an independent debt, contingent on the creditor suffering some loss, and is thereby agreeing to answer for her own debt, not that of another.[33]

On this basis an indemnifier can be held liable for a shortfall on the anticipated profit notwithstanding that there was no further liability on the part of the principal, as in *Goulston Discount Co Ltd v Clarke*.[34] In that case, a man wished to purchase a £400 car with the assistance of the plaintiff finance company by way of a normal hire purchase agreement. The plaintiff bought the car from the defendant dealer from whom the finance company sought an indemnity. The material parts of the indemnity clause read:

> In consideration of your entering into a hire purchase agreement with RH Webb I agree to indemnify you against any loss you may suffer by reason of the fact that the hirer under the said agreement for any cause whatsoever does not pay the amounts which he would if he completed his agreement by exercising the option to purchase. Loss shall mean the difference between the total amount the hirer would have had to pay to acquire title to the goods under the hire purchase agreement, plus your expenses, less payments received by you.

The hire purchase agreement was to run over two years and was calculated to cover the £300 (a £100 credit had been given for the trade-in), a finance cost of £57 and an option to purchase for £1. The total hire purchase price amounted to £458. Webb paid the first few instalments but then defaulted. The plaintiff then legally repossessed the car, sold it for £155 and sued the defendant dealer under the indemnity contract for the balance of the hire purchase price which it was unable to recover from Webb. At first instance it

29 Mitchell, "Is a Surety's Liability Co-extensive With That of the Principal Debtor?" (1947) 63 LQR 355.
30 Pothier, *Law of Obligations*, Evans' translation (1806), 229.
31 (1874) LR 7 HL 17, 24 per Lord Selbourne.
32 *Yeoman Credit Ltd v Latter*, supra at note 4, at 831.
33 *Birkmyr v Darnell* (1704) 1 Salk 27; 91 ER 27.
34 [1967] 2 QB 493 (CA).

was held that the contract was a guarantee and that the plaintiff finance company was therefore only entitled to bring an action for the amount owing in arrears as opposed to the full amount of the hire purchase agreement.

On appeal, Lord Denning MR had no difficulty in reversing this decision and finding that the contract was indeed an indemnity: a very sensible agreement which the defendant ought to honour. Had the contract been a guarantee, the defendant would have been liable only for the payments due at the time of termination.

Creditors' Obligations

What are the obligations of the creditor when taking action against the guarantor? To what extent, if any, must the creditor endeavour to recover from the principal debtor before an action can be brought against the guarantor? Is the creditor under any obligation to notify the guarantor of the principal debtor's default?

A guarantor will be released from liability if there has been a breach of a condition precedent to the operation of the guarantee. Such conditions may be expressed or implied.

PRIOR ACTION AGAINST THE PRINCIPAL DEBTOR

The creditor cannot be required to bring an action against the principal debtor before proceeding against the guarantor.[35] The liability of the guarantor arises contemporaneously with the creditor's right of action against him upon the default of the principal debtor. It is the duty of the guarantor to ensure that the principal obligation is performed and by the very nature of a contract of guarantee the guarantor undertakes to accept the obligation to the creditor upon the principal debtor's default. The primary motivation for the creditor in obtaining a guarantee is to reduce the risk of loss through non-payment. Therefore to impose an implied obligation upon the creditor to exhaust all remedies against the principal debtor before bringing an action against the guarantor would seriously undermine the purpose of the contract of guarantee. Under a contract of indemnity the indemnifier is in the same position as a guarantor in that she cannot require the creditor to first bring an action against the principal debtor; her liability is wholly independent of that of the principal debtor.

NOTIFICATION OF DEFAULT

The creditor is not obliged to notify the guarantor of the default of the principal debtor[36] as it is the duty of the guarantor to see that the principal

[35] *Moschi v Lep Air Services Ltd* [1973] AC 331; *Wright v Simpson* (1802) 6 Ves 714; 31 ER 1272.

[36] *Carter v White* (1884) 25 Ch D 666 (CA).

debtor's obligations are performed.[37] The court will assume that the guarantor is in a superior position to monitor the performance of the principal debtor, although there is no duty on the guarantor to become acquainted with the debtor's affairs.[38] The liability of the surety will therefore arise upon the default of the principal debtor, subject to the terms of the agreement, without notice from the creditor.[39]

It should be noted, however, that it is quite common in modern commercial guarantees to include an express notice provision, or a requirement that the creditor make a demand upon the guarantor for payment within a stipulated time of default, or both.

An indemnifier is in the same position, in that subject to the terms of the agreement, the creditor is under no obligation to notify him of default in payment or loss. The liability of the indemnifier will arise in accordance with the terms of the contract.

The Extent to which the Guarantor is Liable to the Creditor

Under a contract of indemnity the extent of the liability of the indemnifier will depend on the terms of the contract and the extent of the loss suffered by the creditor. Under a contract of guarantee the rights of the creditor are similarly dependent on the terms of the contract and the nature of the guaranteed obligation, but the guarantor's liability is also dependent upon the subject matter of the guarantee.[40]

The two most common classes of guarantee are:[41]

1. A conditional agreement, where upon the default of the principal debtor the creditor may sue the guarantor for a liquidated amount of an accrued debt or sum of money. The guarantor's liability arises upon the failure of the principal debtor to pay. The subject of the guarantee is the payment of the specific debt due.
2. A guarantee the subject of which is the performance of some other kind of obligation, such as an undertaking by the guarantor that the principal debtor will perform. The failure by the principal debtor to perform the obligation thus puts the guarantor in breach of the contract of guarantee, and the creditor is entitled to sue the guarantor for damages for breach of contract.

This distinction is especially significant with respect to contracts allowing

37 *Moschi v Lep Air Services Ltd*, supra at note 35, at 348.

38 *Gwyme v Burnell and Merceron* (1840) 6 Bing NL 453; 133 ER 175.

39 These principles are subject to statutory provisions such as s 28 of the Hire Purchase Act 1971, which requires a vendor, within 21 days of repossessing the goods, to serve a notice on both the purchaser and the guarantor.

40 *Sunbird Plaza Pty Ltd v Maloney* (1988) 77 ALR 205, 207.

41 See *Moschi v Lep Air Services*, supra at note 35; *Sunbird Plaza Pty Ltd v Maloney*, ibid.

for instalment payments where the default of the principal debtor results in cancellation of the contract and the full purchase price has not yet become due. In such a situation it may benefit the creditor either to argue that the guarantor undertook that the principal debtor would carry out the obligation (Class 2 above), thereby allowing a claim in damages by the creditor which may be higher than the accrued debt, or to assert a conditional agreement (Class 1 above) and claim the debt due.

The creditor may bring an action against the guarantor for the full purchase price upon default by the principal debtor if the contract between the principal debtor and the creditor contains a clause providing that upon any default by the principal debtor he will immediately become liable for all future instalments.[42] The full amount therefore becomes due and payable upon default and, assuming that the guarantor has promised to pay the full amount due, she will be liable therefor. This agreement still constitutes a true contract of guarantee. It should be noted, however, that if the guarantor promises to pay the full amount upon the default of the principal debtor, but in the contract between the principal debtor and the creditor there is no provision under which the principal debtor will become liable for the full amount upon default, then the contract is one of indemnity. The surety's liability is different in kind and potentially greater than that of the principal debtor.

Circumstances Affecting the Creditor's Rights

It is proposed to now examine some circumstances which may affect the creditor's right to bring an action against a guarantor or indemnifier. A comprehensive discussion of this aspect of guarantees is O'Donovan and Phillips, *The Modern Contract of Guarantee*.[43] The purpose of this section is not to repeat that summary but rather to utilise it to continue the analysis of the distinction between guarantees and indemnities.

Where the principal contract is defective

The general principle in relation to guarantees of void principal contracts is that the guarantee will also be void and therefore unenforceable.[44] This follows from the accessory nature of the contract of guarantee expressed in *Yeoman Credit Ltd v Latter* by Holroyd Pearce LJ:[45]

> Since a guarantee is by definition an obligation to answer for the debt, default or

42 A good example is *Gilmer and Gilmer v Ross* [1932] NZLR 507.
43 (1985).
44 See *Eldridge & Morris v Taylor* [1931] 2 KB 416 where the surety could not be held liable where the principal debt was unenforceable because it was not evidenced by sufficient memorandum to satisfy the Moneylenders Act 1927 (UK).
45 Supra at note 4, at 830.

miscarriage of another, there cannot, in respect of a void contract, be any debt, default or miscarriage to answer for.

But an indemnity is not accessory in nature and the indemnifier's obligation is not, therefore, necessarily co-extensive with that of the principal debtor. It follows that the voidness of the principal transaction does not affect the primary liability of the indemnifier. Thus in *Yeoman Credit* the contract was held to be one of indemnity and so the indemnifier's obligation to the creditor remained despite the voidness of the principal contract. Indeed, it will often be precisely the unenforceability of the principal contract that leads the creditor to seek the indemnity; the need to be indemnified against loss from a transaction is at its most acute where the principal's obligation cannot be enforced.

It is shown that the guarantee-indemnity distinction is of great importance when the principal contract is defective. But there are exceptions to the rule relating to guarantees which diminish that importance in certain circumstances by holding the guarantor liable notwithstanding the unenforceability of the obligation in respect of which the guarantee was given.

First, there is much authority on the possibility that contracts of guarantee accessory to infant contracts are an exception to the general rule of co-extensiveness. But in New Zealand this problem has been resolved by s 10 of the Minors Contracts Act 1969:

Every contract of guarantee *or indemnity* whereby any person (other than a minor) undertakes to accept liability in the event of the failure of a minor to carry out his obligations under a contract shall be enforceable against that person . . . to the extent that it would be if the minor has been at all material times a person of full age, and that liability shall not be affected by any other provision of this Act or any order made pursuant to any other provision of this Act [emphasis added].

Neither a guarantor nor an indemnifier has a defence that her contract is unenforceable owing to the fact that the principal obligation arises under an infant's contract and is therefore void.

The second exception is that directors will remain liable on their contracts of guarantee notwithstanding that the contract of loan with the company is itself ultra vires and therefore unenforceable. This is consistent with equitable principles as the director of a company will be deemed to know that the principal obligation into which the company has entered is ultra vires. It would therefore be unfair to allow her to escape liability by claiming that the principal transaction was ultra vires and void and that she should therefore be relieved from liability under their guarantees. The exception was first asserted in an obiter statement by Lord Blackburn in *Chambers v Manchester and Milford Ry Co*[46] and later relied on in *Yorkshire Ry Wagon Co v Maclure*:[47]

Lord Blackburn there does not doubt the right of the lender to recover against the sureties,

46 5 B & S 588, 610; 122 ER 951, 959.
47 (1881) 19 Ch D 478, 491 per Kay J.

although the loan was to a railway company which could not borrow. Probably the very reason in this case for requiring the guarantee was the doubt that existed whether the company could be compelled to repay the money. I asked for authority upon this point, but none was cited. I therefore must decide that the directors are liable upon their guarantees.

In cases where all parties knew that the primary obligation was unenforceable, the courts will presume that the parties intended their contract to be an indemnity rather than a guarantee. Otherwise all parties would knowingly have entered into a completely unenforceable and meaningless arrangement. Thus:[48]

the obligation of a mere guarantee for a debt can be satisfied by payments by the surety, who may be considered as prepared to lose his right over against the corporation, if the law forbids it to pay.

Alternatively the liability of the directors as guarantors can be seen as arising from the failure or omission of the company to meet its obligations, whatever the cause.[49] It is, in any case, advisable for a creditor entering into an arrangement in which suretyship is sought to ensure that the principal obligation is in fact enforceable and where possible to obtain a contract of indemnity as opposed to one of guarantee.

Undue influence by the principal debtor in obtaining the contract of guarantee

English law gives relief to one who, without independent advice, enters into a contract upon terms which are very unfair . . . when his bargaining power is grievously impaired by reason of his own needs or desires, or by his own ignorance or infirmity, coupled with undue influence or pressures brought to bear on him by or for the benefit of another.[50]

Because of the onerous obligation that a guarantor assumes, the courts are adamant that the guarantor's decision to enter into the contract must be voluntary and informed. Therefore, equity will set aside a contract of guarantee if the guarantor entered into that contract as a result of the exertion of undue influence by the principal debtor.[51] The onus of proof is on the guarantor to show that reliance was placed upon the principal debtor in making the decision to enter into the contract of guarantee, and that the circumstances were such that the creditor should have known of or suspected undue influence.

The creditor will therefore remain unaffected by the guarantor's defence of undue influence where he has no notice (actual or constructive) of the undue influence or where no duty arises on the part of the creditor to ensure that

48 Rowlatt, *Principal and Surety* (2nd ed 1926) 166, note (d).
49 *Garrard v Jones* [1925] Ch 616.
50 *Lloyd's Bank Ltd v Bundy* [1975] QB 326, 339 per Lord Denning MR.
51 It is taken as understood that normal contractual principles apply where the creditor is the instigator of the undue influence.

the guarantor has made "an independent and informed judgement".[52] Such a duty will arise where the creditor (or his agent) acts as advisor to the guarantor. The guarantor must have a genuine opportunity to adequately assess the merits of the proposed transaction.

Position if the creditor has accepted the breach of the principal debtor and cancelled the contract

The guarantor will not be relieved from liability merely because the principal debtor has repudiated the contract and the creditor has accepted this. In order to determine the extent of the guarantor's liability, it is necessary to refer to the distinction between a guarantee that is an undertaking by the guarantor that the principal debtor will perform, and one which is a conditional agreement that upon the default of the principal debtor the guarantor undertakes to pay the accrued debt due.

Where the creditor is seeking to make the guarantor liable for obligations arising after the date of determination of the principal obligation, she will most likely argue that the guarantor undertook the former: that the principal debtor would perform the principal obligation. The leading case on this point is *Moschi v Lep Air Services*.[53] The creditors in that case agreed to relinquish a lien held by them over the debtor's goods in consideration for the debtor's written undertaking to pay the amount still owing to the creditors in instalments. The guarantor personally guaranteed the performance by the debtor of his obligation to make these payments.

The principal debtor defaulted on its payments and the creditors accepted that as wrongful repudiation, thereby bringing the contract to an end. The principal debtor then went into liquidation and the creditor sought to sue the guarantor for the full amount due, less what had been paid.

The House of Lords saw the construction of the document as the key to determining the subject of the guarantee, which was found to be the performance by the debtor of its principal obligations. Their Lordships held that in treating the contract as rescinded, the creditor was exercising a legal right originating from the principal contract that entitled it to payment of damages. This was seen to amount to an action that enforced rather than varied the contract. Lord Simon was concerned that to deny the creditor this right would:[54]

> make nonsense of the whole commercial purpose of suretyship: you would lose your guarantor at the very moment you most need him – namely, at the moment of fundamental breach by the principal promisor.

The case shows that rescission puts to an end the primary obligations of

[52] Supra at note 50, at 342.
[53] Supra at note 35.
[54] Ibid, 355.

both contracting parties. The primary obligations of the defaulting party are then substituted, by operation of law, by a secondary obligation to pay damages to the innocent party by way of compensation for the loss resulting from the wrongful repudiation. These obligations to pay damages are imposed by law, and not by contract, and therefore cannot possibly amount to novation or material variation. A wrongful repudiation by the principal debtor, entitling the creditor to rescind the contract, not only results in the principal debtor's primary obligation being converted by operation of law into a secondary obligation to pay damages, but also constitutes a failure by the guarantor to perform his primary obligation to ensure that the principal debtor carried out its obligations. Upon the election of the creditor to rescind the contract, the guarantor's primary obligation is also replaced, again by operation of law, by a secondary obligation to pay the creditor damages as compensation for the loss. By suing the guarantor the creditor is enforcing the guarantor's secondary obligation, not the debtor's. The measure of damages will therefore be the balance of the debt owing with some allowance for accelerated payment.

The second class of guarantee to be considered with regard to acceptance by the creditor of the debtor's repudiatory breach, is that of the conditional guarantee undertaking to pay the accrued debt upon default of the debtor. When a court is satisfied that a contract of guarantee falls into this category, the action of the creditor against the guarantor is most likely to be one for accrued obligations subsisting at the time of the determination of the principal contract.

In *Hyundai Heavy Industries Co Ltd v Papadopoulos*[55] the majority of the House of Lords held that under such a guarantee the rescission of the contract does not affect the accrued rights of the creditor to payment of instalments of the purchase price, even if the effect of the rescission is to cancel the accrued rights of the creditor to payment from the buyer. The guarantor therefore remains liable, except in cases of contracts for the sale of land or goods where there has been a total failure of consideration.

The situation is different, and less complex, where the contract is one of indemnity. It has been shown that in guarantees complexity arises because the guarantor's obligation is always dictated by that of the principal debtor. But the indemnifier's obligation is independent of the principal debtor's and so the lawful termination of the principal contract by the creditor will obviously not affect the basis of the indemnifier's liability. A clear example is hire purchase agreements where the creditor, having terminated the principal contract, has suffered a loss over and above the arrears owing. On those facts in *Goulston Discount Co Ltd v Clark*, Lord Denning MR held:[56]

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55 [1980] 1 WLR 1129.

56 Supra at note 34, at 496-497 per Lord Denning MR.

> The question in the case is whether [this] is an agreement of guarantee or of indemnity. If it is a guarantee, the ... defendant, is under no more liability than the hirer, ie to pay the arrears. But if it is an indemnity, he will be liable to pay the whole of the hire-purchase price.

Indeed, where the terms of the contract of suretyship are such that the surety's liability will exceed that of the principal debtor in the circumstances discussed above, that will of itself lead to the transaction being classified as an indemnity rather than as a guarantee.[57]

Release of the Principal Debtor

If the creditor enters into a legally binding agreement to release the principal debtor from liability, then the guarantor will be absolutely discharged. To impose a continued liability upon the guarantor despite the release of the principal debtor would be inconsistent with the essential nature of the contract of guarantee as a secondary liability. As Lord Porter said:[58]

> To hold that in such cases the creditor still retained his right against the surety, and that the surety on his part could still sue the principal debtor, would mean that the release or grant of time was of no effect, inasmuch as the debtor would still be liable at any moment to an action at the suit of the surety.

There are exceptions to this general rule of discharge upon release. First is the case of bankruptcy or liquidation of the principal debtor. Although the principal debtor will then be released from personal liability the guarantor will not, unless, of course, an express term in the contract of guarantee so provides. The second exception concerns reservation of rights clauses: clauses purporting to release the debtor while maintaining an action against the guarantor. Such clauses can be in the contract of guarantee itself or, alternatively, can exist as covenants not to sue between the creditor and the debtor whereby the creditor retains an action against the guarantor and the debtor impliedly consents to the guarantor's continued right of indemnity.[59]

In the case of an indemnity the effect of the release of the debtor is slightly less clear. In the absence of any express provision preserving liability in the contract of indemnity, it seems likely that release of the principal debtor will (as for a guarantor) release the indemnifier.

Although not certain, that view appears to be consistent with the essential nature of the indemnifier's obligation. The indemnifier agrees to indemnify the creditor against the debtor's liability. Where the debtor has no liability, because he has been released, then the indemnifier's liability is itself discharged.[60]

57 See text, supra at page 417.

58 *Mahant Singh v U Ba Yi* [1939] AC 601, 607.

59 See *Cole v Lynn* [1942] 1 KB 142. For a New Zealand example see *Bond & Bond Ltd v Rothery* [1935] GLR 179.

60 *Re Perkins* [1898] 2 Ch 182.

Discharge by reason of the relationship between the principal debtor and the creditor

Upon good and satisfactory payment or performance of the principal obligation by the debtor the guarantor will, of course, be released from all liability. As the contract of guarantee is a secondary obligation, the principal debtor's payment must be made in satisfaction of the principal obligation in respect of which performance is guaranteed. This will be important where the principal debtor and the creditor enter into a number of transactions for not all of which the guarantor undertakes secondary liability. It will be a question of fact as to whether the guarantor's obligation has been discharged.

Satisfaction of the principal obligation by the debtor will not necessarily release an indemnifier. Under a contract of indemnity the primary obligation of the indemnifier is to make good any loss suffered by the creditor, and so the principle of co-extensiveness does not apply. The discharge of the principal debtor is therefore not a defence for an indemnifier.

If the creditor, notwithstanding that the principal obligation has not been fully performed, enters into a legally binding agreement to discharge the principal debtor, then the guarantor must necessarily be discharged:[61]

> It is elementary law that in a simple case of principal and surety . . . if the creditor releases the principal debtor, of course the surety is released too.

A conflict of views arises where the contract can be properly construed as an indemnity. Lindley MR in *Re Perkins* expressed the view that "a liability to indemnify against a liability which has no existence, and which can never arise, is a contradiction in terms".[62] The alternative approach, suggested in *Total Oil Products (Australia) Pty Ltd v Robinson*,[63] is that an indemnifier will only be discharged if her interests are prejudiced by the release. Each case will be a question of fact. The first suggestion seems to focus on the relationship between the indemnifier and the principal debtor, whereas the focus of a contract of indemnity is the primary obligation of the indemnifier to the creditor regardless of the other relationship. In any event, if a creditor wishes to be indemnified against loss, the contract should expressly provide for the preservation of the creditor's rights in the event of the release of the principal debtor.

In addition, a variation to the principal contract will not affect the guarantor's liability where:

1. it is made with the guarantor's consent (the guarantor may be deemed to have consented if she has full knowledge of and participates in the alteration);[64]

61 *Perry v National Provincial Bank of England* [1910] 1 Ch 464, 471 per Cozens-Hardy MR.
62 Supra at note 60, at 189.
63 [1970] 1 NSWR 701, 705.
64 *EA Towns Ltd v Harvey* [1945] 2 DLR 782.

2. the guarantor ratifies a course of dealing resulting in the alteration of the principal contract; or
3. it is authorised by the guarantor.

Outside these exceptions, the material variation rule is applied.[65] It is therefore important to determine what amounts to material variation.

McGuiness suggests that a "material variation is one that alters the business effect of the relationship so as to vary the risk."[66] He relies on the judgment of Lord Campbell CJ in *Pybus v Gibb*.[67] Thus the extent to which a guarantor will be discharged depends on the nature of the alteration and on whether the risk imposed on the guarantor changed as a result thereof.

The leading New Zealand case on material variation is *Dunlop New Zealand Ltd v Dumbleton*.[68] During the currency of the guarantee, and without the knowledge or consent of the guarantors, the creditor and the principal debtor agreed to a severe curtailment of the latter's business and entered into a new stockist agreement. Following the principle in *Holme v Brunskill*,[69] Wilson J found that the stockist agreement amounted to a material variation of the principal contract and discharged the guarantor's obligations, subject to any contrary terms in the contract of guarantee.[70] His Honour reasoned that a material variation amounts to a breach of condition, and therefore that any such variation without the guarantor's consent discharges the guarantor from liability by operation of law: it does not merely give the guarantor the right to have his liability discharged.

In the recent case of *Birrell v Stafford*[71] the guarantor raised material variation as a defence to liability on the grounds that the creditor had inserted the wrong place of execution in the document. Tadgell J used the test of whether the variation altered the operation of the instrument and found that it had not. The guarantor therefore remained liable.[72]

Whereas the general rule for guarantees is that liability is discharged upon variation of the principal contract, the opposite applies to indemnities: liability will subsist notwithstanding variation of the principal contract. That, of course, reflects the primary nature of the indemnifier's obligation as assumed in the contract of indemnity itself.

But sometimes variation of the principal contract may lead to discharge from liability, due not to any equitable principle such as that enjoyed by

65 *Polak v Everett* (1876) 1 QBD 669, 674.
66 *The Law of Guarantee* (1986) 251.
67 (1856) 6 El & Bl 902, 911; 119 ER 1100, 1103 (QB).
68 [1968] NZLR 1092.
69 (1877) 3 QBD 495.
70 Ibid, 1096-1097.
71 [1988] VR 281.
72 Material variation has also been very relevant in banking law, particularly with regard to the rescheduling of loans and increase in interests rates: see *National Bank of Nigeria v Awolesi* [1964] 1 WLR 1311 (PC); *Burnes v Trade Credits Ltd* [1981] 2 All ER 122 (PC).

guarantors, but rather to normal contract rules. It may be possible for a term of a contract of indemnity to specify that any variation of the principal contract will discharge the indemnifier from liability. Such a term may be expressed or, in special circumstances, implied. Sureties entering into contracts of indemnity may therefore be advised to consider the possibility of variation and to accordingly consider the insertion of an express term providing for discharge thereupon.

Discharge of the surety by the creditor agreeing with the principal to give time to the principal

If the creditor and the principal debtor enter into a binding agreement allowing the principal debtor extended time for performance, without the consent of the guarantor, then the guarantor will be discharged from liability, as:[73]

> the creditor, by so giving time to the principal, has put it out of the power of the Surety to consider whether he will have recourse to his remedy against the principal, or not; and because he, in fact, cannot have the same remedy against the principal as he would have had under the original contract.

Such an agreement may take the form of either a forbearance by the creditor to sue the principal debtor or a specific agreement for an extension of time. Most modern contracts of guarantee, however, contain clauses entitling the creditor to allow the debtor an extension of time without discharging the guarantor.

The giving of time by the creditor to the debtor, like variations of contract, will not usually discharge the liability of an indemnifier. The best example is *Way v Hearn*,[74] where the indemnifier was held to be liable notwithstanding the giving of extra time to the debtor by the creditor. Once again the essence of that continued liability is the independence of the indemnifier's obligation. The indemnifier will only escape liability by reason of the giving of time where that constitutes a breach of a term in the contract of indemnity itself. That turns only on the normal rules for breach of contract.

Discharge by Reason of the Creditor's Relationship with the Guarantor

A guarantor will, of course, have a defence under the terms of the contract of guarantee itself where the creditor has breached a condition of that contract. This is likely to occur in two situations: first, where the creditor fails to enter into or perform the contract with the principal debtor as stipulated in the guarantee, resulting in a failure of consideration with respect to the

73 *Samuell v Howarth* (1817) 3 Mer 272, 278; 36 ER 105, 107 per Lord Eldon; see also *Greenwood v Francis* [1899] 1 QB 312.

74 (1862) 11 CB (NS) 774; 142 ER 1000; see also *Wilson v Zealandia Soap and Candle Trading Co Ltd* [1928] GLR 120; *British Airways Board v Parish* [1979] 23 Lloyd's Rep 361.

guarantor; second, where there is a failure by the creditor to fulfil a condition subsequent provided for by the guarantee.

The rights of the guarantor who has satisfied her obligation to the creditor to subrogation include the benefit of any securities held by the creditor for the enforcement of the principal transaction. If the contract of guarantee itself prohibits the interference or impairment of securities, any breach of that term by the creditor will clearly discharge the guarantor absolutely.

Where there is no such prohibition in the contract of guarantee itself, the creditor owes an equitable duty to the guarantor with respect to securities.[75] Upon satisfying her principal obligation, a guarantor is entitled to receive the securities unimpaired by any unreasonable act of the creditor. This includes a duty on the creditor to take reasonable steps to ensure that a fair price is obtained for any security which he may realise, as the guarantor is entitled to have her liability reduced by that price.

What if the contract is one of indemnity? With regard to express terms in the contract relating to impairment of securities, the position is the same as that stated above in relation to guarantees: a breach by the creditor will discharge the indemnifier absolutely. In *Guy-Pell v Foster*, Lawrence LJ held that:[76]

> the performance by the plaintiff of his obligations to retain the [securities] is a condition precedent to his right to enforce the performance of the defendant's obligation to indemnify.

Where the contract of indemnity does not expressly create a duty to preserve and maintain the securities, the position is more complex. The question is then whether the aforementioned equitable duty on a creditor under a contract of guarantee extends to a creditor under a contract of indemnity. There appears to be no authority directly on this point, but logic would dictate that an indemnifier does indeed enjoy similar protection to that of the guarantor. The rationale for the creditor's duty relating to securities is the protection of a surety's right of subrogation to the rights of the creditor thereover, and it is clearly established that the right of subrogation applies equally to indemnifiers and guarantors.[77] There seems no reason, therefore, why the creditor's equitable duty to preserve and maintain securities is not owed equally to an indemnifier. In this respect at least the position of the indemnifier will probably be the same as that of the guarantor.

Conclusions

Whether an undertaking regarding the debt or obligation of a third party is a guarantee or an indemnity will always depend on the facts of the individual

[75] *Cuckmere Brick Co Ltd v Mutual Finance Ltd* [1971] 1 Ch 949.

[76] [1930] 2 Ch 169, 187.

[77] *Morris v Ford Motor Co Ltd* [1973] 2 All ER 1084, 1089-1090 per Lord Denning MR.

case. In entering into such an agreement it is very important that the intentions of each party as to the nature and extent of liability and obligation are made clear in the written agreement in order that the courts may give effect to those intentions.

This article has highlighted the uniqueness of the rights, liabilities and defences available to the parties to a contract of guarantee as opposed to an undertaking of primary liability (albeit contingent upon loss) under a contract of indemnity.