**Chapter Six**

**Surety Ship (Guarantees)**

Learning Objectives: After studying this lesson, students will be able to:

* Define the surety ship (guarantee);
* Describe the essential features of contract in surety ship; and
* Explain the extent of rights and liabilities of surety.

**6.1. Introduction to Surety ship (Guarantees)**

A bank has agreed to lend you money to start a business. But the bank is asking for certain guarantees, including a personal guarantee. You wonder why you need to personally guarantee your company. You also have questions about whether a person who gives a personal guarantee is legally protected, especially when you don't have a chance to negotiate the terms of the guarantee. This article explains this particular kind of guarantee, which is also called surety ship.

A guarantee is a contract by which a person, called a "surety" or "guarantor", agrees to pay money if the person who actually owes the money fails to do so. The guarantor can be a person or a company. (See the question Can a company be a guarantor?) **For example**, a guarantor may agree to pay a loan if the actual borrower fails to pay it back. If the guarantor has to step in and pay on behalf of the borrower, the guarantor can then demand the money from the borrower. A contract of guarantee is almost always in writing. In fact, a written contract of guarantee is highly recommended so that its existence and contents can be easily proved. A guarantee is sometimes part of a loan agreement between a lender and borrower. If this is the case, the guarantor should make sure that she is signing the loan agreement as a guarantor and not as a co-borrower.

## Why do financial institutions ask for guarantees?

Financial institutions ask for guarantees to reduce the risk of not being reimbursed if a borrower does not have enough money or other assets (equipment, buildings, etc.) to pay back the money owed. When you sign a loan agreement with a financial institution to finance your company's operations, you are in fact signing in your company's name. So it is the company that is borrowing the money and agreeing to reimburse it. To protect itself against the risk that your company might not fully pay back its loan, a financial institution may ask one or more people to personally guarantee the loan. If the company does not reimburse the financial institution, the institution can ask these people to pay.

## Who can be a guarantor and who chooses the guarantor?

In theory, any adult can act as a guarantor. In practice, it's the financial institution providing the loan that usually tells the borrower who will act as guarantor. However, sometimes the borrower undertakes to provide a guarantor and then it will be up to the borrower to choose the guarantor. In these situations, the borrower must find a guarantor who lives in Canada (in the case of a company, has its head office in Canada) and has enough money or other assets (property, for example) in Quebec to be able to reimburse the loan. Of course, a lender might accept a guarantor who does not meet these requirements, but this would not be in the lender's best interests.

The law allows the directors of a company to authorize the company to be a guarantor. They must also choose a representative to sign the contract of guarantee in the company's name because the company itself cannot sign. The directors' authorization and the representative's name must be written in a document signed by all of the directors. This document is called a resolution? In the case of a Quebec company, the law also requires the authorization of company shareholders.

In fact, when the company is created, the shareholders usually adopt a rule that allows the directors to do this without the shareholders' authorization. In practice, it is best to check (or ask a legal professional to check) whether a company's internal rules limit the power of its directors to authorize the company to act as a guarantor. Also, in certain situations, the law prevents a company from providing guarantees. It is also important to check that a company's contracts with other people do not include limits or special requirements regarding the company's guarantees. This is often the case with financing contracts.

## Can the guarantor negotiate the contract of guarantee?

In theory, yes but, in practice, financial institutions use their own models that usually cannot be negotiated and must be signed as is. Contracts like this that cannot be negotiated are often called contracts of adhesion? To protect people who sign contracts of adhesion, the law has created certain rules:

* If a contract of adhesion refers to another document, the lender must make sure that the guarantor has knowledge of the other document. If the lender does not do this and, as a result, the guarantor suffers damage, the guarantor can sue the lender.
* If a problem arises between the guarantor and the lender because of information in the contract of guarantee that a court decides is incomprehensible, illegible or abusive, the part of the contract containing this information may be considered to be invalid.
* The guarantor should always take the time to read the contract of guarantee and the main loan agreement carefully. In fact, the contract of guarantee often states that conditions imposed on the borrower in the loan agreement also apply to the guarantee.

## Why would you agree to guarantee someone else's loan?

Providing a guarantee is often one of the only ways a borrower can get financing for her company, especially when the company has little money or few assets (equipment, buildings, etc.). So it's easy to understand why a person would agree to be a guarantor for her own company: she expects to benefit from her company doing well. In other situations, there are several reasons a person might act as a guarantor. **For example**, a company selling exotic fruits might have an interest in acting as the guarantor for a company that imports the exotic fruits it needs. A person might also accept to act as a guarantor in return for getting paid to do so. In all cases, the decision to act as a guarantor depends entirely on a person's confidence in the borrower and the borrower's financial situation. Confidence is essential because acting as a guarantor can have serious consequences.

## What risks does the guarantor accept?

Unless the contract of guarantee says otherwise, the guarantee covers the whole loan given by the financial institution, including interest and all of the other fees related to the loan. However, nothing prevents the guarantor from negotiating limits since sometimes the lender is willing to limit the extent of the guarantee. **For example**, the guarantor could request that:

* the guarantee only last for the first year of the loan
* the guarantee only cover the amount of the actual loan, and not the interest or other fees related to the loan
* A cap is put on the amount of the guarantee (For example: The amount of the guarantee will not exceed $250,000, including interest, penalties and all other fees?)

In financing matters, some model contracts state that the guarantor guarantees all of the borrower's current and future loans. Depending on the situation, it might be better for the guarantor to negotiate a guarantee that is not so broad, so that the risks are reduced.

## Can a guarantor guarantee a line of credit of a company or person?

Yes. But you should know that as long as the line of credit is used (and this might be for several years!), the guarantor will be responsible for reimbursing amounts borrowed from the line of credit and not paid back. However, the law allows a guarantor to free herself from future debts after 3 years by sending a notice to the people concerned (including the borrower and the financial institution). For more information on this subject, the question, can a guarantor put an end to the guarantee of a credit card in our Info sheet Guarantees: How They Work and Come to an End.

**6.2. Essential features of contract**

**Minimum two parties:-** At least two parties are needed to enter into a contact. One party has to make an offer and other must accept it. The person who makes the 'proposal' or 'offer' is called the 'promisor' or 'offeror'. While, the person to whom the offer is made is called the 'offeree' and the person who accepts the offer is called the 'acceptor'.

**Offer and acceptance:-** There must be an 'offer' and an 'acceptance' to the offer, resulting into an agreement. Both offer and acceptance should be lawful.

**Legal obligations: -** The parties must intend to create a legal obligation. The agreement sought to be enforced should contemplate legal relations between the parties to it.

**Lawful consideration:-** A contract is basically a bargain between two parties, each receiving 'something' of value or benefit to them. This 'something' is described in law as 'consideration'. Consideration is an essential element of a valid contract. It is the price for which the promise of the other is bought. A contract without consideration is void. The consideration may be in the form of money, services rendered, goods exchanged or a sacrifice which is of value to the other party. This consideration may be past, present or future, but it must be lawful.

**Competent parties:-** The parties making the contract must be legally competent in the sense that each must be of the age of majority, of a sound mind, and not expressly disqualified from contracting. An agreement by incompetent parties shall be a legal nullity.

**Free consent:-** The contracting parties must give their consent freely. 'Consent' means that the parties must agree about the subject matter of the agreement in the same sense and at the same time. Consent is said to be free if it is not induced by coercion, undue influence, fraud, misrepresentation or mistake. The absence of free consent would affect the legal enforceability of a contract.

**Lawful object:-** The object of the agreement must be lawful. An agreement is unlawful, if it is:- (i) illegal (ii) immoral (iii) fraudulent (iv) of a nature that, if permitted, it would defeat the provisions of any law (v) causes injury to the person or property of another (vi) opposed to public policy.

**Not expressly declared void:-** An agreement expressly declared to be void under the Contract Act or under any other law, is not enforceable and is, thus, not a contract. The Contract Act declares void certain types of agreements such as those in restraint of marriage, or trade, or legal proceedings as well as wagering agreements.

**Certainty and possibility of performance:-** The terms of a contract must not be vague or uncertain. If an agreement is vague and its meaning cannot be ascertained, it cannot be enforced. Also, the terms of a contract must be such as are capable of performance. An agreement to do an impossible act is void and is not enforceable by law.

**Legal formalities:-** Generally, a contract may be oral or in writing. However, certain contracts are required to be in writing and may even require registration. Therefore, where law requires an agreement to be put in writing or be registered, the same must be complied with. For instance, the Indian Trusts Act requires the creation of a trust to be reduced to writing.

**6.3. Liability and Rights of Surety (The Extent of the Surety's Liability)**

The meaning of the [surety](http://chestofbooks.com/society/law/Popular-Law-9/Section-4-The-Surety.html)'s contract having been determined, it remains for the [court](http://chestofbooks.com/society/law/Popular-Law-9/Chapter-IV-Courts-And-Procedure-Therein.html) to say whether a strict [construction](http://chestofbooks.com/society/law/Popular-Law-9/Section-26-Construction-Although-Fire-Insurance-Policies.html) in favor of the surety should be given the contract, or whether the contract should receive the same construction as any other contract. The general rule, which it seems in reason is to be preferred, is to adopt the latter of the two constructions and bring to the analysis of the surety's [liability](http://chestofbooks.com/society/law/Popular-Law-9/Chapter-V-Liability-And-Rights-Of-The-Guarantor-Section-44.html) the same rules of construction that are generally to be applied by the courts in the construction of the ordinary contract.1 **For instance**, the courts have frequently applied to [surety ship](http://chestofbooks.com/society/law/Popular-Law-9/Twenty-Seventh-Subject-Guaranty-And-Suretyship.html) contracts the general rule that a contract is to be most strongly construed against the person who is responsible for the language used in the contract; likewise the courts have endeavored to sustain the obligation of the surety where another construction would leave the [creditor](http://chestofbooks.com/society/law/Popular-Law-9/Chapter-VI-Creditors.html) without a remedy. In any event it is to be remembered that all [questions](http://chestofbooks.com/society/law/Popular-Law-9/Questions-Bills-And-Notes.html) of construction are for the court. It is the duty of the court and the court alone to construe the contract.

In Keeler vs. Herr, the Illinois Court says: "Where the contract is in writing, it is for the court to state its meaning; the acts of the parties are to be looked to, only where there is a doubt as to the meaning of the contract, arising from the ambiguity of the words or phrases used." The student of law should bear in mind that in determining the [liability of the surety](http://chestofbooks.com/society/law/Popular-Law-9/Section-6-The-Liability-Of-The-Surety.html), and in passing on defenses that the surety might plead as the privilege of his office, there should be no confusion of the rule that a surety is a favorite of the law, with the application of the general rules of construction to the surety's contract. The general rules of construction are in no way to interfere with the rule that the surety has the [right](http://chestofbooks.com/society/law/Popular-Law-9/Section-37-The-Rights-And-Remedies-Of-A-Surety-As-To-Co-Sur.html) to stand on the strict terms of the contract, and to claim a discharge where the contract is altered in any respect without his consent.

Usually the surety secures no personal benefit on his contract of surety ship; the purpose of the contract is to assist the [principal](http://chestofbooks.com/society/law/Popular-Law-9/Section-3-The-Principal.html) debtor; therefore he in justice ought to be bound no further than he has expressly obligated himself. In the application of this principle, in this sense, he is a favorite of the law. The contract of surety ship will not begin until the day is reached named in the contract, and will close at the time stipulated, if the parties have agreed on the time in the contract. In such instances, where the terms of the contract are not made uncertain, the liability is limited strictly as shown by the terms of the contract.

**6.3.1. Rights of Surety**

**Right of Subrogation:** Right of a surety against principal debtor: Where a guaranteed debt has become due, or default of the principal debtor to perform a guaranteed duty has taken place, the surety upon payment or performance of all he is liable for, is invested with all the rights which the creditor had against the principal debtor. A surety is thus, upon the payment of the guaranteed sum or on performance of a guaranteed duty, subrogated or invested with all the rights which the creditor had against the principal debtor. This arises on payment of the whole sum due or performance of the entire duty. Surety steps into the shoes of the creditor. Surety may now sue the principal debtor in as much as the creditor had the right to sue the principal debtor.

The 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, though there was no stipulation for that; and to avail himself of all those securities against the debtor. This right of a surety also stands, not upon a principle of natural justice.

**Right to benefit of creditor’s securities Right of surety against the creditor:** A surety is entitled to the benefit of every security which the creditor has against the principal debtor at the time when the contract of surety ship is entered into, whether the surety knows of the existence of such security or not. We have seen above while discussing discharge of surety that if the creditor loses or, without the consent of the surety, parts with such security, the surety is discharged to the extent of the value of the security.

This right of surety arises on payment by him of the whole of the debt due to the creditor. Surety is entitled to be subrogated to all the rights and benefits of securities with the creditor which he has against the principal debtor. His right extends to securities of which he is not aware. He is also entitled to securities received by the creditor before or after the contract of surety ship. If the creditor loses, or without the consent of the surety, parts with such security the surety is discharged to the extent of the value of the security. If the securities are burdened with further advances, if will not affect the rights of the surety.

**Rights to indemnity;** Right of surety against the principal debtor: In every contract of guarantee there is an implied promise by the principal debtor to indemnify the surety. The surety is entitled to recover from the principal debtor whatever sum he has rightfully paid under the guarantee, but no sums which he has paid wrongfully.

**Illustrations:**

*1. B is indebted to C and A is surety for the debt. C demands payment from A and on his refusal sues him for the amount. A defends the suit, having reasonable grounds for doing so, but is compelled to pay the amount of the debt with costs. He can recover from B the amount paid by him for costs, as well as the principal debt.
2. C lends B a sum of money, and A at the request of B accepts a bill of exchange drawn by B upon A to secure the amount. C, the holder of the bill, demands payment of it from A and on A’s refusal to pay, sues him upon the bill. A, not having reasonable grounds for so doing, defends the suit, and has to pay the amount of the bill and costs. He can recover the amount of the bill, but not the sum paid for costs, as there was no real ground for defending the action.
3. A guarantees to C to the extent of Br 2,000 payment for rice to be supplied to B rice of a less amount that Br 2,000 but obtains from A payment of the sum of Br 2,000 in respect of the rice supplied. A cannot recover from B more than the price of the rice actually supplied.*

Surety has a right to be exonerated by the principal debtor where his liability has become absolute. Surety is entitled to recover from the principal debtor actual sum rightfully due from him. For this, in every contract of guarantee, there is an implied promise by the principal debtor to indemnity the surety. In case surety pays less than what is due from the principal debtor, he is entitled to receive the sum actually paid by him.

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| ***Activity 6.1****How the banks are operating with surety ship (guarantee)? Visit banks and make report.* |

**6.3.2. Sureties Secondary Liability**

In a contract guarantee surety comes across secondary liability. The following are situations where sureties’ secondary liability comes to an end.

**(A) Discharge by revocation of guarantee:** The following are Situations where revocation of guarantee takes place by terminating secondary liability of Surety.

* ***By Notice:*** Surety can revoke his guarantee by giving a notice to creditor. Guarantees are of two types. Namely; Specific guarantee and Continuing guarantee. If guarantee is given to a particular debt, it is called specific guarantee. Specific guarantee cannot be revoked by notice on the other hand if guarantee extends to a group of debts, it is called continuing guarantee. Continuing guarantee can be revoked by giving notice. But here surety will be held liable to debts borrowed by principal debtor before such notice.
* ***By Death:*** Whenever surety comes across death, then his secondary liability comes to an end. But sureties’ legal representative will be held liable. In case where surety has given specific guarantee legal representative has to take up the secondary liability absolutely. In case where surety has given continuing guarantee, legal representative is liable to the debts granted by creditor to principal debtor till data of filing death notice by legal representative.
* ***By Renewal:*** Whenever renewal of guarantee contract takes place, old guarantee comes to an end. For example: There is a contract of guarantee among X, Y and Z who are creditor, principal debtor and surety respectively. There after Y has arranged Mr. A as surety in place of Z. As a consequence Z`s guarantee gets revoked and Z`s secondary liability goes off.

**(B) Discharge by activities of creditor:** Whenever creditor renders any of the following activities, surety gets discharges from his secondary liability.

* ***Alterations:*** In case where creditor makes material alterations in guarantee contract deed, without consent of surety discharge of Surety takes place. A case on this point is Witcher Vs Hall. In this case, creditor fraudulently alters the deed and surety gets decree from the court saying that he has no secondary liability.
* ***Releasing principal debtor:*** If creditor releases principal debtor from principal liability automatically sureties’ secondary liability also comes to an end. A case on this point is Hewson Vs Ricketts. In this case the creditor releases principal debtor and after coming to know about it, surety gets decree from court that he (surety) is also discharged.
* ***Improper dealings with principal debtor:*** If creditor collides with principal debtor and tries to defraud Surety, then also discharge of surety takes place. A case on this point is Midlon motor show rooms Vs Newman. In this case creditor joins hands with principal debtor and thus makes effort to cheat surety. Here court decides that surety has no secondary liability.
* ***Loosing securities:*** At times the principal debts may give additional securities also in support of the death besides personnel validity. Whenever creditor looses such securities, both primary and secondary liabilities will go out of existence.

**(C) Discharge by invalidation of guarantee contract:** When guarantee contract becomes invalid and surety will have no secondary liability. The following are situations where guarantee Contract becomes invalid.

* **Mis-Representation:** When surety is made involved in guarantee contract by means of fake representation, guarantee contract becomes invalid and Surety gets discharged.
* **Concealment:** When Surety is made involved in guarantee contract by concealing material facts, then also discharge of surety takes place.
* **No flow of consideration:** when creditor does not grant the loan as per the terms, there is a question of primary as well as secondary liabilities.
* **Absence of other essentials:** Besides consideration, the contract should have certain other features also, to attain validity. When guarantee contract is deficient in any one of those features, guarantee contract becomes invalid.
* **Co-surety not joining:** At times the surety may insist on presence of another surety. Then the guarantee contract becomes contingent contract. In case where such condition is not full filed i.e. co-surety does not join, it becomes invalid.

The implementation has been challenging to say the least. One of the vexed and difficult questions to answer is the extent of liability of a surety for the debts of the company in business rescue and how this ought to be dealt with in business rescue plans. Acting Justice Rogers delivered a judgment on 14 November 2011 in the Western Cape High Court under case number 19449/2011. In that case, Investec Bank Limited sued André Bruyns on surety ships which he had executed in favor of the bank for the debts of two companies which were in liquidation. According to Mr Bruyns the applications to place both companies under business rescue were pending and, therefore, he sought protection from the surety ship on this basis.

An important issue is that banks and other secured creditors may be reluctant to vote in favor of the business rescue plan if they perceive that the liability of the surety may be reduced if the business rescue plan is approved. The underlying philosophy is that creditors will only vote in favor of the business rescue plan if its implementation puts them in a better position regarding recovery. Lending and consequentially economic activity is encouraged when lenders have a right of recourse against the surety. If future decisions point to claims against sureties being compromised then the tendency may be for creditors to become reluctant in giving a breathing space to distressed companies which may prevent the spirit of the legislation may not be achieved.

A creditor of a distressed company holding a surety ship would be well advised to enforce such surety ship quickly in order to avoid running the risk of the claim against the surety being compromised. It is hoped that future judgments will deal with more practical issues arising from the implementation of business rescue plans which will determine the liability of sureties.

Summary

 A bank has agreed to lend you money to start a business. But the bank is asking for certain guarantees, including a personal guarantee. You wonder why you need to personally guarantee your company. You also have questions about whether a person who gives a personal guarantee is legally protected, especially when you don't have a chance to negotiate the terms of the guarantee. This article explains this particular kind of guarantee, which is also called surety ship.

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***Review Questions***

1. *\_\_\_\_\_\_\_\_\_is a contract by which a person, called a "surety" or "guarantor", agrees to pay money if the person who actually owes the money fails to do so.*
2. *Which one of the following contractual agreements is highly secured*
3. *Written contractual agreements*
4. *Oral contractual agreements*
5. *Third party contractual agreement*
6. *All are correct*
7. *Who can be a guarantor?*
8. *A company can be a guarantor*
9. *Authorized body in a company*
10. *Individuals can be a guarantor*
11. *B and C are correct*
12. *List down the laws created to protect people who sign contracts of adhesion*

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1. *List and explain the essential features of contract*

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1. *\_\_\_\_\_\_\_\_ means that the parties must agree about the subject matter of the agreement in the same sense and at the same time.*
2. *What are the important rights of surety?*

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1. *What are the elements of sureties secondary liability*

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1. *One of the following is not elements of discharge activities of creditor*
2. *Alteration*
3. *Releasing principal debtor*
4. *Improper dealing with principal debtor*
5. *Absence of other essentials*

***Self check table for students assessment***

|  |  |  |  |
| --- | --- | --- | --- |
| ***No.*** | ***Do students grasp objectives/competencies*** | ***Yes*** | ***No.*** |
| *1* | Define the surety ship (guarantee) |  |  |
| *2* | Describe the essential features of contract in surety ship and |  |  |
| *3* | Explain the extent of rights and liabilities of surety |  |  |