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Validity of Past Consideration in Guarantee Contracts

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ABSTRACT

The contract law of India came into existence in 1872 and yet there are provisions that are still contentious and need clarification given the advancing economy of the world. One of the contentious topics is the validity of past consideration in guarantee contracts. Guarantee contracts are a part of everyday business and is a way for creditors to make sure they get their credited amount back on time. The dispute in Section 127 of the Indian Contract Act which defines the consideration for a guarantee contract has been going on for years and different courts have given different interpretations of whether past consideration should be valid. With the Supreme Court recently opining that it should be valid while deciding a case, there is finally some direction the Indian courts can use to give the future judgements and develop the jurisprudence on this subject. The validity of past consideration has been upheld in other common law countries as well by using innovative ways to get around the textual barrier of the law as it achieves the objective of the contract which has also been discussed in the article.

Keywords: Past Consideration, guarantee.

I. INTRODUCTION

A contract of guarantee is a special contract mentioned under Section 126 of the Indian Contract Act. It is a contract in which one person agrees to discharge the liability of a third person in case of their default in payment. The three parties are- the surety who give the guarantee, the person whose liability the surety agrees to discharge called the Principal Debtor and the person whom the guarantee is given called the Creditor. Therefore, there is a contract of guarantee between the surety and the creditor and contract of indemnity between the Principal Debtor and the surety.

Before going to the consideration, the reason why this contract is made or the purpose also has to be seen so that it can be checked whether the purpose of the contract is fulfilled with the past considerations. The objective² of the contract is that the person is able to get a loan or get the

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² Volume 12, AVTAR SINGH, CONTRACT AND SPECIFIC RELIEF, 599, EBC 2020.

goods on credit and let the creditor have the assurance that the money will be returned. So, it is an assurance that if the first person responsible to pay isn't able to then the other person can make the payment in his place. Therefore, the purpose is to make sure the creditor gets the credited amount on time.

II. CONSIDERATION AND THE DISPUTE

Now, coming to the topic of discussion, it being a contract, it has to satisfy all the essentials of a contract. And, consideration is one of the essentials. What is consideration for a guarantee contract is given in Section 127 of the Indian Contract Act.

Section 127- *Anything done, or any promise made, for the benefit of the principal debtor, may be a sufficient consideration to the surety for giving the guarantee.*

Illustrations:

(b) A sells and delivers goods to B. C afterwards requests A to forbear to sue B for the debt for a year, and promises that, if he does so, C will pay for them in default of payment by B. A agrees to forbear as requested. This is a sufficient consideration for C's promise.

(c) A sells and delivers goods to B. C afterwards, without consideration, agrees to pay for them in default of B. The agreement is void.³

Therefore, any promise made by the creditor for the benefit of the principal Debtor is a good enough consideration for the surety. According to this section, it is immaterial whether or not there is any benefit for the surety. E.g., If the creditor agrees to but goods from the Principal debtor then this is good consideration for the surety event though it doesn't benefit him.

In this section however, there has been a dispute over whether past consideration will be considered as valid consideration. The issue stems from the ambiguity in the words 'anything done' and illustration 'c' of the section.

If the illustrations of this Section are read, then it becomes clear from illustration c that if the credit has already been given to the PD and at the time of the surety agreeing to give the guarantee, there is no other consideration, then the contract of guarantee is void. As it is given in illustration b, if a contract for the benefit of the PD is from the past then some other consideration has to be there while the contract for guarantee is made. Like in this illustration, the creditor agreed to forbear from suing the PD for one year and as this is beneficial for the PD, it is enough consideration for the contract of guarantee. This was also held in Madan Lal

³ Section 127, Indian Contract Act, 1872.

*Sobe v Rajasthan State Industrial Development and Investment Corpn Ltd*⁴. in which the court said that if credit has been given and when the payment becomes due, the creditor refrains from suing the PD, that would be sufficient consideration for the guarantee. However, this is still not past consideration but present consideration. It further said that a mere reading of the illustrations of this Section would clearly show that past consideration is not valid.

However, the words “anything done” have been interpreted differently by different courts when the question arose before the courts if the words anything done can be interpreted as something done in the past.

III. JUDGEMENTS IN FAVOUR OF PAST CONSIDERATION

The Oudh High Court in the case of *SBI v Premco Saw Mills*⁵ held that it can be a valid consideration. In this case, a lessee agreed to pay the sum due in instalments and the surety after some days agreed to discharge the liability in case of default. The court said that although this is past consideration, the term anything done can be interpreted to include acts done in the past for the benefit of the Principal Debtor and hence it is valid consideration. Although this judgement still stands, it has been criticized in *Pollock and Mulla* as a weird interpretation of the term anything done. The Bombay HC in the case of *SICOM Ltd v Padmashri Mahipatrai Shah*⁶, said that past consideration is valid. In this case, the guarantee contract was executed subsequent to the release of financial assistance to the borrower. It was also held that there need not be an independent consideration for each of the clauses. Even in the case of *Poshya Oxygen P Ltd v Ashwini Suri*⁷ it was held that past consideration is valid. Even the Karnataka HC in the case of *Jayakunvar Manilal Shah v Syndicate Bank*⁸ held that the term anything done is wide enough to include past consideration. It went on to say that the benefit to PD and execution of surety bond need not be contemporaneous.

In all these cases a similar line of reasoning was used. The courts said that the words ‘anything done’ are wide enough to be interpreted in a way to include the past consideration and this helps to protect the interest of creditor. Moreover, Section 2(d) of the ICA also says that past consideration is valid and that we need not follow the English law which says that it needs to be contemporaneous.⁹

⁴ *Madan Lal Sobe v Rajasthan State Industrial Development & Investment Corpn Ltd*, (2006) 135 DLT 554.

⁵ *SBI v Premco Saw Mills*, AIR 1940 Oudh 346.

⁶ *SICOM Ltd v Padmashri Mahipatrai Shah*, (2005) 3 Mah LJ 125.

⁷ *Poshya Oxygen (P) Ltd v Ashwini Suri*, 2009 SCC OnLine Del 2216.

⁸ *Jayakunvar Manilal Shah v Syndicate Bank*, 1991 SCC OnLine Kar 467.

⁹ *Devukutty Amma v Madhusudanan Nair*, (1955) 2 KLT 118.

IV. JUDGEMENTS NOT IN FAVOUR OF PAST CONSIDERATION

But there is a differing opinion given by some other High Courts. Telangana HC in a case¹⁰ held that the case¹¹ usually referred to in the cases in which past consideration is considered valid was not actually a case of past consideration as the security bond was executed in pursuance of the compromise which was in the past. However, this was just obiter dicta and not the ratio. In a case¹² before the Rajasthan HC, the court held that the past consideration is not valid as the guarantee contract has to be contemporaneous with the contract between the PD and creditor and hence past benefit for the PD is not valid consideration. In other cases, like *Nanak Ram v Mahin Lal and Pestonji Meekji Mody v. Meherbai* it was held that it cannot be valid consideration.

The line of reasoning used in all of these cases is that interpreting illustration 'c' of the Section clearly indicates that past consideration is not to be valid and this is often substantiated by the fact that Section 2(d) of the Indian Contract Act requires that the consideration moves at the desire of the promisor and if it has been done in the past then it is not moving at the desire of the promisor.

V. ANALYSIS

Section 2(d) of the Indian Contract Act does consider past consideration as valid but many courts have said that if the word consideration is interpreted according to Section 2d of ICA, then past consideration cannot be considered as consideration as the section says that something has to be done at the desire of the promisor and the consideration being given in the past cannot be at the desire of the promisor. But the first line of the Section also says 'unless a contrary intention appears from the context'. Guarantee contract is a special contract under the ICA and has its own definition for consideration given under 127. Hence, in my opinion, the definition which includes the words "anything done" does show a contrary intention to include even the consideration which does not move on the desire of the surety. Hence, the argument that it should not be allowed due to the limitation of 2(d) does not hold.

This topic does not have a uniform application due to the issue never having been decided by the Supreme Court and hence is still up for debate. In my opinion, although after reading the illustration, it gives the picture that past consideration is invalid for a guarantee contract, there is ambiguity in the Section which can be used to achieve the purpose of the guarantee contract.

¹⁰ *Mir Niyamath Ali Khan v Commercial & Industrial Bank*, AIR 1969 AP 294.

¹¹ *Kali Charan v Abdual Rahman*, AIR 1918 PC 226.

¹² *Ram Narain v Lt Col Hari Singh*, AIR 1964 Rajasthan 76.

As mentioned in the early paragraphs, the objective of guarantee contracts is to benefit the creditor and make sure that the liability of the Principal Debtor is paid on time. And hence if the Section can be interpreted in a way that it benefits the creditor then the same interpretation should be welcomed. Now, multiple courts have said that the term ‘anything done’ can be interpreted widely enough to cover the past consideration especially because Section 23 of the Indian Contract Act says that past consideration is valid. In fact, majority of the High Courts agree with this interpretation over not allowing past consideration and the recent judgements reflect the same.

Also, in the case of *Union Bank of India v Avinash P Bhonsle*¹³ the court said that it is an established understanding that an illustration does not extend the meaning of the section and they should not be read as restricting the operation of a section especially when if interpreted so, it would curtail the right given by the plain text of the Section. In this case, it was also mentioned that in the Indian Evidence Act, the illustration of Section 101 was restricting a right that was given under Section 106 of the act and hence the court had held that the illustration will not restrict a right that is provided in the Section. And hence Section 127 can be interpreted widely enough to not need the guarantee contract at the same time. The illustration c does not prevent the court from doing so and given that it achieves the objective of the contract, it is in my opinion the correct interpretation.

Even though the Supreme Court hasn't decided any case related to this issue, in a recent case¹⁴, the Supreme court did make a statement that “Under Indian Law, which is significantly different from English Law of Contract, past consideration or the consideration towards third person is statutorily held to be good consideration as defined in Section 2(d) and as mentioned in Section 127 of the Contract Act.” However, this particular case was not related to past consideration and hence it is only obiter dicta and not binding. Even though it is only the obiter, it is still an observation made by the Supreme Court and could be used to develop the future jurisprudence on this issue.

VI. LAW UNDER FOREIGN JURISDICTIONS

In Singapore, the guarantee laws are fairly similar to that of India. However, most of the courts in the past have ruled that past consideration will not be considered as valid consideration; however, alternatives can be used to overcome this issue like executing a document under a seal or forbearance to sue. Some of the recent judgements have tried to overcome the problem

¹³ *Union of India v Avinash P Bhonsle*, 1991 Mah LJ 1004.

¹⁴ *Aniuj Jain v Axis Bank Limited & Ors*, MANU/SC/0228/2020.

of past consideration by avoiding literal interpretation of the law.¹⁵ Goh Yihan and Yip Man in 2012¹⁶ did mention that the problem is that the courts use chronology as the sole determinant to decide whether the consideration is given. They suggest that instead the intention should be checked as if the intention of giving the consideration was the guarantee, then it should not matter if it was done in the past.

Even in Hong Kong¹⁷, the literal interpretation of the law would lead to the conclusion that past consideration is not valid but the judicial decisions have tried to interpret it in such a way that the giving of the guarantee is regarded as one single transaction together with the underlying contract. The courts have said that in many cases, there is a term to procure a guarantee while making the contract and hence if the surety comes subsequent to the formation of the contract, it cannot be said that there is no consideration as it can be said that it is part of one transaction. The courts have also constantly said that to avoid this confusion and get around the problem, it is better if people execute a guarantee under a seal or expressly state the consideration under the guarantee contract.

VII. CONCLUSION

Even Hong Kong and Singapore and UK which are the business hubs of the world have tried to get around the traditional interpretation of the law which says that past consideration is invalid because it makes no commercial sense. They have given innovative ways to get around the problem in the text. However, the Indian text does allow for an interpretation to include past consideration without needing innovative methods to get around the restriction and it has been interpreted so by many High Courts and even recently by the Supreme Court. Although the issue is still up for debate, the Supreme Court making a statement that past consideration is valid has given the courts of the country a particular direction to follow which will be beneficial for commercial activities in the country.

¹⁵ SH Lock Discounts & Credits Pty Ltd v Miles, [1963] VR 656.

¹⁶ Yihan Goh Man Yip, *Past Consideration or Unconnected Consideration*, 24, SAclJ, 553, 561-563.

¹⁷DEACONS, <https://www.deacons.com/news-and-insights/publications/have-you-provided-good-consideration-for-your-guarantee.html>, (last visited May 22, 2021).