

## **CHAPTER 23 THE LAW OF GUARANTEES**

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### **SECTION 1 INTRODUCTION**

#### ***Essence of a Guarantee***

23.1.1 A guarantee is an undertaking given by a first person (the surety) to a second person (the creditor) in respect of the payment obligation of a third person (the principal debtor) towards the second person. In essence, a guarantee is where A promises B: 'If C is liable to you and fails to pay you, I will'.

#### ***Sources of Law***

23.1.2 In Singapore, the law of guarantees is to be found primarily in the cases. As regards foreign case authority, English and Australian cases are often referred to; to a lesser extent, reference is made to case law from Canada, Malaysia and other Commonwealth jurisdictions. There are a few statutes of direct relevance to guarantees and they include the Mercantile Law Amendment Act (cap 388), the Hire-Purchase Act (cap 13) and the Minors' Contracts Act (Cap 389).

23.1.3 Since a guarantee is basically a contractual obligation, the law of contract would apply. In addition there are special principles that have been developed in the context of guarantees – in particular, regarding the defences and rights of a surety. It should be noted, however, that the notion of freedom of contract generally prevails and that, consequently, the rights of the parties would usually depend on the terms of the particular guarantee document.

23.1.4 We shall approach the subject in the following order of topics: nature of a guarantee, formation of contract, formalities, liability of surety, discharge of surety, rights of surety, and performance guarantees.

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## **SECTION 2 NATURE OF GUARANTEE**

### ***Collateral Liability***

23.2.1 Earlier, we have seen that a guarantee is a promise by the surety that if the principal debtor is liable and does not pay, the surety will. Such an obligation should be distinguished from another third party obligation which is quite similar – the indemnity. The difference between the two is the principle of collateral or secondary liability. In a guarantee, the surety is liable only if the principal debtor is liable and fails to pay; if the principal debtor is not liable, neither will the surety be. In contrast, the indemnitor's promise is: 'I will hold you harmless...', which is a primary obligation. Even if for some reason the debtor is not liable, the indemnitor is still required to compensate the creditor for his loss.

23.2.2 It is important to distinguish guarantees and indemnities for several reasons. The first is that whilst guarantees are required by statute to be evidenced in writing, indemnities are not. Secondly, if the principal debtor's contract is void, the surety is discharged whereas an indemnitor would remain liable. Thirdly, since the surety's liability is co-extensive with the principal debtor's, the discharge of the principal debtor also discharges the surety; in contrast, the indemnitor is liable even if the debtor is excused. It should be noted, however, that apart from these aspects, many of the principles, defences and rights under suretyship law apply to indemnities as well.

23.2.3 The inclusion of 'principal debtor clauses' in the guarantee document can give rise to interpretational difficulties as to whether the undertaking is a guarantee or an indemnity.

### ***Types of Arrangements***

23.2.4 There are basically three types of suretyship arrangements:

- (a) the normal tripartite arrangement in which suretyship exists as between principal debtor and surety and as between surety and creditor;
- (b) a suretyship arrangement between principal debtor and surety only; and
- (c) a suretyship arrangement between surety and creditor only.

In categories (b) and (c), the surety's rights are not as extensive and are less clear.

23.2.5 While under American law a distinction is drawn between a surety who is compensated and one who is not, Singapore law generally does not make the distinction; the liabilities and rights are largely the same for both categories.

### ***Similar Undertakings***

23.2.6 There are several undertakings or instruments which are somewhat similar to guarantees. The indemnity has been mentioned; in addition, there are contracts of insurance, comfort letters and performance guarantees. Performance guarantees will be dealt with separately at the end of this Section. An insurance contract is really an indemnity. A comfort letter is an amorphous obligation and is typically given in a

situation where a parent company is unwilling to give a guarantee in respect of a subsidiary's liability. Instead, it gives a letter to the creditor and in that letter acknowledges awareness of the proposed financing to the subsidiary and adds a (hopefully) harmless statement such as that 'it is our policy to ensure that our subsidiary is in a position to perform its obligations'. Depending on the actual words used and the circumstances of the case, a comfort letter may be either a legal undertaking (equivalent to a guarantee) or simply a placebo which carries no legal obligation.

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### **SECTION 3   FORMATION OF CONTRACT**

23.3.1   Two aspects of contract law require special mention here: revocation of guarantees and consideration.

#### ***Revocation***

23.3.2   As regards revocation, a guarantee may be either bilateral – a promise in return for a promise, or unilateral – a promise in return for an act. In a bilateral contract, upon the execution of the contract, all the elements of formation are satisfied. In a unilateral contract, however, until the contemplated act is done, there is no acceptance and hence, strictly speaking, the offeror (here, the surety) can revoke his promise.

#### ***Unilateral Guarantees***

23.3.3   Unilateral guarantees fall into two categories – specific (where the consideration is entire and indivisible) and continuing. A continuing guarantee is one where the consideration is divisible, covering a series of acts or transactions. A specific guarantee may be revoked before the entire consideration is given. A continuing guarantee may be revoked, as to future transactions, by giving notice to the creditor. Creditors often insert a clause in the guarantee to remove or restrict this right of revocation; such clauses appear to be effective.

#### ***Death/Insanity of Surety***

23.3.4   A continuing guarantee may also be revoked by the death or insanity of the surety.

#### ***Consideration***

23.3.5   As with all contracts, a contract of guarantee must be supported by consideration. A creditor who wishes to enforce a guarantee must show that he has given consideration (not necessarily to the surety; usually it is given to the principal debtor) for the surety's promise. Thus, if at the time of giving the guarantee the creditor had already given the consideration, such as by the advance of money under a loan, the danger is that the contract is unenforceable since the consideration appears to be past. An alternative is to execute the document under seal; another

alternative is to show forbearance, either through a promise to forbear or actual forbearance at the request of the surety.

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## **SECTION 4 FORMALITIES**

### ***Signed Note***

23.4.1 Section 6(b) of the Civil Law Act provides that in order for a legal proceeding to be brought against a defendant for any promise 'to answer for the debt, default or miscarriage of another person', there must be a written note or memorandum signed by the surety; an oral guarantee is unenforceable under Singapore law.

### ***Ambit of Statute***

23.4.2 The main purpose of such a legal requirement is to protect honest people from being liable for guarantees they never gave. The ambit of the statutory provision, however, is potentially wider. Over time, the courts have established that in order for a promise to be within the statute, four requirements need to be satisfied:

- (1) the promise is made to the creditor;
- (2) the promise is collateral to the primary obligation of another;
- (3) there must be an absence of liability on the part of the defendant or his property apart from his promise; and
- (4) the main object of the promise must be to guarantee.

23.4.3 If any of these requirements is not satisfied, the statute does not apply and an oral promise may be sued upon. The presence of these four hurdles helps to curtail the potential harshness of the writing requirement.

### ***Additional Formalities***

23.4.4 Where guarantees are given in respect of loans by moneylenders or in connection with hire-purchase, there are additional formalities required under the Moneylenders Act (cap 188) and Hire-Purchase Act (cap 125) respectively.

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## **SECTION 5 LIABILITY OF SURETY**

### ***Construction of Guarantee***

23.5.1 The liability of a surety under a guarantee is a matter of construction or interpretation of the guarantee in question. However, there is some controversy as to whether guarantees should be construed somewhat differently from other

contracts. It has been said that the liability of the surety arises *strictissimi juris* – the contract of guarantee is to be strictly construed in favour of the surety. There are two main reasons for such an approach. Firstly, the surety is entering into liability not for himself but for a third person; it is therefore the duty of the creditor to see that the obligation is couched in clear terms so that the surety understands the liability he is undertaking. Secondly, the surety often receives no benefit for his onerous obligation. An opposing view is that a guarantee should be construed no differently from other contracts. The balance of judicial opinion suggests that the *strictissimi juris* rule still exists.

23.5.2 In addition to this rule, the general rules relating to the construction of contracts apply, such as:

- the intention of the parties is to be gathered from the document and from such extrinsic evidence as is admissible;
- the plain meaning of the words used, subject to exceptions, is to be given effect to; and
- the parole evidence rule and its exceptions.

### ***Parole Evidence Rule***

23.5.3 According to the parole evidence rule, no extrinsic evidence is admissible for the purpose of contradicting, varying, adding to or subtracting from the terms of a written contract. The exceptions to the rule include:

- adducing extrinsic evidence to show that the contract is invalid such as because it lacked consideration or was induced by vitiating conduct (eg undue influence);
- giving extrinsic evidence of a separate oral agreement as to a matter on which the written contract is silent.

### ***Extent of Liability***

23.5.4 The extent of liability of a particular surety depends on what was undertaken by the contract. The guarantee has to be construed to determine whether (for example):

- the guarantee covers a past or future debt;
- the guarantee is specific or continuing;
- the guarantee is for the whole or part of the principal debt (if the guarantee is for only part of the debt, upon payment of that part of the debt, the surety has recovery rights against certain parties);
- the guarantee is limited or unlimited in amount (note that leaving the amount blank in a limitation clause gives rise to complications and should be avoided);
- the guarantee is limited or unlimited in duration;
- the principal debtor's guarantee liability i.e., the principal debtor's liability as surety, is also covered; and
- interest and costs are covered.

### ***Estoppel by Convention***

23.5.5 The principle of estoppel by convention may be relevant to the liability of a surety. According to this principle, when parties have acted in their transaction upon the agreed assumption that a given state of facts is to be accepted between them as true, then they will be estopped from questioning the truth of the state of facts so assumed. For instance, on this basis, a surety has been held liable for loans made to a number of companies within a group although the guarantee referred to one of them only.

### ***When Liability Arises***

23.5.6 A surety's liability, being collateral to that of the principal debtor, arises when there has been a default by the principal debtor. The liability arises immediately upon the default and, unless the guarantee provides otherwise, is not conditional upon the creditor doing any of the following:

- notifying the surety of the principal debtor's default;
- making a demand upon the surety;
- suing the principal debtor; or
- realizing any security held by the creditor.

23.5.7 A surety who wishes to make his liability so conditional must make specific provision in the guarantee.

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## **SECTION 6 DISCHARGE OF SURETY**

23.6.1 There is a wide variety of grounds upon which a surety may be discharged from liability; some of these grounds are an application of general law while others are particular to the law of guarantees.

### ***Discharge of Principle Debtor***

23.6.2 As we have seen, collateral liability is an essential aspect of a guarantee, and if the principal debtor is discharged, so is the surety. Thus, if the principal debtor performs his primary obligation and makes payment, the surety is also discharged. There is no general principle that a payment by the principal debtor to the creditor must be made towards the payment of the guaranteed debt. Another situation where the principal debtor is discharged is where the creditor's breach of contract entitles the principal debtor to terminate the principal contract

### ***Discharge by Creditor's Conduct***

23.6.3 There are many scenarios in which the conduct of the creditor may result in the discharge of the surety:

### ***Variation of Principal Contract***

23.6.4 Any variation to the principal contract, other than variations which are beneficial or which cannot be prejudicial to the surety will discharge the surety. The reason for this strict rule is that since the surety is understandably concerned about transactions involving the principal debtor, the creditor must inform and consult him. The surety is not discharged if the principal contract allowed for variations or if the surety had consented, such as through a clause in the guarantee, to the variation. Note, however, that a clause in the guarantee may not justify a radical change.

#### ***Alteration of Terms of Guarantee***

23.6.5 If the creditor deliberately alters the instrument of guarantee in any material particular without the consent of the surety, the instrument will become void and the surety will be discharged.

#### ***Departure from Terms of Guarantee***

23.6.6 If the creditor departs from or breaches a term in the guarantee, whether the surety is discharged depends on the seriousness of the breach. If it is a serious breach, the surety is fully discharged whereas if it is not serious, then the surety is discharged only to the extent that he suffered prejudice.

#### ***Agreement to Give Time to Principal Debtor***

23.6.7 It is a strict principle of suretyship law that an agreement to give time to the principal debtor discharges the surety if it was made without the surety's consent, whether or not the surety is prejudiced by it. The technical reason is that this agreement interferes with the surety's right to pay the creditor and sue the principal debtor.

#### ***Agreement with Principal Debtor to Give Time to Surety***

23.6.8 Where the creditor agrees with the principal debtor to give time to the surety, the surety is discharged. The reason is that such an agreement ties the hands of the creditor from receiving payment from the surety and therefore interferes with the surety's right to pay the debt and sue the principal debtor.

#### ***Release of Principal Debtor***

23.6.9 A release of the principal debtor discharges the surety, for the same technical reason that his right to pay the debt and sue the principal debtor is interfered with. The surety is not discharged if the contract of guarantee provides otherwise.

#### ***Release of Surety***

23.6.10 Obviously, if the creditor chooses to release the surety, the latter is discharged from liability.

#### ***Release of Co-Surety***

23.6.11 A release of a co-surety discharges the surety, the reason being that such release may prejudice his right of contribution from the co-surety.

### ***Release or Loss of Securities***

23.6.12 Where the existence of the security is a condition of the guarantee, the release or loss of the security by the creditor fully discharges the surety. Where there is no such condition, the release or loss discharges the surety only to the extent that he has been prejudiced. The creditor, however, is probably not under a duty to the surety to realize a security before it became worthless; the creditor is free to decide whether or not to realize security, and if so, when.

### ***Negligent Realization***

23.6.13 While a creditor is not under a duty to enforce securities held by him, if he does enforce any such securities, he owes a duty to the surety to take reasonable care in enforcing them. He is under a duty to realize the securities at the 'best possible price' or the 'true market value', at the time he realizes them.

### ***General Duty not to Prejudice the Surety?***

23.6.14 There is some authority for a general proposition that if the creditor does any act which is injurious to the surety or inconsistent with the surety's rights, the surety is discharged.

### ***Clauses Taking Away Surety's Defences***

23.6.15 Most standard form guarantees contain clauses that seek to preserve the surety's liability in every scenario where the surety would have been discharged on account of the creditor's conduct. While such clauses are generally effective, it is possible that in some situations they may amount to unreasonable exclusion clauses under the Unfair Contract Terms Act (cap 396).

### ***Avoidance of Guarantee***

23.6.16 Like any contract, a guarantee can be avoided because of vitiating factors such as misrepresentation, undue influence, illegality and so forth.

### ***Non-Disclosure***

23.6.17 It is well-established that unlike contracts of insurance, a contract of guarantee is not a contract uberrimae fidei – there is no obligation on the part of the creditor to disclose to an intending surety all material facts of which the creditor is aware. Instead, the creditor has a duty to disclose unusual facts or, put in another way, anything that might not naturally be expected to take place between the parties. It has recently been said that 'a creditor is obliged to disclose to a guarantor any unusual feature of the contract between the creditor and the debtor which makes it materially different in a potentially disadvantageous respect from what the guarantor might naturally expect'.

### ***Misrepresentation, Undue Influence and Unconscionability***

23.6.18 A guarantee may be avoided on account of the creditor's vitiating conduct in inducing the other party to give the guarantee, such as through misrepresentation, undue influence and unconscionability. Misrepresentation involves the false statement of a material fact to induce the other party. Undue influence refers to the improper use of pressure or influence. Unconscionability involves the exploitation of a person's disadvantage or disability to achieve an oppressive result. If the creditor uses any of these forms of improper conduct to induce the guarantee to be given, the guarantee may be avoided.

### ***Principal Debtor's Vitiating Conduct***

23.6.19 In the context of guarantees, the vitiating conduct that is likely to occur is not so much that of the creditor but rather that of the principal debtor towards the surety. The typical scenario is where a debtor-husband through some vitiating conduct induces his wife to stand as surety (or mortgagor) for him. The difficulty here is in deciding which of the two apparently innocent parties is deserving of the law's protection – the surety or the creditor. The recent two decades have seen significant developments in this area of law.

23.6.20 The current position, after two landmark House of Lords decisions, appears to be as that the creditor is affected by the principal debtor's misconduct towards the surety if:

- (a) the principal debtor was the creditor's agent in securing the surety's consent to giving the guarantee; or
- (b) the creditor had actual or constructive notice of the principal debtor's impropriety.

### ***Constructive Notice***

23.6.21 The constructive notice concept used here needs elaboration. A creditor who is 'put on inquiry' as to the impropriety is required to take reasonable steps to ensure that the surety understands the nature and effect of the transaction; otherwise he is affixed with constructive notice. A creditor is said to be put on inquiry by a combination of two factors – the transaction not being to the financial advantage of the surety, and substantial risk of the debtor committing wrong in procuring the guarantee.

### ***Reasonable Steps***

23.6.22 The creditor has to take reasonable steps either through a private meeting with the surety or through obtaining confirmation from a solicitor acting for the surety. There are elaborate requirements and qualifications with regard to the steps that should be taken.

### ***Wider Propositions?***

23.6.23 In addition to these principles, there is weighty dicta for two wider propositions of law: that the creditor is put on inquiry whenever a wife stands surety for her husband's debts, and that a creditor is put on inquiry in respect of all non-commercial sureties.

### ***Avoidance of Corporate Guarantees***

23.6.24 A corporate guarantee may be avoided on account of it being ultra vires the company i.e., beyond the company's capacity. In addition, the Companies Act (cap 50) prohibits a company from giving a guarantee:

- for the purpose of the purchase by any person of shares in the company or in its holding company;
- for the benefit of a director of the company or a related company; or
- for the benefit of a company that is connected to the directors of the company giving the guarantee.

However, the respective contraventions have differing effects on the enforceability of the guarantee.

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## **SECTION 7 RIGHTS OF SURETY**

23.7.1 The main rights of a surety are: the right of indemnity as against the principal debtor, the right of subrogation as against the creditor and the right of contribution as against co-sureties.

### ***Right against Principal Debtor***

23.7.2 There are two main bases upon which a surety may claim against the principal debtor – indemnity and restitution. The indemnity basis applies whenever there is as between the principal debtor and the surety an express or implied agreement that the former will indemnify the latter from all losses incurred as a result of giving the guarantee. Upon paying the principal debt, the surety is entitled at law to exercise his right of indemnity. When the creditor makes a demand on the surety, it would be prudent for the surety to inform or consult the principal debtor as:

- it helps the surety to confirm that there has been default;
- it helps the surety to ascertain whether the principal debtor has any defences; and
- the principal debtor may in response give specific instructions to the surety or even assume responsibility of defending the action.

### ***Indemnity Rights***

23.7.3 In equity, even before payment, the surety has indemnity rights. As soon as the surety's liability to pay under the guarantee has become absolute in that the creditor has acquired a right to immediate payment by the surety, the surety is

entitled to call upon the principal debtor to pay the debt in order to relieve the surety of such liability. The surety proceeds by way of a 'quia timet' action (literally, 'because he fears').

### ***Restitutionary Rights***

23.7.4 The second basis is restitution. The restitutionary claim does not depend on any express or implied indemnity on the part of the principal debtor. Rather, the principle is that where the plaintiff has paid money which the defendant is liable to pay, so that the defendant has obtained a benefit by the discharge of his liability, the defendant is indebted to the plaintiff in that amount. Note, however, that the surety should not have 'officiously' assumed responsibility. A surety is officious if it was not reasonably necessary in his interests to assume responsibility.

### ***Rights against Creditor***

23.7.5 A surety who has paid the creditor has the right of subrogation, meaning that he is entitled to all the rights of the creditor in respect of the debt. This means, most importantly, that he is entitled to all the securities which the creditor received from the principal debtor or from a co-surety, whether the securities were given before or after the suretyship was entered into and whether or not the surety was at the time aware of their existence. An unrequested surety probably has subrogation rights. Apart from subrogation rights, a surety also has certain rights which may be exercised even before payment of the debt.

### ***Rights against Co-sureties***

23.7.6 A surety who has paid more than his share of the debt has a right of contribution against the co-sureties. Possibly, before payment, he has quia timet rights against his co-sureties. Co-sureties share their liability in accordance with what was set out in the guarantee. Failing such stipulation, the principle is that if each is a surety for an equal amount, they contribute equally whereas if they are liable for different amounts, they contribute proportionately. It would be prudent for a surety to consult his co-sureties before making any payment to the creditor.

### ***Rights of Set-off***

23.7.7 In addition to the abovementioned rights, there are also rights of set-off. Three forms of set-offs are of interest here: legal set-off, equitable set-off and insolvency set-off. Legal set-off is available where as between the plaintiff and the defendant there are mutual claims (that is, between the same parties and in the same capacities) which are liquidated and due and payable. Equitable set-off is available where the defendant's cross-claim is closely connected with the plaintiff's claim and applies whether or not the two claims are liquidated. Insolvency set-off is an automatic set-off of mutual debts as between a bankrupt and his creditors. The result of a set-off is that the original claim is cancelled out or reduced by the cross-claim.

23.7.8 Set-off may apply to guarantees, for example where:

- the creditor has a claim on the guarantee against a surety who has a cross-claim against him;
- the surety has an indemnity claim against the principal debtor who has a cross-claim against him; or
- the surety has a contribution claim against a co-surety who has a cross-claim against him.

23.7.9 A surety may also be able to invoke the right of set-off which the principal debtor (or a co-surety) has against the creditor, although this is a matter of some debate.

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## **SECTION 8 PERFORMANCE GUARANTEES**

### ***Essence of Performance Guarantee***

23.8.1 A performance guarantee or performance bond, like an irrevocable standby letter of credit, is in essence an unconditional undertaking by a third party to pay the beneficiary upon demand, independent and irrespective of the underlying contract between the beneficiary and the principal. The operative words of the performance guarantee would usually recite, for example, an obligation or undertaking to 'pay on first demand without proof or conditions'. The issuer of the performance guarantee has primary liability, unlike a surety, who has collateral liability. Suretyship concepts, rights and defences are generally not applicable to performance guarantees. It is a question of construction whether a particular instrument is a performance guarantee or a true guarantee.

23.8.2 Unconditionality of payment is the key characteristic of a performance guarantee. So long as the demand requirements stated in the document are complied with, payment has to be made under the performance guarantee. This rule, however, is subject to two exceptions.

### ***Fraud***

23.8.3 The first is where the bank knows that the call on the performance guarantee is clearly or manifestly fraudulent. To obtain an injunction against a bank on the fraud exception, the principal must show that the beneficiary did not honestly believe he had a valid claim and that the bank, at the time of demand, either was aware of the beneficiary's fraud or else was reckless, in that the only realistic inference to be drawn in the circumstances was that the demand was fraudulently made.

### ***Unconscionability***

23.8.4 The second exception is unconscionability, a ground which Singapore courts have deliberately established. Singapore courts will, on the ground of unconscionability, exercise their discretion to prevent abusive calls and prevent the use of performance guarantees as instruments of oppression. Situations in which

unconscionability has been found include fulfillment of the underlying obligation and beneficiary's breach causing non-fulfillment of the underlying obligation.

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