# A Classification of Contracts of Guarantee

The purpose of this comment is to classify commercial[1] "contracts of guarantee" by identifying the basic nature of the guarantor's liability.

The first issue is that of construction. Naturally parties are entitled to make any contract they choose. Having identified the contractual terms agreed upon by the parties, the court must construe the words to decide their meaning and legal impact. In determining whether a particular contract is one of guarantee, the court considers the substance of the agreement.[2] The form of the contract or even the use of the word "guarantee" is not conclusive.[3] It is a question of law in each case. This theoretically simple process is complicated by inexact usage of important words such as "indemnity" and "guarantee and the courts have not always helped to clarify the situation.[4]

In *Moschi v Lep Air Services*[5] Lord Diplock relied on early leading decisions to develop a "correct" definition of the nature of a guarantor's liability. *Moschi* was a case of payment by instalments, where the debtor's default amounted to a serious breach, which led to the termination of the contract before the full purchase price was due. The guarantor "personally guaranteed the performance" by the debtor company "of its obligation to make the payments of £6,000 per week".

Lord Reid defined two types of agreements in relation to instalment repayments. The first was a conditional agreement, where upon the default of the principal debtor the creditor could sue the guarantor for a liquidated amount of an accrued debt. The guarantor's liability arose upon the principal debtors' failure to pay. The second type was a guarantee of the performance of some obligation by the debtor. The failure by the principal debtor to perform the obligation put the guarantor in breach of the contract of guarantee, and the creditor was entitled to sue the guarantor for damages for this breach of contract.[6]

These categories should be explained further. A promise that the debtor will perform contractual obligations (a promise to "see to it" that the debtor performs[7]) can be classified as a simple "guarantee". This definition is consistent with historical sources[8] that define a guarantor's liability as

1 State legislation governs consumer guarantees: for example, ss136-144 of the *Credit Act* 1984 (NSW); for details see O'Donovan and Phillips, *The Modern Contract of Guarantee* (1985) at 585-604.

2 *Seaton v Heath* [1899] 1 QB 782.

3 For example, *Re Australian and Overseas Insurance Co Ltd* [1966] 1 NSWLR 5587.

4 The judicial approach towards ambiguous guarantees has been inconsistent. The more logical approach would seem to be to treat guarantees as ordinary commercial contracts to be given a reasonable business meaning. For a discussion see JW Carter and JC Phillips "Construction of Contracts of Guarantee and the Hong Kong Fir Case" (1988) 1 *JCL* 70.

5 [1973] AC 331 at 347-9.

6 Id at 344-5.

7 In *Wright v Simpson* (1802) 6 Ver Jun 714; 31 ER 1272 at 1282 Lord Eldon stated: "But the surety is a guarantee; and it is his business to see whether the principal pays, and not that of the creditor". See also *Re Lockey* (1845) 1 Ph 509; 41 ER 726 at 727; *Mactaggart v Watson* (1835) 3 Cl and F 525; 6 ER 1534 at 1539-40.

8 Early cases were mainly concerned with the meaning of s4 of the *Statute of Frauds* 1677,

"secondary" or collateral because it is completely dependent on the default of the "primary" obligation of the debtor.[9] Alternatively, a promise to pay a debt upon the debtor's default is a "conditional promise": the promisor will pay if the condition of the debtor's default is fulfilled. In addition, unconditional promises to replace any loss the creditor suffers in the course of a transaction with the debtor make up a third category. This liability, which is usually known as an "indemnity", is wholly independent of the contract between the debtor and creditor, so the debtor's default is not a condition precedent to the promisor's liability.[10]

The contract before the House of Lords in *Moschi*, however, seemed an "hybrid" of the two types of agreement suggested by Lord Reid: it was a promise of the "performance of payment". It has been suggested that in such a case the creditor can simply choose and argue the best remedy.[11] The historical answer in contrast is that an obligation to perform a payment is classified the same way as any other performance obligation, because originally the creditor had to frame an action for unpaid money in special assumpsit, not in indebitatus assumpsit (debt).[12] Lord Diplock accepted this historical analysis of a contract of guarantee (Lord Reid's second category) and classified the "unambiguous" *Moschi* contract as such. Because the guarantor had not fulfilled the contractual duty to ensure the debtor performed, the creditor was entitled to sue, not for the unpaid instalments, but for damages in breach. Lord Diplock summarised the situation:

> The guarantor's liability under this contract does not ... depend upon the debtor's failure to perform his primary obligation continuing to exist after the contract had been rescinded....It was the debtor's failure to perform his primary obligation to pay the instalments in circumstances which put an end to it that constituted a failure by the guarantor to perform his own primary obligation to the creditor to see that the instalments were paid by the debtor, and substituted for it a secondary obligation of the guarantor to pay to the creditor a sum of money for the loss thereby sustained. It is the guarantor's own secondary obligation, not that of the debtor, that the creditor is enforcing in his claim for damages for breach of his contract of guarantee.[13]

The situation seemed very clear, however Mason CJ was of a different opinion when a similar contract came before the High Court in *Sunbird Plaza Pty Ltd v Maloney*.[14] Annexed to a contract for the sale of land was a second contract which guaranteed:

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that applied to "any special promise to answer for the debt, default or miscarriage of another person".

9 See *Fitzgerald v Dressler* (1859) 7 CBNS 374; 141 ER 861; *Harburg India Rubber Comb Co v Martin* [1902] 1 KB 778 (C.A).

10 The debtor's default is the most likely cause of loss to the creditor. For explanations of the guarantee-indemnity distinction see *Forth v Stanton* (1688) 1 Wms Saund 210 at 211; 85 ER 217 at 222; *Birkmyr v Darnell* (1704) 1 Salk 27 at 27; 91 ER 27 at 27; *Lakeman v Mountstephen* (1874) LH 7 HL 17 at 24-5; *Yeoman Credit Ltd v Latter* [1961] 1 WLR 828 per Holroyd Pearce LJ at 831; *Vetro Glass Pty Ltd v Fitzpatrick* (1963) 80 WN (NSW) 1245; *Lac v Leff* (1968) 87 WN (NSW) 2305.

11 Sarah Sinclair, "The Difference between a Guarantee and an Indemnity" (1990) 6 *Auck Uni LR* 414 at 424.

12 *Mines v Sculthorpe* (1809) 2 Camp 215; 170 ER 1134.

13 Above n5 at 351.

> the performance by the ... purchaser of all the terms and conditions of the contract including the payment of all moneys payable hereunder by the above-mentioned purchaser.

The balance of the purchase price was payable "on settlement". Prior to completion, but after the time specified for settlement, the vendor validly terminated the contract of sale and sought from the guarantors the sum which was payable on settlement.

The guarantor, however, was not liable for the purchase price, because there had been no settlement. Mason CJ nevertheless discussed the guarantor's hypothetical liability. His Honour found Lord Diplock's historical analysis in *Moschi* "quite unrealistic"[15] for modern cases. He developed the idea that "some guarantees are enforceable otherwise than by an action for damages for breach of contract".[16] When a debtor defaults the guarantor is sued for the sum left unpaid. As support, Mason CJ cited *Hyundai Heavy Industries Co Ltd v Papadopoulos*,[17] a decision by the House of Lords apparently opposing *Moschi*.

The *Hyundai* contract was for a ship's construction, which was to be paid for by instalments. The guarantee had two parts. First was a promise to "guarantee the payment in accordance with the terms of the contract of all sums due or to become due by the buyer".[18] Lord Fraser alone referred to and employed Lord Reid's categories, classifying this as a guarantee of performance. The second limb promised if the buyer defaulted "we will forthwith make the payment in default on behalf of the buyer",[19] which he classified as belonging to the debt category. Lord Fraser saw "no reason why both types of guarantee should not be included in one document".[20] When the buyer defaulted on the second payment, the builders exercised their contractual right to terminate.

The overall effect of the "guarantee" was a promise to pay the debt upon the default of the debtor.[21] The court looked at the contract in this light primarily because the shipbuilders had sought the instalment-debt rather than damages. An award of damages from the buyers was not ruled out,[22] but there was no need to discuss this in detail, as the guarantors' liability for the debt due was the primary concern. Normally a guarantor is released on the discharge of the principal debtor, since a guarantor's liability is co-extensive with that of the debtor. In *Hyundai*, however, the court unanimously held the guarantors liable for the accrued right to the overdue instalment, even if the buyers were no longer liable. To explain this incongruity, this contract may be defined as a "conditional promise" to pay; the promisors became liable pay

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14 (1988) 166 CLR 245.
15 Id at 256.
16 Id at 257.
17 [1980] 1 WLR 1129.
18 Id at 1151.
19 Ibid.
20 Ibid.
21 Roskill LJ's judgment in the Court of Appeal was approved: "The true meaning is that if the buyer does not pay in time ... the guarantor will pay." [1978] 2 Lloyd's Rep 502 at 506.
22 Above n17 at 1141.

when the condition of the debtors' default occurred and thus a liquidated sum was awarded.

There are, moreover, some dubious aspects in the *Hyundai* judgments. Viscount Dilhorne justified his reliance on a part of the Court of Appeal's judgment, by claiming it was "not subjected to any criticism".[23] However, Lord Reid had clearly rejected the statement "that after accepted repudiation the contractual obligations still exist as obligations",[24] since all obligations are cancelled on termination. It seems Viscount Dilhorne based his judgment partly on a overruled precedent, which tends to undermine the decision's authority in this respect.[25]

In *Sunbird*, however, Mason CJ saw *Hyundai* as a guarantee case in which the recovery of a due but unpaid instalment was allowed. With *Hyundai* in mind, he analysed the *Sunbird* contract, which was expressed:

> we guarantee the performance by the ... purchaser of all the terms and conditions of the contract including the payment of all moneys payable hereunder by ... the purchaser.

This was a guarantee of the debtor's performance of the contractual obligations (including payment), which fell within Lord Reid's guarantee of performance category. Yet "the promise might well fall within the first category" Mason CJ said,[26] because the contract related specifically to payment of moneys. His Honour clearly believed the creditor should receive the fixed debt, rather than damages. This view is inconsistent with historical cases and *Moschi* and it seems to confuse the distinction between guarantees and conditional or unconditional promises. Mason CJ's novel concept was, however, only hypothetical not since been discussed[27] and should not be followed.

Using then the categories of "guarantee", "conditional promise" and "unconditional promise", it is useful to consolidate some of the practical consequences of the termination of the primary contract following a breach, or repudiation of the contract by the debtor. The general rule is that termination of a contract discharges both parties from their obligations to perform their contractual duties,[28] however rights already accrued remain unaltered by the termination.[29] *Moschi* approved this and held that termination did not release the guarantor in respect of the debtor's future

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23 Above n17 at 1136.

24 Above n5 at 345.

25 Lord Edmund-Davies and Viscount Dilhorne also distinguished *Moschi* as dealing with "future liabilities" and "liabilities not yet accrued" (at 1137, 1143), whereas *Moschi* was in fact concerned with the breach of contractual obligations to pay instalments due and the damages for this breach.

26 Above n14 at 257.

27 Even the other substantial *Sunbird* judgment of Gaudron J applied at 270-1 the *Moschi* definition of a guarantee, defining the contract at hand as a promise that the debtors would perform their contractual obligations, not as a promise to pay their debts. In *Nangus Pty Ltd v Charles Donovan Pty Ltd* [1989] VR 184 *Sunbird Plaza* was only discussed in so far as it cited *Moschi*'s definition of guarantees with approval.

28 *McDonald v Dennys Lascelles Ltd* (1933) 48 CLR 457 at 476-477; *Moschi v Lep Air Services Ltd* [1973] AC 331 at 345.

29 Ibid *McDonald v Dennys Lascelles Ltd.*

liability to pay damages for breach of contract, since this was a secondary obligation imposed by law, not by the contract.[30]

The next issue is obviously the remedies available to the creditor. If the principal debtor breaches a contract of "guarantee", the creditor seeks loss of bargain damages, which are assessed by reference to the total loss. For a successful claim, the creditor must terminate the contract[31] and in addition prove the breach was sufficiently serious, rather than just the subject of an express right to terminate.[32] Then the creditor has a choice of suing the debtor or the guarantor. If, in contrast, the contract is construed as an unconditional promise (indemnity), the creditor has the procedural advantages of suing for a liquidated sum: less evidence is required, the defendant carries the burden of proof and the rules of mitigation of loss do not apply. Although the maker of an unconditional promise remains liable notwithstanding the invalidity of the creditor-debtor contract, this would not apply to conditional promises.

The extent of a guarantor's liability depends, of course, on the construction of the specific wording of the contract. As a general rule the guarantor's liability only arises if a legally binding principal contract is concluded.[33] A line of English cases developed the principle of a guarantor's discharge when a creditor's acts or omissions in dealing with the principal debtor substantially and prejudicially alters the guarantor's rights.[34] In the Australian case of *Ankar Pty Ltd v Nat West Finance (Aust) Ltd*,[35] the majority of the High Court held that this equitable rule was subsumed in the general contract law, so a guarantor has the right of election to terminate if the creditor has "failed to comply with a provision that, as a matter of interpretation, required strict performance ... or at least substantial performance".[36] Since an unconditional promise contract is wholly independent, alterations to the principal contract have no affect, but this is too wide for a conditional promise contract.

Some aspects of liability are shared by the makers of unconditional promises and guarantors. If there is doubt as to the status of a term that might release the guarantor/promisor, it will probably be decided in their favour.[37]

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30 Cf *Sunbird Plaza* above n14; *Womboin Pty Ltd v Savannah Island Trading Pty Ltd* (1990) 19 NSWLR 364.

31 *Sunbird Plaza* above n14.

32 *Shevill v Builders Licensing Board* (1982) 149 CLR 620.

33 *Yeoman Credit Ltd v Latter* [1961] 1 WLR 828. There are a few exceptions, for example, infant contracts and directors' guarantees: for details see O'Donovan and Phillips, above n1, ch 5.

34 See *Rees v Berrington* (1795) 2 Ves Jun 540; 30 ER 765; *Samuell v Howarth* (1817) 3 Mer 272, per Lord Eldon at 278; *Creighton v Rankin* (1840) 7 Cl and F 325, 6 ER 1092 at 1100; *Halsbury's Laws of England*, 4th ed, vol 20, par259.

35 (1987) 162 CLR 549.

36 Id at 561. Subject to express agreement, variations to the contract are possible: *Duncombe v ANZ Bank* [1970] Qd R 202; *Burnes v Trade Credits Ltd* [1981] 1 NSWLR 93. It is unclear whether a guarantor would be liable when the debtor is released by an exclusion clause. In certain cases estoppel may be relevant. If there was an implied promise by the guarantor not to rely upon strict legal rights that allowed escape from liabilities knowingly assumed, it would be unconscionable for the guarantor then to rely on those rights when the creditor sought to enforce the contract. For example, *Yeoman Credit Ltd v Latter* [1961] 1 WLR 828: the guarantor knew the contract was illegal and so was held liable as if the contract was an indemnity.

37 Ibid for guarantors. For indemnifiers see *Smith v South Wales Switchgear Ltd* [1978] 1 All

The guarantor has no right to notice of the debtor's default and cannot make the creditor sue the debtor first.[38] However, once the guarantor/promisor's obligations have been satisfied, they have the right of subrogation: to enforce the principal obligation of the debtor and thus be reimbursed.[39]

In conclusion, it would seem that *Moschi* gives the correct explanation of contracts of guarantee, which has been accepted and applied frequently. By labelling Lord Reid's categories as "guarantee" and "conditional promise" (and adding the "unconditional promise" category), it is easier to understand and classify the contract in *Hyundai*. Mason CJ's original interpretation of the *Hyundai* contract and his "deviation" from the *Moschi* formula have proved insignificant, having won no favour. It is hoped this re-classification of contracts of guarantee helps to clarify a confusing area of the law.

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ER 18; *Greenwell v Matthew Hall Pty Ltd (No 2)* (1982) 31 SASR 548.

38 Above n5.

39 See O'Donovan and Phillips, above n1 at 328, 502-22.