to put in appearance before the learned trial Magistrate of the area concerned on January 29, 1987.

KULWANT SINGH TIWANA, J.—I agree.

S. S. DEWAN, J.—I agree.

H. S. B.

Before D. S. Tewatia and J. V. Gupta, JJ.

BANK OF INDIA,—*Appellant.*

versus

YOGESHWAR KANT WADHERA AND OTHERS,—*Respondents.*

Regular Second Appeal No. 1988 *of* 1985

August 28, 1986.

Contract Act (IX of 1872)—*Sections* 128, 140 *and* 141—*Bank loaning cash credit to principal debtor against hypothecation of stocks—Repayment of loan also guaranteed by surety—Principal debtor failing to discharge debt on demand—Bank suing for recovery of loan—Court finding that hypothecated goods were lost due to negligence of the Bank and as such liability of surety stood discharged—Liability of surety in cases of hypothecation—Explained—Surety—Whether can escape liability by invoking the provisions of Section* 141.

Held, that in hypothecation as the possession of the goods hypothecated is with the borrower, it will be wrong to say that the goods are in the constructive possession of the creditor bank because it has no effective control over them. By hypothecation, only an equitable charge is created and nothing more. Similarly, the borrower could not be called an 'agent' of the creditor Bank in this respect while dealing with the hypothecated goods unless so authorised by the Bank. It cannot be disputed that the liability of the surety is co-extensive with that of the principal debtor unless it is otherwise provided by the contract, as contemplated under Section 128 of the Contract Act, 1872. Section 140 thereof provides that 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 that he is liable for invested with all the rights which the creditor has against the principal debtor. Under Section 141 of the Act if the creditor loses, or without the consent of the surety, parts with the security pledged, the surety is discharged to the extent of the value of the security. Such a question cannot arise in the case of hypothecation of goods for the simple reason that when the goods are not in possession of the hypothecatee, there is no question of his losing or parting with the same. As such, surety in the case of hypothecation is not entitled to escape his liability by invoking the provisions of section 141 of the Contract Act.

(Paras 4 and 8)

State Bank of India *vs.* M/s Quality Bread Factory Batala and others AIR 1983 Punjab and Haryana 244.

(Over-ruled).

Case Referred by Hon'ble Mr. Justice J. V. Gupta, and 23rd April, 1986 to a Larger Bench as the case involves an important question of law. The Larger Bench consisting of Hon'ble Mr. Justice D. S. Tewatia, and The Hon'ble Mr. Justice J. V. Gupta, decided the case on 28th August, 1986.

Regular Second Appeal from the decree of the Court of the District Judge, Gurdaspur, dated the 26th day of March, 1985 reversing that of the Sub Judge 1st Class, Pathankot, dated the 4th day of August, 1984 and dismissing the plaintiff's suit qua *Defendant No. 4 and 5, leaving the parties to bear their own costs.*

R. K. Chhibbar, Advocate with R. S. Amol, Advocate, *for the Appellant.*

H. L. Sarin, Sr. Advocate (R. L. Sarin, Advocate with him), *for* the Respondent.

JUDGMENT

J. V. Gupta, J.

(1) The plaintiff-appellant Bank filed the suit for recovery of Rs. 71,500.51 against the principal debtors as well as against the guarantors, i.e., the sureties Yogeshwar Kant Wadhera and Jai Gopal Mehra. The trial Court decreed the plaintiff's suit against both the principal debtors as well as against the sureties. Aggrieved against the judgment and decree of the trial Court, the sureties filed the appeal and the learned District Judge relying upon the Single Bench judgment of this Court in *State Bank of India* v. *M/s. Quality Bread*

Factory, Batala, (1), came to the conclusion that if it was proved that the goods hypothecated by defendants Nos. 1 to 3 with the plaintiff was lost due to the negligence of the plaintiff, a finding will have to be recorded that the liability of the guarantors was discharged. Finally, their appeal was accepted and *qua* them the suit was dismissed.

(2) It would be pertinent to note here, in brief, that in the said Single Bench decision of this Court, it was held that if the loan has been advanced on the basis of security, the surety stands discharged to the extent of the value of the security, if the creditor loses or parts with the security without the consent of surety. Against the said judgment, the parties went to the Supreme Court, wherein their Lordships passed the following orders on November 21, 1983 :

> "The view taken by the High Court in the present case concerns only the hypothecation, and not that of pledge of goods so as to make the bank the bailee of goods highly debatable. But in view of the fact that the amount involved is very small, we do not think it fit to entertain the S.L.P. and hence it is rejected, but we may make it clear that we must not be deemed to have expressed our approval of the view taken by the High Court."

In view of those observations of the Supreme Court, the correctness of the judgment of the learned Single Judge in *M/s. Quality Bread Factory's case* (supra) was challenged in the present case when it came before me while sitting singly. Since the question was of importance for the Banking Industry and the Single Bench judgment of this Court in *M/s. Quality Bread Factory's case* (supra) according to me required re-consideration, I referred the case to a larger Bench,—*vide* my order, dated April 23, 1986. This is how the case is before us.

(2-A) The plaintiff-Bank sanctioned a cash credit limit of Rs. 30,000 against the hypothecation of stocks, re-payable on demand in favour of M/s. Baij Nath-Bhim Sain Wadhera and others, defendants Nos. 1 to 3. In pursuance of the sanction of the aforesaid cash credit limit of Rs. 30,000 by the plaintiff-Bank, defendants

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(1) A.I.R. 1983 Punjab and Haryana 244.

Nos. 2 and 3 on their own behalf and on behalf of their firm, defendant No. 1, executed various security documents in favour of the plaintiff-Bank including a particular joint and several promissory note for Rs. 30,000 and the deed of hypothecation of stocks. Defendants Nos. 4 and 5 executed a joint and several guarantee deed on May 1, 1976, guaranteeing the due payment of the money advanced by the plaintiff-Bank in consideration of the cash credit limit of Rs. 30,000, two days after demand together with interest at the agreed rates. Thereafter, in October/November, 1977, defendants Nos. 2 and 3 again approached the plaintiff-Bank and represented that they were converting their wholesale trade into retail trade and that they required the additional limit of Rs. 18,000 to enable them to meet their working capital requirements. The plaintiff-Bank sanctioned the aggregate cash credit limit of Rs. 40,000 against hypothecation of stocks and also to assure the repayment of the balance due and outstanding in the cash credit account of defendants Nos. 1 to 3. They also executed a joint and several demand promissory note for Rs. 40,000 bearing interest and also a deed of hypothecation in favour of the plaintiff-Bank of all stocks of crockery and cutlery etc. Likewise, defendants Nos. 4 and 5 executed a joint and several guarantee in favour of the plaintiff-Bank wherein they guaranteed the due re-payment of the loan lent by the plaintiff-Bank to the defendants up to the extent of Rs. 40,000 together with interest at the agreed rates. Since the principal debtors failed to make the payment; hence the suit against both the borrowers and the guarantors. The suit was decreed by the trial Court against all the defendants. Appeal filed against the same by the sureties was allowed by the lower appellate Court and the suit against them was dismissed. Dissatisfied with the same, the plaintiff has come up in second appeal to this Court.

3. It is the common case of the parties that the loans are advanced by the Bank to its customers either on key loan system or on open credit system. In the key loan system, the goods pledged are under the lock of the pledgee and the pledgor has no access to them whereas in the open credit system the goods pledged/hypothecated remain in actual possession of the pledgor. In the former system, the pledgor cannot deal with the goods unless the pledgee gives their possession to him, whereas in the latter system, he has freedom to deal with them. In the open credit system, however, the legal character of pledge as such is not maintained. The loan advanced on the basis of key loan system is also called loan, by pledge of goods and the loan advanced on open credit system is also called

factory type loan or loan on the basis of hypothecation. Thus, the main dispute between the parties to be decided in this appeal is : when the delivery of goods is not made over to the creditor, then, how far the sureties can escape liability by invoking section 141 of the Contract Act, 1872, which reads,—

> "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 suretyship is entered into, whether the surety knows of the existence of such security or not; and, 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."

There is no dispute that the Single Bench decision of this Court in *M/s. Quality Bread Factory's case* (supra) fully supports the surety-respondents because therein it has been held that there is no difference with regard to the legal possession of the bank over the security since in both the types of cases, viz., of pledge or of hypothecation, the goods are under the constructive possession of the bank while in the case of pledge they are also in the actual physical possession of the bank, in the case of hypothecated goods, they are in the actual physical possession of the borrower but subject to restrictions. It is the correctness of these observations of the learned Single Judge that the possession over the security remains of the bank in the case of hypothecation also, that are being challenged before us vehemently by the learned counsel for the appellant. We feel the challenge has some force.

4. The distinction between hypothecation of goods and pledge was brought out by the Madras High Court in *Union of India* v. *Ct. Shentilanathan,* (2). It was observed therein,—

> "Hypothecation of goods is a concept which is not expressly provided for in the law of contracts, but is accepted in the law merchant by long usage and practice. Hypothecation is not a pledge and there is no transfer of interest or property in the goods by the hypothecator to the hypothecatee. It only creates a notional and an equitable charge

(2) (1978)48, Company Cases 640.

in favour of the hypothecatee and the right of hypothecatee, as already stated, is only to sue on the debt and proceed in execution against the hypothecated goods, if they are available. As delivery of possession is not a *sine qua non* for the creation of a notional charge under a deed of hypothecation and as possession of the hypothecated goods is always with the hypothecator, a wide door is open to the owner to deal with the goods without reference to the hypothecatee. If, however, the hypothecator, contrary to the stipulation under the hypothecation bond, deals with the property, the breach on his part would certainly be noticed by the hypothecatee and he would be dealt with independently of him. It is in this context that the rights of a *bona fide* transferee for value of such goods are protected in law, for, the hypothecatee who fails to sequester the goods and reduce them into his custody, takes the risk of such clandestine dealings of the hypothecator. If the hypothecatee expressly or constructively notifies the equitable charge, matters would be different; even so, when the hypothecatee has constructive possession of the goods, though not physical possession of the same. In this case, it is not pretended that any such express or constructive notice of the existence of the hypothecation was ever given, nor it is claimed that the hypothecatee, namely, the plaintiff, did ever come into possession of the goods which were the subject-matter of Exhibit A-1. In the absence of such a constructive notice or express notice to the public at large, the right of the hypothecatee is that of a bare private money creditor with the ancillary right to proceed against the goods hypothecated after obtaining a decree in a Court of law. Thus, a hypothecation is a right in a creditor over a thing belonging to another and which consists in the power in him to cause the goods to be sold in order that his debt might be paid to him from the sale proceeds. This right is distinguishable from a mortgage of chattels."

The above observations of the Madras High Court, according to us, are entitled to great weight. That being so, a surety in the case of hypothecation is not entitled to invoke section 141 of the Contract Act for his benefit. Under the said section if the creditor loses, or without the consent of the surety, parts with the security

pledged, the surety is discharged to the extent of the value of the security. Such a question cannot arise in the case of hypothecation of goods for the simple reason that when the goods are not in possession of the hypothecatee, there is no question of his losing or parting with the same. Therefore, we are of the considered opinion that the sureties in the present case could not claim the benefit of section 141 of the Contract Act in such a situation. Reference in this behalf may be made to *Jayant T. Shah* v. *Andhra Bank Ltd.* (3).

5. In *M/s. Quality Bread Factory's case* (supra), the learned Single Judge in coming to the conclusion that when the hypothecated goods are lost by negligence of the pledgee, the surety stands discharged, relied upon the Supreme Court decisions in State of *Madhya Pradesh* v. *Kaluram*, (4), and the *State Bank of Saurashtra* v. *Chitranjan Rangnath Raja*, (5) and distinguished the judgments of the Andhra Pradesh High Court in *Vasireddi Seetharamaiah* v. *Srirama Motor Finance Corporation, Kekinada*, (6) and *Jayant T. Shah's case* (supra) and also of the Karnataka High Court in *Karnataka Bank Ltd.* v. *Gajanan Shankararao Kulkarni*, (7). We have gone through the said judgments. Both the afore-said Supreme Court judgments relate to the cases where the goods were pledged with the creditors and consequently, the delivery of goods was also given to them. None of those cases relates to a situation where the goods were hypothecated: meaning thereby that the delivery of the goods was not made to the hypothecatee. In *Chitranjan Rangnath Raja's case* (supra), the Supreme Court reiterated the view earlier taken in *Amrit Lal Govardhan Lalan* v. *State Bank of Travancore*, (8) and in *Kaluram's case* (supra), that if the creditor loses or without the consent of the surety parts with the security, the surety is discharged to the extent of the security lost as provided under section 141 of the Contract Act. The two judgments of the Supreme Court in *Kaluram's case* (supra) and *Amrit Lal Govardhan Lalan's case* (supra) were noticed by the Andhra Pradesh High Court in *Vasireddi Seetharamaiah's case* (supra), and distinguished on the ground that when the plaintiff had control or possession

(3) (1977)2 Andh. W.R. (H.C.) 129.
(4) A.I.R. 1967 Supreme Court 1105.
(5) A.I.R. 1980 Supreme Court 1528.
(6) A.I.R. 1977 Andhra Pradesh, 164.
(7) A.I.R. 1977 Karanataka 14.
(8) A.I.R. 1968 Supreme Court 1432.

of the security and he lost or parted with the same without the consent of the surety, the surety was entitled to the benefit of section 141 read with section 139 of the Contract Act, but in the case of hypothecation, such a situation did not arise.

6. Similarly, in *Gajanan Shankarrarao Kulkarni's* case (supra) which was a case relating to the hypothecation of goods, after considering the agreement, the Karnataka High Court held that the sureties could not appeal to the provisions of section 141 which in the facts and circumstances of the case, was not attracted. A mere passive inactivity or passive negligence on the part of the creditor by failing to realise the debt from the collateral security is not sufficient in itself to discharge the surety, for the reason that the surety can himself avoid consequences of such passivity by himself paying the debt and becoming subrogated to the rights of the creditor. In the absence of a contract to the contrary, the creditor is under no obligation of active diligence for the protection of the surety, so long as the surety himself remains inactive. Thus tested, the inaction on the part of the creditor-bank would not, of itself, mitigate sureties' liability.

7. Thus the view taken by the learned Single Judge in *M/s. Quality Bread Factory's case* (supra), cannot be upheld. The argument raised therein before the learned Single Judge that in the case of loan advanced on open credit system, the possession of goods remains with the debtor and in case he misappropriates the goods, the creditor cannot be held responsible for the same, could not be repelled on the strength of the Supreme Court decisions in *Kaluram's, Amrit Lal Goverdhan Lalan's* and *Chitranjan Rangnath Raja's case* (supra). As observed in the earlier part of this judgment, the above-said Spureme Court decisions were fully noticed by the Andhra Pradesh High Court in *Vasireddi Seetharamaiah* and *Jayant T. Shah's case* (supra) and by the Karnataka High Court in *Gajanan Shankararao's case* (supra) and distinction was clearly brought out that where the delivery of goods is not given to the creditor as is the case with the hypothecation, the surety was not entitled the claim the protection of section 141 of the Contract Act.

8. As in hypothecation, the possession of the goods hypothecated is with the borrower, it will be wrong to say that the goods are in the constructive possession of the creditor Bank because it has no effective control over them. By hypothecation, only an equitable charge is created and nothing more. Similarly, the borrower could not be called an 'agent' of the creditor Bank in this

respect while dealing with the hypothecated goods unless so authorised by the bank. It cannot be disputed that the liability of the surety is co-extensive with that of the principal debtor unless it is otherwise provided by the contract, as contemplated under section 128 of the Contract Act. Section 140 provides that 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 that he is liable for is invested with all the rights which the creditor has against the principal debtor. The provisions of both these sections came up for consideration before the Supreme Court in *Bank of Bihar* v. *Damodar Prasad,* (9), wherein it was held that under section 128, save as provided in the contract, the liability of the surety is co-extensive with that of the principal debtor. The surety thus becomes liable to pay the entire amount. His liability is immediate. It is not deferred until the creditor exhausts his remedies against the principal debtor. In the absence of some special equity the surety has no right to restrain an action against him by the creditor on the ground that the principal is solvent or that the creditor may have relief against principal in some other proceedings. Likewise where the creditor has obtained a decree against the surety and the principal, the surety has no right to restrain the execution against him until the creditor has exhausted his remedies against the principal. There is no gainsaying that in this case, the Supreme Court was not addressing itself to section 141 of the Contract Act, but still on the general principles relating to the surety, coupled with the fact that in case of hypothecation, the possession over the security, i.e., the goods, does not remain with the creditor and, therefore, the surety in such a case is not entitled to the benefit of section 141, we hold that the view taken by the learned Single Judge in *M/s. Quality Bread Factory's case* (supra), is not correct to the extent it goes in favour of the surety in the case of hypothecated goods also.

9. Consequently, this appeal succeeds and is allowed. The judgment and decree of the lower appellate Court are set aside and that of the trial Court decreeing the plaintiff's suit against both the principal debtor and the sureties are restored with costs.

R. N. R.

(9) A.I.R. 1969 Supreme Court 297.