
(1964) 07 KAR CK 0013
In the Karnataka High Court
Case No : Appeal No. 165 of 1959

Chandrasekhara Pai

APPELLANT

Vs

Town Co-operative Bank Ltd.

RESPONDENT

Date of Decision : 15-07-1964

Acts Referred:

Contract Act, 1872 — Section 139
Evidence Act, 1872 — Section 92

Citation : AIR 1965 Kar 209 : (1964) 2 MysLJ 260

Hon'ble Judges : B.M. Kalagate, J;A.R. Somnath Iyer, J

Bench : Division Bench

Judgement

Somanath Iyer, J.

(1) A certain R.G. Kamath who was a resident of the town of Virajpet in the district of Coorg was the manager of the bank known as the Town Co-Operative Bank, Limited, registered under the Coorg Co-operative Societies Act 1936. On March 14, 1955, a certain Chandrasekhar Pai executed an indemnity bond rendering himself liable in the sum of Rs. 4,500/- as guarantee for the fidelity of Kamath in the performance of his duties as the manager of the bank.

(2) On July 18, 1957, R.G. Kamath committed suicide. Before he died, he prepared a letter Exhibit A-1 in which he confessed that he had misused a large sum of money belonging to the bank for which, according to him, no one else could be blamed. After Kamath committed suicide, there was an investigation into the affairs of the bank which revealed that as large as a sum as Rs. 1,72,350-14 nP, had been lost by the bank by misapplication of funds and falsification of accounts. In consequence of that revelation, the bank sued Chandrasekhar Pai for the recovery of a sum of Rs. 4,511-42 nP. consisting of sum of Rs. 4,500/- which was the upper limit of his liability and a sum of Rs. 11-42 nP. representing the expenses incurred for the issue of notices. Chandrasekhar Pai resisted the suit principally on the ground that the loss occasioned to the bank was directly attributable to dereliction of duty on the part

of the Directors. He also repudiated the truth of the allegation that there was any misapplication of the funds of the bank by Kamath.

(3) The District Judge who came to the conclusion that there was some foundation for the charge made by Chandrasekhar Pai against the Directors of the bank that there was dereliction of duty on their part and disobedience to the provisions of the bank and gave it decree which it wanted. Chandrasekhar Pai appeals.

(4) In this appeal, Miss. Lalithamma appearing for Chandrasekhar Pai made the submission that it was not possible for the District Judge after recording a finding that the misapplications of the funds of the bank by Kamath was accompanied by a dereliction of duty and transgression of the provisions of the bye-laws on the part of the Directors, to make a decree against Chandrasekhar Pai. The argument advanced by Miss. Lalithamma was that since such embezzlement or misapplication of the funds of the bank by Kamath having been assisted by the Directors themselves who neglected the performance of their own duties enjoined by the bye-laws, the obligations of Chandrasekhar Pai under the deed of indemnity executed by him came to an end and that he stood discharged. It is the correctness of this postulate that requires investigation in this appeal.

(5) On the second issue in the case which covers the question whether Chandrasekhar Pai's guarantee came to an end by reason of the conduct of the Directors, the District Judge recorded what I consider to be a colourless finding. That issue reads:

"2. Whether such misapplication was the result of the Directors of the plaintiff bank to adhere to its bye-laws?."

In this issue is involved the plea contained in paragraph 3 of the written statement in which Chandrasekhar Pai asserted that the misapplication of the funds of the bank by Kamath was the natural and direct result of the failure of the bank to adhere to the rules laid down in the bye-laws of the bank that the bank allowed Kamath to retain with himself large sums of money without any let or hindrance and that there was a failure on the part of the bank to scrutinise the cash account maintained by Kamath. On this issue this is what the District Judge observed in paragraph 7 of his judgment:

"I think that adherence to the bye-laws in respect of administration of the affairs of the plaintiff bank was not there to some extent on the part of its Directors consistent with the requirements of the bye-laws and that there was no check of the cash in the hands of the Manager by the Directors and that the Manager was in sole charge of the cash of the plaintiff-bank and that the Directors did not appoint a Treasurer or authorise one of the Directors to attend to the checking of the daily cash balance. The answer to the first point under this issue, therefore, is that adherence to the bye-laws by the Directors to the extent stated above was not there in the matter of the management of the affairs of the plaintiff-bank."

It is to my mind surprising that on a question which is of such great importance in the case, the District Judge recorded a finding in the indefinite and ambiguous manner. It is difficult to understand why the District Judge stopped with an observation that adherence to the bye-laws "was not there" instead of proceeding to pronounce on the further and more vital question whether there was any such conduct on the part of the Directors as would entitle Chandrasekhar Pai to urge that the guarantee had terminated.

(6) Now, in paragraph 7 of his judgment although the District Judge pointed out that the bye-laws of the bank did not authorise the manager to keep with him cash in excess of Rs. 250/- and directed all sums of money in excess of that amount to be deposited in the post office savings bank and further directed daily checks of balance by a director authorised by the Board of Directors and the appointment of a treasurer to be in charge of cash in excess of that which the manager could have in his hands and he further proceeded to point out that there was neither any scrutiny into the cash balance by any Director nor the appointment of a treasurer as enjoined by the bye-laws "was not there" does not, in my opinion, correctly or adequately reflect the inevitable inference which had to be drawn from the premises referred to above.

(7) That is what, in my opinion, we should say since the District Judge did allude in that part of the Judgment to the fact that Kamath was allowed to keep sums of money very much in excess of Rs. 250/- and that not only was there neglect on the part of the Directors to make daily scrutiny into the cash balance or the accounts but also that such scrutiny was not made even at longer intervals. That Kamath was allowed to handle all the cash without the appointment of a treasurer whose appointment enjoined for the custody of money exceeding Rs. 250/- and that there was not even the maintenance of a pass-book which was necessary for recording the passing of cash from the manager to the president was also what was next pointed out. That Kamath was allowed a free hand in the management of the affairs of the bank and was allowed to be in charge and maintenance of all accounts and records of the bank and that in respect of a large sum of Rs. 1,26,023-2-0 which according to Mr. Kamath were remitted to a bank known as the Canara Banking Corporation, there were no receipts of the payee bank and that not even the fact attracted the notice of the directors or the president was what was next pointed out. Indeed, a clerk of the Canara Banking Corporation who gave evidence as P.W. 3 stated that none of those remittances which Kamath pretended to have made to that banking corporation was ever received by that corporation.

(8) There is also in evidence that in consequence of the suicide committed by Kamath, and the letter which he left behind him recording the confession of the misapplication of the funds of the bank, there was a special audit of accounts of the bank conducted by the District Auditor with the assistance of two senior auditors of Bangalore. Exhibit A-2 is the report of that Audit. The relevant parts of that report which throw considerable light on the extremely unbusinesslike

and grossly negligent way in which the Directors of the Bank managed its affairs or neglected their duties are these:

(a) "Bye-law No. 68 reads "that the manager shall not have with him, more than Rs. 250/- at any time." But the cash balance being mentioned by him on no occasion had any reference to the bye-law cited above. There was no separate treasurer appointed in the bank to keep amounts exceeding the limit of Rs. 250/- specified in the said bye-law. In the absence of the treasurer the President ought to have been the custodian of excess cash balance at office as per bye-law 68 wherein it is specifically stated that "none should handle extra cash unnecessarily". It also reads that "all such surplus money shall be deposited in the Postal Savings Bank Accounts u/s 34 of Coorg Co-Operative Act No. 11 of 1936?"

This provisions of the bye-law does not appear to have been followed on any occasion. It is seen from the records maintained by the bank that the president was never in charge of the cash and the entire cash was being handled by the late manager. This can further be substantiated as a passbook had not been maintained for the exchange of cash between the manager and the President as contemplated under bye-law No. 68(2).

(b) ""A bank of this magnitude ought to have maintained the cash held in excess over the average daily requirements under double lock, which was also not followed. The bank was having both savings bank and current accounts in local branch of the Canara Banking Corporation. The excess cash balance could have been remitted everyday. This too was not done."

(c) "This bank balances are also shown as cash on hand. The entries in the bank register do not seem to have been written every day as and when transactions were effected but they seem to be only a copy of the pass books or statement of accounts of different banks. These lapses have gone on unchecked on any occasion by the Board of Directors or the President and observation of the Auditor as regards discrepancies noticed in writing up of accounts and cash balance did not receive due consideration in the hands of the President or Board of Directors. This has led the manager to manipulate the figures and misuse the cash balance. This has resulted in the present state of affairs to a greater extent. The Board of Directors who were elected by the General Body and who had to look after the affairs of the bank as trustees of the public funds have not exercised required care and vigilance expected of them and as contemplated under bye-law No. 43(10)."

The report abounds in many more enumerations of the gross indifference with which the president and the Board of Directors attended to their own duties which the bye-laws imposed on them in regard to the management of the affairs of the bank.

(9) That the District Judge should have merely found it sufficient to say that adherence to the bye-laws "was not there" instead of recording a clear finding as

he should have done that there was deplorable neglect and deliberate disregard of their own duties on the part of the Board of Directors and the President, is what should astonish any one.

(10) But the question with which we are really concerned in this appeal is whether in consequence of the remissness on the part of the Directors to which I have referred and about which there can be no controversy after the elaborate and careful investigation made by the District Auditor whose report was marked as an Exhibit on behalf of the bank, Chandrasekhar Pai could contend that he stood discharged from his obligations under the indemnity bond. The District Judge was of the view that his obligations did not cease in that way, and, Miss. Lalithamma asked us to say that that conclusion reached by him cannot be supported.

(11) Now, there is a very wellknown rule governing a contract of guarantee and that rule is that a person in whose favour a guarantee is given is bound to a "faithful observance of the rights of the surety and to the performance of every duty necessary for the protection of those rights." In 50 American Jurisprudence page 232, paragraph 40, it is explained that that duty arises not from any contract of the creditor with his surety but from the equities of the situation. It seems to me that Section 139 of the Contract Act is what incorporates in substance the rule that it is the duty of the person who has secured a guarantee to do every act necessary for the protection of the rights of the surety. That section discharges a surety in all cases in which a creditor does any act which is inconsistent with the rights of the surety or omits to do any act which his duty as surety requires him to do and the eventual remedy of the surety is in consequence impaired.

(12) If the case before us can be brought within this principle, there can be no doubt that what should follow is that Chandrasekhar Pai stood discharged from his obligations as indemnity. The question, therefore, is whether there has been any neglect on the part of the bank to protect the rights of the surety which it was under a duty to protect and whether the remedy of Chandrasekhar Pai in consequence became impaired.

(13) Chandrasekhar Pai gave evidence that he had with him when he executed Ex. A-8 a copy of the bye-laws of the bank and that he stood guarantee for the fidelity of Kamath in the belief and on condition that the Directors of the bank perform their own duties imposed on them by those bye-laws and that his liability as indemnity would not arise unless in addition to there being misconduct on the part of Kamath there was also strict adherence to the provisions of the bye-laws on the part of the Directors who were in management of the affairs of the bank. It is on this evidence that Miss. Lalithamma relied to support the argument which she constructed that if there was evidence as undoubtedly there is, that the provisions of the bye-laws had been transgressed by the Directors in consequence of which it became possible for Kamath to help himself to large sums of money belonging to the bank, Chandrasekhar Pai's obligations as is

guarantor terminated.

(14) Mr. Ranganatha Rao in meeting this argument made a forceful submission that it was nowhere pleaded in the written statement that strict obedience to the bye-laws on the part of the Directors was a condition precedent to Chandrasekhar Pai's liability as a guarantor fastening itself on him. Mr. Ranganatha Rao's further submission was that no such condition precedent was proved. It was also submitted by Mr. Ranganatha Rao that since the indemnity bond Exhibit A-8 did not itself incorporate any such stipulation or condition precedent, it was not possible for Chandrasekhar Pai to produce any evidence of it in violation of the provisions of Section 92 of the Evidence Act.

(15) It does not appear to me to be right for Mr. Ranganatha Rao to contend that Exhibit A-8 does not besides imposing a liability on Chandrasekhar Pai, enjoin any obedience to the bye-laws on the part of the Directors. While it is true that Exhibit A-8 mainly concerns itself with the proper and faithful performance of his duties by Kamath and imposes a liability on Chandrasekhar Pai to the extent provided in respect of any loss caused or occasioned to the bank, it does contain a sufficiently clear and plain indication that the liability imposed on the defendant is only that which arises in consequence of Kamath's misconduct provided there was the performance of their own duties by the Directors and officers "according to the rules and regulations of the Bank." The relevant part of Exhibit A-8 stated that Chandrasekhar Pai guaranteed a true and full account by Kamath of all the assets belonging to the bank when required by the committee or Board of Directors of Management of the Bank and as to the assignment, transfer and delivery of all such assets to such person or persons as the said Board of Directors and officers may appoint "according to the rules and regulations of the Bank for the time being in force." It proceeded to state that Chandrasekhar Pai further guaranteed the faithful performances and fulfillment by Kamath of his duties "according to the rules."

(16) It cannot, therefore, be said that Mr. Ranganatha Rao is right in suggesting to us that Chandrasekhar Pai agreed to guarantee the faithful performance of his duties by Kamath even though there was on the part of the Directors and officers of their of the bank utter negligence or gross indifference to their own duties prescribed by the bye-laws of the bank. Although Chandrasekhar Pai gave evidence that when he executed Exhibit A-8, he had stated in the bye-laws formed the foundation and the basis of the terms and conditions incorporated in Ex. A-8 it is of the greatest significance to notice that that evidence remained uncontradicted since no officer of the bank and no Director stepped into the box to give evidence on that matter.

(17) However that may be, it seems to me that section 139 of the Indian Contract Act besides prohibiting on the part of the creditor acts of commission and omission which would impair the remedy of the surety incorporates the further rule which is implicit in its provisions that in a case like this where an employer by his own employee, the guarantor who guarantees fidelity on the

part of the employee stands discharged. That, in my opinion, is what flows from the phraseology and language of section 139 of the Contract Act.

(18) That that is the common law rule in England is what emerges at least three pronouncements of the Courts of that country. In *M'Taggart v. Watson* (1836) 3 CI&F 525 : 6 ER 1534 Lord Brougham observed:

"It is, however, undeniable that the Courts of equity will look narrowly to everything in the conduct of the obligee which has a direct tendency to wrong the surety and injure his rights and equities, and will, as Lord Loughborough said in *Rees v. Berrington* (1795) 2 VJ 540, lay hold of such errors to release him. * *
* All this may be generally true, and yet it cannot avail to discharge a surety who has expressly bound himself for a person's doing certain things, unless it can be shown that the party taking the security has, by his conduct, either prevented the things from being done, or connived at their omission, or enabled the person to do what he ought not to have done, or leave undone what he ought to have done, and that but for such conduct the omission or commission would not have happened." (Page 542)

(19) In *Dawson v. Lawes* (1854) 23 LJ Ch 434 Wood V.C. expressed the view that to discharge a surety from the due performance of duties, there must be on the part of the obligee such act of connivance or gross negligence amounting to a willful shutting of the eyes to the fraud or something approximating to. That this enunciation is what was made by Lord Brougham in *M'Taggart's* case, (1836) 3 CI&F 525 : 6 ER (HL) 1534 was that was explained by the Vice-Chancellor who, after referring to the observations made by Lord Brougham in that case, explained that what discharges a surety was

"an act of connivance as enabled the party to get the fund in his hands or such an act of gross negligence as to amount to a willful shutting of the person's eyes to the fraud which the party was about to commit, or something approximating to it....."

(20) The recognition of the correctness of these rules is to be found in *Durham Corporation v. Fowler* (1889) 22 QBD 394. Lord Denman referring to the *M'Taggart's* case (1836) 3 Clause & Fin 525 : 6 ER (HL) 1534 and *Dawson's* case (1854) 23 LJ Ch 434, reproduced at page 419 of the Judgment, the relevant passages in those decisions to which I have referred.

(21) If there be the principles by which the continuance or otherwise of the obligation of Chandrasekhar Pai under the deed of indemnity executed by him has to be determined, what arises for consideration is whether there has been on the part of the Directors or the President who were in charge of the management of the bank either an act of connivance which enabled Kamath to get funds into his hands or such act of gross negligence as to amount to a willful shutting by the Directors of their eyes to the fraud which Kamath was about to commit. In my opinion, the many acts of dereliction of duty and transgression of the provisions of the bye-laws to which I have referred and to which the District

Auditor alluded in his report, cannot lead to any other conclusion than that there was not only conduct approximating to connivance on the part of the Directors and the President which made it possible for Kamath to get into his hands large sums of money belonging to the bank but also deliberate and willful indifference amounting to a willful shutting of their eyes to the fraud which Kamath was systematically perpetrating.

(22) It may be, as contended by Mr. Ranganatha Rao, mere passive acquiescence on the part of the Directors or the President, if the case before us was one in which there was no more than such acquiescence would not have enabled Chandrasekhar Pai to avoid his obligations under the indemnity bond since what is necessary to earn for him a discharge is not a mere acquiescence of that description but connivance or deliberate indifference such as what is referred to in M"Taggart's case (1836) 3Cl& F 525 : 6ER (HL) 1534 and Dawson's case (1854) 23 LJ Ch 434. But I have no doubt in my mind that both those elements of connivance and indifference existed in this case and it is that feature of the case before us which distinguishes it from, cases in which what was established was no more than passive acquiescence or incomplete or inadequate supervision on the part of the employer.

(23) Mr. Ranganatha Rao, however, asked us to say that there is something in what P.B. Mukharji, J. said in Radha Kanta Pal Vs. United Bank of India Ltd., which can be of assistance to the bank in this case. I am unable to read that decision in that way. That decision does not, formulate a principle different from that which was formulated in the English cases to which I have referred or which flows from the language of Section 139 of the Contract Act.

(24) I am unable to accede to the contention which was at one stage urged by Mr. Ranganatha Rao that there is no plea of connivance or deliberate indifference on the part of the Directors of the Bank in the written statement of Chandrasekhar Pai. To my mind paragraph 3 of the written statement does in substance raise that plea. Issues 2 and 3 would have been quite unnecessary if there was no such plea in the written statement of the defendant

(25) In my opinion, we should in reversal, of the finding of the District Judge say that this was a case in which the conduct of the Directors amounting as it did to connivance or willful shutting of their eyes to the fraud which Kamath was about to perpetrate and which made it possible for Kamath to come into possession of large sums of money belonging to the bank which he would never have been able to secure has the Directors not deliberately disregarded the duties enjoined on them by the bye-laws, is what discharges Chandrasekhar Pai. This, in my opinion, is what we should say notwithstanding the argument advanced by Mr. Ranganatha Rao that for the purpose of determining the existence of the liability of Chandrasekhar Pai, we should do no more than to understand the effect and scope of the recitals contained in the bond and scope of the recitals contained in the bond Exhibit A-8 without importing into it what is not contained there.

It may be, as Mr. Ranganatha Rao submitted, that by that bond Chandrasekhar Pai guaranteed the faithful performance of Kamath's duties as manager. It is also true that if Kamath was in possession of funds exceeding Rs. 250/- in violation of the provisions of bye-law 68, there was on the part of Kamath a transgression of the provisions of that bye-law, which justified a charge of misconduct on the part of Kamath himself. If that was all that could be said about the matter, it would have been easy for Mr. Ranganatha Rao, to sustain his contention that since what the Defendant undertook was the performance of Kamath's obligations as an employee and there was a violation of his own duties by Kamath when he retained in his own hands large sums of money exceeding Rs. 250/- that misconduct on his part was what attracted the liability of Chandrasekhar Pai and that it was not the duty of the Directors to prevent such misconduct on the part of Kamath. That argument to the extent it goes may be above reproach since the basic and fundamental principle is that a person who guarantees the fidelity of an employee cannot take shelter under the fact that the employer did not prevent what the guarantor had guaranteed would not happen. But, this is not a case in which there was any such mere omission on the part of the Director or the President.

This was a case in which, as I have already observed, there was something more than passive acquiescence on the part of the Directors by their own systematic neglect and deliberate disregard of the duties which they had undertaken as directors having got themselves elected to those positions. Not even the most ordinary supervision which was expected of them was made and as the District Auditor observed in Exhibit A-2, on each occasion when Kamath, from the commencement and until he committed suicide, perpetrated a fraud on the bank, the Directors willfully shut their eyes to the fraudulent career on which Kamath embarked. It is not difficult to infer from such conduct that what the directors did amounted to connivance on the part of the Directors in consequence of which it became possible for Kamath not only to retain with himself inordinately large sums of money but also to manipulate the accounts and misuse the cash balances. As observed by the District Auditor in Exhibit A-2, it was that conduct that "led the manager to manipulate the figures and misuse the cash balance."

(26) In that situation, the argument that it was the sole and exclusive responsibility of Chandrasekhar Pai to make himself sure that Kamath committed no act of misconduct and that the Directors who in reality and in effect assisted the various acts of fraud committed by Kamath, can ask the guarantor to perform his guarantee, is clearly unavailable to the bank. No employer who secures a fidelity guarantee can tell his guarantor that the guarantor is liable even if an act of infidelity was assisted by the employer himself.

(27) In my opinion, this appeal should be allowed. We should, in my opinion, in reversal of the decree of the District Judge, dismiss the plaintiff's suit.

(28) The defendant will be entitled to his costs both in this Court as well as in the Court below.

Kalagate, J.

(29) I agree.

(30) Appeal allowed.