1955 *Present : Gratiaen J. and Sansoni J.*

DAMBADENI HATPATTU CO-OPERATIVE STORES UNION, LTD., Appellant, *and* Y. P. A. YAGODA *et al.*, Respondents

S. C. 357—D. C. Kurunegala, 5,634

Guarantee—Fidelity bond—Misbehaviour of employee—Duty of employer to inform guarantor about it immediately—Co-operative Societies.

In the case of a continuing guarantee for the honesty of a servant there should be read into the contract " an implied term between the employer and the fidelity guarantor that the former will inform the latter of such cases of dishonesty in the servant as will entitle the employer to dismiss him and that the surety is then entitled to call upon the employer either to dismiss the servant or to discharge him (the surety) from further liability ".

By a bond dated January 14, 1946, the 1st, 2nd and 3rd defendants bound themselves jointly and severally in a sum of Rs. 4,000 to indemnify a registered Co-operative Society against the loss of its property or monies through defalcation or other breach of duty on the part of the 1st defendant during the period of his stewardship as Manager of the Society's Wholesale Department. On March 21, 1946, a shortage of Rs. 1,500 was detected for which the 1st defendant was unable to account. The offence was, however, condoned upon the replacement of the money within a week. Subsequently, on June 30, 1947, it was discovered that 1st defendant had been committing a series of misappropriations to the extent of Rs. 13,701·52 between March 21, 1946, and June 30, 1947. The Co-operative Society thereupon sued all three defendants on the bond dated January 14, 1946, for the recovery of Rs. 4,000.

***Held*, that the conduct of the Co-operative Society in condoning, without the knowledge or approval of the 2nd and 3rd defendants, the misappropriation brought to light in March, 1946, had the effect of discharging the 2nd and 3rd defendants from liability to indemnify the Society in respect of subsequent acts of dishonesty.**

APPEAL from a judgment of the District Court, Kurunegala.

N. E. Weerasooria, Q.C., with *W. D. Gunasekera*, for the plaintiff-appellant.

H. W. Tambiah, with *A. I. Rajasingham*, for the 2nd and 3rd defendant-respondents.

Cur. adv. vult.

February 24, 1955. GRATIAEN J.—

The plaintiffs, a Co-operative Stores Union duly registered under the Co-operative Societies Ordinance, employed the 1st defendant as the Manager of its Wholesale Department on 1st June, 1945. His duties involved the handling of large sums of money and the custody of considerable quantities of stores belonging to the Union. Accordingly, the 1st

defendant was called upon to furnish security in a sum of Rs. 4,000 for the faithful discharge of his duties. By a bond dated 14th January, 1946 the 1st defendant, together with the 2nd and 3rd defendants (described as " sureties ") bound themselves jointly and severally to indemnify the Union against the loss of its property or monies through defalcation or other breach of duty on the part of the 1st defendant during the period of his stewardship.

On 21st March, 1946 (about two months after the execution of the bond) the Assistant Registrar of the Co-operative Department checked the cash balance in the department and detected a shortage of Rs. 1,500 for which the 1st defendant was unable to account. This discovery took place in the presence of the President and two Committee members of the Union. The 1st defendant offered an explanation which did not satisfy the Assistant Registrar who threatened to hand the matter over to the Police unless the money was replaced within a week. This officer also sent a copy of his notes of inquiry to the Committee and " took the office-bearers to task for allowing this kind of thing to go on ".

The 1st defendant replaced the money within the stipulated time. He has explained in evidence how he solved his immediate problem. Having borrowed the sum required from some friends, and by this means avoided his prosecution and summary dismissal, he repaid them out of his daily collections. Further misappropriations followed, and, as he naively says, " I went on ' rolling ' until finally the day came (i.e. 30th June 1947) when I got caught . . . . then I went on a pilgrimage ". In point of fact, this " pilgrimage " ended at the Welikade jail where he is now serving a term of imprisonment for criminal breach of trust of Rs. 13,701·52. The offence was committed on various dates between 21st March, 1946 (when the first irregularity was detected and condoned) and 30th June, 1947 (when the " pilgrimage " commenced).

The Union has sued all three defendants on the bond dated 14th January, 1946, for the recovery of Rs. 4,000 out of the sum embezzled as previously described. The 1st defendant, while still in prison, consented to judgment, but the decree against him is clearly valueless. The " sureties " disclaimed liability on various grounds only one of which need be discussed for the purposes of this appeal. In my opinion the learned Judge has correctly decided that the Union's conduct in condoning, without the knowledge or approval of the 2nd and 3rd defendants, the misappropriation brought to light in March, 1946 had the effect of discharging the 2nd and 3rd defendants from liability to indemnify the Union in respect of any subsequent acts of dishonesty.

This special defence is no doubt governed by the Roman-Dutch Law, but it is convenient in the first instance to examine the English law on the subject.

" In a case of a continuing guarantee for the honesty of a servant, if the master discovers that the servant has been guilty of acts of dishonesty

in the course of his service, to which the guarantee relates, and if, instead of dismissing the servant, as he may do at once and without notice, he chooses to continue in his employ the dishonest servant without the consent of the surety, express or implied, he cannot afterwards have recourse to the surety to make good any loss which may arise from the dishonesty of the servant during the subsequent service". *Phillips v. Foxhall* [1]. The guarantee, at its inception, was founded on the trustworthiness of the servant, so far as was known to both parties; so that, as soon as his dishonesty is subsequently discovered by the master (but not communicated by the master to the guarantor) the whole foundation for the continuance of the contract fails. "It seems to us, in accordance with the plainest principles of equity and fair dealing, that the master should, on making such discovery, either dismiss the servant, or, if he chooses to continue him in his employ without the knowledge or assent of the surety, he must himself stand the risk of loss arising from any future dishonesty". *Smith v. The Bank of Scotland* [2].

I reject the argument that this requirement of "fair dealing" is peculiar to the English law. *Wessells' Law of Contract in South Africa* ii, page 1109 para. 4026 regards it as fundamental to all contracts for continuing guarantees of this nature that there should be read into them "an implied term between the employer and the fidelity guarantor that the former will inform the latter of such cases of dishonesty in the servant as will entitle the employer to dismiss him and that the surety is then entitled to call upon the employer either to dismiss the servant or to discharge him (the surety) from further liability". The continuing obligation undertaken by the guarantor calls for continuing good faith on the part of the employer who must not wilfully conceal subsequent frauds of the employee; nor must the employer during the period covered by the guarantee be guilty of negligence "so gross as to be equivalent to a wilful shutting of the eyes to the fraud which the employee is about to commit". *Dawson v. Lawes* [3].

In this case, the Union officials were at least guilty after 21st March, 1946 of callous indifference to the obvious risk of further dishonesty on the part of the 1st defendant; this conduct constitutes "gross negligence" of the kind condemned in *Dawson v. Lawes* (supra).

It was suggested that these principles protect only a surety and not a person who (like the 2nd and 3rd defendants) has undertaken the liabilities of a principal debtor. I disagree. The more onerous the liability undertaken by the fidelity guarantor, the greater is the degree of good faith which the employer must observe. I would dismiss the appeal with costs.

SANSONI J.—I agree.

Appeal dismissed.

[1] *(1872) L. R. 7 Q. B. 666.* [2] *1 Dow. 272 H. L.*
[3] *(1854) 69 E. R. 119.*