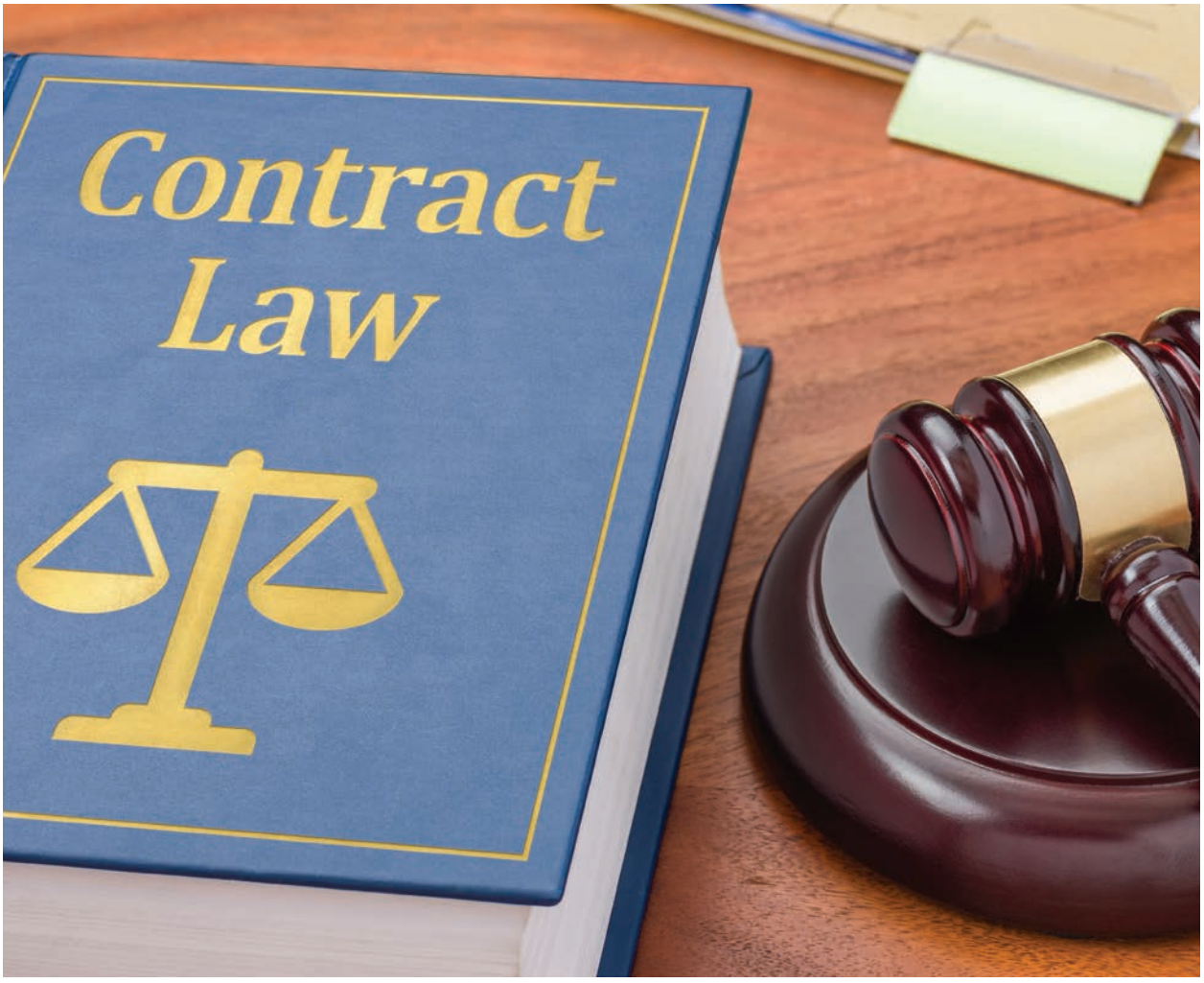
Law of Contract – Vital Issues



Law of Contract is the basic business law and foundation of trade, commerce and industry in the modern world. The market economy functions with contractual relations by relative assessment of rights and duties arising out of contract. The law provides parties freedom to contract as well as the restraints within which this freedom has to be exercised within the legal and regulatory framework of the subject matter of contract. The author discusses some of the vital issues pertaining to business contracts and suggests golden rules for effective contract management.

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Introduction

Law of Contract is the basic business law and foundation of trade, commerce and industry. The right to property and freedom of contract are the fundamentals of modern society. The law provides parties freedom to contract as well as the restraints within which this freedom has to be exercised within the legal and regulatory framework of the

subject matter of contract. In this context, an attempt is made to discuss some of the important issues in business contracts.

Indian Contract Act

Law of Contract Act, 1872 (Act) is among the oldest pieces of legislation which govern the trade and commerce. The principles of the Act are timeless and have catered to the changing nature and needs of business. Enforcement, however, continues to be a problematic area.

Agreement and Contract

In the law, there is a difference between 'agreement' and 'contract'. For example, Memo of Understanding (MoU) reached between the parties about the scope of work is an agreement, but it becomes contract after agreed terms of payment as per schedule and execution by the partiers.

As per the law, in an agreement there must be at least two parties. One who makes a proposal is called 'promisor', whereas one who accepts the proposal is called 'promisee'. A 'proposal' is to do or abstain from doing any things, with a view to obtain the asset of the other to such act. When at the desire of the promisor, the promisee or any other person does or abstain from doing, such an act or abstinence or promise is called a 'consideration' for the promise. In other words, when the person to whom the proposal is made signifies his assent thereto, the proposal is accepted. Section 2(e) defines an "agreement" as *'every promise and every set of promises forming consideration for each other.'*

An agreement is essentially a contract, though all agreements are not contracts.

According to section 2(j) of the Act, "contract" is an agreement, enforceable by law. Simply stated, an agreement being legally enforceable must fulfill the following conditions:

(i) Parties must be willing to enter into legal relationship;

(ii) Parties must be competent to enter into contract that results in legally enforceable rights, duties and obligations;

(iii) Parties must have free consent to the terms of the contract;

(iv) There is a lawful object and consideration;

(v) The agreement is not against public policy or morality; and

There is a tendency to include `time is of essence' clause in agreements. The clause cannot be interpreted mechanically without ascertaining the intention of the parties entering into the contract. It is a question of fact in each case whether time was the essence of the contract.

(vi) The agreement is not otherwise void in the eyes of law.

Simply stated, every agreement of which the object or consideration is unlawful or conflicts with morals of the time and contravenes any established interest of society is void as being against public policy, *that is, fundamental policy of Indian Law or is in conflict with the most basic notions of morality or justice.*

Agreements in Restraint of Legal Proceedings are Void Except Resolution of Commercial Disputes by Arbitration

Section 28 of the Act provides that agreements in restraint of legal proceedings to enforce legal rights of any party under a contract are void to that extent. The only exception to section 28 is the saving of contracts by referring to arbitration disputes which may arise or have already arisen between the parties.

In India, the Arbitration and Conciliation Act, governs the law and procedure for adjudicating commercial disputes. Arbitration is economical, efficient, speedy and flexible method of adjudicating disputes on merit. In fact, arbitration is the creation of business community itself. The basic principles of arbitration are almost universally acceptable for the simple reason that the world over practice of business is much the same.

Effect of Failure to Perform Contract When Time is of Essence

There is a tendency to include 'time is of essence' clause in agreements. The clause cannot be interpreted mechanically without ascertaining the intention of the parties entering into the contract. It is a question of fact in each case whether time was the essence of the contract. The burden of proof is on the party, who alleges that time is of essence, to show the terms of the contract, the nature of the obligation and other circumstances to establish the allegations.

Section 55 of the Act gives to the promisee an option to avoid the contract where the promisor fails to perform his part of the contract at the time fixed in the contract. However, if it was not the intention of the parties that time should be of essence of the contract, the contract does not become voidable by the failure to do such thing at or before the specified time, but the promisee is entitled to compensation from the promisor for any loss occasioned to him by such failure.

Section 55 of the Act also deals with effect of acceptance of performance at time other than that agreed upon. It states that if, in case of a contract avoidable on account of the promiser's failure to perform his promise at the time agreed, the promises accepts performance of such promise at any time other than that agreed, the promisee cannot claim compensation for any loss occasioned by the non-performance of the promise at the time agreed, unless, at the time of such acceptance he gives notice to the promisee of his intention to do so.

The Supreme Court in *Pillai vs. Palaniswami Nadar* (AIR 1967 SC 863) ruled that only inclusion of the phrase 'time is of essence' does not attract section 55. Other conditions such as provision for extension of time dilute the applicability of this section. Therefore, in no way the contract could have become voidable due to delay in performance, entitling the Respondent to terminate it and then not pay for part of the work already executed. Further, in a contract for sale of land or immovable property, it would normally be presumed that time was not the essence of the contract.

Consequences of Breach of Contract

Breach often occurs due to failure of one contracting party to fulfill its contractual obligations. According to the legal maxim *"Ubi jus, ibi remedium"* - 'where a right is broken, there must be remedy'. The remedy is that the defaulting party is required to pay damages to the aggrieved party who suffers losses due to breach of contract.

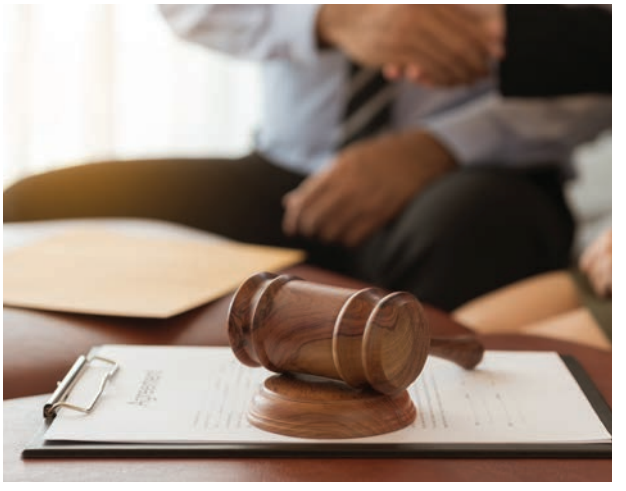
Un-Liquidated Damage

Section 73 deals with the compensation for the normal anticipated loss or damage caused by breach of contract. The section provides that in case of breach of contract, the aggrieved party is entitled to receive from the defaulter, compensation for any loss or damage caused to it, which arose in the usual course of things from such breach, or known to the parties to likely result from such breach, when contract was made. However, such compensation is not given for any remote and indirect loss or damage sustained by reason of the breach. Further, explanation to Section 73 provides that in estimating the loss or damage arising from a breach of contract, the means which existed of remedying the inconvenience caused by non-performance of the contract must be taken into account.

Liquidated Damages

Liquidated damages are the agreed quantum or method of calculation of damages in the event of breach of contract by any party. Section 74 of the Act deals with compensation for breach of contract where penalty stipulated for – 'When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contractor contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract, reasonable compensation not exceeding the amount so named, or as the case may be, penalty stipulated for".

According to the Supreme Court, *"The section is clearly an attempt to eliminate the somewhat elaborate refinements made under the English common law in distinguishing between stipulations providing for payment of liquidated damages and stipulations to the nature of penalty. Under the common law a genuine pre-estimate of damages by mutual agreement is regarded as a stipulation naming liquidated damages and binding between the parties: a stipulation in a contract in terrorem is a penalty and the Court refuses to enforce it, awarding*



the aggrieved party only reasonable compensation. The Indian Legislature has sought to cut across the web of rules and presumptions under the English common Law, by enacting a uniform principle applicable to all stipulations naming amount to be paid in case of breach, and stipulations by way of penalty." - Fateh Chand v. Balkishan Das (AIR 1963 SC 1405).

Simply stated, Section 73 of the Act provides compensation for the normal anticipated loss or damage caused by breach of contract. Section 74 of the Act provides for liquidated damages for breach of contract, up to the sum named in the contract to be paid to the party complaining of breach. Liquidated damages should not be in the nature of punitive damages for delayed performance of a contract. Section 75 of the Act provides that a party, who rightfully rescinds a contract, is entitled to compensation for any damage sustained by it due to non-fulfillment of the contract.

The important rulings of law of damages include:

(i) The party in breach must make compensation in respect of the direct consequences flowing from the breach and not in respect of loss or damage indirectly or remotely caused- *Pannalal Jankidas v. Mohanlal* (AIR 1951 SC 145);

(ii) A seller who commits breach will be liable to compensate according to the prices at the place of sale and not at destination- *Murlidhar Chiranji Lal v. Harish Chandra Dwarkadas* (AIR, 1962 SC 366);

(iii) Where there is the right to recover liquidated damages under section 74, there is no question of ascertaining damages really arising from the breach of contract– *Chunilal Mehta & Sons Ltd. v. Century Spinning & Mfg. Co. Ltd.* (AIR 1962 SC 1314).

(iv) The jurisdiction of the Court to award compensation under section 73 in case of breach of contract is unqualified except as to the maximum stipulated. Section 73 is to be read with Section 74. Section 74 emphasises that in case of breach of contract, the party complaining of the breach is entitled to receive reasonable compensation whether or not the actual loss is proved. Therefore, the emphasis is on reasonable compensation. If the compensation specified in the contract is by way of penalty, consideration would be different and the party is entitled only to a reasonable compensation for the loss suffered. However, if the compensation specified in the contract for such breach is genuine pre-estimate of loss which the parties knew when they made the contract to be likely to result from the breach of it, there is no question of proving such losses suffered by him. The burden is on the other party to lead evidence for proving that no loss is likely to occur by such breach - *Fateh Chand v. Balkishan Das* (AIR 1963 SC 1405).

(v) If no loss is proved, both Sections 73 and 74 are not attracted. The words "*whether or not actual damage/loss is proved to have been caused thereby*" used in Section 74 of the Contract Act, are confined to cases in which it is not possible to prove the monetary value of the loss and, therefore, reasonable compensation even as fixed by the parties, may be allowed. Where the loss in money can be determined, it must be proved - *Maula Bux v. Union of India* 1971 (1) SCR 928.

(vi) The Supreme Court referred to Pullock & Mulla, 14th Edition, Vol.II, Page 1174 and clarified Section 74 that *"The primary object for protection of expectation interest, has been described as to put the innocent party in the position which he would have occupied had the contract been performed. The general aim of law being to protect the innocent party's defeated financial expectations and compensate him for his loss of bargain, subject to the rules of causation and remoteness. The purpose of protection of reliance interest is to be put to the plaintiff in the position in which he would have been if the contract had never been made. The loss may include expenses incurred in preparation by the innocent party's own performance, expenses incurred after the breach or even pre-contract expenditure subject to remoteness. The aforesaid discussion leads to the inevitable conclusion that the applicant had failed to establish its claim that the breach by the Respondent was the cause for losses of anticipated profit, that the profitability projections in the loan application was a reasonable basis for the award of damages towards loss of anticipated profits. The Applicant had failed to abide by its own obligations and lacked adequate infrastructure, finance and manpower to run its business. It also failed to take reasonable steps to mitigate its losses. The appeal lacked*

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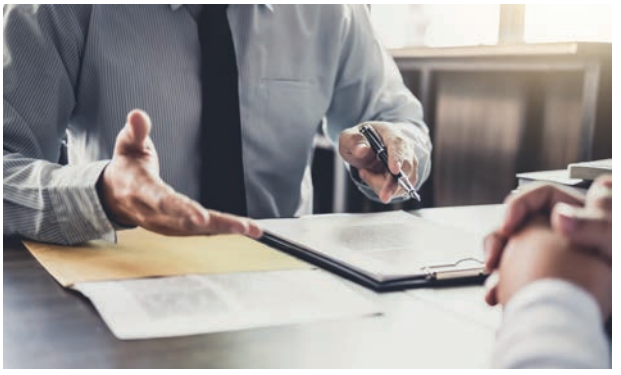

merit and is dismissed– Kanchan Udyog Ltd. v. United Spirits Ltd. (Civil Appeal No.1168 of 2017 decided by the SC on 19.06.2017)"

Contract of Guarantee

As per Section 126 of the Act, a 'contract of guarantee' is a contract to perform the promise, or discharge the liability, of a third person in case of his default. The person who gives the guarantee is called the 'surety', the person in respect of whom default the guarantee is given is called the 'principal debtor' and the person to whom the guarantee is given called the 'creditor'.

Section 133 of the Act is an important rider, which states that 'any variance made without the surety's consent, in the terms of the contract between the principal debtor and the creditor, discharges the surety as to transactions subsequent to the variance'. Further, as per Section 134 of the Contract Act, surety is discharged by any contract between the creditor and the principal debtor, by which the principal debtor is released, or by any act or omission of the creditor, the legal consequence of which is the discharge of the principal debtor. However, Section 135 of the Contract Act provides that the surety is discharged when the creditor compounds with, gives time to, or agrees not to sue the principal debtor.

A creditor is entitled to demand payment from the surety as soon as the principal debtor refuses to pay or makes default in payment. The liability of the surety cannot be postponed till all other remedies against the principal debtor have been exhausted. In other words, the creditor cannot be asked to exhaust all other remedies against principal debtor before proceeding against surety. The creditor can file suit against the surety without suing the principal debtor.

Liability of Guarantor in Bank Guarantee

A bank guarantee is the common mode of security payment of money in commercial dealings as the beneficiary, under the guarantee, is entitled to realise the whole of the amount under that guarantee in terms thereof in respect of any pending dispute between the person on whose behalf the guarantee was given and the beneficiary (*Interior's India v. Balmer Laurie*, AIR 2007 Del.16.) It is well settled that bank guarantee is an autonomous contract.

Government/Public Contracts

All government bodies and enterprises are State under Article 12 of the Constitution of India. Further, provisions of Article 299 of the Constitution are mandatory for entering into contracts by government bodies and public sector companies. Article 299 provides that all contracts to be made in exercise of the executive power of the Union or a state shall be executed by the President, or by the Governor of the state, as the case may be, or on their behalf in the prescribed manner. However, the President, Governor or the authorised person shall not be personally liable in respect of the contract made and executed by him. The rationale behind Article 299 is to ensure that prescribed procedure must be followed for executing contract by the agents of the Union and State, in order to bind the Union and the State.

The constitutional code for public contracts does not provide the entire law and has to be supplemented with the provisions of the Indian Contract Act. As such, a Public Sector Company must ensure that all contracts executed by it are signed and executed by the designated authority as per the delegation of powers, after following the prescribed procedure. Further, without compliance of the requirements of Article 299, the contract is not binding on or enforceable by or against the Government [*Bhikraj v. Union of India* (1962) SC 113; *K. P. Chowdhury v. State of MP* 1967 SC 203] though a suit may lie against the officer who made the contract in his personal capacity (if contract is otherwise valid)– *Timber Kashmir v. Conservator* 1977 SC 151.

Golden Rules for Effective Contract Management

The other golden rules of contract management include:

1. Ensure that the objects and intentions of the contracting parties and their rights and obligations are crystal clearly set out in the contract. All clauses of contracts are written in simple, clear and plain language, devoid of technical and legal jargons to avoid ambiguity and dispute between the parties.
2. The agreement should contain all averments, representations, warrants, and assurances made by the respective parties. It should also include clauses relating to protection of trade related intellectual property rights, confidentiality, non-assignment, service of notice, amendment and obligation of the parties on termination of the contract, etc.
3. Ensure that the terms of contract are fair to all the parties and a party taking undue advantage of its smart negotiating skill may render the contract unconscientious.
4. Comply with relevant provisions of other laws. *For example, stipulating a longer or shorter period of limitation than prescribed under the Limitation Act may result in enforcing the right itself.* The contract should stand the scrutiny of the law for easy enforcement.
5. The estimated amount of liquidated damages to be levied should not be in the nature of punitive damages. Further, notice of imposing damages must be given and an opportunity of being heard be provided to the concerned party before imposing damages.
6. *Mention the preferred method of dispute resolution (conciliation, mediation, arbitration or litigation).* Check that the kind of disputes referred to arbitral tribunal must be capable of being settled by arbitration. For example, oppression and management comes under the Companies Act, anti-competitive practices under the Competition Act and insolvency under Insolvency and Bankruptcy Code. Further, the arbitration clause, should clearly mention the composition of arbitral tribunal, applicable law, venue of arbitration and language to be used.
7. The force-majeure clause should cover *force majeure* event, nexus with force majeure and its effect and notice period.
8. *The government undertakings should keep in mind that they are State under Article 12 of the Constitution and abide by the constitutional provisions.*

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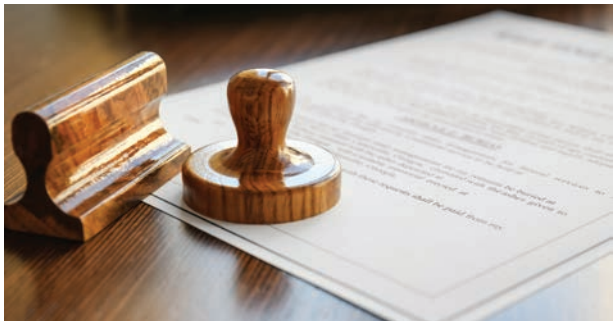

Conclusion

The foundation stones of modern civilisation and market economy are the right to property and freedom to contract. The law of contract provides parties freedom to contract, but this freedom must be exercised within the legal and regulatory framework. In case of breach of contract, the legal remedy for the injured party is to seek damages for the loss suffered due to breach of contract. The estimated amount of liquidated damages should not be in the nature of punitive damages. It is, therefore, advisable to avoid disputes on quantum of damages by fixing a realistic amount of liquidated damages payable in case of breach of contract. Equally important is to incorporate in the contract, the mode of resolution of dispute to *save time, money and business relations.* ■