PAPER

2

FOUNDATION COURSE

STUDY MATERIAL

BUSINESS LAWS

Board of Studies (Academic)
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)

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BEFORE WE BEGIN

The contents of the study material for Foundation have been designed and developed by the Board of Studies (Academic), ICAI with an objective to synchronize the syllabus with the International Education Standards (IESs) of IFAC (International Federation of Accountants) to instill and enhance the necessary pre-requisites for becoming a well-rounded, competent and globally competitive Accounting Professional.

The requirements of "IES 1 Entry Level Requirements" have been kept in mind while developing the different chapters of study material.

This study material also lays emphasis on National Education Policy 2020 (NEP 2020) initiatives like conceptual clarity rather than rote learning and new pedagogical and curriculum restructuring based on the use of technology while teaching.

Laws in general, regulate the relationship of business and profession with the society. As Business forms an integral part of the society, so, law is essential for regulating the rules by which people and businesses connect with each other. Law affects almost every function and area of business. In order to resolve the conflicts between social groups and commercial establishments, Law has to be in place. Study of Law is also important because it gives a legal framework which is ultimately accepted in society.

This paper on Business Laws intends to make the students aware of legal background relating to business laws. As a student aspiring to become a Chartered Accountant, he should have knowledge of those legal frameworks, which influences the business transactions. The syllabus of Business Laws has been segregated into seven chapters covering the following:

Chapter 1, Indian Regulatory Framework: In this chapter, the students will be familiarised with some of the major Regulators and the laws which are enforced by them.

Chapter 2, The Indian Contract Act, 1872: This Act basically identifies the ingredients of a legally enforceable valid contract in addition to dealing with certain special type of contractual relationships like indemnity, guarantee, bailment, pledge, quasi contracts, contingent contracts, etc.

Chapter 3, The Sale of Goods Act, 1930: This is one of the specific forms of contracts recognized and regulated by law in India. Sale is a typical bargain between the buyer and the seller. The provisions of the Act are applicable to the contracts related to the sale of goods which means movable properties.

Chapter 4, The Indian Partnership Act, 1932: This Act provides Rules and Regulations for a general form of Partnership when two or more people come together as partners.

Chapter 5, The Limited Liability Partnership Act, 2008: This Act provides Rules and Regulations which contains elements of both 'corporate structure' as well as 'partnership firm structure'. In order to acquaint the students with this significant Act, only introduction is covered at this level so they can easily understand its application at Intermediate level.

Chapter 6, The Companies Act, 2013: The Act regulates the functioning of Companies in India. This is the most important piece of legislation that empowers the Central Government to regulate the formation, financing, functioning and winding up of companies. In order to apprise the students with this prominent Act, only introduction is covered at this level so they can easily understand it and apply the same for practical scenarios at further levels.

Chapter 7, The Negotiable Instruments Act, 1881: The Law in India relating to negotiable instruments is contained in the Negotiable Instruments Act, 1881. This is an Act to define and enforce the law relating to promissory notes, bills of exchange and cheques.

We hope that the introduction to Business Laws will set a good foundation for students to understand significant provisions of select business laws and acquire the ability to address basic application- oriented issues.

Also, for the benefit of the students, the chapters are inclusive of following:

- *Learning outcomes and chapter overview at the beginning of each chapter for better understanding*
- *Step by step approach is followed in each chapter*
- *Appropriate explanation of the text through examples*
- *Summary*
- *Questions along with their answers*

We hope that students will find this study material user friendly and in case of any queries that they may have while reading the material, they are welcome to write at bosnoida@icai.in

Happy Reading and Best Wishes!

SYLLABUS

PAPER – 2: BUSINESS LAWS (100 MARKS)

Objective:

To develop general legal knowledge of the law of Contracts, Sales and understanding of various forms of businesses and their functioning to regulate business environment and to acquire the ability to address basic application-oriented issues.

Contents:

1. **Indian Regulatory Framework-** Major Regulatory Bodies such as Ministry of Finance, Ministry of Corporate Affairs, SEBI, RBI, IBBI, Ministry of Law and Justice etc.
2. **The Indian Contract Act, 1872:** General nature of contract, Consideration, Other essential elements of a valid contract, Performance of contract, Breach of contract, Contingent and Quasi Contract, Contract of Indemnity and Guarantee, Contract of Bailment and Pledge, Contract of Agency.
3. **The Sale of Goods Act, 1930:** Formation of the contract of sale, Conditions and Warranties, Transfer of ownership and Delivery of goods, Unpaid seller and his rights**.**
4. **The Indian Partnership Act, 1932:** General Nature of Partnership, Rights and Duties of partners, Reconstitution of firms, Registration and Dissolution of a firm.
5. **The Limited Liability Partnership Act, 2008:** Introduction-covering nature and scope, Essential features, Characteristics of LLP, Incorporation and Differences with other forms of organizations.
6. **The Companies Act, 2013:** Essential features of company, Corporate veil theory, Classes of companies, Types of share capital, Incorporation of company, Memorandum of Association, Articles of Association, Doctrine of Indoor Management.
7. **The Negotiable Instruments Act, 1881:** Meaning of Negotiable Instruments, Characteristics, Classification of Instruments, Different provisions relating to Negotiation, Presentment of Instruments, Rules of Compensation.

Note: ***If new legislations are enacted in place of the existing legislations, the syllabus would include the corresponding provisions of such new legislations with effect from dates notified by the Institute.***

The specific inclusions/ exclusions in the various topics covered in the syllabus will be effected every year by way of Study Guidelines, if required.

CONTENTS

CHAPTER 1

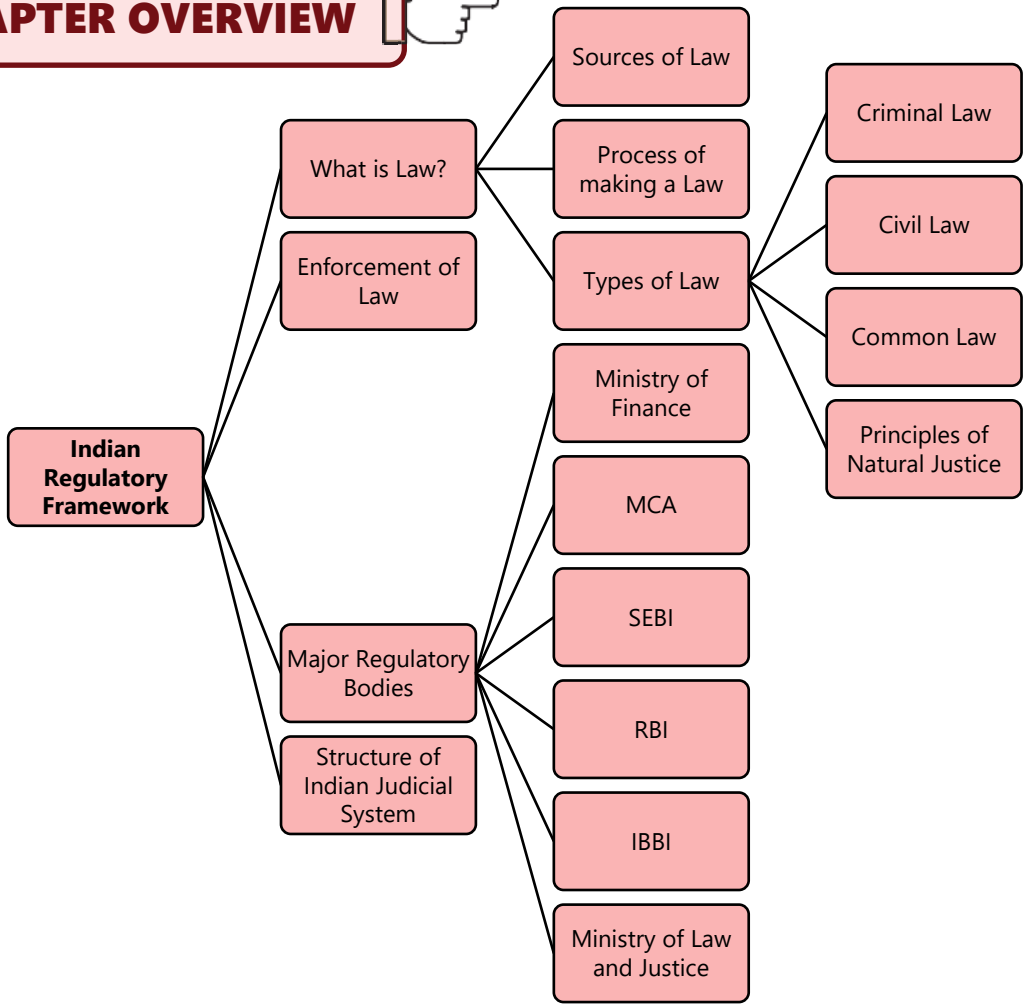
INDIAN REGULATORY FRAMEWORK

LEARNING OUTCOMES

After studying this Chapter, you will be able to understand:

- Meaning of Law and its sources
- Types of laws in the Indian Legal System
- Enforcement of Law
- Introduction of Major Regulatory Bodies such as Ministry of Finance, MCA, SEBI, RBI, IBBI and Ministry of Law and Justice.

CHAPTER OVERVIEW



1. INTRODUCTION

Have you ever wondered why you are studying this subject called law? Is it only because it has been prescribed in the syllabus or is it because you will need this knowledge as a member of the Institute of Chartered Accountants of India?

Awareness of law is essential to become a full-fledged Chartered Accountant. This is because a Chartered Accountant is the first level of contact on many legal matters. So, we should possess knowledge of law so that we can advise our management and clients on legal matters at a basic or threshold level.

Some of you may later wish to specialise in a subject called taxation. Remember tax laws are also laws. In order to become an expert in taxation you should possess a basic awareness of the legal and regulatory framework of our country. The purpose of a regulatory framework is

to provide a set of uniform rules and regulations that will govern the conduct of people interacting with each other in personal as well as business relationships.

Down the ages, mankind has evolved from a hunter- gatherer society through agriculture and industrial revolution to a complex social framework. Throughout this journey, we have always needed laws and regulations to guide us on the right course of conduct as well as to identify violations and punish them.

If we talk about ancient law, on the basis of information available from different sources "Code of Hammurabi" is known for oldest law in written form. King Hammurabi ruled Babylon for the period from 1792 BC to 1758 BC. He carved the code on bulky stone slabs and ordered to place those stones on different places all over the city so that the public may have the knowledge of codes. He also appointed judges to check whether public is following the laws or not.

In 450 BC, a set of laws was engraved on 12 bronze tablets in Rome which is considered as first most detailed code of any of the civilisations and called Twelve Tables. The purpose of these tables was to protect the rights of public and to provide remedy for wrongs. All the citizens of Rome were supposed to have the knowledge of these tables. Over the time, many amendments were done in these laws as per the requirements.

In this subject, you will be introduced to many laws. Therefore, in this chapter we will first understand how these laws are made and how they are implemented.

2. WHAT IS LAW?

Law is a set of obligations and duties imposed by the government for securing welfare and providing justice to society. India's legal framework reflects the social, political, economic, and cultural aspects of our vast and diversified country.

3. SOURCES OF LAW

The main sources of law in India are the Constitution, the statutes or laws made by Parliament and State Assemblies, Precedents or the Judicial Decisions of various Courts and in some cases, established Customs and Usages.

You must be aware that India is a parliamentary democracy. We have a constitution which is the basis and source for all laws. We elect our representatives to the parliament as well as to the legislative assemblies of various States. These representatives of the people make laws in parliament or in their state assemblies as the case may be. So, Parliament is the ultimate

law-making body. The laws passed by parliament may apply throughout all or a portion of India, whereas the laws passed by state legislatures apply only within the borders of the states concerned.

The Government of India Act, 1935, passed by the Parliament of the United Kingdom is the precursor for the Constitution of India. It defined the characteristics of the Government from "unitary" to "federal". Powers were distributed between Centre and State to avoid any disputes. In 1937, Federal Court was established and had the jurisdiction of appellate, original and advisory. The powers of Appellate Jurisdiction extended to civil and criminal cases whereas the Advisory Jurisdiction was extended with the powers to Federal Court to advise Governor-General in matters of public opinion. The Federal Court operated for 12 years and heard roughly 151 cases. The Federal Court was supplanted by India's current Apex Court, the Supreme Court of India.

The Constitution of India, 1950 is the foremost law that deals with the framework within which our democratic system works, and our laws are made for the people, by the people. The Constitution also provides for and protects certain Fundamental rights of citizens. It also lays down Fundamental duties as well as the powers and duties of Governments, both Central and State. The laws in India are interconnected with each other forming a hybrid legal system.

The people who wrote the Constitution decided to divide the law-making power between the Central Government and the various State Governments. So, the Indian Constitution has three lists Viz., Central List, State List and Joint List.

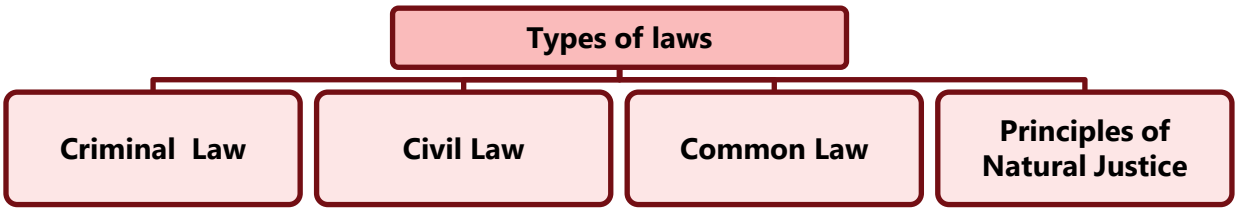
Depending on the list in which it figures a matter would become the subject for Central law or a State law. For example, Income Tax is a Central subject. So, throughout India we have only one law for Income Tax which is implemented by the Central Government through the Ministry of Finance. We also have matters for which both Central as well as State Governments can pass laws. Levy of stamp duty is such an example. Both Central Government and State Government have laws governing Levy of stamp duty.

4. THE PROCESS OF MAKING A LAW

When a law is proposed in parliament it is called a Bill. After discussion and debate, the law is passed in Lok Sabha. Thereafter, it has to be passed in Rajya Sabha. It then has to obtain the assent of the President of India. Finally, the law will be notified by the Government in the publication called the Official Gazette of India. The law will become applicable from the date mentioned in the notification as the effective date. Once it is notified and effective, it is called an Act of Parliament.

Types of laws in the Indian Legal System

The laws in the Indian legal system could be broadly classified as follows:



Criminal Law

Criminal law is concerned with laws pertaining to violations of the rule of law or public wrongs and punishment of the same. Criminal Law is governed under the Indian Penal Code, 1860, and the Code of Criminal Procedure, 1973 (Crpc). The Indian Penal Code, 1860, defines the crime, its nature, and punishments whereas the Criminal Procedure Code, 1973, defines exhaustive procedure for executing the punishments of the crimes.

Murder, rape, theft, fraud, cheating and assault are some examples of criminal offences under the law.

Civil Law

Matters of disputes between individuals or organisations are dealt with under Civil Law. Civil courts enforce the violation of certain rights and obligations through the institution of a civil suit. Civil law primarily focuses on dispute resolution rather than punishment. The act of process and the administration of civil law are governed by the Code of Civil Procedure, 1908 (CPC). Civil law can be further classified into Law of Contract, Family Law, Property Law, and Law of Tort.

Some examples of civil offences are breach of contract, non-delivery of goods, non-payment of dues to lender or seller defamation, breach of contract, and disputes between landlord and tenant.

Common Law

A judicial precedent or a case law is common law. A judgment delivered by the Supreme Court will be binding upon the courts within the territory of India under Article 141 of the Indian Constitution. The doctrine of *Stare Decisis* is the principle supporting common law. It is a Latin phrase that means "to stand by that which is decided." The doctrine of *Stare Decisis* reinforces the obligation of courts to follow the same principle or judgement established by previous decisions while ruling a case where the facts are similar or "on all four legs" with the earlier decision.

Principles of Natural Justice

Natural justice, often known as *Jus Natural* deals with certain fundamental principles of justice going beyond written law. *Nemo judex in causa sua* (Literally meaning "No one should be made a judge in his own cause, and it's a Rule against Prejudice), *audi alteram partem* (Literally meaning "hear the other party or give the other party a fair hearing), and reasoned decision are the rules of Natural Justice. A judgement can override or alter a common law, but it cannot override or change the statute.

5. ENFORCING THE LAW

After a law is passed in parliament it has to be enforced. Somebody should monitor whether the law is being followed. This is the job of the executive. Depending on whether a law is a Central law or a State law the Central or State Government will be the enforcing authority. For this purpose government functions are distributed to various ministries. Some of the popular Ministries are the Ministry of Finance, the Ministry of Corporate Affairs, the Ministry of Home Affairs, the Ministry of Law and Justice and so on. These Ministries are headed by a minister and run by officers of the Indian administrative and other services.

The Government of India exercises its executive authority through a number of Government Ministries or Departments of State. A Ministry is composed of employed officials, known as civil servants, and is politically accountable through a minister. Most major Ministries are headed by a Cabinet Minister, who sits in the Union Council of Ministers, and is typically supported by a team of junior ministers called the Ministers of State.

For example, the Income Tax Act is implemented and enforced by the Ministry of Finance through the Central Board for Direct Taxes coming under the Department of Revenue and is administered by the officers of the Indian Revenue Service. We will see some of the major Ministries and the laws which are enforced by them:

(1) The Ministry of Finance

The Ministry of Finance (Vitta Mantralaya) is a Ministry within the Government of India concerned with the economy of India, serving as the Treasury of India. In particular, it concerns itself with taxation, financial legislation, financial institutions, capital markets, centre and state finances, and the Union Budget. As a Chartered Accountant, many of your day-to-day work life will be impacted by this ministry and its proclamations. This Ministry is so important that many ministers have preferred to hold the portfolio of Finance Minister also. One of the important functions of the Finance Ministry is the presentation of the Union Budget. This annual event is eagerly awaited by professionals and the common man as it provides for the rates of taxes and budget allocations for the ensuing year.

Who presented the Maximum number of Union Budgets as Finance Minister?

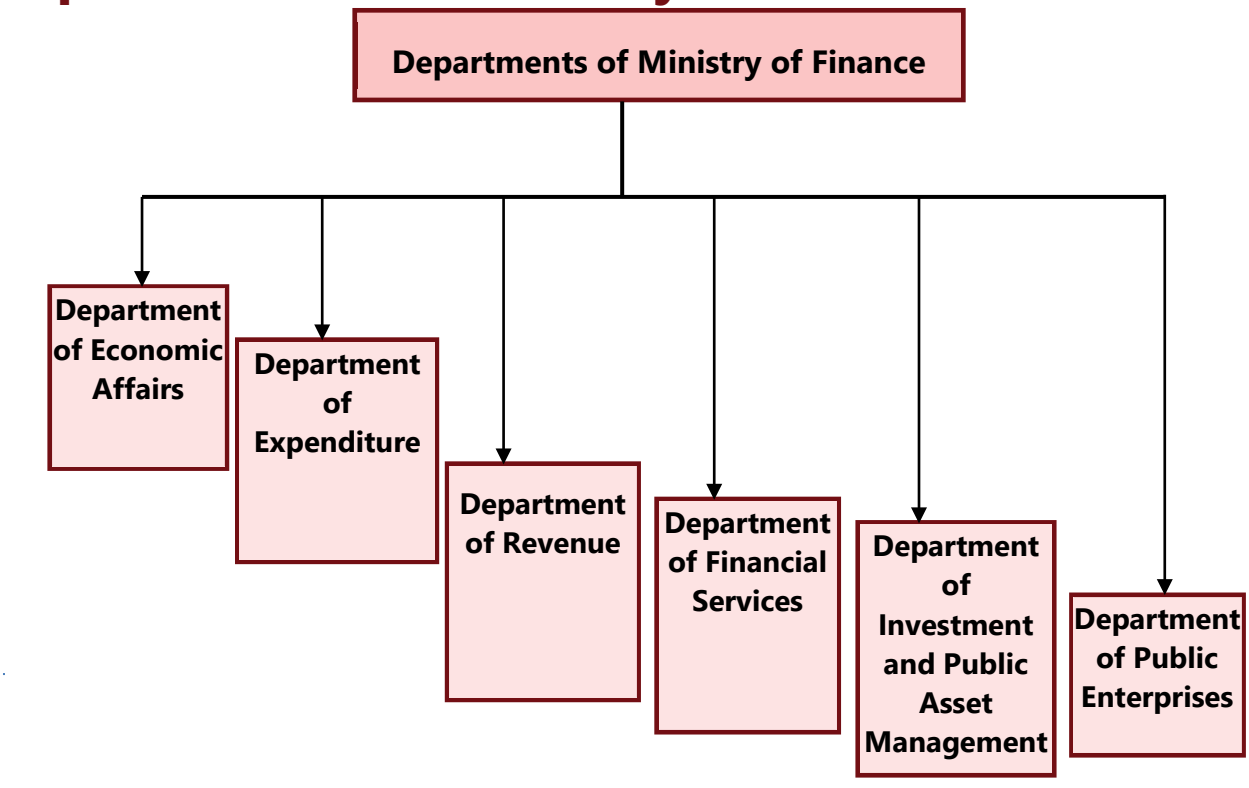
Shri. Morarji Desai during his stint as Finance Minister between 1962 and 1969 has presented 10 Union Budgets making it the highest. The next on the list is Shri. P Chidambaram at 9, followed by Shri. Pranab Mukherjee at 8. Shri. Yashwant Sinha and Dr. Manmohan Singh have presented 8 and 6 budgets respectively.

Constitution of the Ministry of Finance-

Ministry of Finance

- is the apex controlling authority
- of *four* Central Civil Services, namely:
  - Indian Revenue Service
  - Indian Audit and Accounts Service
  - Indian Economic Service and
  - Indian Civil Accounts Service.
- Also the apex controlling authority of one of the central commerce services namely
- Indian Cost and Management Accounts Service.

Departments under the Ministry of Finance-



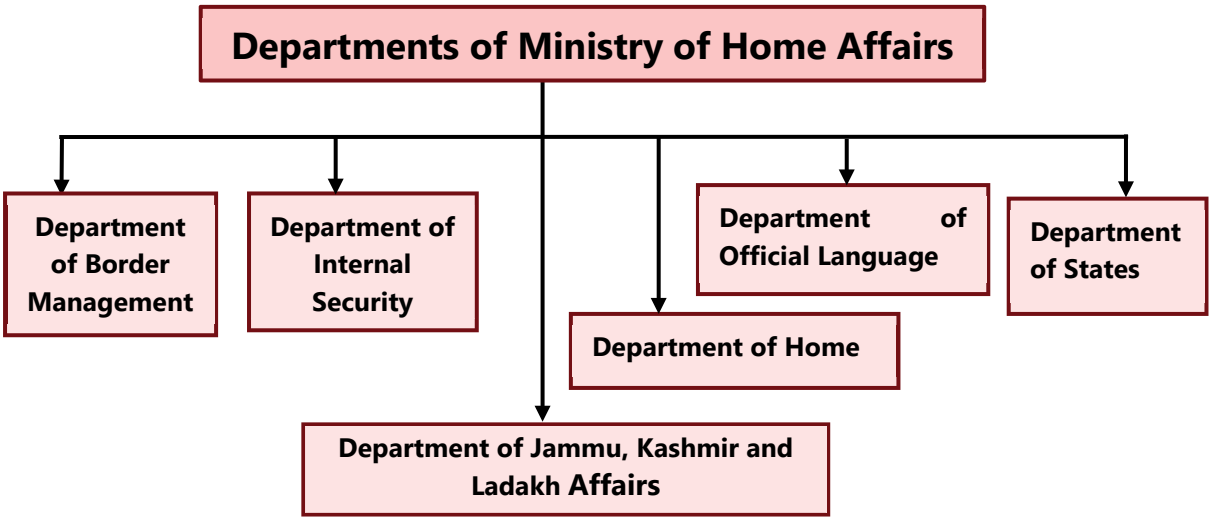
(i) Ministry of Corporate Affairs (MCA)

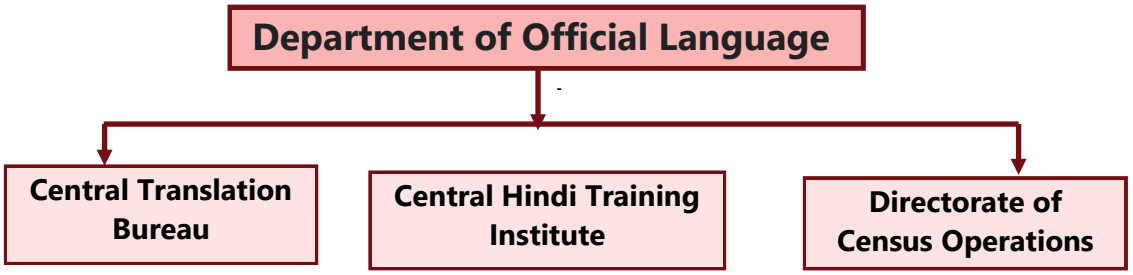
Ministry of Corporate Affairs

- is an Indian Government Ministry.
- primarily concerned with administration of the Companies Act 2013, the Companies Act 1956, the Limited Liability Partnership Act, 2008, and the Insolvency and Bankruptcy Code, 2016.
- responsible mainly for the regulation of Indian enterprises in the industrial and services sector.
- The Ministry is mostly run by civil servants of the ICLS cadre.
- These officers are elected through the Civil Services Examination conducted by Union Public Service Commission.
- The highest post, Director General of Corporate Affairs (DGCoA), is fixed at Apex Scale for the ICLS.

Ministry of Home Affairs (Gṛha Mantralaya)

- is a ministry of the Government of India.
- As an interior ministry of India, it is mainly responsible for the maintenance of internal security and domestic policy.
- The Home Ministry is headed by Union Minister of Home Affairs.

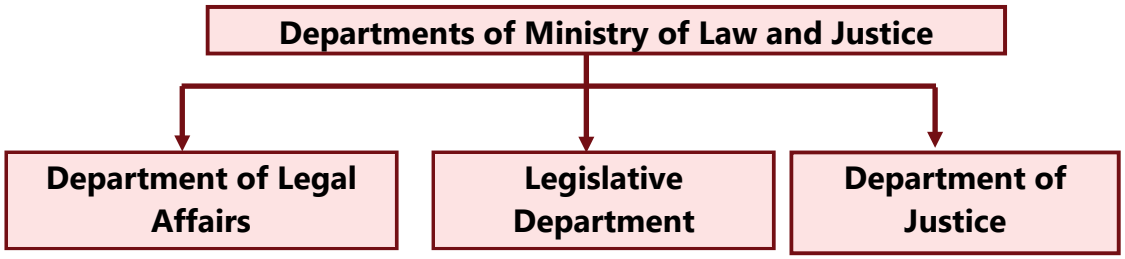




Ministry of Law and Justice

Ministry of Law and Justice

- in the Government of India is a Cabinet Ministry
- deals with the
  - ➢ management of the legal affairs, through the Legislative Department
  - ➢ legislative activities through the Department of Legal Affairs
  - ➢ administration of justice in India through the Department of Justice
- The Department of Legal Affairs is concerned with advising the various Ministries of the Central Government while the Legislative Department is concerned with drafting of principal legislation for the Central Government.



(ii) The Securities and Exchange Board of India (SEBI)

The Securities and Exchange Board of India (SEBI)

- is the regulatory body
- for securities and commodity market in India
- under the ownership of Ministry of Finance within the Government of India.
- It was established on 12 April, 1988 as an executive body and was given statutory powers on 30 January, 1992 through the SEBI Act, 1992.

(iii) Reserve Bank of India (RBI)

Reserve Bank of India-

- is India's Central Bank and regulatory body responsible for regulation of the Indian banking system.
- It is under the ownership of Ministry of Finance, Government of India.
- It is responsible for the control, issue and maintaining supply of the Indian rupee.
- It also manages the country's main payment systems and works to promote its economic development.
- Bharatiya Reserve Bank Note Mudran (BRBNM) is a specialised division of RBI through which it prints and mints Indian currency notes (INR) in two of its currency printing presses located in Nashik (Western India) and Dewas (Central India).
- RBI established the National Payments Corporation of India as one of its specialised division to regulate the payment and settlement systems in India.
- Deposit Insurance and Credit Guarantee Corporation was established by RBI as one of its specialised division for the purpose of providing insurance of deposits and guaranteeing of credit facilities to all Indian banks.

(iv) Insolvency and Bankruptcy Board of India (IBBI)-

Insolvency and Bankruptcy Board of India (IBBI)-

- is the regulator for overseeing insolvency proceedings and entities like Insolvency Professional Agencies (IPA), Insolvency Professionals (IP) and Information Utilities (IU) in India.
- It was established on 1 October 2016 and given statutory powers through the Insolvency and Bankruptcy Code, which was passed by Lok Sabha on 5th May 2016.
- It covers Individuals, Companies, Limited Liability, Partnerships and Partnership firms. The new code will speed up the resolution process for stressed assets in the country.
- It attempts to simplify the process of insolvency and bankruptcy proceedings.
- It handles the cases using two tribunals like NCLT (National company law tribunal) and Debt recovery tribunal.

6. STRUCTURE OF THE INDIAN JUDICIAL SYSTEM

When there is a dispute between citizens or between citizens and the Government, these disputes are resolved by the judiciary.

The **functions** of judiciary system of India are:

- Regulation of the interpretation of the Acts and Codes,
- Dispute Resolution,
- Promotion of fairness among the citizens of the land.

In the **hierarchy of courts**, the Supreme Court is at the top, followed by the High Courts and District Courts. Decisions of a High Court are binding in the respective state but are only persuasive in other states. Decisions of the Supreme Court are binding on all High Courts under Article 141 of the Indian Constitution. In fact, a Supreme Court decision is the final word on the matter.

(i) Supreme Court

The Supreme Court is the apex body of the judiciary. It was established on 26th January, 1950. The Chief Justice of India is the highest authority appointed under Article 126. The principal bench of the Supreme Court consists of seven members including the Chief Justice of India. Presently, the number has increased to 34 including the Chief Justice of India due to the rise in the number of cases and workload. An individual can seek relief in the Supreme Court by filing a writ petition under Article 32.

(ii) High Court

The highest court of appeal in each state and union territory is the High Court. Article 214 of the Indian Constitution states that there must be a High Court in each state. The High Court has appellant, original jurisdiction, and Supervisory jurisdiction. However, Article 227 of the Indian Constitution limits a High Court's supervisory power. In India, there are twenty-five High Courts, one for each state and union territory, and one for each state and union territory. Six states share a single High Court. An individual can seek remedies against violation of fundamental rights in High Court by filing a writ under Article 226.

Which is the oldest High Court in India?

The oldest high court in the country is the Calcutta High Court, established on 2nd July, 1862.

(iii) District Court

Below the High Courts are the District Courts. The Courts of District Judge deal with Civil law matters i.e. contractual disputes and claims for damages etc., The Courts of Sessions deals with Criminal matters.

Under pecuniary jurisdiction, a civil judge can try suits valuing not more than Rupees two crore.

Jurisdiction means the power to control. Courts get territorial Jurisdiction based on the areas covered by them. Cases are decided based on the local limits within which the parties reside or the property under dispute is situated.

(iv) Metropolitan courts

Metropolitan courts are established in metropolitan cities in consultation with the High Court where the population is ten lakh or more. Chief Metropolitan Magistrate has powers as Chief Judicial Magistrate and Metropolitan Magistrate has powers as the Court of a Magistrate of the first class.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *A Chartered Accountant should be aware of law because*
   - *(a) He has to be an expert in law*
   - *(b) He has to argue in High court and Supreme court*
   - *(c) He has to advice management and clients on legal matters at a basic or threshold level.*
   - *(d) None of the above.*
2. *Which of the following is not a MAIN source of law in India?*
   - *(a) Legal text books*
   - *(b) The Parliament*
   - *(c) State Assemblies*
   - *(d) The Constitution*

3. *In India we follow the federal system of Government. This means that*

   (a) *All the power is with the President of India*

   (b) *Powers are distributed between Centre and States*

   (c) *All the power is with the Centre*

   (d) *There are no restrictions on the power of States.*

4. *The Constitution of India was adopted in*

   (a) 1947

   (b) 1949

   (c) 1950

   (d) 1951

5. *Income Tax Act, 1961 is a part of the*

   (a) *Central list*

   (b) *State list*

   (c) *Joint list*

   (d) *None of the above*

6. *The law concerned with violation of the rule of law and punishment of the same is called -*

   (a) *Family law*

   (b) *Criminal law*

   (c) *Civil law*

   (d) *Property law*

7. *Which of the following is NOT an example of Civil law?*

   (a) Breach of contract

   (b) Non-delivery of goods

   (c) Traffic offenses

   (d) Non-payment of dues

8. *When a law is proposed in Parliament it is called*

   (a) Act

   (b) Statute

   (c) Bill

   (d) Notification

9. *Which of the following is NOT a department of the Ministry of Finance?*

   (a) Department of Economic Affairs

   (b) Department of Expenditure

   (c) Department of States

   (d) Department of Revenue

10. *Courts get territorial limits based on*

   (a) The local limits within which the party resides

   (b) The local limits within which the property under dispute is located

   (c) either a or b

   (d) None of the above

ANSWERS

1.	**(c)**	2	**(a)**	3	**(b)**	4.	**(c)**	5.	**(a)**	6.	**(b)**
7.	**(c)**	8.	**(c)**	9.	**(c)**	10.	**(c)**				

NOTES

CHAPTER 2

INDIAN CONTRACT ACT, 1872

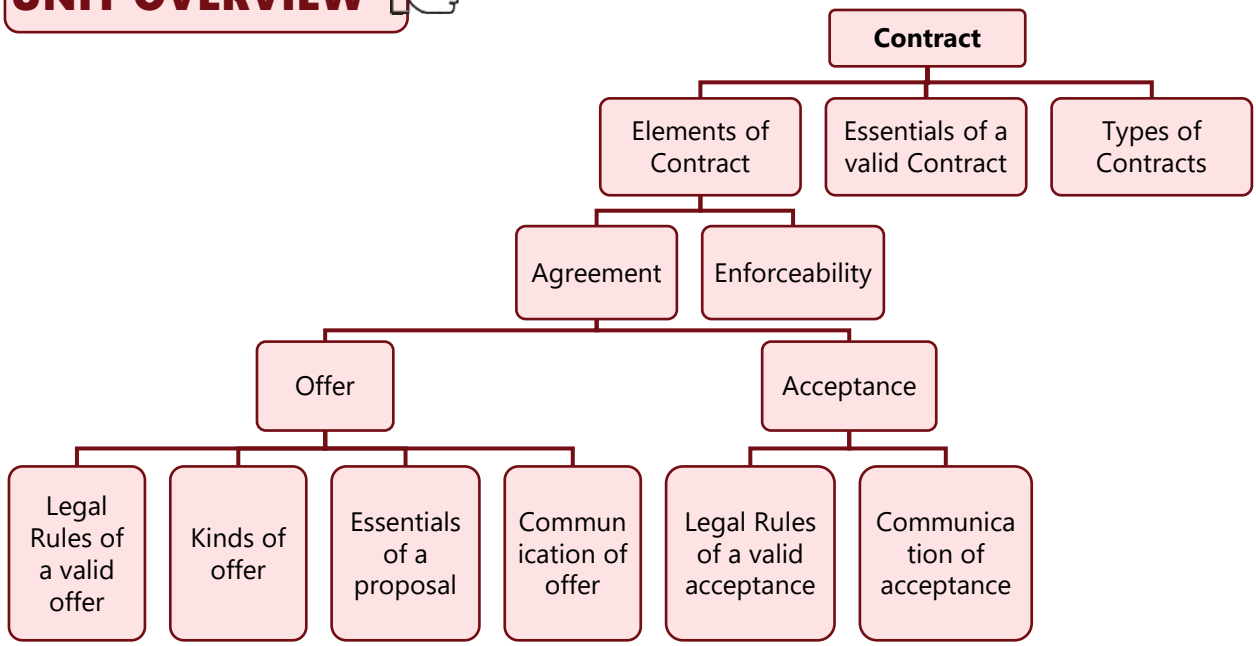
UNIT – 1: NATURE OF CONTRACTS

LEARNING OUTCOMES

After studying this Chapter, you will be able to understand:

- The meaning of the terms 'agreement' and 'contract' and note the distinction between the two.
- The essential elements of a contract.
- About various types of contract.
- The concept of offer and acceptance and rules of communication and revocation thereof.

UNIT OVERVIEW



Contract Law before Indian Contract Act, 1872

To understand the Contract Law before the Indian Contract Act, 1872, we should understand the journey of contract law during different time periods. In the ancient and medieval time, there was no specific law for contracts. For this purpose, generally, different sources of Hindu law like; Vedas, Dharam shastras, Smritis, Shrutis etc. were referred which gave a vivid description of the law similar to contracts in those times. During the period of Mauryas, contracts were in the form of "bilateral transactions" which were based on free consent on all the terms and conditions involved.

During the Mughal rule in India, contracts were governed by Mohammedan Law of Contract. In this law, the Arabic word 'Aqd' is known for contract which means a conjunction. In the same way, word 'Ijab' was used for proposal and 'Qabul' was used for acceptance. The formation of a contract according to Islamic law does not require any kind of formality; the only requirement is the express consent of both parties on the same thing in the same sense.

Hindu law is basically different from that of English law. Hindu law is actually the compilation of numerous customs and works of Smritikaras, who interpreted and analysed Vedas to develop the various aspect of Hindu law. According to Hindu law, minor, intoxicated person, old man or handicapped cannot enter into a valid contract. According to Narada smriti, someone of age upto 8 years is considered as an infant. Age from 8 years to 16 years is considered as boyhood and after 16 years the person is competent to enter into a contract.

During British period; before the advent of the Indian Contract Act, the English Law was applied in the Presidency Towns of Madras, Bombay and Calcutta under the Charter of 1726 issued by king George to the East India Company. If one of the parties of contract is from either of the religion and other is from other religion then the law of the defendant is to be used. This was followed in the presidency towns, but in cities outside the presidency towns, the matters were solved on the basis of justice, equity and good conscience. This procedure was followed till the Indian Contract Act was implemented in India.

The Law of contract: Introduction

The Law of Contract constitutes the most important branch of mercantile or commercial law. It affects everybody, more so, trade, commerce and industry. It may be said that the contract is the foundation of the civilized world. The law relating to contract is governed by the Indian Contract Act, 1872. It was formed on April 25, 1872 and came into force on September 01, 1872. The preamble to the Act says that it is an Act "to define and amend certain parts of the law relating to contract". It extends to the whole of India including the state of Jammu and Kashmir after removal of Article – 370 of Indian Constitution.

The Act mostly deals with the general principles and rules governing contracts. The Act is divisible into two parts. The first part (Section 1-75) deals with the general principles of the law of contract, and therefore applies to all contracts irrespective of their nature. The second part (Sections 124-238) deals with certain special kinds of contracts, e.g., Indemnity and guarantee, bailment, pledge, and agency.

As a result of increasing complexities of business environment, innumerable contracts are entered into by the parties in the usual course of carrying on their business. 'Contract' is the most usual method of defining the rights and duties in a business transaction. This branch of law is different from other branches of law in a very important aspect. It does not prescribe so many rights and duties, which the law will protect or enforce; instead it contains a number of limiting principles subject to which the parties may create rights and duties for themselves. The Indian Contract Act, 1872 codifies the legal principles that govern 'contracts'. The Act basically identifies the ingredients of a legally enforceable valid contract in addition to dealing with certain special type of contractual relationships like indemnity, guarantee, bailment, pledge, quasi contracts, contingent contracts etc. It basically defines the circumstances in which promises made by the parties to a contract shall be legally binding on them.

This unit refers to the essentials of a legally enforceable agreement or contract. It sets out rules for the offer and acceptance and revocation thereof. It states the circumstances when an agreement is voidable or enforceable by one party only, and when the agreements are void, i.e. not enforceable at all.

1.1 WHAT IS A CONTRACT?

The term contract is defined under section 2(h) of the Indian Contract Act, 1872 as-

"an agreement enforceable by law".

The contract consists of two essential elements:

(i) an agreement, and

(ii) its enforceability by law.

(i) Agreement - The term 'agreement' **given in Section 2(e)** of the Act is defined as- "every promise and every set of promises, forming the consideration for each other".

To have an insight into the definition of agreement, we need to understand promise.

Section 2 (b) defines promise as- "when the person to whom the proposal is made signifies his assent there to, the proposal is said to be accepted. Proposal when accepted, becomes a promise".

The following points emerge from the above definition:

1. when the person to whom the proposal is made
2. signifies his assent on that proposal which is made to him
3. the proposal becomes accepted
4. accepted proposal becomes promise

Thus, we say that an agreement is the result of the proposal made by one party to the other party and that other party gives his acceptance thereto of course for mutual consideration.

Agreement = Offer/Proposal + Acceptance + Consideration

(ii) Enforceability by law – An agreement to become a contract must give rise to a legal obligation which means a duly enforceable by law.

Thus, from above definitions it can be concluded that –

Contract = Agreement + Enforceability by law

On elaborating the above two concepts, it is obvious that contract comprises of an agreement which is a promise or a set of reciprocal promises, that a promise is the acceptance of a proposal giving rise to a binding contract. Further, section 2(h) requires an agreement capable of being enforceable by law before it is called 'contract'. Where parties have made a binding contract, they created rights and obligations between themselves.

Example 1: A agrees with B to sell car for ₹ 2 lacs to B. Here A is under an obligation to give car to B and B has the right to receive the car on payment of ₹ 2 lacs and also B is under an obligation to pay ₹ 2 lacs to A and A has a right to receive ₹ 2 lacs.

Example 2: Father promises his son to pay him pocket allowance of Rs. 500 every month. But he refuses to pay later. The son cannot recover the same in court of law as this is a social agreement. This is not created with an intention to create legal relationship and hence it is not a contract.

So, Law of Contract deals with only such legal obligations which has resulted from agreements. Such obligation must be contractual in nature. However, some obligations are outside the purview of the law of contract.

Example 3: An obligation to maintain wife and children, an order of the court of law etc. These are status obligations and so out of the scope of the Contract Act.

Difference between Agreement and Contract

Basis of differences	Agreement	Contract
Meaning	Every promise and every set of promises, forming the consideration for each other. (Promise + Consideration)	Agreement enforceable by law. (Agreement + Legal enforceability)
Scope	It's a wider term including both legal and social agreement.	It is used in a narrow sense with the specification that contract is only legally enforceable agreement.
Legal obligation	It may not create legal obligation. An agreement does not always grant rights to the parties	Necessarily creates a legal obligation. A contract always grants certain rights to every party.
Nature	All agreement are not contracts.	All contracts are agreements.

1.2 ESSENTIALS OF A VALID CONTRACT

Essentials of a valid contract

	As given by Section 10 of Indian Contract Act, 1872		Not given by Section 10 but are also considered essential
1	Agreement	1	Two parties
2	Free consent	2	Intention to create legal relationship

3	Competency of the parties	3	Fulfilments of legal formalities
4	Lawful consideration	4	Certainty of meaning
5	Legal object	5	Possibility of performance
6	Not expressly declared to be void [as per Section 24 to 30 and 56]	6	-

In terms of Section 10 of the Act, "all agreements are contracts if they are made by the free consent of the parties competent to contract, for a lawful consideration and with a lawful object and are not expressly declared to be void".

Since section 10 is not complete and exhaustive, so there are certain other sections which also contains requirements for an agreement to be enforceable. Thus, in order to create a valid contract, the following elements should be present:

1. **Two Parties:** One cannot contract with himself. A contract involves at least two parties- one party making the offer and the other party accepting it. A contract may be made by natural persons and by other persons having legal existence e.g. companies, universities etc. It is necessary to remember that identity of the parties be ascertainable.

   Example 4: To constitute a contract of sale, there must be two parties- seller and buyer. The seller and buyer must be two different persons, because a person cannot buy his own goods.

   In ***State of Gujarat vs. Ramanlal S & Co.*** when on dissolution of a partnership, the assets of the firm were divided among the partners, the sales tax officer wanted to tax this transaction. It was held that it was not a sale. The partners being joint owner of those assets cannot be both buyer and seller.

2. **Parties must intend to create legal obligations:** There must be an intention on the part of the parties to create legal relationship between them. Social or domestic type of agreements are not enforceable in court of law and hence they do not result into contracts.

   Example 5: A husband agreed to pay to his wife certain amount as maintenance every month while he was abroad. Husband failed to pay the promised amount. Wife sued him for the recovery of the amount. Here, in this case, wife could not recover as it was a social agreement and the parties did not intend to create any legal relations. ***(Balfour v. Balfour)***

   Example 6: Mr. Lekhpal promises to pay ₹ 5 lakhs to his son if the son passes the CA exams. On passing the exams, the son claims the money. Here, the son could not recover as it was a social agreement.

Example 7: A sold goods to B on a condition that he must pay for the amount of goods within 30 days. Here A intended to create legal relationship with B. Hence the same is contract. On failure by B for making a payment on due date, A can sue him in the court of law.

3. **Other Formalities to be complied with in certain cases:** A contract may be written or spoken. As to legal effects, there is no difference between a written contract and contract made by word of mouth. But in the interest of the parties the contract must be written. In case of certain contracts some other formalities have to be complied with to make an agreement legally enforceable.

   For e.g. Contract of Insurance is not valid except as a written contract. Further, in case of certain contracts, registration of contract under the laws which is in force at the time, is essential for it to be valid, e.g. in the case of immovable property.

   Thus, where there is any statutory requirement that any contract is to be made in writing or in the presence of witness, or any law relating to the registration of documents must be complied with.

4. **Certainty of meaning:** The agreement must be certain and not vague or indefinite.

   Example 8: A agrees to sell to B a hundred tons of oil. There is nothing certain in order to show what kind of oil was intended for.

   Example 9: XYZ Ltd. agreed to lease the land to Mr. A for indefinite years. The contract is not valid as the period of lease is not mentioned.

5. **Possibility of performance of an agreement:** The terms of agreement should be capable of performance. An agreement to do an act impossible in itself cannot be enforced.

   Example 10: A agrees with B to discover treasure by magic. The agreement cannot be enforced as it is not possible to be performed

Now, according to Section 10 of the Indian Contract Act, 1872, the following are the essential elements of a Valid Contract:

I. **Offer and Acceptance or an agreement:** An agreement is the first essential element of a valid contract. According to Section 2(e) of the Indian Contract Act, 1872, "Every promise and every set of promises, forming consideration for each other, is an agreement" and according to Section 2(b) "A proposal when accepted, becomes a promise". An agreement is an outcome of offer and acceptance for consideration.

II. **Free Consent:** Two or more persons are said to consent when they agree upon the same thing in the same sense. This can also be understood as identity of minds in understanding the terms viz consensus ad idem. Further such consent must be free.

Consent would be considered as free consent if it is not caused by coercion, undue influence, fraud, misrepresentation or mistake.

Example 11: A, who owns two cars is selling red car to B. B thinks he is purchasing the black car. There is no *consensus ad idem* and hence no contract.

To determine *consensus ad idem* the language of the contract should be clearly drafted. Thus, if A says B "Will you buy my red car for ₹ 3,00,000?". B says "yes" to it. There is said to *be consensus ad idem* i.e. the meaning is taken in same sense by both the parties.

Example 12: A threatened to shoot B if he (B) does not lend him ₹ 2,00,000 and B agreed to it. Here the agreement is entered into under coercion and hence not a valid contract.

(Students may note that the terms coercion, undue influence, fraud, misrepresentation, mistake are explained in the Unit-3)

III. Capacity of the parties: Capacity to contract means the legal ability of a person to enter into a valid contract. Section 11 of the Indian Contract Act specifies that every person is competent to contract who

(a) is of the age of majority according to the law to which he is subject and

(b) is of sound mind and

(c) is not otherwise disqualified from contracting by any law to which he is subject.

A person for being competent to contract must fulfil all the above three qualifications.

Qualification (a) refers to the age of the contracting person i.e. the person entering into contract must be of 18 years of age. Persons below 18 years of age are considered minor, therefore, incompetent to contract.

Qualification (b) requires a person to be of sound mind i.e. he should be in his senses so that he understands the implications of the contract at the time of entering into a contract. A lunatic, an idiot, a drunken person or under the influence of some intoxicant is not supposed to be a person of sound mind.

Qualification (c) requires that a person entering into a contract should not be disqualified by his status, in entering into such contracts. Such persons are an alien enemy, foreign sovereigns, convicts etc. They are disqualified unless they fulfil certain formalities required by law.

Contracts entered by persons not competent to contract are not valid.

IV. Consideration: It is referred to as *'quid pro quo'* i.e. 'something in return'. A valuable consideration in the sense of law may consist either in some right, interest, profit or benefit accruing to one party, or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other.

Example 13: A agrees to sell his books to B for ₹ 100.

B's promise to pay ₹ 100 is the consideration for A's promise to sell his books.

A's promise to sell the books is the consideration for B's promise to pay ₹ 100.

V. **Lawful Consideration and Object:** The consideration and object of the agreement must be lawful.

Section 23 states that consideration or object is not lawful if it is prohibited by law, or it is such as would defeat the provisions of law, if it is fraudulent or involves injury to the person or property of another or court regards it as immoral or opposed to public policy.

Example 14: 'A' promises to drop prosecution instituted against 'B' for robbery and 'B' promises to restore the value of the things taken. The agreement is void, as its object is unlawful.

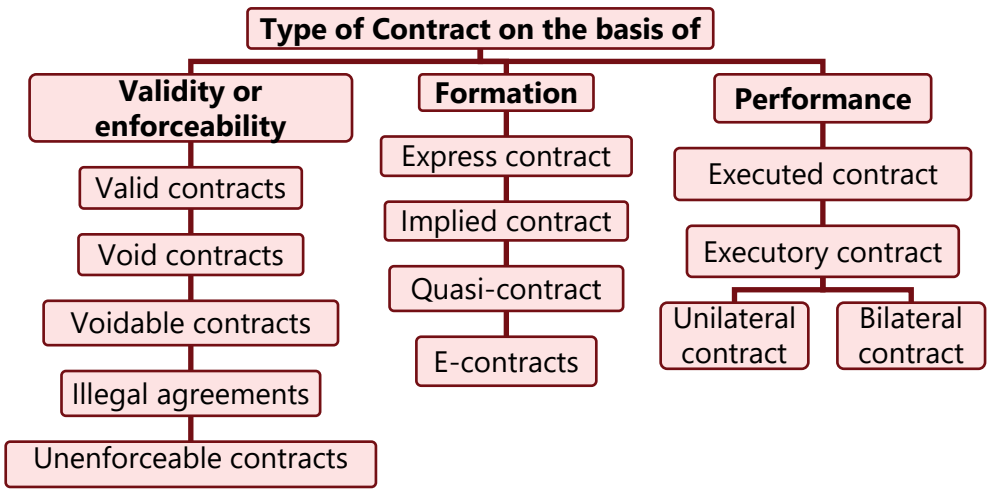
Example 15: A agrees to sell his house to B against 100 kgs of cocaine (drugs). Such agreement is illegal as the consideration is unlawful.

VI. **Not expressly declared to be void:** The agreement entered into must not be which the law declares to be either illegal or void. An illegal agreement is an agreement expressly or impliedly prohibited by law. A void agreement is one without any legal effects.

Example 16: Threat to commit murder or making/publishing defamatory statements or entering into agreements which are opposed to public policy are illegal in nature. Similarly, any agreement in restraint of trade, marriage, legal proceedings, etc. are classic examples of void agreements.

1.3 TYPES OF CONTRACTS

Now let us discuss various types of contracts.



I. On the basis of the validity

1. **Valid Contract:** An agreement which is binding and enforceable is a valid contract. It contains all the essential elements of a valid contract.

Example 17: A ask B if he wants to buy his bike for ₹ 50,000. B agrees to buy bike. It is agreement which is enforceable by law. Hence, it is a valid contract.

2. **Void Contract: Section 2 (j) states as follows:** *"A contract which ceases to be enforceable by law becomes void when it ceases to be enforceable"*. Thus, a void contract is one which cannot be enforced by a court of law.

Example 18: Mr. X agrees to write a book with a publisher. Such contract is valid. But after few days, X dies in an accident. Here the contract becomes void due to the impossibility of performance of the contract. Thus, a valid contract when cannot be performed because of some uncalled happening becomes void.

Example 19: A contracts with B (owner of the factory) for the supply of 10 tons of sugar, but before the supply is effected, the fire caught in the factory and everything was destroyed. Here the contract becomes void.

It may be added by way of clarification here that when a contract is void, it is not a contract at all but for the purpose of identifying it, it has to be called a [void] contract.

3. **Voidable Contract:** Section 2(i) defines that **"an agreement which is enforceable by law at the option of one or more parties thereto, but not at the option of the other or others is a voidable contract".**

This in fact means where one of the parties to the agreement is in a position or is legally entitled or authorized to avoid performing his part, then the agreement is treated and becomes voidable.

Following are the situations where a contract is voidable:

(i) When the consent of party is not free is caused by coercion, undue influence, misrepresentation or fraud.

Example 20: X promise to sell his scooter to Y for ₹ 1 Lac. However, the consent of X has been procured by Y at a gun point. X is an aggrieved party, and the contract is voidable at his option but not on the option of Y. It means if X accepts the contract, the contract becomes a valid contract then Y has no option of rescinding the contract.

(ii) When a person promises to do something for another person, but the other person prevents him from performing his promise, the contract becomes voidable at the option of first person.

Example 21: There is a contact between A and B to sell car of A to B for ₹ 2,00,000. On due date of performance, A asks B that he does not want to sell his car. Here contract is voidable at the option of B.

(iii) When a party to a contract promise to perform a work within a specified time, could not perform with in that time, the contract is voidable at the option of promisee.

Example 22: A agrees to construct a house for B upto 31-3-2022 but A could not complete the house on that date. Here contract is voidable at the option of B.

At this juncture it would be desirable to know **the distinction between a Void Contract and a Voidable Contract**. These are elaborated hereunder:

S. No.	Basis	Void Contract	Voidable Contract
1	**Meaning**	A Contract ceases to be enforceable by law becomes void when it ceases to be enforceable.	An agreement which is enforceable by law at the option of one or more of the parties thereto, but not at the option of the other or others, is a voidable contract.
2	**Enforceability**	A void contract cannot be enforced at all.	It is enforceable only at the option of aggrieved party and not at the option of other party.
3	**Cause**	A contract becomes void due to change in law or change in circumstances beyond the contemplation of parties.	A contract becomes a voidable contract if the consent of a party was not free.

4	**Performance of contract**	A void contract cannot be performed.	If the aggrieved party does not, within reasonable time, exercise his right to avoid the contract, any party can sue the other for claiming the performance of the contract.
5	**Rights**	A void contract does not grant any legal remedy to any party.	The party whose consent was not free has the right to rescind the contract within a reasonable time. If so rescinded, it becomes a void contract. If it is not rescinded it becomes a valid contract.

4. **Illegal Contract:** It is a contract which the law forbids to be made. The court will not enforce such a contract but also the connected contracts. All illegal agreements are void but all void agreements are not necessarily illegal. Despite this, there is similarity between them is that in both cases they are void ab initio and cannot be enforced by law.

Example 23: Contract that is immoral or opposed to public policy are illegal in nature. Similarly, if R agrees with S, to purchase brown sugar, it is an illegal agreement.

According to Section 2(g) of the Indian Contract Act, "an agreement not enforceable by law is void". The Act has specified various factors due to which an agreement may be considered as void agreement. One of these factors is unlawfulness of object and consideration of the contract i.e. illegality of the contract which makes it void. The illegal and void agreement differ from each other in the following respects:

Basis of difference	**Void agreement**	**Illegal agreement**
Scope	A void agreement is not necessarily illegal.	An illegal agreement is always void.
Nature	Not forbidden under law.	Are forbidden under law.
Punishment	Parties are not liable for any punishment under the law.	Parties to illegal agreements are liable for punishment.

Collateral Agreement	It's not necessary that agreements collateral to void agreements may also be void. It may be valid also.	Agreements collateral to illegal agreements are always void.

5. **Unenforceable Contract:** Where a contract is good in substance but because of some technical defect i.e. absence in writing, barred by limitation etc. one or both the parties cannot sue upon it, it is described as an unenforceable contract.

Example 24: A bought goods from B in 2018. But no payment was made till 2022. B cannot sue A for the payment in 2022 as it has crossed three years and barred by Limitation Act. A good debt becomes unenforceable after the period of three years as barred by Limitation Act.

Similarly, an agreement for transfer of immovable property should be written for being enforceable.

II. On the basis of the formation of contract

1. **Express Contracts:** A contract would be an express contract if the terms are expressed by words or in writing. Section 9 of the Act provides that if a proposal or acceptance of any promise is made in words, the promise is said to be express.

Example 25: A tells B on telephone that he offers to sell his house for ₹ 20 lacs and B in reply informs A that he accepts the offer, this is an express contract.

2. **Implied Contracts:** Implied contracts in contrast come into existence by implication. Most often the implication is by action or conduct of parties or course of dealings between them. Section 9 of the Act contemplates such implied contracts when it lays down that in so far as such proposal or acceptance is made otherwise than in words, the promise is said to be implied.

Example 26: Where a coolie in uniform picks up the luggage of A to be carried out of the railway station without being asked by A and A allows him to do so, it is an implied contract and A must pay for the services of the coolie detailed by him.

Example 27: A drinks a coffee in restaurant. There is an implied contract that he should pay for the price of coffee.

Tacit Contracts: The word Tacit means silent. Tacit contracts are those that are inferred through the conduct of parties without any words spoken or written. A classic example of tacit contract would be when cash is withdrawn by a

customer of a bank from the automatic teller machine [ATM]. Another example of tacit contract is where a contract is assumed to have been entered when a sale is given effect to at the fall of hammer in an auction sale. It is not a separate form of contract but falls within the scope of implied contracts.

3. **Quasi-Contract:** A quasi-contract is not an actual contract, but it resembles a contract. It is created by law under certain circumstances. The law creates and enforces legal rights and obligations when no real contract exists. Such obligations are known as quasi-contracts. In other words, it is a contract in which there is no intention on part of either party to make a contract but law imposes a contract upon the parties.

Example 28: Obligation of finder of lost goods to return them to the true owner or liability of person to whom money is paid under mistake to repay it back cannot be said to arise out of a contract even in its remotest sense, as there is neither offer and acceptance nor consent. These are said to be quasi-contracts.

Example 29: T, a tradesman, leaves goods at C's house by mistake. C treats the goods as his own. C is bound to pay for the goods.

4. **E-Contracts:** When a contract is entered into by two or more parties using electronics means, such as e-mails is known as e-commerce contracts. In electronic commerce, different parties/persons create networks which are linked to other networks through ED1 - Electronic Data Inter change. This helps in doing business transactions using electronic mode. These are known as EDI contracts or Cyber contracts or mouse click contracts.

III. On the basis of the performance of the contract

1. **Executed Contract:** The consideration in a given contract could be an act or forbearance. When the act is done or executed or the forbearance is brought on record, then the contract is an executed contract.

Example 30: When a grocer sells a sugar on cash payment it is an executed contract because both the parties have done what they were to do under the contract.

2. **Executory Contract:** In an executory contract the consideration is reciprocal promise or obligation. Such consideration is to be performed in future only and therefore these contracts are described as executory contracts.

Example 31: Where G agrees to take the tuition of H, a pre-engineering student, from the next month and H in consideration promises to pay G ₹ 1,000 per month, the contract is executory because it is yet to be carried out.

Unilateral or Bilateral are kinds of Executory Contracts and are not separate kinds.

(a) **Unilateral Contract:** Unilateral contract is a one sided contract in which one party has performed his duty or obligation and the other party's obligation is outstanding.

Example 32: M advertises payment of award of ₹ 50,000 to any one who finds his missing boy and brings him. As soon as B traces the boy, there comes into existence an executed contract because B has performed his share of obligation and it remains for M to pay the amount of reward to B. This type of Executory contract is also called unilateral contract.

(b) **Bilateral Contract:** A Bilateral contract is one where the obligation or promise is outstanding on the part of both the parties.

Example 33: A promises to sell his plot to B for ₹10 lacs cash down, but B pays only ₹ 2,50,000 as earnest money and promises to pay the balance on next Sunday. On the other hand, A gives the possession of plot to B and promises to execute a sale deed on the receipt of the whole amount. The contract between the A and B is executory because there remains something to be done on both sides. Such Executory contracts are also known as Bilateral contracts.

1.4 PROPOSAL / OFFER [SECTION 2(a) OF THE INDIAN CONTRACT ACT, 1872]

Definition of Offer/Proposal:

According to Section 2(a) of the Indian Contract Act, 1872, "when one person signifies to another his willingness to do or to abstain from doing anything with a view to obtaining the assent of that other to such act or abstinence, he is said to make a proposal".

Essentials of a proposal/offer are-

1. **The person making the proposal or offer is called the 'promisor' or 'offeror':** The person to whom the offer is made is called the 'offeree' and the person accepting the offer is called the 'promisee' or 'acceptor'.

2. **For a valid offer, the party making it must express his willingness 'to do' or 'not to do' something:** There must be an expression of willingness to do or not to do some act by the offeror.

Example 34: A willing to sell his good at certain price to B.

Example 35: A is willing to not to dance in a competition if B pays him certain sum of money.

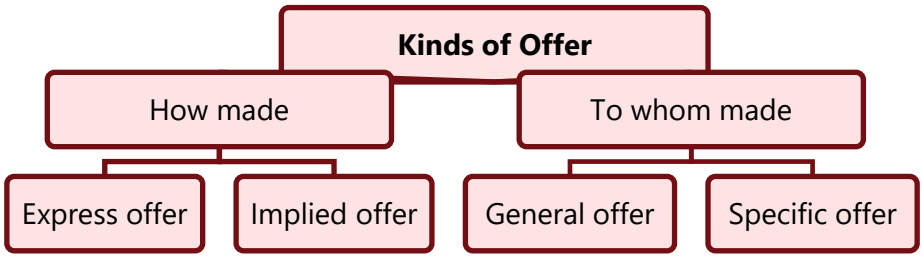
3. **The willingness must be expressed with a view to obtain the assent of the other party to whom the offer is made.**

Example 36: Where 'A' tells 'B' that he desires to marry by the end of 2022, it does not constitute an offer of marriage by 'A' to 'B'. Therefore, to constitute a valid offer expression of willingness must be made to obtain the assent (acceptance) of the other. Thus, if in the above **example,** 'A' further adds, 'Will you marry me', it will constitute an offer.

4. **An offer can be positive as well as negative:** Thus "doing" is a positive act and "not doing", or "abstinence" is a negative act; nonetheless both these acts have the same effect in the eyes of law.

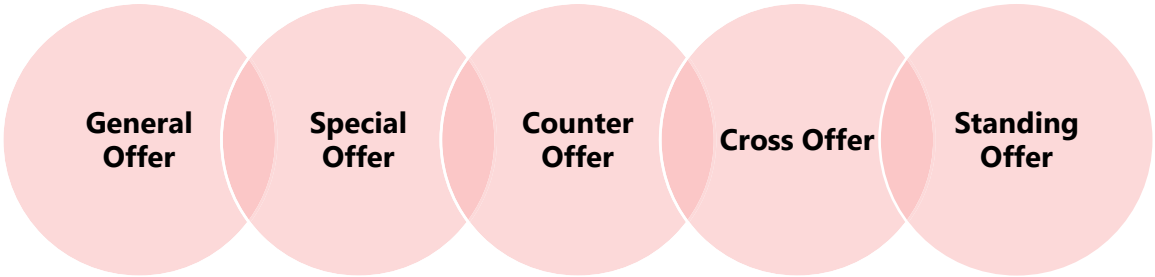
Example 37: A offers to sell his car to B for ₹ 3 lacs is an act of doing. So in this case, A is making an offer to B.

Example 38: When A ask B after his car meets with an accident with B's scooter not to go to Court and he will pay the repair charges to B for the damage to B's scooter; it is an act of not doing or abstinence.



Classification of offer

An offer can be classified as general offer, special/specific offer, cross offer, counter offer, standing/ open/ continuing offer.



Now let us examine each one of them.

(a) **General offer:** It is an offer made to public at large and hence anyone can accept and do the desired act ***(Carlill Vs. Carbolic Smoke Ball Co.).*** In terms of Section 8 of the Act, anyone performing the conditions of the offer can be considered to have accepted the offer. Until the general offer is retracted or withdrawn, it can be accepted by anyone at any time as it is a continuing offer.

Case Law: Carlill Vs. Carbolic Smoke Ball Co. (1893)

Facts: In this famous case, Carbolic smoke Ball Co. advertised in several newspapers that a reward of £100 would be given to any person who contracted influenza after using the smoke balls produced by the Carbolic Smoke Ball Co. according to printed directions. One lady, Mrs. Carlill, used the smoke balls as per the directions of company and even then, suffered from influenza. Held, she could recover the amount as by using the smoke balls she had accepted the offer.

(b) **Special/specific offer:** When the offer is made to a specific or an ascertained person, it is known as a specific offer. Specific offer can be accepted only by that specified person to whom the offer has been made. ***[Boulton Vs. Jones]***

Example 39: 'A' offers to sell his car to 'B' at a certain cost. This is a specific offer.

(c) **Cross offer:** When two parties exchange identical offers in ignorance at the time of each other's offer, the offers are called cross offers. There is no binding contract in such a case because offer made by a person cannot be construed as acceptance of the another's offer.

Example 40: If A makes a proposal to B to sell his car for ₹ 2 lacs and B, without knowing the proposal of A, makes an offer to purchase the same car at ₹ 2 lacs from A, it is not an acceptance, as B was not aware of proposal made by A. It is only cross proposal (cross offer). And when two persons make offer to each other, it cannot be treated as mutual acceptance. There is no binding contract in such a case.

(d) **Counter offer:** When the offeree offers to qualified acceptance of the offer subject to modifications and variations in the terms of original offer, he is said to have made a counter offer. Counter-offer amounts to rejection of the original offer. It is also called as Conditional Acceptance.

Example 41: 'A' offers to sell his plot to 'B' for ₹10 lakhs. 'B' agrees to buy it for ₹ 8 lakhs. It amounts to counter offer. It will result in the termination of the offer of 'A'. If later on 'B' agrees to buy the plot for ₹ 10 lakhs, 'A' may refuse.

(e) Standing or continuing or open offer: An offer which is allowed to remain open for acceptance over a period of time is known as standing or continuing or open offer. Tenders that are invited for supply of goods is a kind of standing offer.

Essential of a valid offer

1. ***It must be capable of creating legal relations:*** Offer must be such as in law is capable of being accepted and giving rise to legal relationship. If the offer does not intend to give rise to legal consequences and creating legal relations, it is not considered as a valid offer in the eye of law. A social invitation, even if it is accepted, does not create legal relations because it is not so intended.

   Example 42: A invited B on his birthday party. B accepted the proposal but when B reached the venue, he (B) found that A was not there. He filed the suit against A for recovery of travelling expenses incurred by him to join the birthday party. Held, such an invitation did not create a legal relationship. It is a social activity. Hence, B could not succeed.

2. ***It must be certain, definite and not vague:*** If the terms of an offer are vague or indefinite, its acceptance cannot create any contractual relationship.

   Example 43*:* A offers to sell B 100 quintals of oil, there is nothing whatever to show what kind of oil was intended. The offer is not capable of being accepted for want of certainty.

   If in the above example, A is a dealer in mustard oil only, it shall constitute a valid offer.

3. ***It must be communicated to the offeree:*** An offer, to be complete, must be communicated to the person to whom it is made, otherwise there can be no acceptance of it. Unless an offer is communicated, there can be no acceptance by it. An acceptance of an offer, in ignorance of the offer, is not acceptance and does not confer any right on the acceptor.

   This can be illustrated by the landmark case of ***Lalman Shukla v. GauriDutt***

   Facts: G (Gauridutt) sent his servant L (Lalman) to trace his missing nephew. He then announced that anybody who traced his nephew would be entitled to a certain reward. L traced the boy in ignorance of this announcement. Subsequently when he came to know of the reward, he claimed it. **Held,** he was not entitled to the reward, as he did not know the offer.

4. ***It must be made with a view to obtaining the assent of the other party:*** Offer must be made with a view to obtaining the assent of the other party addressed and not merely with a view to disclosing the intention of making an offer.

5. ***It may be conditional:*** An offer can be made subject to any terms and conditions by the offeror.

Example 44: Offeror may ask for payment by RTGS, NEFT etc. The offeree will have to accept all the terms of the offer otherwise the contract will be treated as invalid.

6. ***Offer should not contain a term the non-compliance of which would amount to acceptance:*** Thus, one cannot say that if acceptance is not communicated by a certain time the offer would be considered as accepted.

Example 45: A proposes B to purchase his android mobile for ₹5000 and if no reply by him in a week, it would be assumed that B had accepted the proposal. This would not result into contract.

7. ***The offer may be either specific or general:*** Any offer can be made to either public at large or to the any specific person. (Already explained in the heading-types of the offer)

8. ***The offer may be express or implied*:** An offer may be made either by words or by conduct.

Example 46: A boy starts cleaning the car as it stops on the traffic signal without being asked to do so, in such circumstances any reasonable man could guess that he expects to be paid for this, here boy makes an implied offer.

9. ***Offer is Different from a mere statement of intention, an invitation to offer, a mere communication of information, A prospectus and Advertisement.***

(i) A statement of intention and announcement.

Example 47: A father wrote his son about his wish of making him the owner of all his property is mere a statement of intention.

Example 48: An announcement to give scholarships to children scoring more than 95% in 12th board is not an offer.

(ii) Offer must be distinguished from an answer to a question.

Case Law: Harvey vs. Facie [1893] AC 552

In this case, Privy Council succinctly explained the distinction between an offer and an invitation to offer. In the given case, the plaintiffs through a telegram asked the defendants two questions namely,

(i) Will you sell us Bumper Hall Pen? and

(ii) Telegraph lowest cash price.

The defendants replied through telegram that the "lowest price for Bumper Hall Pen is £ 900". The plaintiffs sent another telegram stating "we agree to buy Bumper Hall Pen at £ 900". However, the defendants refused to sell the property at the price.

The plaintiffs sued the defendants contending that they had made an offer to sell the property at £ 900 and therefore they are bound by the offer.

However, the Privy Council did not agree with the plaintiffs on the ground that while plaintiffs had asked two questions, the defendant replied only to the second question by quoting the price but reserved their answer with regard to their willingness to sell. Thus, they made no offer at all. Their Lordships held that the mere statement of the lowest price at which the vendor would sell contained no implied contract to sell to the person who had enquired about the price.

The above decision was followed in Mac Pherson vs Appanna [1951] A.S.C. 184 where the owner of the property had said that he would not accept less than £ 6000/- for it. This statement did not indicate any offer but indicated only an invitation to offer.

(iii) ***A statement of price is not an offer:*** Quoting the price of a product does not constitute it as offer. (refer case of ***Harvey Vs. Facie*** as discussed above)

Example 49: The price list of goods does not constitute an offer for sale of certain goods on the listed prices. It is an invitation to offer.

(iv) **An invitation to make an offer or do business.** In case of "an invitation to make an offer", the person making the invitation does not make an offer rather invites the other party to make an offer. His objective is to send out the invitation that he is willing to deal with any person who, on the basis of such invitation, is ready to enter into contract with him subject to final terms and conditions.

Example 50: An advertisement for sale of goods by auction is an invitation to the offer. It merely invites offers/bids made at the auction.

When goods are sold through auction, the auctioneer does not contract with anyone who attends the sale. The auction is only an advertisement to sell but the items are not put for sale though persons who have come to the auction may have the intention to purchase. Similar decision was given in the case of ***Harris vs. Nickerson (1873).***

Similarly, Prospectus issued by a company, is only an invitation to the public to make an offer to subscribe to the securities of the company.

10. A statement of price is not an offer

What is invitation to offer?

An offer should be distinguished from an invitation to offer. An offer is definite and capable of converting an intention into a contract. Whereas an invitation to an offer is only a circulation of an offer, it is an attempt to induce offers and precedes a definite offer. An invitation to offer is an act precedent to making an offer. Acceptance of an invitation to an offer does not result in the contract and only an offer emerges in the process of negotiation.

When a person advertises that he has stock of books to sell or houses to let, there is no offer to be bound by any contract. Such advertisements are offers to negotiate-offers to receive offers. In order to ascertain whether a particular statement amounts to an 'offer' or an 'invitation to offer', the test would be intention with which such statement is made. Does the person who made the statement intend to be bound by it as soon as it is accepted by the other or he intends to do some further act, before he becomes bound by it. In the former case, it amounts to an offer and in the latter case, it is an invitation to offer.

Difference between offer and invitation to make an offer:

In terms of Section 2(a) of the Act, an offer is the final expression of willingness by the offeror to be bound by the offer should the other party chooses to accept it. On the other hand, offers made with the intention to negotiate or offers to receive offers are known as invitation to offer. Thus, where a party without expressing his final willingness proposes certain terms on which he is willing to negotiate he does not make an offer, but only invites the other party to make an offer on those terms. Hence the only thing that is required is the willingness of the offeree to abide by the terms of offer.

In order to ascertain whether a particular statement amounts to an offer or an invitation to offer, the test would be intention with which such statement is made. The mere statement of the lowest price which the vendor would sell contains no implied contract to sell at that price to the person making the inquiry.

If a person who makes the statement has the intention to be bound by it as soon as the other accepts, he is making an offer. Thus, the intention to be bound is important factor to be considered in deciding whether a statement is an 'offer' or 'invitation to offer.'

Following are instances of invitation to offer to buy or sell:

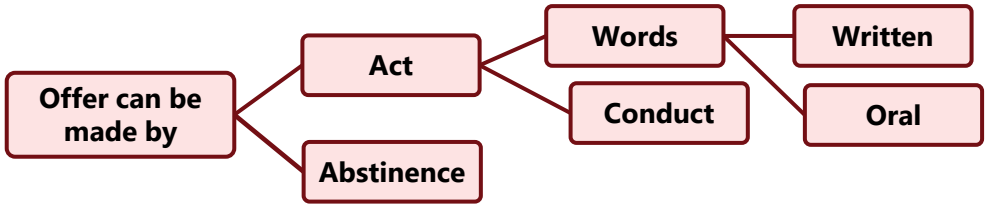
(i) A Prospectus by a company to the public to subscribe for its shares.

(ii) Display of goods for sale in shop windows.

(iii) Advertising auction sales and

(iv) Quotation of prices sent in reply to a query regarding price.

Basis	Offer	Invitation to offer
Meaning	Section 2(a) of the Act, an offer is the final expression of willingness by the offeror to be bound by the offer should the other party chooses to accept it.	Where a party without expressing his final willingness proposes certain terms on which he is willing to negotiate he does not make an offer, but only invites the other party to make an offer on those terms.
Intention of the parties	If a person who makes the statement has the intention to be bound by it as soon as the other accepts, he is making an offer.	If a person has the intention of negotiating on terms it is called invitation to offer.
Sequence	An offer cannot be an act precedent to invitation to offer.	An invitation to offer is always an act precedent to offer.



1.5 ACCEPTANCE

Definition of Acceptance: In terms of Section 2(b) of the Act, 'the term acceptance' is defined as follows:

"When the person to whom the proposal is made signifies his assent thereto, proposal is said to be accepted. The proposal, when accepted, becomes a promise".

Analysis of the above definition

1. When the person to whom proposal is made - for example if A offers to sell his car to B for ₹ 2,00,000. Here, proposal is made to B.

2. The person to whom proposal is made i.e. B in the above example and if B signifies his consent on that proposal, then we can say that B has signified his consent on the proposal made by A.

3. When B has signified his consent on that proposal, we can say that the proposal has been accepted.

4. Accepted proposal becomes promise.

Relationship between offer and acceptance: ***According to Sir William Anson "Acceptance is to offer what a lighted match is to a train of gun powder"***. The effect of this observation is that what acceptance triggers cannot be recalled or undone. But there is a choice to the person who had the train to remove it before the match is applied. It in effect means that the offer can be withdrawn just before it is accepted. Acceptance converts the offer into a promise and then it is too late to revoke it. This means as soon as the train of gun powder is lighted it would explode. Train of Gun powder [offer] in itself is inert, but it is the lighted match [the acceptance] which causes the gun powder to explode. The significance of this is an offer in itself cannot create any legal relationship but it is the acceptance by the offeree which creates a legal relationship. Once an offer is accepted it becomes a promise and cannot be withdrawn or revoked. An offer remains an offer so long as it is not accepted but becomes a contract as soon as it is accepted.

Legal Rules regarding a valid acceptance

(1) **Acceptance can be given only by the person to whom offer is made:** In case of a specific offer, it can be accepted only by the person to whom it is made. [***Boulton vs. Jones (1857)]***

Case Law: Boulton vs. Jones (1857)

Facts: Boulton bought a business from Brocklehurst. Jones, who was Broklehurst's creditor, placed an order with Brocklehurst for the supply of certain goods. Boulton supplied the goods even though the order was not in his name. Jones refused to pay Boultan for the goods because by entering into the contract with Blocklehurst, he intended to set off his debt against Brocklehurst. **Held,** as the offer was not made to Boulton, therefore, there was no contract between Boulton and Jones.

In case of a general offer, it can be accepted by any person who has the knowledge of the offer. ***[Carlill vs. Carbolic Smoke Ball Co. (1893)]***

(2) ***Acceptance must be absolute and unqualified:*** As per section 7 of the Act, acceptance is valid only when it is absolute and unqualified and is also expressed in some usual and reasonable manner unless the proposal prescribes the manner in which it must be accepted. If the proposal prescribes the manner in which it must be accepted, then it must be accepted accordingly.

M offered to sell his land to N for £280. N replied purporting to accept the offer but enclosed a cheque for £ 80 only. He promised to pay the balance of £ 200 by monthly instalments of £ 50 each. It was held that N could not enforce his acceptance because it was not an unqualified one. ***[Neale vs. Merret [1930] W. N. 189].***

A offers to sell his house to B for ₹ 30,00,000/-. B replied that, "I can pay ₹ 24,00,000 for it. The offer of 'A' is rejected by 'B' as the acceptance is not unqualified. B however changes his mind and is prepared to pay ₹ 30,00,000/-. This is also treated as counter offer and it is upto A whether to accept it or not. ***[Union of India v. Bahulal AIR 1968 Bombay 294].***

Example 51: 'A' enquires from 'B', "Will you purchase my car for ₹ 2 lakhs?" If 'B' replies "I shall purchase your car for ₹ 2 lakhs, if you buy my motorcycle for ₹ 50,000/-, here 'B' cannot be considered to have accepted the proposal. If on the other hand 'B' agrees to purchase the car from 'A' as per his proposal subject to availability of valid Registration Certificate / book for the car, then the acceptance is in place though the offer contained no mention of R.C. book. This is because expecting a valid title for the car is not a condition. Therefore, the acceptance in this case is unconditional.

(3) ***The acceptance must be communicated:*** To conclude a contract between the parties, the acceptance must be communicated in some perceptible form. Any conditional acceptance or acceptance with varying or too deviant conditions is no acceptance. Such conditional acceptance is a counter proposal and has to be accepted by the proposer, if the original proposal has to materialize into a contract. Further when a proposal is accepted, the offeree must have the knowledge of the offer made to him. If he does not have the knowledge, there can be no acceptance. The acceptance must relate specifically to the offer made. Then only it can materialize into a contract. The above points will be clearer from the following examples:

Brogden vs. Metropolitan Railway Co. (1877)

Facts: B a supplier, sent a draft agreement relating to the supply of coal to the manager of railway Co. viz, Metropolitian railway for his acceptance. The manager wrote the word "Approved" on the same and put the draft agreement in the drawer of the table intending to send it to the company's solicitors for a formal contract to be drawn up. By an over sight the draft agreement remained in drawer. Held, that there was no contract as the manager had not communicated his acceptance to the supplier, B.

Where an offer made by the intended offeree without the knowledge that an offer has been made to him cannot be deemed as an acceptance thereto. ***(Bhagwandas v. Girdharilal)***

A mere variation in the language not involving any difference in substance would not make the acceptance ineffective. ***[Heyworth vs. Knight [1864] 144 ER 120].***

Example 52: A proposed B to marry him. B informed A's sister that she is ready to marry him. But his sister didn't inform A about the acceptance of proposal. There is no contract as acceptance was not communicated to A.

(4) ***Acceptance must be in the prescribed mode:*** Where the mode of acceptance is prescribed in the proposal, it must be accepted in that manner. But if the proposer does not insist on the proposal being accepted in the manner prescribed after it has been accepted otherwise, i.e., not in the prescribed manner, the proposer is presumed to have consented to the acceptance.

Example 53: If the offeror prescribes acceptance through messenger and offeree sends acceptance by email, there is no acceptance of the offer if the offeror informs the offeree that the acceptance is not according to the mode prescribed. But if the offeror fails to do so, it will be presumed that he has accepted the acceptance and a valid contract will arise.

(5) ***Time:*** Acceptance must be given within the specified time limit, if any, and if no time is stipulated, acceptance must be given within the reasonable time and before the offer lapses. What is reasonable time is nowhere defined in the law and thus would depend on facts and circumstances of the particular case.

Example 54: A offered to sell B 50 kgs of bananas at Rs. 500. B communicated the acceptance after four days. Such is not a valid contract as bananas being perishable items could not stay for a period of week. Four days is not a reasonable time in this case.

Example 55: A offers B to sell his house at Rs. 20,00,000. B accepted the offer and communicated to A after 4 days. Held the contract is valid as four days can be considered as reasonable time in case of sell of house.

(6) ***Mere silence is not acceptance:*** The acceptance of an offer cannot be implied from the silence of the offeree or his failure to answer, unless the offeree has in any previous conduct indicated that his silence is the evidence of acceptance.

Case Law: Felthouse vs. Bindley (1862)

Facts: F (Uncle) offered to buy his nephew's horse for £30 saying "If I hear no more about it I shall consider the horse mine at £30." The nephew did not reply to F at all. He told his auctioneer, B to keep the particular horse out of sale of his farm stock as he intended to reserve it for his uncle. By mistake the auctioneer sold the horse. F sued

him for conversion of his property. **Held,** F could not succeed as his nephew had not communicated the acceptance to him.

Example 56: 'A' subscribed for the weekly magazine for one year. Even after expiry of his subscription, the magazine company continued to send him magazine for five years. And also 'A' continued to use the magazine but denied to pay the bills sent to him. 'A' would be liable to pay as his continued use of the magazine was his acceptance of the offer.

(7) ***Acceptance by conduct/Implied Acceptance:*** Section 8 of the Act lays down that "the performance of the conditions of a proposal, or the acceptance of any consideration for a reciprocal promise which may be offered with a proposal, constitutes an acceptance of the proposal. This section provides the acceptance of the proposal by conduct as against other modes of acceptance i.e. verbal or written communication.

Therefore, when a person performs the act intended by the proposer as the consideration for the promise offered by him, the performance of the act constitutes acceptance.

Example 57: when a tradesman receives an order from a customer and executes the order by sending the goods, the customer's order for goods constitutes the offer, which has been accepted by the trades man subsequently by sending the goods. It is a case of acceptance by conduct.

1.6 COMMUNICATION OF OFFER AND ACCEPTANCE

The importance of 'offer' and 'acceptance' in giving effect to a valid contract was explained in the previous paragraphs. One important common requirement for both 'offer' and 'acceptance' is their effective communication. Effective and proper communication prevents avoidable revocation and misunderstanding between parties.

When the contracting parties are face-to-face, there is no problem of communication because there is instantaneous communication of offer and acceptance. In such a case the question of revocation does not arise since the offer and its acceptance are made instantly.

The difficulty arises when the contracting parties are at a distance from one another and they utilise the services of the post office or telephone or email (internet). In such cases, it is very much relevant for us to know the exact time when the offer or acceptance is made or complete.

The Indian Contract Act, 1872 gives a lot of importance to "time" element in deciding when the offer and acceptance is complete.

Communication of offer: In terms of Section 4 of the Act, "the communication of offer is complete when it comes to the knowledge of the person to whom it is made".

Example 58: Where 'A' makes a proposal to 'B' by post to sell his house for ₹ 5 lakhs and if the letter containing the offer is posted on 10th March and if that letter reaches 'B' on 12th March the offer is said to have been communicated on 12th March when B received the letter.

Thus, it can be summed up that when a proposal is made by post, its communication will be complete when the letter containing the proposal reaches the person to whom it is made.

Mere receiving of the letter is not sufficient, he must receive or read the message contained in the letter.

He receives the letter on 12th March, but he reads it on 15th of March. In this case offer is communicated on 15th of March, and not 12th of March.

Communication of acceptance: There are two issues for discussion and understanding. They are: The modes of acceptance and when is acceptance complete?

Let us, first consider the **modes of acceptance.** Section 3 of the Act prescribes in general terms two modes of communication namely, (a) by any act and (b) by omission, intending thereby, to communicate to the other or which has the effect of communicating it to the other.

Communication by act would include any expression of words whether written or oral. Written words will include letters, telegrams, faxes, emails and even advertisements. Oral words will include telephone messages. Again communication would include any conduct intended to communicate like positive acts or signs so that the other person understands what the person 'acting ' or 'making signs' means to say or convey.

Communication of acceptance by 'omission' to do something. Such omission is conveyed by a conduct or by forbearance on the part of one person to convey his willingness or assent. However, silence would not be treated as communication by 'omission'.

Example 59: A offers ₹ 50,000 to B if he does not arrive before the court of law as an evidence to the case. B does not arrive on the date of hearing to the court. Here omission of doing an act amounts to acceptance.

Communication of acceptance by conduct. For instance, delivery of goods at a price by a seller to a willing buyer will be understood as a communication by conduct to convey acceptance. Similarly, one need not explain why one boards a public bus or drop a coin in a weighing machine. The first act is a conduct of acceptance against its communication to the offer by the public transport authority to carry any passenger. The second act is again a conduct conveying acceptance to use the weighing machine kept by the vending company as an offer to render that service for a consideration.

The other issue in communication of acceptance is about the effect of act or omission or conduct. These indirect efforts must result in effectively communicating its acceptance or non acceptance. If it has no such effect, there is no communication regardless of which the acceptor thinks about the offer within himself. Thus, a mere mental unilateral assent in one's own mind would not amount to communication. Where a resolution passed by a bank to sell land to 'A' remained uncommunicated to 'A', it was held that there was no communication and hence no contract. ***[Central Bank Yeotmal vs Vyankatesh (1949) A. Nag. 286].***

Let us now come to the issue of when communication of acceptance is complete. In terms of Section 4 of the Act, it is complete,

(i) **As against the proposer,** when it is put in the course of transmission to him so as to be out of the power of the acceptor to withdraw the same;

(ii) **As against the acceptor,** when it comes to the knowledge of the proposer.

Where a proposal is accepted by a letter sent by the post, the communication of acceptance will be complete as against the proposer when the letter of acceptance is posted and as against the acceptor when the letter reaches the proposer.

For instance in the above *example,* if 'B' accepts, A's proposal and sends his acceptance by post on 14th, the communication of acceptance as against 'A' is complete on 14th, i.e. when the letter is posted. As against 'B' acceptance will be complete, when the letter reaches 'A'.

Here 'A' the proposer will be bound by B's acceptance, even if the letter of acceptance is delayed in post or lost in transit. The golden rule is proposer becomes bound by the contract, the moment acceptor has posted the letter of acceptance. But it is necessary that the letter is correctly addressed, adequately stamped and duly posted. In such an event the loss of letter in transit, wrong delivery, non delivery etc., will not affect the validity of the contract.

However, from the view point of acceptor, he will be bound by his acceptance only when the letter of acceptance has reached the proposer. So, it is crucial in this case that the letter reaches the proposer. If there is no delivery of the letter, the acceptance could be treated as having been completed from the viewpoint of proposer but not from the viewpoint of acceptor. Of course this will give rise to an awkward situation of only one party to the contract, being treated as bound by the contract though no one would be sure as to where the letter of acceptance had gone.

Acceptance over telephone or telex or fax: When an offer is made of instantaneous communication like telex, telephone, fax or through e-mail, the contract is only complete when the acceptance is received by the offeree, and the contract is made at the place where the acceptance is received ***(Entores Ltd. v. Miles Far East Corporation).*** However, in case of a call drops and disturbances in the line, there may not be a valid contract.

Communication of special conditions: Sometimes there are situations where there are contracts with special conditions. These special conditions are conveyed tacitly and the acceptance of these conditions are also conveyed by the offeree again tacitly or without him even realizing it.

Example 60: Where a passenger undertakes a travel, the conditions of travel are printed at the back of the tickets, sometimes these special conditions are brought to the notice of the passenger, sometimes not. In any event, the passenger is treated as having accepted the special condition the moment he bought his ticket.

When someone travels from one place to another by air, it could be seen that special conditions are printed at the back of the air ticket in small letters [in a non-computerized train ticket even these are not printed] Sometimes these conditions are found to have been displayed at the notice board of the Airlines office, which passengers may not have cared to read. The question here is whether these conditions can be considered to have been communicated to the passengers of the Airlines and can the passengers be treated as having accepted the conditions. The answer to the question is in the affirmative and was so held in ***Mukul Datta vs. Indian Airlines [1962] AIR cal. 314*** where the plaintiff had travelled from Delhi to Kolkata by air and the ticket bore conditions in fine print. But such terms and condition should be reasonable.

Example 61: Where a launderer gives his customer a receipt for clothes received for washing. The receipt carries special conditions and are to be treated as having been duly communicated to the customer and therein a tacit acceptance of these conditions is implied by the customer's acceptance of the receipt ***[Lily White vs. R. Mannuswamy [1966] A. Mad. 13].***

CASE LAW: Lilly White vs. Mannuswamy (1970)

Facts: P delivered some clothes to drycleaner for which she received a laundry receipt containing a condition that in case of loss, customer would be entitled to claim 15% of the market price of value of the article, P lost her new saree. Held, the terms were unreasonable and P was entitled to recover full value of the saree from the drycleaner.

In the cases referred above, the respective documents have been accepted without a protest and hence amounted to tacit acceptance.

Standard forms of contracts: It is well established that a standard form of contract may be enforced on another who is subjectively unaware of the contents of the document, provided the party wanting to enforce the contract has given notice which, in the circumstances of a case, is sufficiently reasonable. But the acceptor will not incur any contractual obligation, if the document is so printed and delivered to him in such a state that it does not give reasonable notice on its face that it contains certain special conditions. In this connection, let us consider a converse situation. A transport carrier accepted the goods for transport without

any conditions. Subsequently, he issued a circular to the owners of goods limiting his liability for the goods. In such a case, since the special conditions were not communicated prior to the date of contract for transport, these were not binding on the owners of goods ***[Raipur transport Co. vs. Ghanshyam [1956] A. Nag.145].***

1.7 COMMUNICATION OF PERFORMANCE

We have already discussed that in terms of Section 4 of the Act, communication of a proposal is complete when it comes to the knowledge of the person to whom it is meant. As regards acceptance of the proposal, the same would be viewed from two angles. These are:

(i) from the viewpoint of proposer and

(ii) the other from the viewpoint of acceptor himself

From the viewpoint of proposer, when the acceptance is put into a course of transmission, when it would be out of the power of acceptor. From the viewpoint of acceptor, it would be complete when it comes to the knowledge of the proposer.

At times the offeree may be required to communicate the performance (or act) by way of acceptance. In this case, it is not enough if the offeree merely performs the act but he should also communicate his performance unless the offer includes a term that a mere performance will constitute acceptance. The position was clearly explained in the famous case of ***Carlill Vs Carbolic & Smokeball Co.*** In this case the defendant a sole proprietary concern manufacturing a medicine which was a carbolic ball whose smoke could be inhaled through the nose to cure influenza, cold and other connected ailments issued an advertisement for sale of this medicine. The advertisement also included a reward of $100 to any person who contracted influenza, after using the medicine (which was described as 'carbolic smoke ball'). Mrs. Carlill bought these smoke balls and used them as directed but contracted influenza. It was held that Mrs. Carlill was entitled to a reward of $100 as she had performed the condition for acceptance. Further as the advertisement did not require any communication of compliance of the condition, it was not necessary to communicate the same. The court thus in the process laid down the following three important principles:

(i) an offer, to be capable of acceptance, must contain a definite promise by the offeror that he would be bound provided the terms specified by him are accepted;

(ii) an offer may be made either to a particular person or to the public at large, and

(iii) if an offer is made in the form of a promise in return for an act, the performance of that act, even without any communication thereof, is to be treated as an acceptance of the offer.

1.8 REVOCATION OF OFFER AND ACCEPTANCE

If there are specific requirements governing the making of an offer and the acceptance of that offer, we also have specific law governing their revocation.

In term of **Section 4,** communication of revocation (of the proposal or its acceptance) is complete.

(i) **as against the person who makes it** when it is put into a course of transmission to the person to whom it is made so as to be out of the power of the person who makes it, and

(ii) as against the person to whom it is made, when it comes to his knowledge.

The above law can be *illustrated* as follows: If you revoke your proposal made to me by a telegram, the revocation will be complete, as far as you are concerned when you have dispatched the telegram. But as far as I am concerned, it will be complete only when I receive the telegram.

As regards revocation of acceptance, if you go by the above example, I can revoke my acceptance (of your offer) by a telegram. This revocation of acceptance by me will be complete when I dispatch the telegram and against you, it will be complete when it reaches you.

But the important question for consideration is when a proposal can be revoked? And when can an acceptance be revoked? These questions are more important than the question when the revocation (of proposal and acceptance) is complete.

Ordinarily, the offeror can revoke his offer before it is accepted. If he does so, the offeree cannot create a contract by accepting the revoked offer.

Example 62: the bidder at an auction sale may withdraw (revoke) his bid (offer) before it is accepted by the auctioneer by fall of hammer.

An offer may be revoked by the offeror before its acceptance, even though he had originally agreed to hold it open for a definite period of time. So long as it is a mere offer, it can be withdrawn whenever the offeror desires.

Example 63: X offered to sell 50 bales of cotton at a certain price and promised to keep it open for acceptance by Y till 6 pm of that day. Before that time X sold them to Z. Y accepted before 6 p.m., but after the revocation by X. In this case it was held that the offer was already revoked.

In terms of **Section 5** of the Act a proposal can be revoked at any time before the communication of its acceptance is complete as against the proposer. An acceptance may be revoked at any time before the communication of acceptance is complete as against the acceptor.

Example 64: A proposes, by a letter sent by post, to sell his house to B. B accepts the proposal by a letter sent by post. A may revoke his proposal at any time before or at the moment when B posts his letter of acceptance, but not afterwards. Whereas B may revoke his acceptance at any time before or at the moment when the letter communicating it reaches A, but not afterwards.

An acceptance to an offer must be made before that offer lapses or is revoked.

The law relating to the revocation of offer is the same in India as in England, but the law relating to the revocation of acceptance is different.

In English law, the moment a person expresses his acceptance of an offer, that moment the contract is concluded, and such an acceptance becomes irrevocable, whether it is made orally or through the post. In Indian law, the position is different as regards contract through post.

Contract through post- As acceptance, in English law, cannot be revoked, so that once the letter of acceptance is properly posted the contract is concluded. In Indian law, the acceptor or can revoke his acceptance any time before the letter of acceptance reaches the offeror, if the revocation telegram arrives before or at the same time with the letter of acceptance, the revocation is absolute.

Contract over Telephone- A contract can be made over telephone. The rules regarding offer and acceptance as well as their communication by telephone or telex are the same as for the contract made by the mutual meeting of the parties. The contract is formed as soon as the offer is accepted but the offeree must make it sure that his acceptance is received by the offeror, otherwise there will be no contract, as communication of acceptance is not complete. If telephone unexpectedly goes dead during conversation, the acceptor must confirm again that the words of acceptance were duly heard by the offeror.

Revocation of proposal otherwise than by communication: When a proposal is made, the proposer may not wait indefinitely for its acceptance. The offer can be revoked otherwise than by communication or sometimes by lapse.

Modes of revocation of offer

(i) By notice of revocation:

Example 65: A offered B to sell goods at Rs. 5,000 through a post but before B could accept the offer A received highest bid for the goods from C. So, A revoked the offer to B by informing B over the telephone and sold goods to C.

(ii) **By lapse of time:** The time for acceptance can lapse if the acceptance is not given within the specified time and where no time is specified, then within a reasonable time. This is for the reason that proposer should not be made to wait indefinitely. It was held in ***Ramsgate Victoria Hotel Co. Vs Montefiore (1866 L.R.Z. Ex 109)***, that a person

who applied for shares in June was not bound by an allotment made in November. This decision was also followed in ***India Cooperative Navigation and Trading Co. Ltd. Vs Padamsey Prem Ji***. However, these decisions now will have no relevance in the context of allotment of shares since the Companies Act, 2013 has several provisions specifically covering these issues.

(iii) **By non-fulfilment of condition precedent:** Where the acceptor fails to fulfill a condition precedent to acceptance the proposal gets revoked. This principle is laid down in Section 6 of the Act. The offeror for instance may impose certain conditions such as executing a certain document or depositing certain amount as earnest money. Failure to satisfy any condition will result in lapse of the proposal. As stated earlier 'condition precedent' to acceptance prevents an obligation from coming into existence until the condition is satisfied. Suppose where 'A' proposes to sell his house to be 'B' for ₹ 5 lakhs provided 'B' leases his land to 'A'. If 'B' refuses to lease the land, the offer of 'A' is revoked automatically.

(iv) **By death or insanity:** Death or insanity of the proposer would result in automatic revocation of the proposal but only if the fact of death or insanity comes to the knowledge of the acceptor.

(v) By counter offer

(vi) By the non-acceptance of the offer according to the prescribed or usual mode

(vii) By subsequent illegality.

SUMMARY

Contract: A Contract is an agreement enforceable by law [Section 2(h)]. An agreement is enforceable by law, if it is made by the free consent of the parties who are competent to contract and the agreement is made with a lawful object and is for a lawful consideration and is not hereby expressly declared to be void [Section 10]. All contracts are agreements, but all agreements are not contracts. Agreements lacking any of the above said characteristics are not contracts. A contract that ceases to be enforceable by law is called 'void contract', [Section 2(i)], but an agreement which is enforceable by law at the option of one party thereto, but not at the option of the other is called 'voidable contract' [(Section 2(i)].

Offer and Acceptance: Offeror undertakes to do or to abstain from doing a certain act if the offer is properly accepted by the offeree. Offer may be expressly made or may even be implied by the conduct of the offeror, but it must have intention and be capable of creating legal relations. The terms of offer must be certain or at least be capable of being made certain.

Acceptance of offer must be absolute and unqualified and must be according to the prescribed or usual mode. If the offer has been made to a specific person, it must be accepted by that person only, but a general offer may be accepted by any person.

Communication of offer and acceptance, and revocation thereof-

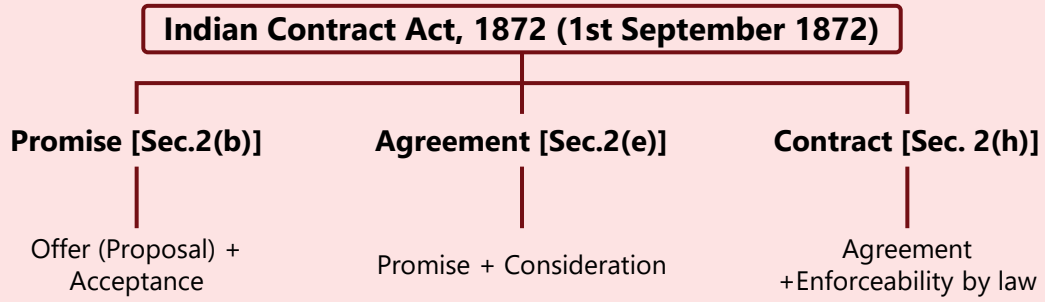
(a) Communication of an offer is complete when it comes to the knowledge of the offeree.

(b) Communication of an acceptance is complete: As against the offeror when it is put in the course of transmission to him and as against the acceptor, when it comes to the knowledge of the offeror.

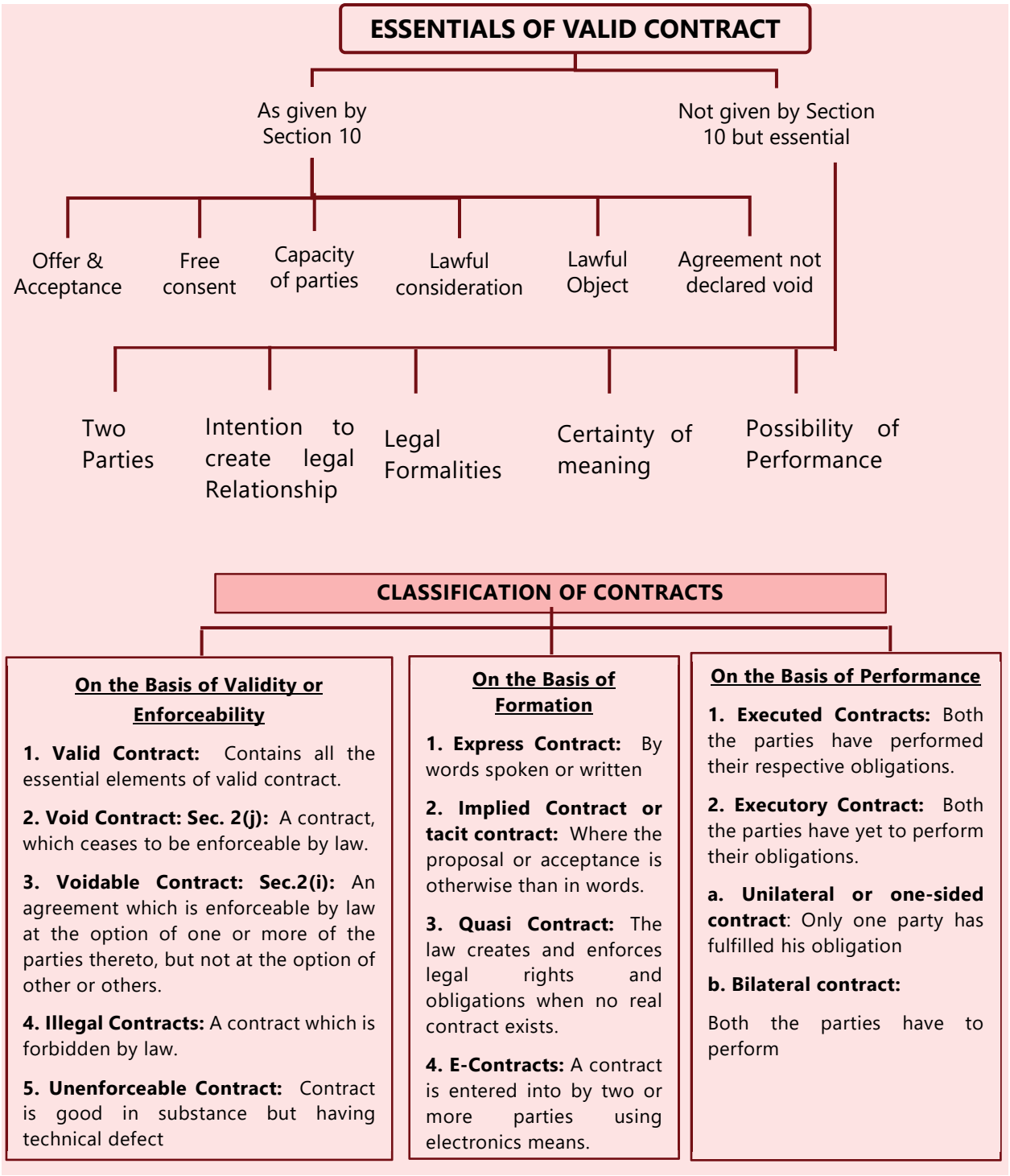
(c) Communication of revocation of an offer or acceptance is complete: It is complete as against the person making it, when it is put into a course of transmission so as to be out of power of the person making it and as against the person to whom it is made, when it comes to his knowledge.

Meaning of certain terms	
Proposal [(i.e., offer) Section 2(a)]	♦ When one person signifies to another ♦ his willingness ♦ to do or to abstain from doing anything ♦ with a view to obtaining the assent of that either to- • such act; or • abstinence, ♦ he is said to make a proposal (i.e. offer).
Promise [Section 2 (b)]	♦ When the person to whom the proposal is made, ♦ signifies his assent thereto, ♦ the proposal is said to be accepted. ♦ A proposal, when accepted, becomes a promise.
Agreement [Section 2(e)]	♦ Every promise and every set of promises, ♦ forming consideration for each other, ♦ is an agreement.
Contract [Section 2(h)]	♦ An agreement enforceable by law is a contract.

Promisor and Promisee [Section 2(c)]	When the proposal is accepted- ♦ the person making the proposal is called as 'promisor'; and ♦ the person accepting the proposal is called as 'promisee'.
Consideration [Section 2(d)]	When, at the desire of the promisor, the promisee ♦ has done or abstained from doing something; or ♦ does or abstains from doing something; or any other person ♦ promises to do or abstain from doing something, Such act, abstinence or promise is called a consideration for the promise.
Void agreement [Section 2(g)]	An agreement not enforceable by law is said to be void. A void agreement is not enforceable from the very beginning, i.e. it is void ab initio.
Voidable Contract [Section 2(i)]	An agreement is a voidable contract if- ♦ it is enforceable by law at the option of one or more of the parties thereto, ♦ it is not enforceable by law at the option of the other or others.
Void contract [Section 2 (j)]	♦ A contract ♦ which ceases to be enforceable by law ♦ becomes void when it ceases to be enforceable.



Note: *Agreement may be social or legal. Social Agreement is not enforceable by law.*



CLASSIFICATION OF CONTRACTS

On the Basis of Validity or Enforceability

1. Valid Contract: Contains all the essential elements of valid contract.

2. Void Contract: Sec. 2(j): A contract, which ceases to be enforceable by law.

3. Voidable Contract: Sec.2(i): An agreement which is enforceable by law at the option of one or more of the parties thereto, but not at the option of other or others.

4. Illegal Contracts: A contract which is forbidden by law.

5. Unenforceable Contract: Contract is good in substance but having technical defect

On the Basis of Formation

1. Express Contract: By words spoken or written

2. Implied Contract or tacit contract: Where the proposal or acceptance is otherwise than in words.

3. Quasi Contract: The law creates and enforces legal rights and obligations when no real contract exists.

4. E-Contracts: A contract is entered into by two or more parties using electronics means.

On the Basis of Performance

1. Executed Contracts: Both the parties have performed their respective obligations.

2. Executory Contract: Both the parties have yet to perform their obligations.

a. Unilateral or one-sided contract: Only one party has fulfilled his obligation

b. Bilateral contract:

Both the parties have to perform

PROPOSAL OR OFFER Sec.2(a)

"When one person signifies to another his willingness to do or to abstain from doing anything with a view to obtaining the assent of that other to such act or abstinence, he is said to make a proposal".

Classification of Offer

(a) General Offer: Offer to the world at large.

(b) Specific Offer: Offer made to a definite person

(c) Cross Offer: When two parties make identical offers to each other

(d) Counter Offer: When offeree imposes conditions which have the effect of modifying or varying the offer.

(e) Standing or continue or open offer: Offer to public at large for acceptance for certain period of time

Essentials of A Valid Offer

1. Must be with intent to create legal relationship
2. Terms of the offer must be certain, definite & unambiguous.
3. Must be communicated to the offeree.
4. Must be made with a view to obtaining the assent of the other party.
5. May be conditional.
6. Must not contain a term the non-compliance of which amount acceptance.
7. May be general or specific or express or implied.
8. An offer must be distinguished from an invitation to offer.

ACCEPTANCE Sec 2(b)

"When the person to whom the proposal is made signifies his assent thereto, proposal is said to be accepted. The proposal when accepted, becomes a promise".

Legal Rules

1. Given only by the person to whom offer is made.
2. Must be absolute and unqualified.
3. Must be communicated.
4. Must be in the prescribed mode.
5. Mere silence is not acceptance.
6. May be by conduct/implied Acceptance

COMMUNICATION OF OFFER AND ACCEPTANCE

Mode of Communication: By Act, By Omission, By Conduct

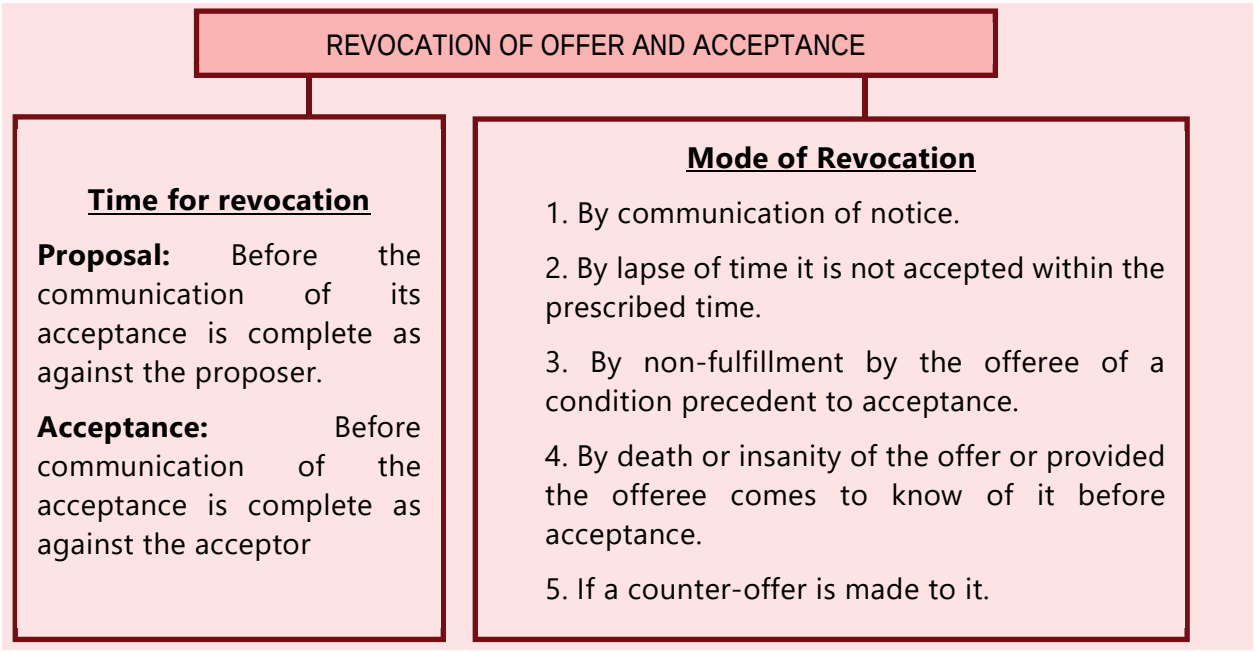
Communication of Offer: (Sec.4)

The communication of offer is completed when it comes to the knowledge of person to whom it is made.

Communication of Acceptance: (Sec.4)

The communication of acceptance is complete-

- as against the proposer when it is put into a course of transmission to him, so as to be out of the power of acceptor to withdraw the same.
- as against the acceptor when it comes to the knowledge of proposer.



TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *An agreement enforceable by law is a*
   - *(a) Promise*
   - *(b) Contract*
   - *(c) Obligation*
   - *(d) Lawful promise*
2. *A void agreement is one which is -*
   - *(a) Valid but not enforceable*
   - *(b) Enforceable at the option of both the parties*
   - *(c) Enforceable at the option of one party*
   - *(d) Not enforceable in a court of law.*
3. *An agreement which is enforceable by law at the option of one or more of the parties thereon but not at the option of the other or others is a*
   - *(a) Valid Contract*
   - *(b) Void contract*

(c) *Voidable contract*

(d) *Illegal contract*

4. *When the consent of a party is not free, the contract is*

(a) *Void*

(b) *Voidable*

(c) *Valid*

(d) *Illegal*

5. *In case of illegal agreements, the collateral agreements are:*

(a) *Valid*

(b) *Void*

(c) *Voidable*

(d) *None of these*

6. *An offer may lapse by:*

(a) *Revocation*

(b) *Counter Offer*

(c) *Rejection of offer by offeree*

(d) *All of these*

7. *A proposal when accepted becomes a*

(a) *Promise*

(b) *Contract*

(c) *Offer*

(d) *Acceptance*

8. *If A says to B "I offer to sell my house to you for ₹40,00,000" and B accepts the offer by saying clearly "I accept your offer", it is a/an*

(a) *Implied offer*

(b) *Express offer*

(c) *General offer*

(d) *None of the above*

9. *'A' offered a reward of ₹ 1,00,000 for recovery of some valuable missing articles. 'B' who did not know of this offer, found the missing articles. Which one of the following is the correct solution to this problem?*

   (a) *Giving delivery of articles to 'A' amounts to an acceptance and hence 'B' is entitled to get the reward of ₹ 1,00,000*

   (b) *Giving delivery of articles to 'A' amounts to performance of a condition precedent to an offer and hence there is valid acceptance. So 'B' must get the reward of ₹ 1,00,000*

   (c) *As there is no acceptance of an offer due to want of Knowledge, 'B', is not entitled to get the reward of ₹ 1,00,000*

   (d) *In the absence of any legal obligation on 'A', no claim for reward of ₹ 1,00,000 is maintainable by 'B'.*

10. *Arun has two cars- one of white colour and another of red colour. He offers to sell one of the cars to Basu thinking that he is selling the car which has white colour. Basu agrees to buy the car thinking that Arun is selling the car which has red colour. Will this agreement become a valid contract?*

   (a) *Yes*

   (b) *No*

   (c) *Insufficient information*

   (d) *None of the above.*

11. *A dress is displayed in the showroom with a price tag attached to the dress. A buyer interested in the dress and ready to pay the price mentioned in the tag approached the shopkeeper for purchasing the dress.*

   (a) *The shopkeeper can refuse to sell the dress as display of dress is just an invitation to offer.*

   (b) *The shopkeeper cannot refuse to sell the dress as the buyer has accepted the offer*

   (c) *In case of refusal, the shopkeeper will be liable for breach of contract*

   (d) *The shopkeeper cannot refuse to sell the dress but may charge higher price*

12. *A agrees to pay ₹ 1,000 to B if a certain ship returns within a year. However, the ship sinks within the year. In this case, the contract becomes*

   (a) *Valid*

   (b) *Void*

(c) *Voidable*

(d) *Illegal*

13. *A notice in the newspaper inviting tenders is*

(a) *a proposal*

(b) *An invitation to proposal*

(c) *A promise*

(d) *An invitation for negotiation*

14. *A telephonic acceptance is complete when the offer is*

(a) *spoken into the telephone*

(b) *heard but not understood by the offeror*

(c) *heard and understood by the offeror*

(d) *is received, heard and understood by some person in the offeror's house*

15. *A and B agree to deal in smuggled goods and share the profits. A refuses to give B's share of profit. In this case:*

(a) *B can enforce the agreement in the court*

(b) *B can only claim damages*

(c) *B has no remedy as the contract is illegal*

(d) *B can enforce the contract and claim damages*

16. *Which one of the following statements is correct?*

(a) *Void agreements are always illegal*

(b) *Illegal agreements are voidable*

(c) *Illegal agreement can be ratified by the parties*

(d) *Illegal agreements are always void*

17. *A voidable contract is one which*

(a) *Can be enforced at the option of aggrieved party*

(b) *Can be enforced at the option of both the parties*

(c) *Cannot be enforced in a court of law*

(d) *Courts prohibit*

18. *When offer is made to a definite person, it is known as*

(a) *General Offer*

(b) *Cross Offer*

(c) *Counter offer*

(d) *Special offer*

19. *On the face of a ticket, it is mentioned that to look for the terms and conditions look behind. Mr. A bought the ticket but didn't read the terms and conditions. He:*

(a) *is not bound by the terms and condition*

(b) *may decide to bound by certain terms and ignore others*

(c) *is bound by all the terms and conditions whether he read it or not*

(d) *none of the above*

20. *It does not effect the free consent of the parties,*

(a) *Fraud*

(b) *Coercion*

(c) *Incompetency of parties*

(d) *Undue Influence*

21. *_____ contract is made without intention of parties.*

(a) *Express*

(b) *Implied*

(c) *Quasi*

(d) *Executory*

22. *A offers B to supply Books at Rs. 500 each. B accepts the same with condition of 30% discount. It is _____*

(a) *Counter Offer*

(b) *Cross Offer*

(c) *Specific Offer*

(d) *General Offer*

Descriptive Questions

1. *"All contracts are agreements, but all agreements are not contracts". Comment.*

2. *A sends an offer to B to sell his second-car for ₹ 1,40,000 with a condition that if B does not reply within a week, he (A) shall treat the offer as accepted. Is A correct in his proposition?*

3. *Explain the type of contracts in the following agreements under the Indian Contract Act, 1872:*

   (i) A coolie in uniform picks up the luggage of A to be carried out of the railway station without being asked by A and A allows him to do so.

   (ii) Obligation of finder of lost goods to return them to the true owner.

   (iii) A contracts with B (owner of the factory) for the supply of 10 tons of sugar, but before the supply is effected, the fire caught in the factory and everything was destroyed.

4. *Shambhu Dayal started "self service" system in his shop. Smt. Prakash entered the shop, took a basket and after taking articles of her choice into the basket reached the cashier for payments. The cashier refuses to accept the price. Can Shambhu Dayal be compelled to sell the said articles to Smt. Prakash? Decide as per the provisions of the Indian Contract Act, 1872.*

5. *State whether there is any contract in following cases:*

   (a) A engages B to do certain work and remuneration to be paid as fixed by C.

   (b) A and B promise to pay for the studies of their maid's son

   (c) A takes a seat in public bus.

   (d) A, a chartered accountant promises to help his friend to file his return.

6. *Miss Shakuntala puts an application to be a teacher in the school. She was appointed by the trust of the school. Her friend who works in the same school informs her about her appointment informally. But later due to some internal reasons her appointment was cancelled. Can Miss Shakuntala claim for damages?*

ANSWER/HINTS

Answers to MCQs

1.	**(b)**	2.	**(d)**	3.	**(c)**	4.	**(b)**	5.	**(b)**	6.	**(d)**
7.	**(a)**	8.	**(b)**	9.	**(c)**	10.	**(b)**	11.	**(a)**	12.	**(b)**
13.	**(b)**	14.	**(c)**	15.	**(c)**	16.	**(d)**	17.	**(a)**	18.	**(d)**
19.	**(c)**	20	**(c)**	21	**(c)**	22	**(a)**				

Answers to the Descriptive Questions

1. An agreement comes into existence when one party makes a proposal or offer to the other party and that other party gives his acceptance to it. A contract is an agreement enforceable by law. It means that to become a contract an agreement must give rise to a legal obligation i.e. duty enforceable by law. If an agreement is incapable of creating a duty enforceable by law, it is not a contract. There can be agreements which are not enforceable by law, such as social, moral or religious agreements. The agreement is a wider term than the contract. All agreements need not necessarily become contracts but all contracts shall always be agreements.

All agreements are not contracts: When there is an agreement between the parties and they do not intend to create a legal relationship, it is not a contract.

All contracts are agreements: For a contract there must be two things (a) an agreement and (b) enforceability by law. Thus, existence of an agreement is a pre-requisite existence of a contract. Therefore, it is true to say that all contracts are agreements.

Thus, we can say that there can be an agreement without it becoming a contract, but we can't have a contract without an agreement.

2. Acceptance to an offer cannot be implied merely from the silence of the offeree, even if it is expressly stated in the offer itself. Unless the offeree has by his previous conduct indicated that his silence amount to acceptance, it cannot be taken as valid acceptance. So, in the given problem, if B remains silent, it does not amount to acceptance.

The acceptance must be made within the time limit prescribed by the offer. The acceptance of an offer after the time prescribed by the offeror has elapsed will not avail to turn the offer into a contract.

3. (i) It is an implied contract and A must pay for the services of the coolie detailed by him.

Implied Contracts: Implied contracts come into existence by implication. Most often the implication is by law and or by action. Section 9 of the Act

contemplates such implied contracts when it lays down that in so far as such proposal or acceptance is made otherwise than in words, the promise is said to be implied.

(ii) Obligation of finder of lost goods to return them to the true owner cannot be said to arise out of a contract even in its remotest sense, as there is neither offer and acceptance nor consent. These are said to be quasi-contracts.

Quasi-Contract: A quasi-contract is not an actual contract but it resembles a contract. It is created by law under certain circumstances. The law creates and enforces legal rights and obligations when no real contract exists. Such obligations are known as quasi-contracts. In other words, it is a contract in which there is no intention on part of either party to make a contract but law imposes a contract upon the parties.

(iii) The above contract is a void contract.

Void Contract: Section 2 (j) states as follows: "A contract which ceases to be enforceable by law becomes void when it ceases to be enforceable". Thus, a void contract is one which cannot be enforced by a court of law.

4. **Invitation to offer:** The offer should be distinguished from an invitation to offer. An offer is the final expression of willingness by the offeror to be bound by his offer should the party chooses to accept it. Where a party, without expressing his final willingness, proposes certain terms on which he is willing to negotiate, he does not make an offer, but invites only the other party to make an offer on those terms. This is the basic distinction between offer and invitation to offer.

The display of articles with a price in it in a self-service shop is merely an invitation to offer. It is in no sense an offer for sale, the acceptance of which constitutes a contract. In this case, Smt. Prakash by selecting some articles and approaching the cashier for payment simply made an offer to buy the articles selected by her. If the cashier does not accept the price, the interested buyer cannot compel him to sell.

5. (a) It is a valid express contract

(b) It is not a contract as it is a social agreement

(c) It is an implied contract. A is bound to pay for the bus fare.

(d) It is a social agreement without any intention to create a legal relationship.

6. No, Miss Shakuntala cannot claim damages. As per Section 4, communication of acceptance is complete as against proposer when it is put in the course of transmission to him.

In the present case, school authorities have not put any offer letter in transmission. Her information from a third person will not form part of contract.

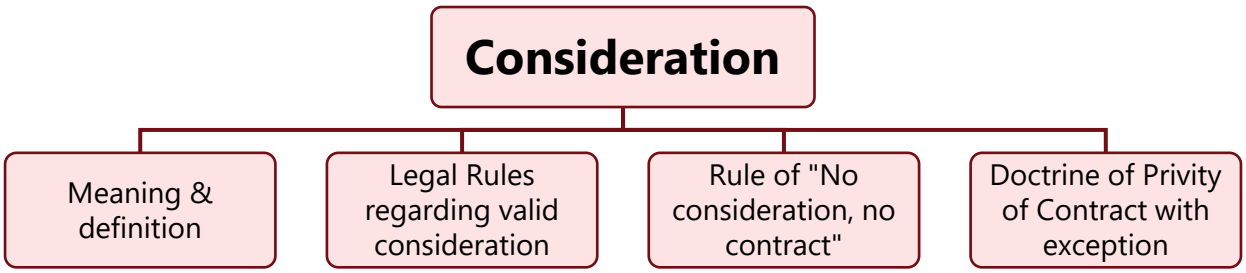
UNIT-2: CONSIDERATION

LEARNING OUTCOMES

After studying this Chapter, you will be able to understand:

- The concept of consideration, its importance for a contract and its double aspect.
- How consideration may move from a third party and how this makes the contract valid.
- The peculiar circumstances when a contract is valid even without consideration.
- The rule 'A stranger to a contract cannot sue' and exceptions thereof.

UNIT OVERVIEW



Consideration is an essential element of a valid contract without which no single promise will be enforceable. It is a term used in the sense of *quid pro quo,* i.e., 'something in return'. Having a double aspect of a benefit to the promisor and a detriment to the promisee, it has to be really understood in the sense of some detriment as envisaged by English Law. In this Unit, we shall try to understand the concept of consideration and also the legal requirements regarding consideration.

2.1 WHAT IS CONSIDERATION?

Consideration is the price agreed to be paid by the promisee for the obligation of the promisor. The word consideration was described in a very popular English case of ***Misa v. Currie*** as:

"A valuable consideration in the sense of law may consist either in some right, interest, profit or benefit accruing to one party (i.e. promisor) or forbearance, detriment, loss or responsibility given, suffered or undertaken by the other (i.e. the promisee)."

Section 2(d) defines consideration as follows:

"When at the desire of the promisor, the promisee or any other person has done or abstained from doing, or does or abstains from doing or promises to do or abstain from doing something, such an act or abstinence or promise is called consideration for the promise".

(1) Consideration is an act- doing something.

Example 1: Ajay guarantees Bhuvan for payment of price of the goods which Bhuvan wanted to sell on one month credit to Chaitanya. Here selling of goods on credit by Bhuvan to Chaitanya is consideration for A's promise.

Example 2: A college promises students, who will score above 95% for the job in MNC. Consideration need not to be monetary. Here the promise for recruitment of candidate will be considered as consideration for the act of students scoring above 95%.

(2) Consideration is abstinence- abstain from doing something.

Example 3: Abhishek promises Bharti not to file a suit against him if she (Bharti) would pay him (Abhishek) ₹ 1,00,000. Here abstinence on the part of Abhishek would constitute consideration against Bharti's payment of ₹ 1,00,000 in favor of Abhishek.

Example 4: ABC has a shop of electric items. XYZ wishes to open another electric shop next to his shop. ABC offers Rs 2,00,000 to XYZ for shifting the same away from 1 km of ABC's shop. Here, consideration is given for abstaining XYZ from opening his shop nearby.

(3) Consideration must be at the desire of the promisor.

(4) Consideration may move from promisee or any other person.

(5) Consideration may be past, present or future.

Thus, from above it can be concluded that:

Consideration = Promise / Performance that parties exchange with each other.

Form of consideration = Some benefit, right or profit to one party / some detriment, loss, or forbearance to the other.

2.2 LEGAL RULES REGARDING CONSIDERATION

(i) **Consideration must move at the desire of the promisor:** Consideration must be offered by the promisee or the third party at the desire or request of the promisor. This implies "return" element of consideration. Contract of marriage in consideration of promise of settlement is enforceable.

An act done at the desire of a third party is not a consideration.

In ***Durga Prasad v. Baldeo,*** D (defendant) promised to pay to P (plaintiff) a certain commission on articles which would be sold through their agency in a market. Market was constructed by P at the desire of the C (Collector), and not at the desire of the D. D was not bound to pay as it was without consideration and hence void.

Example 5: R saves S's goods from fire without being asked to do so. R cannot demand any reward for his services, as the act being done voluntary.

(ii) **Consideration may move from promisee or any other person:** In India, consideration may proceed from the promisee or any other person who is not a party to the contract. The definition of consideration as given in Section 2(d) makes that proposition clear. According to the definition, when at the desire of the promisor, the promisee or any other person does something such an act is consideration. In other words, there can be a stranger to a consideration but not stranger to a contract.

Example 6: An old lady made a gift of her property to her daughter with a direction to pay a certain sum of money to the maternal uncle by way of annuity. On the same day, the daughter executed a writing in favour of the brother agreeing to pay annuity. The daughter did not, however, pay the annuity and the uncle sued to recover it. It was held that there was sufficient consideration for the uncle to recover the money from the daughter. ***[Chinnayya vs. Ramayya (1882)]***

(iii) **Executed and executory consideration:** A consideration which consists in the performance of an act is said to be executed. When it consists in a promise, it is said to be executory. The promise by one party may be the consideration for an act by some other party, and vice versa.

Example 7: A pays ₹ 5,000 to B and B promises to deliver to him a certain quantity of wheat within a month. In this case, A pays the amount, whereas B merely makes a

promise. Therefore, the consideration paid by A is executed, whereas the consideration promised by B is executory.

(iv) **Consideration may be past, present or future:** The words "has done or abstained from doing" [as contained in Section 2(d)] are a recognition of the doctrine of past consideration. In order to support a promise, a past consideration must move by a previous request. It is a general principle that consideration is given and accepted in exchange for the promise. The consideration, if past, may be the motive but cannot be the real consideration of a subsequent promise. But in the event of the services being rendered in the past at the request or the desire of the promisor, the subsequent promise is regarded as an admission that the past consideration was not gratuitous.

Example 8: 'A' performed some services to 'B' at his desire. After a week, 'B' promises to compensate 'A' for the work done by him. It is said to be past consideration and A can sue B for recovering the promised money.

Example 9: A cash sale of goods is an example of present consideration. The consideration is immediately made against delivery of goods.

(v) **Consideration need not be adequate:** Consideration need not to be of any particular value. It need not be approximately of equal value with the promise for which it is exchanged but it must be something which the law would regard as having some value. Something in return need not be equal to something given. It can be considered a bad bargain of the party.

It may be noted in this context that Explanation 2 to Section 25 states that an agreement to which the consent of the promisor is freely given is not void merely because the consideration is inadequate.

But as an exception if it is shockingly less and the other party alleges that his consent was not free than this inadequate consideration can be taken as an evidence in support of this allegation.

Example 10: X promises to sell a house worth ₹60 lacs for ₹10 lacs only, the adequacy of the price in itself shall not render the transaction void, unless the party pleads that transaction takes place under coercion, undue influence or fraud.

(vi) **Performance of what one is legally bound to perform:** The performance of an act by a person who is legally bound to perform the same cannot be consideration for a contract. Hence, a promise to pay money to a witness is void, for it is without consideration. Hence, such a contract is void for want of consideration. Similarly, an agreement by a client to pay to his counsel after the latter has been engaged, a

certain sum over and above the fee, in the event of success of the case would be void, since it is without consideration.

Example 11: A promise to pay ₹ 2,000 to a doctor over the fees is invalid as it is the duty of a doctor to give a treatment for his normal fees.

But where a person promises to do more that he is legally bound to do or such a promise provided it is not opposed to public policy, is a good consideration. It should not be vague or uncertain.

(vii) **Consideration must be real and not illusory:** Consideration must be real and must not be illusory. It must be something to which the law attaches some value. If it is legally or physically impossible it is not considered valid consideration.

Examples 12: A man promises to discover treasure by magic, bringing the dead person to live again. This transaction can be said to be void as it is illusory.

(viii) **Consideration must not be unlawful, immoral, or opposed to public policy.** Only presence of consideration is not sufficient it must be lawful. Anything which is immoral or opposed to public policy also cannot be valued as valid consideration.

Example 13: ABC Ltd. promises to give job to Mr. X in a Government bank against payment of ₹ 50,000 is void as the promise is opposed to public policy.

2.3 SUIT BY A THIRD PARTY TO A CONTRACT

Though under the Indian Contract Act, 1872, the consideration for an agreement may proceed from a third party, the third party cannot sue on contract. Only a person who is party to a contract can sue on it.

Thus, the concept of stranger to consideration is a valid and is different from stranger to a contract.

Example 14: P who is indebted to Q, sells his property to R and R promises to pay off the debt amount to Q. If R fails to pay, then in such situation Q has no right to sue, as R is a stranger to contract.

The aforesaid rule, that **stranger to a contract cannot sue is known as a "doctrine of privity of contract",** is however, subject to certain exceptions. In other words, even a stranger to a contract may enforce a claim in the following cases:

(1) **In the case of trust,** a beneficiary can enforce his right under the trust, though he was not a party to the contract between the settler and the trustee.

(2) **In the case of a family settlement,** if the terms of the settlement are reduced into writing, the members of family who originally had not been parties to the settlement may enforce the agreement.

Example 15: Two brothers X and Y agreed to pay an allowance of ₹ 20,000 to mother on partition of joint properties. But later they denied to abide by it. Held their mother although stranger to contract can require their sons for such allowance in the court of law.

(3) **In the case of certain marriage contracts/arrangements,** a provision may be made for the benefit of a person, he may file the suit though he is not a party to the agreement.

Example 16: Mr. X's wife deserted him for ill-treating her. Mr. X promised his wife's father Mr. Puri that he will treat her properly or else pay her monthly allowance. But she was again ill-treated by her husband. Held, she has all right to sue Mr. X against the contract made between Mr. X and Mr. Puri even though she was stranger to contract.

(4) **In the case of assignment of a contract,** when the benefit under a contract has been assigned, the assignee can enforce the contract but such assignment should not involve any personal skill.

Example 17: Mr. Ankit Sharma has assigned his insurance policy to his son. Now son can claim even if he was not a party to contract.

(5) **Acknowledgement or estoppel** – where the promisor by his conduct acknowledges himself as an agent of the third party, it would result into a binding obligation towards third party.

Example 18: If L gives to M ₹20,000 to be given to N, and M informs N that he is holding the money for him, but afterwards M refuses to pay the money. N will be entitled to recover the same from the former i.e. M.

(6) **In the case of covenant running with the land,** the person who purchases land with notice that the owner of land is bound by certain duties affecting land, the covenant affecting the land may be enforced by the successor of the seller.

Example 19: One owner of the land having two land adjacent to each other. One was agricultural land. He sold the other land containing a condition that it can never be used for Industrial purpose so as to protect the other agricultural land from pollution. Such condition is attached with the land so who so ever is the successor of land has to abide by it. Such are called restrictive covenants and all successor are bind to it.

(7) **Contracts entered into through an agent:** The principal can enforce the contracts entered by his agent where the agent has acted within the scope of his authority and in the name of the principal.

Example 20: Prashant appoints Abhinav as his agent to sell his house. Abhinav sells house to Tarun. Now Prashant has right to recover the price from Tarun.

2.4 VALIDITY OF AN AGREEMENT WITHOUT CONSIDERATION

The general rule is that an agreement made without consideration is void (Section 25). In every valid contract, consideration is very important. A contract may only be enforceable when consideration is there. However, the Indian Contract Act contains certain exceptions to this rule. In the following cases, the agreement though made without consideration, will be valid and enforceable.

1. **Natural Love and Affection:** Conditions to be fulfilled under section 25(1)

   (i) It must be made out of natural love and affection between the parties.

   (ii) Parties must stand in near relationship to each other.

   (iii) It must be in writing.

   (iv) It must also be registered under the law.

   A written and registered agreement based on natural love and affection between the parties standing in near relation (e.g., husband and wife) to each other is enforceable even without consideration.

   Example 21: A husband, by a registered agreement promised to pay his earnings to his wife. Held the agreement though without consideration, was valid.

   Example 22: A out of natural love and affection promises to give his newly wedded daughter- in -law a golden necklace worth ₹ 5,00,000. 'A' made the promise in writing and signed it and registered. The agreement is valid.

2. **Compensation for past voluntary services:** A promise to compensate, wholly or in part, a person who has already voluntarily done something for the promisor, is enforceable under Section 25(2). In order that a promise to pay for the past voluntary services be binding, the following essential factors must exist:

   (i) The services should have been rendered voluntarily.

   (ii) The services must have been rendered for the promisor.

   (iii) The promisor must be in existence at the time when services were rendered.

(iv) The promisor must have intended to compensate the promisee.

Example 23: P finds R's wallet and gives it to him. R promises to give P ₹10,000. This is a valid contract.

Example 24: Mr. X had helped his nephew Mr. Y to fight a case in the court of law using his knowledge and intellect. After Mr. Y won the case, he promised Mr. X to pay Rs. 10,000. Held, this is a valid contract as it is compensation to past services.

3. **Promise to pay time barred debt:** Where a promise in writing signed by the person making it or by his authorised agent, is made to pay a debt barred by limitation it is valid without consideration [Section 25(3)].

Example 25: A is indebted to C for ₹60,000 but the debt is barred by the Limitation Act. A sign a written promise now to pay ₹50,000 in final settlement of the debt. This is a contract without consideration, but enforceable for ₹50,000 only.

4. **Agency:** According to Section 185 of the Indian Contract Act, 1872, no consideration is necessary to create an agency.

5. **Completed gift:** In case of completed gifts, the rule no consideration no contract does not apply. Explanation (1) to Section 25 states "nothing in this section shall affect the validity as between the donor and donee, of any gift actually made." Thus, gifts do not require any consideration.

6. **Bailment:** No consideration is required to affect the contract of bailment. Section 148 of the Indian Contract Act, 1872, defines bailment as the delivery of goods from one person to another for some purpose. This delivery is made upon a contract that post accomplishment of the purpose, the goods will either be returned or disposed of, according to the directions of the person delivering them. No consideration is required to affect a contract of bailment.

Example 26: Mr. A hand over the keys of his godown to Mr. Y as Mr. Y had deposited his goods in the same. Mr. Y gets possession of godown but not the ownership. As soon as Mr. Y lifts his goods from godown he is liable to hand over the keys back to Mr. A.

7. **Charity:** If a promisee undertakes the liability on the promise of the person to contribute to charity, there the contract shall be valid. ***(Kadarnath v. Gorie Mohammad)***

Example 27: Mr. G promised Mr. K, the secretary of committee of temple to donate ₹ 1,00,000 for renovation of that temple. On the faith of his promise, secretary has incurred some cost for renovation. Now secretary can claim from Mr. G even the contract was without consideration.

SUMMARY

The students may note that:

(a) Consideration is a price for the promise of the other party and it may either be in the form of 'benefit' or some 'detriment' to the parties.

(b) Consideration must move at the desire of the promisor.

(c) It may be executed or executory.

(d) Past consideration is valid provided it moved at the previous request of the promisor.

(e) It must not be something which the promisor is already legally bound to do.

(f) It may move from the promisee or any third party.

(g) Inadequacy of consideration is not relevant.

(h) Consideration must be legal.

(i) The general rule of law is "No Consideration, No Contract" but there are a few exceptional cases where a contract, even though without consideration is valid.

(j) "Stranger to a contract can't sue but in some exceptional cases the contract may be enforced by a person who is not a party to the contract.

CONSIDERATION Sec.2(d)

"When at the desire of the promisor, the promise or any other person has done or abstained from doing, something, such act or abstinence or promise is called a consideration for the promise."

Legal Rules

(i) move at the desire of the promisor.
(ii) move from the promise or any other person.
(iii) may be executed and executor.
(iv) May be past, present or future.
(v) need not be adequate.
(vi) must be something which the promisor is not already bound to do.
(vii) must be real, not illusory.
(viii) must not be unlawful, immoral or opposed to public policy.

Suit by a Third Party to any Agreement

(i) Trust
(ii) Family Settlement
(iii) Marriage contracts
(iv) Assignment of contract
(v) Acknowledgement or estoppel
(vi) Covenants running with land
(viii) Agency

Contract is Valid even without Consideration in following situations:

(i) A written and registered agreement based on natural love and affection between near relatives
(ii) A promise to pay for a past voluntary service is binding
(iii) A written promise to pay time-time barred debt.
(iv) Agency.
(v) Completed gifts
(vi) Bailment(sec.148).
(vii) Charity

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *Which of the following statement is false? Consideration:*
   - *(a) Must move at the desire of the promisor.*
   - *(b) May move from any person*
   - *(c) Must be illusory*
   - *(d) Must be of some value*
2. *Consideration must move at the desire of*
   - *(a) Promisor*
   - *(b) Promisee*
   - *(c) Any other person*
   - *(d) Any of these*
3. *Consideration may be*
   - *(a) Past*
   - *(b) Present*
   - *(c) Future*
   - *(d) All of the above*
4. *Consideration in simple term means:*
   - *(a) Anything in return*
   - *(b) Something in return*
   - *(c) Everything in return*
   - *(d) Nothing in return*
5. *Which of the following is not an exception to the rule - No consideration, No Contract*
   - *(a) Compensation for involuntary services*
   - *(b) Love & Affection*
   - *(c) Contract of Agency*
   - *(d) Gift*

6. *Past consideration means*

   (a) Consideration and promise should move together

   (b) Executed consideration

   (c) Consideration is provided prior to the making of the contract

   (d) Invalid consideration

7. *A contract without consideration under Section 25 is:*

   (a) void

   (b) voidable

   (c) valid

   (d) illegal

Descriptive Questions

1. *"To form a valid contract, consideration must be adequate". Comment.*

2. *Mr. Sohanlal sold 10 acres of his agricultural land to Mr. Mohanlal on 25th September 2022 for ₹ 25 Lakhs. The Property papers mentioned a condition, amongst other details, that whosoever purchases the land is free to use 9 acres as per his choice but the remaining 1 acre has to be allowed to be used by Mr. Chotelal, son of the seller for carrying out farming or other activity of his choice. On 12th October, 2022, Mr. Sohanlal died leaving behind his son and life. On 15th October, 2022 purchaser started construction of an auditorium on the whole 10 acres of land and denied any land to the son.*

   Now Mr. Chotelal wants to file a case against the purchaser and get a suitable redressal. Discuss the above in light of provisions of Indian Contract Act, 1872 and decide upon Mr. Chotelal's plan of action?

ANSWER/HINTS

Answers to MCQs

1.	**(c)**	2.	**(a)**	3.	**(d)**	4.	**(b)**	5.	**(a)**	6.	**(c)**
7.	**(c)**										

Answers to the Descriptive Questions

1. The law provides that a contract should be supported by consideration. So long as consideration exists, the Courts are not concerned to its adequacy, provided it is of some value. The adequacy of the consideration is for the parties to consider at the time of making the agreement, not for the Court when it is sought to be enforced ***(Bolton v. Modden).*** Consideration must however, be something to which the law attaches value though it need not be equivalent in value to the promise made.

According to Explanation 2 to Section 25 of the Indian Contract Act, 1872, an agreement to which the consent of the promisor is freely given is not void merely because the consideration is inadequate but the inadequacy of the consideration may be taken into account by the Court in determining the question whether the consent of the promisor was freely given.

2. Problem as asked in the question is based on the provisions of the Indian Contract Act, 1872 as contained in section 2(d) and on the principle 'privity of consideration'. Consideration is one of the essential elements to make a contract valid and it can flow from the promisee or any other person. In view of the clear language used in definition of 'consideration' in Section 2(d), it is not necessary that consideration should be furnished by the promisee only. A promise is enforceable if there is some consideration for it and it is quite immaterial whether it moves from the promisee or any other person.

The leading authority in the decision of the ***Chinnaya Vs. Ramayya***, held that the consideration can legitimately move from a third party and it is an accepted principle of law in India.

In the given problem, Mr. Sohanlal has entered into a contract with Mr. Mohanlal, but Mr. Chotelal has not given any consideration to Mr. Mohanlal but the consideration did flow from Mr. Sohanlal to Mr. Mohanlal on the behalf of Mr. Chotelal and such consideration from third party is sufficient to enforce the promise of Mr. Mohanlal to allow Mr. Chotelal to use 1 acre of land. Further the deed of sale and the promise made by Mr. Mohanlal to Mr. Chotelal to allow the use of 1 acre of land were executed simultaneously and therefore they should be regarded as one transaction and there was sufficient consideration for it.

Moreover, it is provided in the law that "in case covenant running with the land, where a person purchases land with notice that the owner of the land is bound by certain duties affecting land, the covenant affecting the land may be enforced by the successor of the seller."

In such a case, third party to a contract can file the suit although it has not moved the consideration.

Hence, Mr. Chotelal is entitled to file a petition against Mr. Mohanlal for execution of contract.

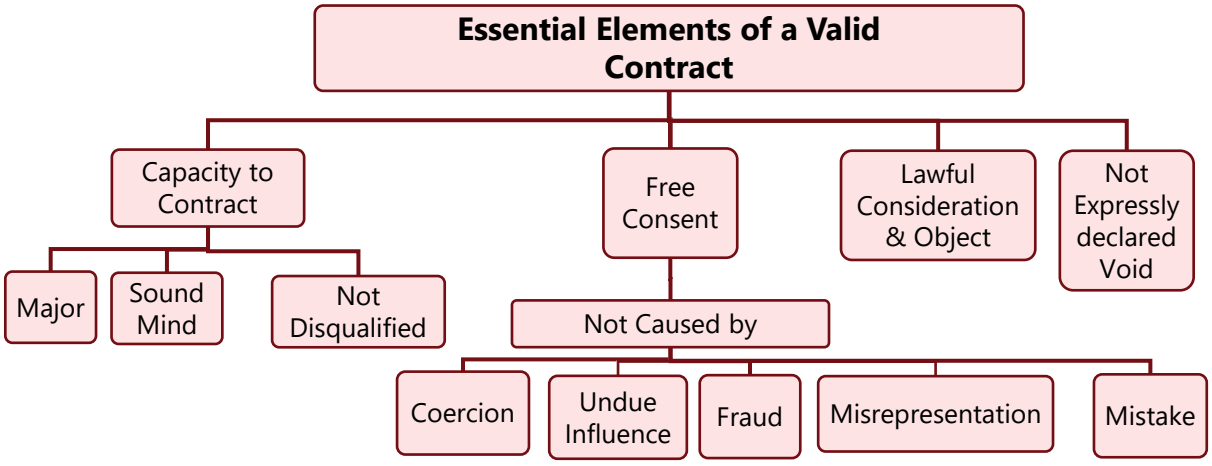
UNIT-3: OTHER ESSENTIAL ELEMENTS OF A CONTRACT

LEARNING OUTCOMES

After studying this Chapter, you will be able to understand:

- The various ingredients of incapacity to contract.
- The legal consequence of contracting with a minor.
- The concept of 'consensus ad idem' i.e. parties agreeing upon the same thing in the same sense.
- The characteristics of different elements vitiating free consent and particularly to distinguish amongst fraud, misrepresentation and mistake.
- The circumstances when object and consideration become unlawful.
- Agreements opposed to public policy.

UNIT OVERVIEW



It has already been discussed that an agreement results from a proposal by one party and its acceptance by the other party. We have already discussed offer, acceptance and consideration in detail. We shall now discuss in detail the elements which constitute a valid contract enforceable in law.

Section 10 of the Indian Contract Act, 1872 provides that an agreement in order to be a contract, must satisfy the following conditions:

(1) the parties must be competent to contract;

(2) it must be made by the free consent of the parties;

(3) it must be made for a lawful consideration and with a lawful object;

(4) it should not have been expressly declared as void by law.

3.1 CAPACITY TO CONTRACT

Meaning: Capacity refers to the competence of the parties to make a contract. It is one of the essential elements to form a valid contract.

Who is competent to contract (Section 11)

Every person is competent to contract who-

(A) has attained the age of majority,

(B) is of sound mind and

(C) is not disqualified from contracting by any law to which he is subject.

(A) Age of Majority: In India, the age of majority is regulated by the Indian Majority Act, 1875.

Every person domiciled in India shall attain the age of majority on the completion of 18 years of age and not before. The age of majority being 18 years, a person less than that age even by a day would be minor for the purpose of contracting.

Law relating to Minor's agreement/Position of Minor

1. A contract made with or by a minor is void ab-initio: A minor is not competent to contract and any agreement with or by a minor is void from the very beginning.

In the leading case of ***Mohori Bibi vs. Dharmo Das Ghose (1903),*** ""Mr. D a minor, mortgaged his house for Rs. 20,000 to money lender, but the mortgagee i.e. money lender has paid him Rs. 8,000. Subsequently the minor

had filed a suit for cancellation of contract. Held the contract is void as Mr. D is minor and therefore he is not liable to pay anything to lender."

2. **No ratification after attaining majority:** A minor cannot ratify the agreement on attaining majority as the original agreement is void ab initio and a void agreement can never be ratified.

Example 1: X, a minor makes a promissory note in favour of Y. On attaining majority, he cannot ratify it and if he makes a new promissory note in place of old one, here the new promissory note which he executed after attaining majority is also void being without consideration.

3. **Minor can be a beneficiary or can take benefit out of a contract:** Though a minor is not competent to contract, nothing in the Contract Act prevents the minor from making the other party bound to him. Thus, a promissory note duly executed in favour of a minor is not void and can be sued upon by him, because he though incompetent to contract, may yet accept a benefit.

A minor cannot become partner in a partnership firm. However, he may with the consent of all the partners, be admitted to the benefits of partnership (Section 30 of the Indian Partnership Act, 1932).

Example 2: A mortgage was executed in favour of a minor. Held, he can get a decree for the enforcement of the mortgage.

4. **A minor can always plead minority:** A minor can always plead minority and is not stopped to do so even where he has taken any loan or entered into any contract by falsely representing that he was major. Rule of estoppel cannot be applied against a minor. It means he can be allowed to plea his minority in defence.

Example 3: A, a minor has falsely induced himself as major and contracted with Mr. X for loan of ₹ 20,000. When Mr. X asked for the repayment A denied to pay. He pleaded that he was a minor so cannot enter into any contract. Held, A cannot be held liable for repayment of amount. However, if he has not spent the same, he may be asked to repay it but the minor shall not be liable for any amount which he has already spent even though he received the same by fraud. Thus, a minor can always plead minority and is not estopped from doing so even where he had produced a loan or entered into some other contract by falsely representing that he was of full age, when in reality he was a minor.

5. **Liability for necessaries:** The case of necessaries supplied to a minor or to any other person whom such minor is legally bound to support is governed by

section 68 of the Indian Contract Act. A claim for necessaries supplied to a minor is enforceable by law. But a minor is not liable for any price that he may promise and never for more than the value of the necessaries. There is no personal liability of the minor, but only his property is liable.

To render minor's estate liable for necessaries two conditions must be satisfied.

(i) The contract must be for the goods reasonably necessary for his support in the station in life.

(ii) The minor must not have already a sufficient supply of these necessaries.

Necessaries mean those things that are essentially needed by a minor. They cannot include luxuries or costly or unnecessary articles. Necessaries extend to all such things as reasonable persons would supply to an infant in that class of society to which the infant belongs. Expenses on minor's education, on funeral ceremonies come within the scope of the word 'necessaries'.

The whole question turns upon the minor's status in life. Utility rather than ornament is the criterion.

Example 4: Shruti being a minor purchased a laptop for her online classes of ₹ 70,000 on credit from a shop. But her assets could pay only ₹ 20,000. The shop keeper could not hold Shruti personally liable and could recover only amount recoverable through her assets i.e. upto ₹ 20,000.

6. **Contract by guardian - how far enforceable:** Though a minor's agreement is void, his guardian can, under certain circumstances enter into a valid contract on minor's behalf. Where the guardian makes a contract for the minor, which is within his competence and which is for the benefit of the minor, there will be valid contract which the minor can enforce.

   But all contracts made by guardian on behalf of a minor are not valid. For instance, the guardian of a minor has no power to bind the minor by a contact for the purchase of immovable Property. But a contract entered into by a certified guardian (appointed by the Court) of a minor, with the sanction of the court for the sale of the minor's property, may be enforced by either party to the contract.

7. **No specific performance:** A minor's agreement being absolutely void, there can be no question of the specific performance of such an agreement.

8. **No insolvency:** A minor cannot be declared insolvent as he is incapable of contracting debts and dues are payable from the personal properties of minor and he shall never be held personally liable.

9. **Partnership:** A minor being incompetent to contract cannot be a partner in a partnership firm, but under Section 30 of the Indian Partnership Act, he can be admitted to the benefits of partnership.

10. **Minor can be an agent:** A minor can act as an agent. But he will not be liable to his principal for his acts. A minor can draw, deliver and endorse negotiable instruments without himself being liable.

Example 5: A minor can have an account in the bank. He can draw a cheque for his purchases. But he shall not be liable for cheque bounces nor can he be sued under court of law for any fraud done from his account.

11. **Minor cannot bind parent or guardian:** In the absence of authority, express or implied, an infant is not capable of binding his parent or guardian, even for necessaries. The parents will be held liable only when the child is acting as an agent for parents.

Example 6: Richa a minor entered into contract of buying a scooty from the dealer and mentioned that her parents will be liable for the payment of scooty. The dealer sent a letter to her parents for money. The parents will not be liable for such payment as the contract was entered by a minor in their absence and out of their knowledge.

12. **Joint contract by minor and adult:** In such a case, the adult will be liable on the contract and not the minor. ***In Sain Das vs. Ram Chand***, where there was a joint purchase by two purchasers, one of them was a minor, it was held that the vendor could enforce the contract against the major purchaser and not the minor.

13. **Surety (Guarantor) for a minor:** In a contract of guarantee when an adult stands surety for a minor then he (adult) is liable to third party as there is direct contract between the surety and the third party.

Example 7: Mr. X guaranteed for the purchase of a mobile phone by Krish, a minor. In case of failure for payment by Krish, Mr. X will be liable to make the payment.

14. **Minor as Shareholder:** A minor, being incompetent to contract cannot be a shareholder of the company. If by mistake he becomes a member, the company can rescind the transaction and remove his name from register. But,

a minor may, acting though his lawful guardian become a shareholder by transfer or transmission of fully paid shares to him.

15. **Liability for torts:** A tort is a civil wrong. A minor is liable in tort unless the tort in reality is a breach of contract. Thus, where a minor borrowed a horse for riding only, he was held liable when he lent the horse to one of his friends who jumped and killed the horse. Similarly, a minor was held liable for his failure to return certain instruments which he had hired and then passed on to a friend.

(B) **Person of sound mind:** According to Section 12 of Indian Contract Act, "a person is said to be of sound mind for the purposes of making a contract if, at the time when he makes it is capable of understanding it and of forming a rational judgement as to its effect upon his interests."

A person who is usually of unsound mind, but occasionally of sound mind, may make a contract when he is of sound mind.

A person who is usually of sound mind, but occasionally of unsound mind, may not make a contract when he is of unsound mind.

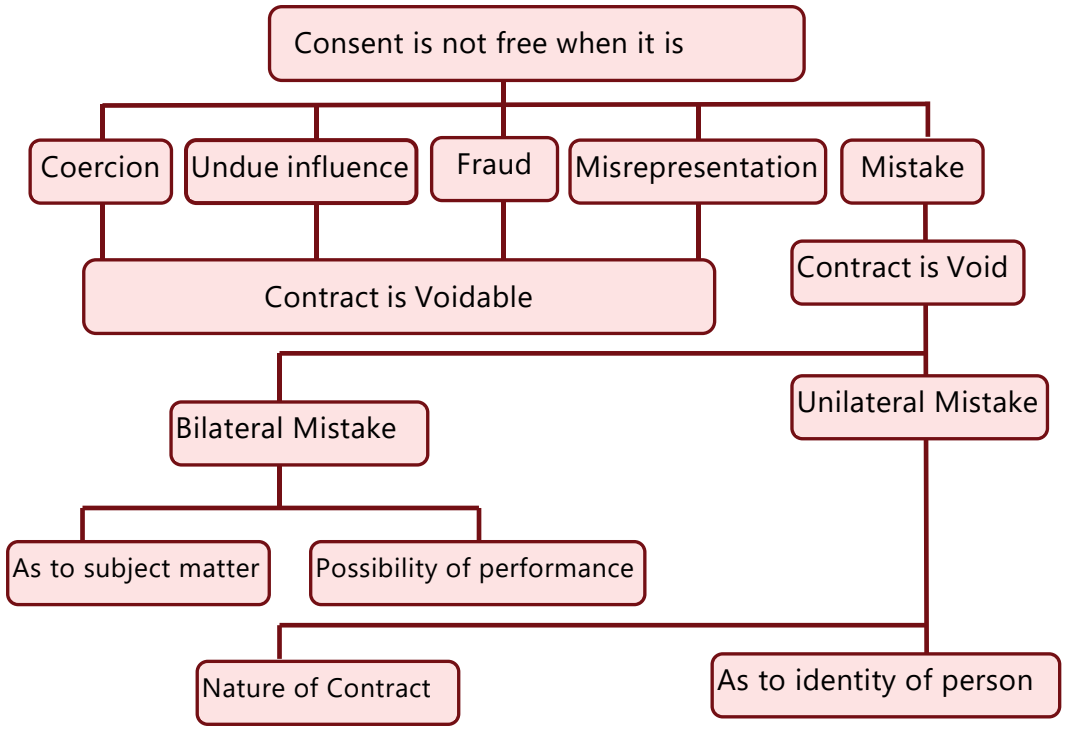
Example 8: A patient in a lunatic asylum, who is at intervals, of sound mind, may contract during those intervals.

Example 9: A sane man, who is delirious from fever, or who is so drunk that he cannot understand the terms of a contract, or form a rational judgement as to its effect on his interests, cannot contract whilst such delirium or drunkenness lasts.

Position of unsound mind person making a contract: A contract by a person who is not of sound mind is void.

(C) **Contract by disqualified persons:** Besides minors and persons of unsound mind, there are also other persons who are disqualified from contracting, partially or wholly, so that the contracts by such person are void. Incompetency to contract may arise from political status, corporate status, legal status, etc. The following persons fall in this category: Foreign Sovereigns and Ambassadors, Alien enemy, Corporations, Convicts, Insolvent etc.

3.2 FREE CONSENT



Definition of Consent according to Section 13:

"two or more persons are said to consent when they agree upon the same thing in the same sense."

Parties are said to have consented when they not only agreed upon the same thing but also agreed upon that thing in the same sense. 'Same thing' must be understood as the whole content of the agreement. Consequently, when parties to a contract make some fundamental error as to the nature of the transaction, or as to the person dealt with or as to the subject-matter of the agreement, it cannot be said that they have agreed upon the same thing in the same sense. And if they do not agree in the same sense, there cannot be consent. A contract cannot arise in the absence of consent.

If two persons enter into an apparent contract concerning a particular person or ship, and it turns out that each of them, misled by similarity of name, had a different person or ship in his mind, no contract would exist between them as they were not ad idem, i.e., of the same mind. Again, ambiguity in the terms of an agreement, or an error as to the nature of any transaction or as to the subject-matter of any agreement may prevent the formation of any contract on the ground of absence of consent. In the case of fundamental error, there is really no consent whereas, in the case of mistake, there is no real consent.

As has been said already, one of the essential elements of a contract is consent and there cannot be a contract without consent. Consent may be free or not free. Only free consent is necessary for the validity of a contract.

Definition of 'Free Consent' (Section 14)

Consent is said to be free when it is not caused by:

1. Coercion, as defined in Section 15; or
2. Undue Influence, as defined in Section 16; or
3. Fraud, as defined in Section 17; or
4. Misrepresentation, as defined in Section 18 or
5. Mistake, subject to the provisions of Sections 20, 21, and 22.

When consent to an agreement is caused by coercion, fraud, misrepresentation, or undue influence, the agreement is a contract voidable at the option of the party whose consent was so caused. When the consent is vitiated by mistake, the contract becomes void.

3.3 ELEMENTS VITIATING FREE CONSENT

We shall now explain these elements one by one.

I Coercion (Section 15)

"Coercion' is the committing, or threatening to commit, any act forbidden by the Indian Penal Code or the unlawful detaining, or threatening to detain any property, to the prejudice of any person whatever, with the intention of causing any person to enter into an agreement."

It is to be noted that the section does not require that coercion must proceed from a party to the contract; nor is it necessary that subject of the coercion must be the other contracting party, it may be directed against any third person whatever.

Effects of coercion under section 19 of Indian Contract Act, 1872

(i) Contract induced by coercion is voidable at the option of the party whose consent was so obtained.

(ii) A person to whom money has been paid or anything delivered under coercion must repay or return it. (Section 72)

Threat to commit suicide – Whether is it coercion?

Suicide though forbidden by Indian Penal Code is not punishable, as a dead man cannot be punished. But Section 15 declares that committing or threatening to commit any act

forbidden by Indian Penal Code is coercion. Hence, a threat to commit suicide will be regarded as coercion.

Example 10: Where husband obtained a release deed from his wife and son under a threat of committing suicide, the transaction was set aside on the ground of coercion, suicide being forbidden by the Indian Penal Code.

Example 11: An agent refused to give books of accounts to the principal unless he frees him from all his liabilities. The principal had to give the release deed. Held, the contract was under coercion by unlawful detaining of the principal's property.

II Undue influence (Section 16)

According to section 16 of the Indian Contract Act, 1872, "A contract is said to be induced by 'undue influence' where the relations subsisting between the parties are such that one of the parties is in a position to dominate the will of the other and he uses that position to obtain an unfair advantage over the other".

Example 12: A having advanced money to his son, B, during his minority, upon B's coming of age obtains, by misuse of parental influence, a bond from B for a greater amount than the sum due in respect of the advance. A employs undue influence.

The essential ingredients under this provision are:

(1) ***Relation between the parties:*** A person can be influenced by the other when a near relation between the two exists.

(2) ***Position to dominate the will:*** Relation between the parties exist in such a manner that one of them is in a position to dominate the will of the other. A person is deemed to be in such position in the following circumstances:

(a) **Real and apparent authority:** Where a person holds a real authority over the other as in the case of master and servant, doctor and patient and etc.

Example 13: A father, by reason of his authority over the son can dominate the will of the son.

(b) **Fiduciary relationship:** Where relation of trust and confidence exists between the parties to a contract. Such type of relationship exists between father and son, solicitor and client, husband and wife, creditor and debtor, etc.

Example 14: By reason of fiduciary relationship, a solicitor can dominate the will of his client and a trustee can dominate the will of the beneficiary.

Example 15: A spiritual guru induced his devotee to gift to him the whole of his property in return of a promise of salvation of the devotee. Held, the consent of the devotee was given under undue influence. Here, the

relationship was fiduciary relationship between Guru and devotee and Guru was in a position to dominate the will of devotee.

(c) **Mental distress:** An undue influence can be used against a person to get his consent on a contract where the mental capacity of the person is temporarily or permanently affected by the reason of mental or bodily distress, illness or of old age.

Example 16: A doctor is deemed to be in a position to dominate the will of his patient enfeebled by protracted illness.

(d) **Unconscionable bargains:** Where one of the parties to a contract is in a position to dominate the will of the other and the contract is apparently unconscionable i.e., unfair, it is presumed by law that consent must have been obtained by undue influence. Unconscionable bargains are witnessed mostly in money-lending transactions and in gifts.

Example 17: A, being in debt to B, the money-lender of his village, contracts a fresh loan on terms which appear to be unconscionable. It lies on B to prove that the contract was not induced by undue influence.

Example 18: A applies to a banker for a loan at a time when there is a stringency in money market. The banker declines to make the loan except at an unusually high rate of interest. A accepts the loan on these terms. This is a transaction in the ordinary course of business, and the contract is not induced by undue influence.

(3) ***The object must be to take undue advantage:*** Where the person is in a position to influence the will of the other in getting consent, must have the object to take advantage of the other.

Example 19: A teacher asks her daughter to get marry to one of his brilliant students. Both the girl and boy were smart, settled and intelligent. Here the teacher had a relation which can have influence on both of them. But as no undue advantage of such influence was taken such contract of marriage is said to be made by free consent.

(4) ***Burden of proof:*** When a party to contract decides to avoid the contract on the ground of undue influence, he has to prove that-

(a) The other party is in position to dominate his will,

(b) the other party actually used his position to obtain his consent,

(c) transaction is unfair or unconscionable.

Effect of undue influence- (Section 19A)

(i) When consent to an agreement is caused by undue influence, the agreement is a contract voidable at the option of the party whose consent was so caused.

(ii) Any such contract may be set aside either absolutely or, if the party who was entitled to avoid it has received any benefit thereunder, upon such terms and conditions as to the Court may seem just.

Example 20: A, a money lender advances ₹ 1,00,000 to B, an agriculturist, and by undue influence induces B to execute a bond for ₹ 2,00,000 with interest at 6 percent per month. The court may set aside the bond, ordering B to repay ₹ 1,00,000 with such interest as may seem just.

III Fraud (Section 17)

Definition of Fraud under Section 17: 'Fraud' means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agent, with an intent to deceive another party thereto or his agent, or to induce him to enter into the contract:

(1) the suggestion, as a fact, of that which is not true, by one who does not believe it to be true;

(2) the active concealment of a fact by one having knowledge or belief of the fact;

(3) a promise made without any intention of performing it;

(4) any other act fitted to deceive;

(5) any such act or omission as the law specially declares to be fraudulent.

The following are the essential elements of the fraud:

(1) There must be a representation or assertion and it must be false. However, silence may amount to fraud or an active concealment may amount to fraud.

Whether Silence is fraud or not?

As per explanation of section 17, silence is fraud in following situations:

(a) There is duty to speak.

Example 21: A sell, by auction, to B, a horse which A knows to be unsound, A says nothing to B about the unsoundness of the horse. This is not fraud by A.

Example 22: In the above example, B is A's daughter. Here, the relation between the parties would make it A's duty to tell B if the horse is unsound.

(b) When silence is equal to speech.

Example 23: B says to A –"If you do not deny it, I shall assume that the horse is sound". A says nothing. Here A's silence is equivalent to speech.

(2) The representation must be related to a fact.

Example 24: 'A' who is about to sell goods says that goods cost him Rs. 50,000. This is statement of fact. But if he says the goods are worth Rs. 50,000, it is a statement of opinion.

(3) The representation should be made before the conclusion of the contract with the intention to induce the other party to act upon it.

(4) The representation or statement should be made with a knowledge of its falsity or without belief in its truth or recklessly not caring whether it is true or false.

(5) The other party must have been induced to act upon the representation or assertion.

Example 25: 'A' bought shares in a company on the faith of a prospectus which contained an untrue statement that 'B' was a director of the company. 'A' had never heard of 'B' and, therefore, the statement was immaterial from his point of view. A's claim for damages in this case was dismissed because the untrue statement had not induced 'A' to buy the shares.

(6) The other party must have relied upon the representation and must have been deceived.

(7) The other party acting on the representation must have consequently suffered a loss.

Effect of Fraud upon validity of a contract: When the consent to an agreement in caused by the fraud, the contract is voidable at option of the party defrauded and he has the following remedies:

(1) He can rescind the contract within a reasonable time.

(2) He can sue for damages.

(3) He can insist on the performance of the contract on the condition that he shall be put in the position in which he would have been had the representation made been true.

Exception: In the following cases, contract is not voidable:

(i) If the party whose consent was caused by silence which amounting to fraud, had the means of discovering the truth with ordinary diligence.

(ii) A fraud which did not cause the consent of the party to agreement.

IV Misrepresentation (Section 18)

According to Section 18, there is misrepresentation:

(1) Statement of fact, which of false, would constitute misrepresentation if the maker believes it to be true but which is not justified by the information he possesses;

(2) When there is a breach of duty by a person without any intention to deceive which brings an advantage to him;

(3) When a party causes, even though done innocently, the other party to the agreement to make a mistake as to the subject matter.

Example 26: A makes a positive statement to B that C will be made the director of a company. A makes the statement on information derived, not directly from C but from M. B applies for shares on the faith of the statement which turns out to be false. The statement amounts to misrepresentation, because the information received second-hand did not warrant A to make the positive statement to B.

Example 27: 'A' believed the engine of his motor cycle to be in an excellent condition. 'A' without getting it checked in a workshop, told to 'B' that the motor cycle was in excellent condition. On this statement, 'B' bought the motor cycle, whose engine proved to be defective. Here, 'A's statement is misrepresentation as the statement turns out to be false.

Example 28: A while selling his mare to B, tells him that the mare is thoroughly sound. A genuinely believes the mare to be sound although he has no sufficient ground for the belief. Later on, B finds the mare to be unsound. The representation made by A is a misrepresentation.

Example 29: A buy an article thinking that it is worth ₹ 1000 when in fact it is worth only ₹ 500. There has been no misrepresentation on the part of the seller. The contract is valid.

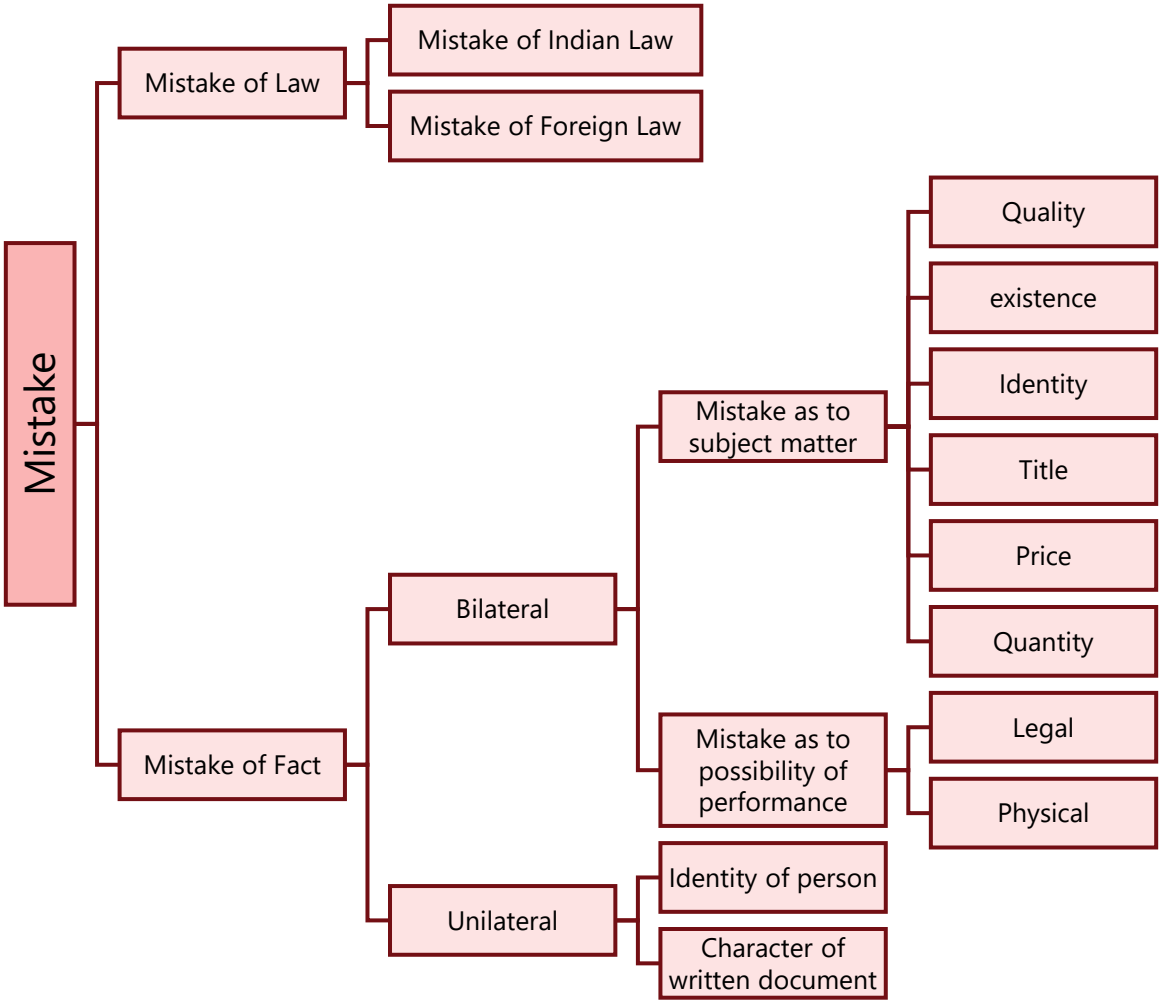
Difference between Coercion and Undue influence:

Basis of difference	Coercion	Undue Influence
Nature of action	It involves the physical force or threat. The aggrieved party is compelled to make the contract against its will.	It involves moral or mental pressure.
Involvement of criminal action	It involves committing or threatening to commit and act forbidden by Indian Penal Code or detaining or	No such illegal act is committed or a threat is given.

	threatening to detain property unlawfully.	
Relationship between parties	It is not necessary that there must be some sort of relationship between the parties.	Some sort of relationship between the parties is absolutely necessary.
Exercised by whom	Coercion need not proceed from the promisor nor need it be the directed against the promisor. It can be used even by a stranger to the contract.	Undue influence is always exercised between parties to the contract.
Enforceability	The contract is voidable at the option of the party whose consent has been obtained by the coercion.	Where the consent is induced by undue influence, the contract is either voidable or the court may set it aside or enforce it in a modified form.
Position of benefits received	In case of coercion where the contract is rescinded by the aggrieved party, as per Section 64, any benefit received has to be restored back to the other party.	The court has the discretion to direct the aggrieved party to return the benefit in whole or in part or not to give any such directions.

Distinction between fraud and misrepresentation:

Basis of difference	Fraud	Misrepresentation
Intention	To deceive the other party by hiding the truth.	There is no such intention to deceive the other party.
Knowledge of truth	The person making the suggestion believes that the statement as untrue.	The person making the statement believes it to be true, although it is not true.
Rescission of the contract and claim for damages	The injured party can repudiate the contract and claim damages.	The injured party is entitled to repudiate the contract or sue for restitution but cannot claim the damages.
Means to discover the truth	The party using the fraudulent act cannot secure or protect himself by saying that the injured party had means to discover the truth.	Party can always plead that the injured party had the means to discover the truth.



Mistake: Mistake may be defined as innocent or erroneous belief which leads the party to misunderstand the others. Mistake may be either mistake of law or mistake of fact.

Mistake of Law: Mistake of law is further classified as mistake of Indian law or mistake of foreign law.

(i) Mistake of Indian Law: A person cannot be allowed to get any relief on the ground that it had done a particular act in ignorance of law.

Example 30: A and B enter into a contract on the erroneous belief that a particular debt is barred by the Indian Law of Limitation. This contract is not voidable.

(ii) Mistake of foreign law: Such a mistake is treated as mistake of fact and the agreement in such a case is void.

Mistake of fact: Mistake of fact are of two types – (i) Bilateral Mistake, (ii) Unilateral Mistake

(i) Bilateral mistake: Where both the parties to an agreement are under a mistake as to a matter of fact essential to the agreement, there is a bilateral mistake. In such a case, the agreement is void (Section 20).

Cases of Bilateral Mistakes

(i) Mistake as to the quality of the subject-matter.

(ii) Mistake as to the existence of the subject-matter.

(iii) Mistake as to the identity of the subject-matter.

(iv) Mistake as to the title of the subject-matter.

(v) Mistake as to the price of the subject-matter.

(vi) Mistake as to the quantity of the subject-matter.

(ii) Unilateral Mistake: According to Section 22, a contract is not voidable merely because it was caused by one of the parties to it being under a mistake as to a matter of fact.

3.4 LEGALITY OF OBJECT AND CONSIDERATION

Which considerations and objects are lawful, and those which are not (Section 23):

Under Section 23 of the Indian Contract Act, in each of the following cases the consideration or object of an agreement is said to be unlawful:

(i) When consideration or object is forbidden by law: Acts forbidden by law are those which are punishable under any statute as well as those prohibited by regulations or orders made in exercise of the authority conferred by the legislature.

Example 31: A father had arranged for marriage of his 17 years boy and took dowry from the girl's parents. Such marriage contract cannot take place as in India the minimum age for boy marriage is 21 years and dowry is not permissible in Indian law. Such is not a valid contract as the consideration and object both are forbidden by law.

(ii) When consideration or object are of such a nature that if permitted it would defeats the provisions of law:

If the consideration or the object of an agreement is of such a nature that not directly but indirectly, it would defeat the provisions of the law, the agreement is void.

Example 32: A's estate is sold for arrears of revenue under the provisions of an Act of the Legislature, by which the defaulter is prohibited from purchasing the estate. B, upon an understanding with A, becomes the purchaser, and agrees to convey the estate to A upon receiving from him the price which B has paid. The agreement is void, as it renders the transaction, in effect, a purchase by the defaulter, and would so defeat the object of the law.

(iii) **When it is fraudulent:** Agreements which are entered into to promote fraud are void.

Example 33: A, B and C enter into an agreement for the division among them of gains acquired, or to be acquired, by them by fraud. The agreement is void, as its object, viz., acquisition of gains by fraud is unlawful.

(iv) The general term "injury" means criminal or wrongful harm. In the following examples, the object or consideration is unlawful as it involves injury to the person or property of another.

Example 34: An agreement to print a book in violation of another's copyright is void, as the object is to cause injury to the property of another. It is also void as the object of the agreement is forbidden by the law relating to copyright.

Example 35: A promises to repay his debt by doing manual labour daily for a special period and agrees to pay interest at an exorbitant rate in case of default. Here A's promise to repay by manual labour is the consideration for the loan, and this consideration is illegal as it imposes what, in substance, amounts to slavery on the part of A. In other words, as the consideration involves injury to the person A, the consideration is illegal. Here, the object too is illegal, as it seeks to impose slavery which is opposed to public policy. Hence, the agreement is void.

(v) **When consideration is immoral:** The following are the examples of agreements where the object or consideration is unlawful, being immoral.

Example 36: Where P had advanced money to D, a married woman to enable her to obtain a divorce from her husband and D had agreed to marry him as soon as she could obtain the divorce, it was held that P was not entitled to recover the amount, since the agreement had for its object the divorce of D from her husband and the promise of marriage given under these circumstances was against good morals.

Example 37: A asks B, "If you arrange a girl for marriage with me, I will give Rs. 50,000." Here contract is void as it is immoral.

(vi) **When consideration is opposed to public policy:** The expression 'public policy' can be interpreted either in a wide or in a narrow sense. The freedom to contract may

become illusory, unless the scope of 'public policy' is restricted. In the name of public policy, freedom of contract is restricted by law only for the good for the community.

Some of the agreements which are held to be opposed to public policy are-

(1) **Trading with enemy:** Any trade with person owing allegiance to a Government at war with India without the licence of the Government of India is void, as the object is opposed to public policy. Here, the agreement to trade offends against the public policy by tending to prejudice the interest of the State in times of war.

Example 38: India entered in war like situation with China. Mr. A from India entered into contract with China for import of toys. Such contract is void as China is alien enemy of India. The contract if made before such war like situation may be suspended or dissolved. Like India felt apps like tik tok and PUBG will provide some internal information of the country, hence such apps were banned and any contract with them were dissolved.

(2) **Stifling Prosecution:** An agreement to stifle prosecution i.e. "an agreement to present proceedings already instituted from running their normal course using force" tends to be a perversion or an abuse of justice; therefore, such an agreement is void. The principle is that one should not make a trade of felony. The compromise of any public offence is generally illegal.

Under the Indian Criminal Procedure Code, there is, however, a statutory list of compoundable offences and an agreement to drop proceeding relating to such offences with or without the permission of the Court, as the case may be, in consideration the accused promising to do something for the complainant, is not opposed to public policy. Thus, where A agrees to sell certain land to B in consideration of B abstaining from taking criminal proceeding against A with respect to an offence which is compoundable, the agreement is not opposed to public policy. But, it is otherwise, if the offence is uncompoundable.

(3) **Maintenance and Champerty:** *Maintenance* is an agreement in which a person promises to maintain suit in which he has no interest.

Example 39: A offer B ₹ 2000, if he sues C for a case which they could have settled mutually under provisions of law, just to annoy C. Such agreement is maintenance agreement.

Champerty is an agreement in which a person agrees to assist another in litigation in-exchange of a promise to hand over a portion of the proceeds of the action.

Example 40: A agrees to pay expenses to B if he sues C and B agrees to pay half of the amount received from result of such suit. This is an agreement of champerty. The agreement for supplying funds by way of Maintenance or Champerty is valid unless

(a) It is unreasonable so as to be unjust to other party or

(b) It is made by a malicious motive like that of gambling in litigation or oppressing other party by encouraging unrighteous suits and not with the bonafide object of assisting a claim believed to be just.

(4) Trafficking relating to Public Offices and titles: An agreement to trafficking in public office is opposed to public policy, as it interferes with the appointment of a person best qualified for the service of the public. Public policy requires that there should be no money consideration for the appointment to an office in which the public is interested. The following are the examples of agreements that are void; since they are tantamount to sale of public offices.

(1) An agreement to pay money to a public servant in order to induce him to retire from his office so that another person may secure the appointment is void.

(2) An agreement to procure a public recognition like Padma Vibhushan for reward is void.

Example 41: Harish paid ₹ 15000 to the officer to give his son the job in the Forest department of India. On failure by officer he couldn't recover the amount as such contract amounts to trafficking in public office which is opposed to public policy.

(5) Agreements tending to create monopolies: Agreements having for their object the establishment of monopolies are opposed to public policy and therefore void.

Example 42: XYZ and ABC were only the manufactures of oxygen cylinders in West Bengal. They both entered into contract of supplying the same at very high rates and enjoy the monopoly rates during the covid period in the country. Such contract is opposed to public policy as they intended to create monopolies.

(6) Marriage brokerage agreements: An agreement to negotiate marriage for reward, which is known as a marriage brokerage contract, is void, as it is opposed to public policy. For instance, an agreement to pay money to a person hired to procure a wife is opposed to public policy and therefore void.

Note: Marriage bureau only provides information and doesn't negotiate marriage for reward, therefore, it is not covered under this point.

(7) Interference with the course of justice: An agreement whose object is to induce any judicial officer of the State to act partially or corruptly is void, as it is opposed to

public policy; so also is an agreement by A to reward B, who is an intended witness in a suit against A in consideration of B's absenting himself from the trial. For the same reasons, an agreement which contemplates the use of under-hand means to influence legislation is void.

(8) **Interest against obligation:** The following are examples of agreement that are void as they tend to create an interest against obligation. The object of such agreements is opposed to public policy.

(1) An agreement by an agent to receive without his principal's consent compensation from another for the performance of his agency is invalid.

(2) A, who is the manager of a firm, agrees to pass a contract to X if X pays to A ₹ 200,000 privately; the agreement is void.

(9) **Consideration Unlawful in Part:** By virtue of Section 24, if any part of a single consideration for one or more objects, or any one or any part of any one of several considerations for a single object, is unlawful, the agreement is void."

This section is an obvious consequence of the general principle of Section 23. There is no promise for a lawful consideration if there is anything illegal in a consideration which must be taken as a whole. The general rule is that where the legal part of a contract can be severed from the illegal part, the bad part may be rejected and the good one can be retained. But where the illegal part cannot be severed, the contract is altogether void.

3.5 VOID AGREEMENTS

Expressly declared Void Agreements

1.	Made by incompetent parties (Section 11)	6.	Agreement in restraint of marriage (Section 26)
2.	Agreements made under Bilateral mistake of fact (Section 20)	7.	Agreements in restraint of trade (Section 27)
3.	Agreements the consideration or object of which is unlawful (Section 23)	8.	Agreement in restraint of legal proceedings (Section 28)
4.	Agreement the consideration or object of which is unlawful in parts (Section 24)	9.	Agreement the meaning of which is uncertain (Section 29)

5.	Agreements made without consideration (Section 25)	10.	Wagering Agreement (Section 30)
	[Refer Unit 2]	11.	Agreements to do impossible Acts (Section 56)

(1) **Agreement in restraint of marriage (Section 26):** Every agreement in restraint of marriage of any person other than a minor, is void. So, if a person, being a major, agrees for good consideration not to marry, the promise is not binding and considered as void agreement.

(2) **Agreement in restraint of trade (Section 27):** An agreement by which any person is restrained from exercising a lawful profession, trade or business of any kind, is to that extent void. But this rule is subject to the following exceptions, namely, where a person sells the goodwill of a business and agrees with the buyer to refrain from carrying on a similar business, within specified local limits, so long as the buyer or his successor in interest carries on a like business therein, such an agreement is valid (goodwill is the advantage enjoyed by a business on account of public patronage and encouragement from habitual customers). The local limits within which the seller of the goodwill agrees not to carry on similar business must be reasonable. Under Section 36 of the Indian Partnership Act, 1932 if an outgoing partner makes an agreement with the continuing partners that he will not carry on any business similar to that of the firm within a specified period or within specified local limits, such an agreement, thought in restraint of trade, will be valid, if the restrictions imposed are reasonable. Similarly, under Section 11 of that Act an agreement between partners not to carry on competing business during the continuance of partnership is valid.

But an agreement of service by which an employee binds himself, during the term of his agreement, not to compete with his employer is not in restraint of trade.

Example 43: B, a physician and surgeon, employs A as an assistant for a term of three years and A agrees not to practice as a surgeon and physician during these three years. The agreement is valid and A can be restrained by an injunction if he starts independent practice during this period.

Example 44: An agreement by a manufacturer to sell during a certain period his entire production to a wholesale merchant is not in restraint of trade.

Example 45: Agreement among the sellers of a particular commodity not to sell the commodity for less than a fixed price to maintain the quality of the product, is not an agreement in restraint of trade.

(3) **Agreement in restraint of legal proceedings (Section 28):** An agreement in restraint of legal proceeding is the one by which any party thereto is restricted

absolutely from enforcing his rights under a contract through a Court or which abridges the usual period for starting legal proceedings. A contract of this nature is void.

However, there are certain exceptions to the above rule:

(i) A contract by which the parties agree that any dispute between them in respect of any subject shall be referred to arbitration and that only the amount awarded in such arbitration shall be recoverable is a valid contract.

(ii) Similarly, a contract by which the parties agree to refer to arbitration any question between them which has already arisen or which may arise in future, is valid; but such a contract must be in writing.

(4) Agreement - the meaning of which is uncertain (Section 29): An agreement, the meaning of which is not certain, is void, but where the meaning thereof is capable of being made certain, the agreement is valid.

Example 46: A agrees to sell B "a hundred tons of oil". There is nothing whatever to show what kind of oil was intended. The agreement is void for uncertainty. But the agreement would be valid if A was dealer only in coconut oil; because in such a case its meaning would be capable of being made certain.

(5) Wagering agreement (Section 30): An agreement by way of a wager is void. It is an agreement involving payment of a sum of money upon the determination of an uncertain event. The essence of a wager is that each side should stand to win or lose, depending on the way an uncertain event takes place in reference to which the chance is taken and in the occurrence of which neither of the parties has legitimate interest.

Example 47: A agrees to pay ₹ 50,000 to B if it rains, and B promises to pay a like amount to A if it does not rain, the agreement will be by way of wager. But if one of the parties has control over the event, agreement is not a wager.

Essentials of a Wager

1. There must be a promise to pay money or money's worth.
2. Promise must be conditional on an event happening or not happening.
3. There must be uncertainty of event.
4. There must be two parties, each party must stand to win or lose.
5. There must be common intention to bet at the timing of making such agreement.
6. Parties should have no interest in the event except for stake.

Transactions similar to Wager (Gambling)

(i) **Lottery transactions:** A lottery is a game of chance and not of skill or knowledge. Where the prime motive of participant is gambling, the transaction amounts to a wager. Even if the lottery is sanctioned by the Government of India it is a wagering transaction. The only effect of such sanction is that the person responsible for running the lottery will not be punished under the Indian Penal Code. Lotteries are illegal and even collateral transactions to it are tainted with illegality (Section 294A of Indian Penal Code).

(ii) **Crossword Puzzles and Competitions:** Crossword puzzles in which prizes depend upon the correspondence of the competitor's solution with a previously prepared solution kept with the editor of a newspaper is a lottery and therefore, a wagering transaction.

Case Law: State of Bombay vs. R.M.D. Chamarbangwala AIR (1957)

Facts: A crossword puzzle was given in magazine. Abovementioned clause was stated in the magazine. A solved his crossword puzzle and his solution corresponded with previously prepared solution kept with the editor. Held, this was a game of chance and therefore a lottery (wagering transaction).

Crossword puzzles, picture competitions and athletic competitions where prizes are awarded on the basis of skill and intelligence are the games of skill and hence such competitions are valid. According to the Prize Competition Act, 1955 prize competitions in games of skill are not wagers provided the prize money does not exceed ₹ 1,000.

(iii) **Speculative transactions:** an agreement or a share market transaction where the parties intend to settle the difference between the contract price and the market price of certain goods or shares on a specified day, is a gambling and hence void.

(iv) **Horse Race Transactions:** A horse race competition where prize payable to the bet winner is less than ₹ 500, is a wager.

Example 48: A and B enter into an agreement in which A promises to pay ₹ 2,00,000 provided 'Chetak' wins the horse race competition. This is not a wagering transaction.

However, Section 30 is not applicable in an agreement to contribute toward plate, prize or sum of money of the value of ₹ 500 or above to be awarded to the winner of a horse race.

Transactions resembling with wagering transaction but are not void

(i) **Chit fund:** Chit fund does not come within the scope of wager (Section 30). In case of a chit fund, a certain number of persons decide to contribute a fixed sum for a specified period and at the end of a month, the amount so contributed is paid to the lucky winner of the lucky draw.

(ii) **Commercial transactions or share market transactions:** In these transactions in which delivery of goods or shares is intended to be given or taken, do not amount to wagers.

(iii) **Games of skill and Athletic Competition:** Crossword puzzles, picture competitions and athletic competitions where prizes are awarded on the basis of skill and intelligence are the games of skill and hence such competition are valid. According to the Prize Competition Act, 1955 prize competition in games of skill are not wagers provided the prize money does not exceed ₹ 1,000.

(iv) **A contract of insurance:** A contract of insurance is a type of contingent contract and is valid under law and these contracts are different from wagering agreements.

Distinction between Contract of Insurance and Wagering Agreement

	Basis	Contracts of Insurance	Wagering Agreement
1.	**Meaning**	It is a contract to indemnify the loss.	It is a promise to pay money or money's worth on the happening or non- happening of an uncertain event.
2.	**Consideration**	The crux of insurance contract is the mutual consideration (premium and compensation amount).	There is no consideration between the two parties. There is just gambling for money.
3.	**Insurable Interest**	Insured party has insurable interest in the life or property sought to be insured.	There is no property in case of wagering agreement. There is betting on other's life and properties.
4.	**Contract of Indemnity**	Except life insurance, the contract of insurance indemnifies the insured person against loss.	Loser has to pay the fixed amount on the happening of uncertain event.
5.	**Enforceability**	It is valid and enforceable	It is void and unenforceable agreement.

6.	**Premium**	Calculation of premium is based on scientific and actuarial calculation of risks.	No such logical calculations are required in case of wagering agreement.
7.	**Public Welfare**	They are beneficial to the society.	They have been regarded as against the public welfare.

SUMMARY

The following persons are incompetent to contract: (a) minor, (b) persons of unsound mind, (c) other disqualified persons.

(a) **Minor:** Agreement with a minor is altogether void but his property is liable for necessaries supplied to him. He cannot be a partner but can be admitted to benefits of partnership with the consent of all partners. He can always plead minority and cannot be asked to compensate for any benefit received under a void agreement. Under certain circumstances, a guardian can enter into valid contract on behalf of minor. Minor cannot ratify a contract on attaining majority.

(b) **Persons of unsound mind:** Persons of unsound mind such as idiots, lunatics and drunker cannot enter into a contract, but a lunatic can enter into a valid contract when he is in a sound state of mind. The liability for necessities of life supplied to persons of unsound mind is the same as in case of minors. (Section 68).

(c) Certain other persons are disqualified due to their status.

Free Consent

Two or more persons are said to consent when they agree upon the same thing in the same sense (Section 13). Consent is free when it is not caused by mistake, misrepresentation, undue influence, fraud or coercion. When consent is caused by any of above said elements, the contract is voidable at the option of the party whose consent was so caused (Sections 19 and 19A)

(a) **Coercion:** Coercion is the committing or threatening to commit any act, forbidden by the Indian Penal Code or the unlawful detaining or threatening to detain, any property, to the prejudice of any person with the intention of causing any person to enter into an agreement (Section 15). A contract induced by coercion is voidable at the option of the aggrieved party.

(b) **Undue influence:** When one party to a contract is able to dominate the will of the other and uses the position to obtain an unfair advantage, the contract is said to be induced by undue influence. (Section 16). Such contract is voidable, not void.

(c) **Fraud:** Fraud exists when a false representation has been made knowingly with an intention to deceive the other party, or to induce him to enter a contract (Section 17). Contract in the case is voidable.

(d) **Misrepresentation:** Means a misstatement of a material fact made believing it to be true, without an intent to deceive the other party (Section 18). Contract will be voidable in this case.

(e) **Mistake:** When both the parties are at a mistake to a matter of fact to the agreement, the agreement is altogether void.

Lawful Object and Consideration

An agreement where the object or the consideration is unlawful, is void. Object or consideration is unlawful if it is forbidden by law, it defeats the provisions of law; or is fraudulent, or involves injury to the person or property of another; or is immoral; or is opposed to public policy.

Besides the above said agreements, certain agreements have been expressly declared to be void by the Contract Act such as - wagering agreements, agreement with uncertain meaning, agreements where consideration is unlawful in part etc.

Minor: Sec.3 Indian Majority Act, 1875: Minor who is under 18 years.

Position of a contract with Minor

1.Agreement with or by minor is void-ab-initio agreement 2. Cannot be ratified on attaining majority. 3.Minor can be a beneficiary or can take benefit out of a contract. 4.Minor can always plead minority. 5.Minor's estate is liable for necessaries. 6.Minor is personally liable for contracts for his benefit or supply of necessaries entered by guardian within scope of authority. 7. No specific performance can be claimed. 8. Minor cannot be adjusted insolvent. 9.Minor cannot enter into partnership.	10. Minor can be an agent without incurring any personal liability. 11. Parents/guardians are not liable for the contract entered into by him. 12. In case of joint contract by adult and minor, only adult is liable. 13. If adult is surety for minor, adult is liable as direct contract between adult and third party. 14. Shares cannot be allotted to minor but minor can become a shareholder by transfer or transmission of fully paid shares to him. 15. Minor is Liable for torts.

1. Contract with person of unsound mind is void.
2. Person usually Unsound. sometimes sound - can contract when sound.
3. Person usually sound. sometimes unsound - cannot contract when unsound.

Disqualified by Law

1. Foreign sovereigns (Rulers)
2. Alien Enemy
3. Corporations
4. Convicts.

CONSENT & FREE CONSENT

Consent: "Two or more persons are said to consent when they agree upon the same thing in the same sense." (Consensus-ad-idem). When there is no consent, there is no contract.

Free Consent(Sec.14): Consent is said to be free when it is not caused by

Coercion (Sec. 15)	Undue Influence (Sec. 16)	Fraud (Sec. 17)	Mis-representation (Sec. 18)	Mistake (Sec. 20 to Sec.22)
(i) Committing or threatening to commit any act forbidden by IPC (ii) Unlawful detaining or threatening to detain any property. **Consequences** (i) Voidable at the option of party whose consent was so caused. (ii) Person to whom money is paid or thing delivered under coercion must repay or return it. **Burden of Proof** Lies on the aggrieved party Note: Threat to commit suicide is coercion	One party is in the position to dominate the will of other and it takes unfair advantages of relation. **Consequences** (i) Voidable at the option of party whose consent was so caused. (ii) Such contract may be set aside either absolutely or if the party who is entitled to avoid it has received any benefit thereunder, upon such terms and conditions as to the court may seem just and equitable. Burden of Proof Firstly, Lies on the aggrieved party after that other party has to prove that no undue influence.	(i) Knowingly make a false suggestion. (ii) Active concealment of a fact (iii) Promise without any intention of performance. (iv) Any other act fitted to deceive. (v) Act or omission declared by law as fraud. **Essentials** (i) The representation must be false. (ii) Misrepresentation must be made willfully. (iii) Misrepresentation must be made with intention to deceive the other party. (iv) The other party is actually deceived. (v) The other party has suffered a loss. **Note. Silence amounts to fraud where:** (i)There is a duty to speak. (ii) His silence is speech. **Consequences** Party can • rescind the contract. • insist for genuine performance. • sue for damages. Note: ·If party takes any benefit, contract is not voidable.	(i) False statement but maker believes it to be true. (ii) Breach of duty without any intention to deceive. (iii) Mis-representation even made innocently, the other party has actually acted. **Consequences** Party can • rescind the contract. • insist for genuine performance.	**Mistake of Law** (i) Mistake of law of the country- Contract is not voidable. (ii) Mistake of law of a foreign country- Contract is void. **Mistake of Fact** (i) Bilateral Mistake- Contract is void if- mistakes relates to material fact; both parties are under mistake. (ii) Unilateral Mistake- Contract is neither void nor voidable

UNLAWFUL OBJECT AND CONSIDERATION (Sec.23)

If consideration or object forbidden by law	When consideration or object is of such a nature that if permitted it would defeats provisions of law	When it is fraudulent	When consideration involves injury to person or property of another	When consideration is immoral	When consideration is opposed to public policy

Agreements of trading with enemy	Trafficking relating to Public Offices & titles.	Interference with the course of justice
Agreement of stifling prosecution	Agreements tending to create monopolies	Interest against obligation
Maintenance & champerty	Marriage brokerage agreements	Consideration unlawful in part

VOID AGREEMENTS

Made by Incompetent Parties(S.11)	Without consideration (S.25)	With uncertain meaning (S.29)
Under a mutual mistake of fact (S.20)	In restraint of marriage (S.26)	Wagering Agreements (S.30)
Unlawful consideration or object (S.23)	In restraint of trade (S.27)	To do impossible act (S.56)
Unlawful consideration or object in part(S.24)	In restraint of legal proceedings (S.28)	

WAGERING AGREEMENT (SEC. 30)

Meaning: Agreement between two parties by which one promises to pay money or money's worth on the happening of same uncertain event in consideration of the other party's promises to pay if the event does not happen.	**Essentials** (i) Promises to pay money (ii) Uncertain event (iii)Mutual Chances of win or lose. (iv)No control over the event (v) No other interest in the event. **Effects** (i) Agreement is void (ii) No suit to recover amount won.	**Transactions are not Wager** (i) Chit Fund (ii) Share market transactions in which delivery of stocks and shares in intended to be given & taken. (iii)Game of skill, crossword, etc. (iv)a contribution toward any prize value of Rs. 500 or above to the awarded to the winner or winners of a horse race. (v) A contract of insurance.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *Ordinarily, a minor's agreement is*
   - *(a) Void ab initio*
   - *(b) Voidable*
   - *(c) Valid*
   - *(d) Unlawful*
2. *Consent is not said to be free when it is caused by*
   - *(a) Coercion*
   - *(b) Undue influence*
   - *(c) Fraud*
   - *(d) All of these*

3. *When the consent of a party is obtained by fraud, the contract is;*

   (a) Void

   (b) Voidable

   (c) Valid

   (d) Illegal

4. *The threat to commit suicide amounts to*

   (a) Coercion

   (b) Undue influence

   (c) Misrepresentation

   (d) Fraud

5. *Moral pressure is involved in the case of*

   (a) Coercion

   (b) Undue Influence

   (c) Misrepresentation

   (d) Fraud

6. *A wrong representation when made without any intention to deceive the other party amounts to*

   (a) Coercion

   (b) Undue influence

   (c) Misrepresentation

   (d) Fraud

7. *Which of the following statement is true?*

   (a) A threat to commit suicide does not amount to coercion

   (b) Undue influence involves use of physical pressure

   (c) Ignorance of law is no excuse

   (d) Silence always amounts to fraud

8. *In case of illegal agreement, the collateral agreements are:*

   (a) Valid

   (b) Void

(c) *Voidable*

(d) *Any of these*

9. *An agreement the object or consideration of which is unlawful, is*

(a) *Void*

(b) *Valid*

(c) *Voidable*

(d) *Contingent*

10. *An agreement is void if it is opposed to public policy. Which of the following is not covered by heads of public policy?*

(a) *Trading with an enemy*

(b) *Trafficking in public offices*

(c) *Marriage brokerage contracts*

(d) *Contracts to do impossible acts.*

11. *A paid ₹ 5000 to a Government servant to get him a contract for the canteen. The Government servant could not get the contract. Can A recover ₹ 5000 paid by him to the Government servant?*

(a) *Yes, the agreement is opposed to public policy*

(b) *No, the agreement is opposed to public policy*

(c) *No, the agreements are a voidable agreement and can be avoided by A*

(d) *No, the agreement falls under section 23 and hence illegal*

12. *With regard to the contractual capacity of a person of unsound mind, which one of the following statements is most appropriate?*

(a) *A person of unsound mind can never enter into a contract*

(b) *A person of unsound mind can enter into a contract*

(c) *A person who is usually of unsound mind can contract when he is, at the time of entering into a contract, of sound mind*

(d) *A person who is occasionally of unsound mind can contract although at the time of making the contract, he is of unsound mind*

13. *An agreement made under mistake of fact, by both the parties, forming the essential subject matter of the agreement is:*

    (a) Void

    (b) Voidable

    (c) Valid

    (d) Unenforceable

14. *A is in dire need of ₹ 1,00,000 but was unable to get any loan from banks as he had no security to offer. A approached his friend B who knowing the helpless position of A lent money at a very high rate of interest, saying that he had himself borrowed money from C. The contract is:*

    (a) Vitiated by undue influence that B had exercised over A due to his close friendship.

    (b) Void as the rate of interest being very high was unconscionable.

    (c) Not valid as B had wrongly misled A that he had borrowed money from C.

    (d) Valid as a friend could not be supposed to have wielded undue influence only because the money lent carried higher rate of interest.

15. *Which of the following is not an exception to the rule that the agreement in restraint of trade is void:*

    (a) A partner can be prevented for carrying on similar business

    (b) An outgoing partner can be restrained on carrying similar business

    (c) On dissolution of firm, partners may agree not to carry on similar business

    (d) The seller of goodwill of business can be prevented for carrying any kind of business at any place.

16. *An agreement to pay money or money's worth on the happening or non-happening of a specified uncertain event, is a*

    (a) Wagering agreement

    (b) Contingent contract

    (c) Quasi contract

    (d) Uncertain agreement

17. *A wagering agreement in India is declared by the Contract Act as*

(a) *Illegal and void*

(b) *Void but not illegal*

(c) *Voidable at the option of the aggrieved party*

(d) *Immoral*

18. *An agreement, the object of which is to procure a public post, is*

(a) *Void*

(b) *Voidable*

(c) *Valid*

(d) *Defective*

19. *While obtaining the consent of the promise, keeping silence by the promisor when he has a duty to speak about the material facts, amounts to consent obtained by:*

(a) *Coercion*

(b) *Misrepresentation*

(c) *Mistake*

(d) *Fraud*

20. *A enters into an agreement with B who has robbed A of ₹ 10,000 to drop prosecution against him in consideration of B's returning ₹ 8,000. Afterwards B refused to pay. A can get from B*

(a) *₹ 8,000*

(b) *₹ 100*

(c) *Nothing*

(d) *₹ 10,000 plus damages*

21. *On attaining the age of majority, a minor's agreement:*

(a) *cannot be ratified by him*

(b) *becomes valid*

(c) *can be ratified by him*

(d) *becomes void*

22. *A threat to kidnap one's son in consideration of ₹5,00,000 is void because of:*

(a) *inadequacy of consideration*

(b) *incompetence of parties*

(c) *absence of free consent*

(d) *all of the above*

23. *In which of the following case, aggrieved part can sue for damages:*

(a) *Fraud*

(b) *mistake*

(c) *undue influence*

(d) *misrepresentation*

24. *A mere attempt to deceive a party to a contract:*

(a) *is fraud even though the party is not deceived*

(b) *is not fraud unless the party is actually deceived*

(c) *amounts to coercion*

(d) *amounts to misrepresentation*

Descriptive Questions

1. *"An agreement, the meaning of which is not certain, is void". Discuss.*

2. *"Though a minor is not competent to contract, nothing in the Contract Act prevents him from making the other party bound to the minor". Discuss.*

3. *A student was induced by his teacher to sell his brand new car to the later at less than the purchase price to secure more marks in the examination. Accordingly, the car was sold. However, the father of the student persuaded him to sue his teacher. State whether the student can sue the teacher?*

4. *Explain the concept of 'misrepresentation' in matters of contract. Sohan induced Suraj to buy his motorcycle saying that it was in a very good condition. After taking the motorcycle, Suraj complained that there were many defects in the motorcycle. Sohan proposed to get it repaired and promised to pay 40% cost of repairs. After few days, the motorcycle did not work at all. Now Suraj wants to rescind the contract. Decide giving reasons whether Suraj can rescind the contract?*

5. *Mr. SAMANT owned a motor car. He approached Mr. CHHOTU and offered to sell his motor car for ₹3,00,000. Mr. SAMANT told Mr. CHHOTU that the motor car is running*

at the rate of 30 KMs per litre of petrol. Both the fuel meter and the speed meter of the car were working perfectly. Mr. CHHOTU agreed with the proposal of Mr. SAMANT and took delivery of the car by paying ₹ 3,00,000/- to Mr. SAMANT. After 10 days, Mr. CHHOTU came back with the car and stated that the claim made by Mr. SAMANT regarding fuel efficiency was not correct and therefore there was a case of misrepresentation. Referring to the provisions of the Indian Contract Act, 1872, decide and write whether Mr. CHHOTU can rescind the contract in the above ground.

6. *Ishaan, aged 16 years, was studying in an engineering college. On 1st March, 2018 he took a loan of ₹ 2 lakhs from Vishal for the payment of his college fee and agreed to pay by 30th May, 2019. Ishaan possesses assets worth ₹ 15 lakhs. On due date Ishaan fails to pay back the loan to Vishal. Vishal now wants to recover the loan from Ishaan out of his assets. Decide whether Vishal would succeed referring to the provisions of the Indian Contract Act, 1872.*

ANSWER/HINTS

Answers to MCQs

1.	**(a)**	2.	**(d)**	3.	**(b)**	4.	**(a)**	5.	**(b)**	6.	**(c)**
7.	**(c)**	8.	**(b)**	9.	**(a)**	10.	**(d)**	11.	**(d)**	12.	**(c)**
13.	**(a)**	14.	**(d)**	15.	**(d)**	16.	**(a)**	17.	**(b)**	18.	**(a)**
19.	**(d)**	20.	**(c)**	21.	**(a)**	22.	**(c)**	23.	**(a)**	24.	**(b)**

Answers to the Descriptive Questions

1. **Agreement - the meaning of which is uncertain (Section 29):** An agreement, the meaning of which is not certain, is void, but where the meaning thereof is capable of being made certain, the agreement is valid. For example, A agrees to sell B "a hundred tons of oil". There is nothing whatever to show what kind of oil was intended. The agreement is void for uncertainty. But the agreement would be valid if A was dealer only in coconut oil; because in such a case its meaning would be capable of being made certain.

2. **Minor can be a beneficiary or can take benefit out of a contract:** Though a minor is not competent to contract, nothing in the Contract Act prevents him from making the other party bound to the minor. Thus, a promissory note duly executed in favour

of a minor is not void and can be sued upon by him, because he though incompetent to contract, may yet accept a benefit.

A minor cannot become partner in a partnership firm. However, he may with the consent of all the partners, be admitted to the benefits of partnership (Section 30 of the Indian Partnership Act, 1932).

Example: A mortgage was executed in favour of a minor. Held, he can get a decree for the enforcement of the mortgage.

3. Yes, A can sue his teacher on the ground of undue influence under the provisions of Indian Contract Act, 1872.

According to section 16 of the Indian Contract Act, 1872, "A contract is said to be induced by 'undue influence' where the relations subsisting between the parties are such that one of the parties is in a position to dominate the will of the other and he uses that position to obtain an unfair advantage over the other".

A person is deemed to be in position to dominate the will of another:

(a) Where he holds a real or apparent authority over the other; or

(b) Where he stands in a fiduciary relationship to the other; or

(c) Where he makes a contract with a person whose mental capacity is temporarily or permanently affected by reason of age, illness or mental or bodily distress for example, an old illiterate person.

A contract brought as a result of coercion, undue influence, fraud or misrepresentation would be voidable at the option of the person whose consent was caused.

4. **Misrepresentation:** According to Section 18 of the Indian Contract Act, 1872, misrepresentation is:

1. When a person positively asserts that a fact is true when his information does not warrant it to be so, though he believes it to be true.

2. When there is any breach of duty by a person, which brings an advantage to the person committing it by misleading another to his prejudice.

3. When a party causes, however, innocently, the other party to the agreement to make a mistake as to the substance of the thing which is the subject of the agreement.

The aggrieved party, in case of misrepresentation by the other party, can avoid or rescind the contract [Section 19, Indian Contract Act, 1872]. The aggrieved party

loses the right to rescind the contract if he, after becoming aware of the misrepresentation, takes a benefit under the contract or in some way affirms it.

Accordingly, in the given case, Suraj could not rescind the contract, as his acceptance to the offer of Sohan to bear 40% of the cost of repairs impliedly amount to final acceptance of the sale.

5. As per the provisions of Section 19 of the Indian Contract Act, 1872, when consent to an agreement is caused by coercion, fraud or misrepresentation, the agreement is a contract voidable at the option of the party whose consent was so caused.

A party to contract, whose consent was caused by fraud or misrepresentation, may, if he thinks fit, insist that the contract shall be performed, and that he shall be put in the position in which he would have been if the representations made had been true.

Exception: If such consent was caused by misrepresentation or by silence, fraudulent within the meaning of section 17, the contract, nevertheless, is not voidable if the party whose consent was so caused had the means of discovering the truth with ordinary diligence.

In the situation given in the question, both the fuel meter and the speed meter of the car were working perfectly, Mr. CHHOTU had the means of discovering the truth with ordinary diligence. Therefore, the contract is not voidable. Hence, Mr. CHHOTU cannot rescind the contract in the above ground.

6. According to Section 11 of the Indian Contract Act, 1872, every person is competent to contract who is of the age of majority according to the law to which he is subject, and who is of sound mind and is not disqualified from contracting by any law to which he is subject.

A person who has completed the age of 18 years is a major and otherwise he will be treated as minor. Thus, Ishaan who is a minor is incompetent to contract and any agreement with him is void [*Mohori Bibi Vs Dharmo Das Ghose 1903*].

Section 68 of the Indian Contract Act, 1872 however, prescribes the liability of a minor for the supply of the things which are the necessaries of life to him. It says that though minor is not personally liable to pay the price of necessaries supplied to him or money lent for the purpose, the supplier or lender will be entitled to claim the money/price of goods or services which are necessaries suited to his condition of life provided that the minor has a property. The liability of minor is only to the extent of the minor's property. Thus, according to the above provision, Vishal will be entitled to recover the amount of loan given to Ishaan for payment of the college fees from the property of the minor.

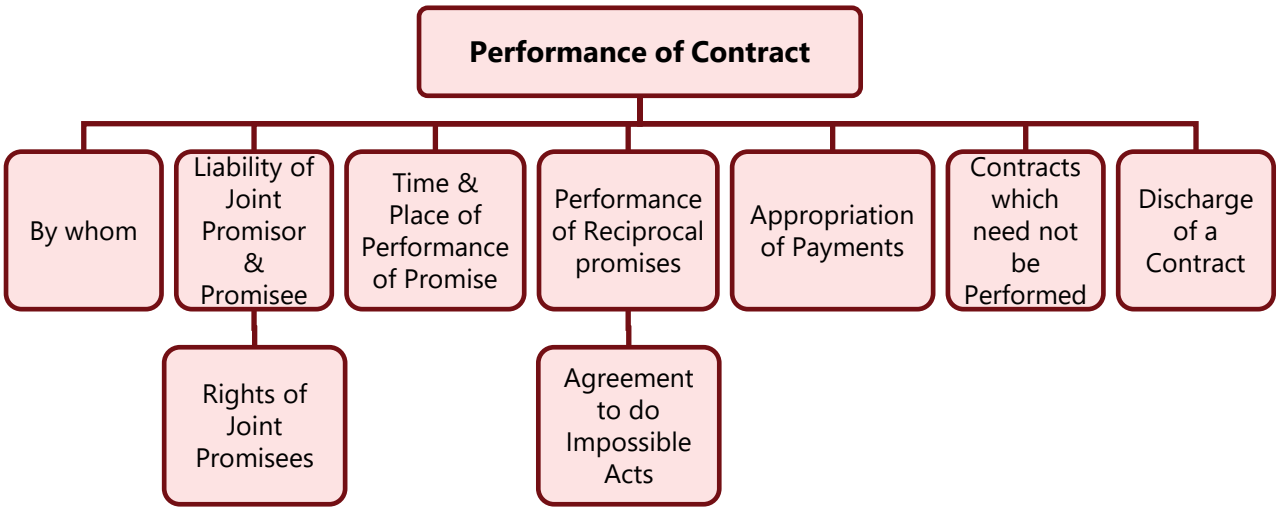
UNIT–4: PERFORMANCE OF CONTRACT

LEARNING OUTCOMES

After studying this Chapter, you will be able to understand:

- How obligations under a contract must be carried out by the parties.
- Various modes of performance.
- Consequence of refusal of performance or refusal to accept performance, by either of the parties.
- Rights of joint promisees, liabilities of joint promisors, and rules regarding appropriation of payments.

UNIT OVERVIEW



This unit explains who must perform his obligation, what should be the mode of performance, and what shall be the consequences of non- performance.

4.1 PERFORMANCE OF CONTRACT

Meaning: "Performance of Contract" means fulfilment of obligations to the contract. According to Section 37, the parties to a contract must either perform, or offer to perform, their respective promises unless such performance is dispensed with or excused under the provisions of the Contract Act or of any other law.

Types: On the basis of Section 37, "Performance of Contract" may be actual or attempted.

(a) **Actual Performance:** Where a party to a contract has done what he had undertaken to do or either of the parties has fulfilled their obligations under the contract within the time and in the manner prescribed.

Example 1: X borrows ₹ 5,00,000 from Y with a promise to be paid after 1 month. X repays the amount on the due date. This is actual performance.

(b) **Offer to perform or attempted performance or tender of performance:** It may happen sometimes, when the performance becomes due, the promisor offers to perform his obligation but the promisee refuses to accept the performance.

Example 2: A promises to deliver certain goods to B. A takes the goods to the appointed place during business hours but B refuses to take the delivery of goods. This is an attempted performance as A the promisor has done what he was required to do under the contract.

4.2 CONDITIONS TO BE SATISFIED FOR A VALID TENDER OR ATTEMPTED PERFORMANCE

(i) **It must be unconditional.**

Example 3: A offers to B to repay only the principal amount of the loan. This is not a valid tender since the whole amount of principal and interest is not offered.

(ii) **It must be made at proper time and place.**

Example 4: If the promisor wants to deliver the goods at 2 a.m., this is not a valid tender unless it was so agreed.

(iii) **Reasonable opportunity to examine goods.**

Example 5: A contract's to deliver B at his warehouse 1000 Kgs of wheat on certain date. A must bring the wheat to B's warehouse on the appointed day, under such circumstances that B may have reasonable opportunity of satisfying himself that the thing offered is wheat of the quality contracted for, and that there are 1000 Kgs.

(iv) It must be for whole obligation.

Example 6: X, a singer enters into a contract with Y, the manager of a theatre to sing at his theatres two nights in every week during the next two months, and Y engaged to pay her ₹ 10,000 for each night's performance. On the sixth night, X willfully absents herself from the theatre. Y is at liberty to put an end to the contract.

Example 7: A promises to deliver 100 bales of cotton on a certain day. On the agreed day and place 'A' offers to deliver 80 bales only. This is not a valid tender.

4.3 BY WHOM A CONTRACT MAY BE PERFORMED (SECTION 40, 41 AND 42)

The promise under a contract may be performed, as the circumstances may permit, by the promisor himself, or by his agent or his legal representative.

1. **Promisor himself:** If there is something in the contract to show that it was the intention of the parties that the promise should be performed by the promisor himself, such promise must be performed by the promisor. This means contracts which involve the exercise of personal skill or diligence, or which are founded on personal confidence between the parties must be performed by the promisor himself.

   Example 8: A promises to paint a picture for B and this must be performed by the promisor himself.

2. **Agent:** Where personal consideration is not the foundation of a contract, the promisor or his representative may employ a competent person to perform it.

3. **Legal Representatives:** A contract which involves the use of personal skill or is founded on personal consideration comes to an end on the death of the promisor. As regards any other contract the legal representatives of the deceased promisor are bound to perform it unless a contrary intention appears from the contract (Section 37, para 2). But their liability under a contract is limited to the value of the property they inherit from the deceased.

   Example 9: A promises to B to pay ₹ 100,000 on delivery of certain goods. A may perform this promise either himself or causing someone else to pay the money to B. If A dies before the time appointed for payment, his representative must pay the money or employ some other person to pay the money. If B dies before the time appointed for the delivery of goods, B's representative shall be bound to deliver the goods to A and A is bound to pay ₹100,000 to B's representative.

Example 10: A promises to paint a picture for B for a certain price. A is bound to perform the promise himself. He cannot ask some other painter to paint the picture on his behalf. If A dies before painting the picture, the contract cannot be enforced either by A's representative or by B.

4. **Third persons: Effect of accepting performance from third person- Section 41**: When a promisee accepts performance of the promise from a third person, he cannot afterwards enforce it against the promisor. That is, performance by a stranger, if accepted by the promisee, this results in discharging the promisor, although the latter has neither authorised not ratified the act of the third party.

Example 11: A received certain goods from B promising to pay ₹ 100,000/-. Later on, A expressed his inability to make payment. C, who is known to A, pays ₹ 60,000/- to B on behalf of A. However, A was not aware of the payment. Now B is intending to sue A for the amount of ₹ 100,000/-. Therefore, in the present instance, B can sue only for the balance amount i.e., ₹ 40,000/- and not for the whole amount.

5. **Joint promisors (Section 42):** When two or more persons have made a joint promise, then unless a contrary intention appears by the contract, all such persons must jointly fulfil the promise. If any of them dies, his legal representatives must, jointly with the surviving promisors, fulfil the promise. If all of them die, the legal representatives of all of them must fulfil the promise jointly.

Example 12: 'A', 'B' and 'C' jointly promised to pay ₹ 6,00,000 to 'D'. Here 'A', 'B' and 'C' must jointly perform the promise. If 'A' dies before performance, then his legal representatives must jointly with 'B' and 'C' perform the promise, and so on. And if all the three (i.e. 'A', 'B' and 'C') die before performance, then the legal representatives of all must jointly perform the promise.

4.4 DISTINCTION BETWEEN SUCCESSION AND ASSIGNMENT

Distinction between two legal concepts, viz., succession and assignment may be noted carefully. When the benefits of a contract are succeeded to by process of law, then both burden and benefits attaching to the contract, may sometimes devolve on the legal heir. Suppose, a son succeeds to the estate of his father after his death, he will be liable to pay the debts and liabilities of his father owed during his life-time. But if the debts owed by his father exceed the value of the estate inherited by the son then he would not be called upon to pay the excess. In other words, the liability of the son will be limited to the extent of the property inherited by him.

In the matter of assignment, however the benefit of a contract can only be assigned but not the liabilities thereunder. This is because when liability is assigned, a third party gets involved therein. Thus, a debtor cannot relieve himself of his liability to creditor by assigning to someone else his obligation to repay the debt.

On the other hand, if a creditor assigns the benefit of a promise, he thereby entitles the assignee to realise the debt from the debtor but where the benefit is coupled with a liability or when a personal consideration has entered into the making of the contract then the benefit cannot be assigned.

4.5 LIABILITY OF JOINT PROMISOR & PROMISEE

Devolution of joint liabilities (Section 42)

If two or more persons have made a joint promise, ordinarily all of them during their life-time must jointly fulfil the promise. After death of any one of them, his legal representative jointly with the survivor or survivors should do so. After the death of the last survivor the legal representatives of all the original co-promisors must fulfil the promise.

Example 13: X, Y and Z who had jointly borrowed money must, during their life-time jointly repay the debt. Upon the death of X his representative, say, S along with Y and Z should jointly repay the debt and so on. If in an accident all the borrowers X, Y and Z dies then their legal representatives must fulfil the promise and repay the borrowed amount. This rule is applicable only if the contract reveals no contrary intention.

We have seen that **Section 42 deals with voluntary discharge of obligations by joint promisors.** But if they do not discharge their obligation on their own volition, **what will happen?** This is what Section 43 resolves.

Any one of joint promisors may be compelled to perform – Section 43

When two or more persons make a joint promise, the promisee may, in the absence of express agreement to the contrary, compel any one or more of such joint promisors to perform the whole of the promise.

Each promisor may compel contribution – Each of two or more joint promisors may compel every other joint promisor to contribute equally with himself to the performance of the promise, unless a contrary intention appears from the contract.

In other words, if one of the joint promisors is made to perform the whole contract, he can call for a contribution from others.

Sharing of loss by default in contribution – If any one of two or more joint promisors makes default in such contribution, the remaining joint promisors must bear the loss arising from such default in equal shares.

Explanation to Section 43

Nothing in this section shall prevent a surety from recovering, from his principal, payments made by the surety on behalf of the principal, or entitle the principal to recover anything from the surety on account of payment made by the principal.

Example 14: A, B and C jointly promise to pay D ₹ 3,00,000. D may compel either A or B or C to pay him ₹ 3,00,000.

Example 15: A, B and C are under a joint promise to pay D ₹ 3,00,000. C is unable to pay anything A is compelled to pay the whole. A is entitled to receive ₹ 1,50,000 from B.

Example 16: X, Y and Z jointly promise to pay ₹ 6,000 to A. A may compel either X or Y or Z to pay the amount. If Z is compelled to pay the whole amount; X is insolvent but his assets are sufficient to pay one-half of his debts. Z is entitled to receive ₹ 1,000 from X's estate and ₹ 2,500 from Y.

We thus observe that the effect of Section 43 is to make the liability in the event of a joint contract, both joint & several, in so far as the promisee may, in the absence of a contract to the contrary, compel anyone or more of the joint promisors to perform the whole of the promise.

Effect of release of one joint promisor- Section 44

The effect of release of one of the joint promisors is dealt with in Section 44 which is stated below:

Where two or more persons have made a joint promise, a release of one of such joint promisors by the promisee does not discharge the other joint promisor or joint promisors, neither does it free the joint promisors so released from responsibility to the other joint promisor or promisors.

Example 17: 'A', 'B' and 'C' jointly promised to pay ₹ 9,00,000 to 'D'. 'D' released 'A' from liability. In this case, the release of 'A' does not discharge 'B' and 'C' from their liability. They remain liable to pay the entire amount of ₹ 9,00,000 to 'D'. And though 'A' is not liable to pay to 'D', but he remains liable to pay to 'B' and 'C' i.e. he is liable to make the contribution to the other joint promisors.

Rights of Joint Promisees

The law relating to Devolution of joint rights is contained in Section 45 which is reproduced below:

"When a person has made a promise to two or more persons jointly, then unless a contrary intention appears from the contract, the right to claim performance rests, as between him and them, with them during their joint lives, and after the death of any of them, with the representative of such deceased person jointly with the survivor or survivors, and after the death of the last survivor, with the representatives of all jointly".

Example 18: A, in consideration of ₹ 5,00,000 rupees lent to him by B and C, promises B and C jointly to repay them that sum with interest on a specified day but B dies. In such a case right to demand payment shall rest with B's legal representatives, jointly with C during C's life-time, and after the death of C, with the legal representatives of B and C jointly.

4.6 TIME AND PLACE FOR PERFORMANCE OF THE PROMISE

The law on the subject is contained in Sections 46 to 50 explained below:

(i) Time for performance of promise, where no application is to be made and no time is specified - Section 46

Where, by the contract, a promisor is to perform his promise without application by the promisee, and no time for performance is specified, the engagement must be performed within a reasonable time.

Explanation to Section 46 - The expression reasonable time is to be interpreted having regard to the facts and circumstances of a particular case.

(ii) Time and place for performance of promise, where time is specified and no application to be made – Section 47

When a promise is to be performed on a certain day, and the promisor has undertaken to perform it without application by the promise, the promisor may perform it at any time during the usual hours of business, on such day and the place at which the promise ought to be performed.

Example 19: If the delivery of goods is offered say after 8.30 pm, the promisee may refuse to accept delivery, for the usual business hours are over. Moreover, the delivery must be made at the usual place of business.

(iii) Application for performance on certain day to be at proper time and place – Section 48

When a promise is to be performed on a certain day, and the promisor has not undertaken to perform it without application by the promisee, it is the duty of the promisee to apply for performance at a proper place and within the usual hours of business.

Explanation to Section 48 states that the question "what is a proper time and place" is, in each particular case, a question of fact.

(iv) Place for the performance of promise, where no application to be made and no place fixed for performance - Section 49

When a promise is to be performed without application by the promisee, and no place is fixed for the performance of it, it is the duty of the promisor to apply to the promisee to appoint a reasonable place for the performance of the promise, and to perform it at such a place.

Example 20: A undertakes to deliver a thousand maunds of jute to B on a fixed day. A must apply to B to appoint a reasonable place for the purpose of receiving it, and must deliver it to him at such place.

(v) Performance in manner or at time prescribed or sanctioned by promisee - Section 50

The performance of any promise may be made in any such manner, or at any time which the promisee prescribes or sanctions.

4.7 PERFORMANCE OF RECIPROCAL PROMISE

The law on the subject is contained in Sections 51 to 58. The provisions thereof are summarized below:

(i) Promisor not bound to perform, unless reciprocal promisee ready and willing to perform- Section 51

When a contract consists of reciprocal promises to be simultaneously performed, no promisor needs to perform his promise unless the promisee is ready and willing to perform his reciprocal promise.

Example 21: A and B contract that A shall deliver the goods to B to be paid for by B on delivery. A need not deliver the goods, unless B is ready and willing to pay for the goods on delivery.

(ii) Order of performance of reciprocal promises- Section 52

When the order of performance of the reciprocal promises is expressly fixed by the contract, they shall be performed in that order; and where the order is not expressly fixed by the contract, they shall be performed in that order which the nature of the transaction requires.

Example 22: A and B contract that A shall build a house for B at a fixed price. A's promise to build the house must be performed before B's promise to pay for it.

(iii) Liability of party preventing event on which the contract is to take effect – Section 53

When a contract contains reciprocal promises, and one party to the contract prevents the other from performing his promise, the contract becomes voidable at the option of the party so prevented; and he is entitled to compensation from the other party for any loss he may sustain in consequence of the non- performance of the contract.

Example 23: A and B contract that B shall execute some work for A for a thousand rupees. B is ready and willing to execute the work accordingly, but A prevents him from doing so. The contract is voidable at the option of B; and if he elects to rescind it, he is entitled to recover from A compensation for any loss which he has incurred by its non-performance.

Example 24: In a contract for the sale of standing timber, the seller is to cut and cord it, whereupon buyer is to take it away and pay for it. The seller cords only a part of the timber and neglects to cord the rest. In that event the buyer may avoid the contract and claim compensation from the seller for any loss which he may have sustained for the non-performance of the contract.

(iv) Effect of default as to that promise which should be first performed, in contract consisting of reciprocal promises (Section 54)

Section 54 applies when the promises are reciprocal and dependent. If the promisor who has to perform his promise before the performance of the other's promise fails to perform it, he cannot claim performance of the other's promise, and is also liable for compensation for his non- performance.

Example 25: A hires B's ship to take in and convey, from Kolkata to the Mauritius, a cargo to be provided by A, B receiving a certain freight for its conveyance. A does not provide any cargo for the ship. A cannot claim the performance of B's promise, and must make compensation to B for the loss which B sustains by the non-performance of the contract.

Example 26: A hires B to make a shoe rack. A will supply the plywood, fevicol and other items required for making the shoe rack. B arrived on the appointed day and time but A could not arrange for the required materials. A cannot claim the performance of B's promise, and must make compensation to B for the loss which B sustains by the non-performance of the contract.

(v) Effects of Failure to Perform at a Time Fixed in a Contract in which Time is Essential (Section 55)

The law on the subject is contained in Section 55 which is reproduced below:

"When a party to a contract promises to do certain thing at or before the specified time, and fails to do any such thing at or before the specified time, the contract, or so much of it as has not been performed, becomes voidable at the option of the promisee, if the intention of the parties was that time should be of essence of the contract".

Effect of such failure when time is not essential

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.

Effect of acceptance of performance at time other than agreed upon -

If, in case of a contract voidable on account of the promisor's failure to perform his promise at the time agreed, the promisee accepts performance of such promise at any time other than 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 acceptance, he gives notice to the promisor of his intention to do so.

(vi) Agreement to do Impossible Act (Section 56)

The impossibility of performance may be of the two types, namely (a) initial impossibility, and (b) subsequent impossibility.

(a) Initial Impossibility (Impossibility existing at the time of contract): When the parties agree upon doing of something which is obviously impossible in itself the agreement would be void. Impossible in itself means impossible in the nature of things. The fact of impossibility may be and may not be known to the parties.

Example 27: 'A', a Hindu, who was already married, contracted to marry 'B', a Hindu girl. According to law, 'A' being married, could not marry 'B'. In this case, 'A' must make compensation to 'B' for the loss caused to her by the non-performance of the contract.

(1) **If known to the parties:** It would be observed that an agreement constituted, quite unknown to the parties, may be impossible of being performed and hence void.

Example 28: B promises to pay a sum of ₹ 5,00,000 if he is able to swim across the Indian Ocean from Mumbai to Aden within a week. In this case, there is no real agreement, since both the parties are quite certain in their mind that the act is impossible of achievement. Therefore, the agreement, being impossible in itself, is void.

(2) **If unknown to the parties:** Where both the promisor and the promisee are ignorant of the impossibility of performance, the contract is void.

Example 29: A contracted B to sell his brown horse for ₹ 2,50,000 both unaware that the horse was dead a day before the agreement.

(3) **If known to the promisor only:** Where at the time of entering into a contract, the promisor alone knows about the impossibility of performance, or even if he does not know though he should have known it with reasonable diligence, the promisee is entitled to claim compensation for any loss he suffered on account of non-performance.

(b) **Subsequent or Supervening impossibility (Becomes impossible after entering into contract):** When performance of promise become impossible or illegal by occurrence of an unexpected event or a change of circumstances beyond the contemplation of parties, the contract becomes void e.g. change in law etc. In other words, sometimes, the performance of a contract is quite possible when it is made. But subsequently, some event happens which renders the performance impossible or unlawful. ***Such impossibility is called the subsequent or supervening. It is also called the post-contractual impossibility.*** The effect of such impossibility is that it makes the contract void, and the parties are discharged from further performance of the contract.

Example 30: 'A' and 'B' contracted to marry each other. Before the time fixed for the marriage, 'A' became mad. In this case, the contract becomes void due to subsequent impossibility, and thus discharged.

(vii) Reciprocal promise to do certain things that are legal, and also some other things that are illegal- Section 57

Where persons reciprocally promise, first to do certain things which are legal and secondly, under specified circumstances, to do certain other things which are illegal, the first set of promises is a valid contract, but the second is a void agreement.

Example 31: A and B agree that A will sell a house to B for ₹ 50,00,000 and also that if B uses it as a gambling house, he will pay a further sum of ₹ 75,00,000. The first set of reciprocal promises, i.e. to sell the house and to pay ₹ 50,00,000 for it, constitutes a valid contract. But the object of the second, being unlawful, is void.

(viii) 'Alternative promise' one branch being illegal- Section 58

The law on this point is contained in Section 58 which says that "In the case of the alternative promise, one branch of which is legal and the other illegal, the legal branch alone can be enforced".

Example 32: A and B agree that A shall pay B ₹ 1,00,000, for which B shall afterwards deliver to A either rice or smuggled opium.

This is a valid contract to deliver rice, and a void agreement as to the opium.

4.8 APPROPRIATION OF PAYMENTS

Sometimes, a debtor owes several debts to the same creditor and makes payment, which is not sufficient to discharge all the debts. In such cases, the payment is appropriated (i.e. adjusted against the debts) as per **Section 59 to 61** of the Indian Contract Act.

(i) Application of payment where debt to be discharged is indicated (Section 59): Where a debtor, owing several distinct debts to one person, makes a payment to him either with express intimation or under circumstances implying that the payment is to be applied to the discharge of some particular debt, the payment, if accepted, must be applied accordingly.

(ii) Application of payment where debt to be discharged is not indicated (Section 60): Where the debtor has omitted to intimate and there are no other circumstances indicating to which debt the payment is to be applied the creditor may apply it at his discretion to any lawful debt actually due and payable to him from the debtor, where its recovery is or is not barred by the law in force for the time being as to the limitation of suits. However, he cannot apply the payment to the disputed debt.

(iii) Application of payment where neither party appropriates (Section 61): Where neither party makes any appropriation, the payment shall be applied in discharge of the debts in order of time, whether they are or are not barred by the law in force for the time being as to the limitation of suits. If the debts are of equal standing, the payments shall be applied in discharge of each proportionately.

4.9 CONTRACTS, WHICH NEED NOT BE PERFORMED – WITH THE CONSENT OF BOTH THE PARTIES

Under this heading, we shall discuss the principles of Novation, Rescission and Alteration. The law is contained in Sections 62 to 67 of the Contract Act.

(i) Effect of novation, rescission, and alteration of contract (Section 62)

"If the parties to a contract agree to substitute a new contract for it, or to rescind or alter it, the original contract need not be performed".

Analysis of Section 62

(a) Effect of novation: The parties to a contract may substitute a new contract for the old. If they do so, it will be a case of novation. On novation, the old contract is discharged and consequently it need not be performed. Thus, it is a case where there being a contract in existence some new contract is substituted for it either between the same parties or between different parties the consideration mutually being the discharge of old contract. Novation can take place only by mutual agreement between the parties.

Example 33: A owes B ₹ 100,000. A, B and C agree that C will pay B and he will accept ₹ 100,000 from C in lieu of the sum due from A. A's liability thereby shall come to an end, and the old contract between A and B will be substituted by the new contract between B and C.

(b) Effect of rescission: A contract is also discharged by rescission. When the parties to a contract agree to rescind it, the contract need not be performed. In the case of rescission, only the old contract is cancelled and no new contract comes to exist in its place. It is needless to point out that novation also involves rescission. Both in novation and in rescission, the contract is discharged by mutual agreement.

(c) Effect of alteration of contract: As in the case of novation and rescission, so also in a case where the parties to a contract agree to alter it, the original contract is rescinded, with the result that it need not be performed. In other

words, a contract is also discharged by alteration. The terms of contract may be so altered by mutual agreement that the alteration may have the effect of substituting a new contract for the old one. In other words, the distinction between novation and alteration is very slender.

Novation and alteration: The law pertaining to novation and alteration is contained in Sections 62 to 67 of the Indian Contract Act. In both these cases the original contract need not be performed. Still there is a difference between these two.

1. Novation means substitution of an existing contract with a new one. Novation may be made by changing in the terms of the contract or there may be a change in the contracting parties. But in case of alteration the terms of the contract may be altered by mutual agreement by the contracting parties but the parties to the contract will remain the same.

2. In case of novation there is altogether a substitution of new contract in place of the old contract. But in case of alteration it is not essential to substitute a new contract in place of the old contract. In alteration, there may be a change in some of the terms and conditions of the original agreement.

(ii) Promisee may waive or remit performance of promise (Section 63): "Every promisee may dispense with or remit, wholly or in part, the performance of the promise made to him, or may extend the time for such performance or may accept instead of it any satisfaction which he thinks fit". In other words, a contract may be discharged by remission.

Example 34: A owes B ₹5,00,000. A pays to B, and B accepts, in satisfaction of the whole debt, ₹ 2,00,000 paid at the time and place at which the ₹ 5,00,000 were payable. The whole debt is discharged.

(iii) Restoration of Benefit under a Voidable Contract (Section 64)

The law on the subject is "When a person at whose option a contract is voidable rescinds it, the other party thereto need not perform any promise therein contained in which he is the promisor. The party rescinding avoidable contract shall, if he has received any benefit thereunder from another party to such contract, restore such benefit, so far as may be, to the person from whom it was received".

Analysis of Section 64

Such a contract can be terminated at the option of the party who is empowered to do so. If he has received any benefit under the contract, he must restore such benefit to the person from whom he has received it.

Example 35: An insurance company may rescind a policy on the ground that material fact has not been disclosed. When it does so, the premium collected by it in respect of the policy reduced by the amount of expenses incurred by it in this connection must be repaid to the policy holder.

(iv) Obligations of Person who has Received Advantage under Void Agreement or contract that becomes void (Section 65)

"When an agreement is discovered to be void or when a contract becomes void, any person who has received any advantage under such agreement or contract is bound to restore it, or to make compensation for it to the person from whom he received it."

Analysis of Section 65

From the language of the Section, it is clear that in such a case either the advantage received must be restored back or a compensation, sufficient to put the position prior to contract, should be paid.

Example 36: A pays B ₹ 1,00,000, in consideration of B's promising to marry C, A's daughter. C is dead at the time of the promise. The agreement is void, but B must repay A ₹ 1,00,000.

In a case, the plaintiff hired a godown from the defendant for twelve months and paid the whole of the rent in advance. After about seven months the godown was destroyed by fire, without any fault or negligence on the part of the plaintiff and the plaintiff claimed a refund of a proportionate amount of the rent. Held, the plaintiff was entitled to recover the rent for the unexpired term, of the contract.

The Act requires that a party must give back whatever he has received under the contract. The benefit to be restored under this section must be benefit received under the contract (and not any other amount). A agrees to sell land to B for ₹ 400,000. B pays to A ₹ 40,000 as a deposit at the time of the contract, the amount to be forfeited by A if B does not complete the sale within a specified period. B fails to complete the sale within the specified period, nor is he ready and willing to complete the sale within a reasonable time after the expiry of that period. A is entitled to rescind the contract and to retain the deposit. The deposit is not a benefit

received under the contract, it is a security that the purchaser would fulfil his contract and is ancillary to the contract for the sale of the land.

(v) **Communication of rescission (Section 66):** You have noticed that a contract voidable at the option of one of the parties can be rescinded; but rescission must be communicated to the other party in the same manner as a proposal is communicated under Section 4 of the Contract Act. Similarly, a rescission may be revoked in the same manner as a proposal is revoked.

(vi) **Effects of neglect of promisee to afford promisor reasonable facilities for performance (Section 67):** If any promisee neglects or refuses to afford the promisor reasonable facilities for the performance of his promise, the promisor is excused by such neglect or refusal as to any non-performance caused thereby.

Example 37: If an apprentice refuses to learn, the teacher cannot be held liable for not teaching.

Example 38: A contracts with B to repair B's house. B neglects or refuses to appoint out to A the places in which his house requires repair. A is excused for the non-performance of the contract, if it is caused by such neglect or refusal.

4.10 DISCHARGE OF A CONTRACT

A contract is discharged when the obligations created by it come to an end. A contract may be discharged in any one of the following ways:

(i) **Discharge by performance:** It takes place when the parties to the contract fulfil their obligations arising under the contract within the time and in the manner prescribed. Discharge by performance may be

(1) Actual performance; or

(2) Attempted performance.

Actual performance is said to have taken place, when each of the parties has done what he had agreed to do under the agreement. When the promisor offers to perform his obligation, but the promisee refuses to accept the performance, it amounts to attempted performance or tender.

Example 39: A contracts to sell his car to B on the agreed price. As soon as the car is delivered to B and B pays the agreed price for it, the contract comes to an end by performance.

Example 40: A contracted to supply certain quantity of timber to B. B made the supply of timber at appointed time and place but A refused to accept the delivery. This is called as attempted performance.

(ii) **Discharge by mutual agreement:** Section 62 of the Indian Contract Act provides if the parties to a contract agree to substitute a new contract for it, or to rescind or remit or alter it, the original contract need not be performed. The principles of Novation, Rescission, Alteration and Remission are already discussed.

Example 41: A owes B ₹ 1,00,000. A enters into an agreement with B and mortgage his (A's), estates for ₹ 50,000 in place of the debt of ₹ 1,00,000. This is a new contract and extinguishes the old.

Example 42: A owes B ₹ 5,00,000. A pays to B ₹ 3,00,000 who accepts it in full satisfaction of the debt. The whole is discharged.

(iii) **Discharge by impossibility of performance:** The impossibility may exist from the very start. In that case, it would be impossibility ab initio. Alternatively, it may supervene. Supervening impossibility may take place owing to:

(a) an unforeseen change in law;

(b) the destruction of the subject-matter essential to that performance;

(c) the non-existence or non-occurrence of particular state of things, which was naturally contemplated for performing the contract, as a result of some personal incapacity like dangerous malady;

(d) the declaration of a war (Section 56).

Example 43: A agrees with B to discover a treasure by magic. The agreement is void due to initial impossibility.

Example 44: A and B contract to marry each other. Before the time fixed for the marriage, A goes mad. The contract becomes void.

Example 45: A contracts to act at a theatre for six months in consideration of a sum paid in advance by B. On several occasions A is too ill to act. The contract to act on those occasions becomes void.

Example 46: X agrees to sell his horse to Y for ₹ 5,000 but the horse died in an accident. Here, it become impossible to perform the contract due to destruction of the subject. Thus, a valid contract changes into void contract because of impossibility of performance.

(iv) **Discharge by lapse of time:** A contract should be performed within a specified period as prescribed by the Limitation Act, 1963. If it is not performed and if no

action is taken by the promisee within the specified period of limitation, he is deprived of remedy at law.

Example 47: If a creditor does not file a suit against the buyer for recovery of the price within three years, the debt becomes time-barred and hence irrecoverable.

(v) **Discharge by operation of law:** A contract may be discharged by operation of law which includes by death of the promisor, by insolvency etc.

(vi) **Discharge by breach of contract:** Breach of contract may be actual breach of contract or anticipatory breach of contract. If one party defaults in performing his part of the contract on the due date, he is said to have committed breach thereof. When on the other hand, a person repudiates a contract before the stipulated time for its performance has arrived, he is deemed to have committed anticipatory breach. If one of the parties to a contract breaks the promise the party injured thereby, has not only a right of action for damages but he is also discharged from performing his part of the contract.

Example 48: A contracted with B to supply 100 kgs of rice on 1st June. But A failed to deliver the same on said date. This is actual breach of contract. If time is not essential essence of contract B can give him another date for supply of goods and he will not be liable to claim for any damages if prior notice for the same is not given to A while giving another date.

(vii) **Promisee may waive or remit performance of promise:** Every promisee may dispense with or remit, wholly or in part, the performance of the promise made to him, or may extend the time for such performance or may accept instead of it any satisfaction which he thinks fit. In other words, a contract may be discharged by remission. (Section 63)

Example 49: A owes B ₹ 5,00,000. C pays to B ₹1,00,000 and B accepts them, in satisfaction of his claim on A. This payment is a discharge of the whole claim.

(viii) **Effects of neglect of promisee to afford promisor reasonable facilities for performance:** If any promisee neglects or refuses to afford the promisor reasonable facilities for the performance of his promise, the promisor is excused by such neglect or refusal as to any non-performance caused thereby. (Section 67)

(ix) **Merger of rights:** Sometimes, the inferior rights and the superior rights coincide and meet in one and the same person. In such cases, the inferior rights merge into the superior rights. On merger, the inferior rights vanish and are not required to be enforced.

Example 50: A took a land on lease from B. Subsequently, A purchases that very land. Now, A becomes the owner of the land and the ownership rights being superior to rights of a lessee, the earlier contract of lease stands terminated.

SUMMARY

1. The promisor or his representative must perform unless the nature of contract shows that it may be performed by a third person, but the promisee may accept performance by a third party. (Sections 37, 40 and 41)
2. In case of joint promisors, all must perform, and after the death of any of them, the survivors and the representatives of the deceased must perform. But their liability is joint and several. If the promisee requires any one of them perform the whole promise, he can claim contribution from others. (Sections 42, 43 and 44)
3. Joint promisees have only a joint right to claim performance. (Section 45)
4. The promisor must offer to perform and such offer must be unconditional, and be made at the proper time and place, allowing the promisee a reasonable opportunity of inspection of the things to be delivered. (Sections 38, 46, 47, 48, 49 and 50)
5. If the performance consists of payment of money and there are several debts to be paid, the payment shall be appropriated as per provisions of Sections 59, 60 and 61. The debtor has, at the time of payment, the right of appropriating the payment. In default of debtor, the creditor has option of election and in default of either the law will allow appropriation of debts in order of time.
6. If an offer of performance is not accepted, the promisor is not responsible for non-performance and does not lose his rights under the contract; so also, if the promisee fails to afford reasonable facilities. He may sue for specific performance or he may avoid the contract and claim compensation (Sections 38, 39, 53 and 67).
7. Rescission is communicated and revoked in the same way as a promise. The effect is to dispense with further performance and to render the party rescinding liable to restore any benefit he may have received. (Sections 64 and 66)
8. Parties may agree to cancel the contract or to alter it or to substitute a new contract for it. (Section 62)

PERFORMANCE OF CONTRACTS (SEC.37)			
Meaning: Fulfillment of obligations to contract **Types** (i) Actual: Party actually fulfills the obligation. (ii) Tender Performance (Sec. 38): Promisor offers to perform his obligation under the contract at the proper time and place but the promisee refuses to accept the performance.	**Condition for a Valid Tender Performance** 1.Must be unconditional. 2.At proper time & Place. 3.Reasonable opportunity to examine goods. 4. For whole obligation.	**By Whom** 1. Promisor himself 2. Agent: Where contract doesn't involve personal skills. 3. Legal Representative: In case of death of promisor. However, if contract involves personal skill, it comes to an end with death of promisor. 4. Third persons: When promisee accepts performance from a third person, he cannot afterward enforce it against promisor.	**Performance of Joint Promises** 1. All joint promisors are liable jointly and severally. However Contract may provide otherwise. 2. In case of death of any joint promisor, legal representative with surviving joint promisors jointly fulfill the promise. 3. One has right of contribution from others. 4. If one of the joint promisors is released, he is responsible to the other joint promisor or promisors.
Time place and manner: As decided otherwise during business hours at business place or residence of promise.			

Performance of Reciprocal Promises

1. Mutual and Concurrent- Promises have to be simultaneously performed.

2. Mutual and Dependent-If the promisor, who must perform, fails to perform it, he cannot claim the performance of the reciprocal promise.

3. Mutual and Independent- Each party must perform his promise without waiting for the performance or readiness to perform on the part of the other.

Note1: Where contract is not complete in time &:-

(a) Time is essential – Contract is voidable.

(b) Time is not essential – Contract not voidable but compensation is there.

Note2: Contract to do impossible act is void.

Note3: Reciprocal promises to do things legal and also other things illegal-first set of promises is a contract but second is a void agreement.

Appropriation of Payment (Adjustment of Payment Against Debt)

Rule1: Appropriation by Debtor-if accepted, must be applied to that debt.

Rule2: Appropriation by Creditor-Debtor does not intimate, the creditor may apply it at his discretion to any lawful debt including a time-barred debt. (But not to a disputed debt)

Rule3: Where neither party appropriates – neither party makes any appropriation the payment is to be applied in discharge of the debts in order of time, including time-barred debts. If the debts are equal the payment is to be applied proportionately.

Contracts which need not be performed

1. If the parties mutually agree to substitute the original contract by a new one or to rescind or alter it.

2. If the promise dispenses with or remits, wholly or in part the performance of the promise made to or extends the time for such performance or accepts any satisfaction for it.

3. If the person, at whose option the contract is voidable, rescinds it.

4. If the promisee neglects or refuses.

5. If it is illegal.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *On the valid performance of the contractual obligations by the parties, the contract*
   - *(a) Is discharged*
   - *(b) becomes enforceable*
   - *(c) becomes void*
   - *(d) None of these*
2. *Which of the following person can perform the contract?*
   - *(a) Promisor alone*
   - *(b) Legal representatives of promisor*
   - *(c) Agent of the promisor*
   - *(d) All of these.*
3. *A contract is discharged by novation which means the*
   - *(a) cancellation of the existing contract*
   - *(b) change in one or more terms of the contract*
   - *(c) substitution of existing contract for a new one*
   - *(d) none of these*
4. *A contract is discharged by rescission which means the*
   - *(a) change in one or more terms of the contract*
   - *(b) acceptance of lesser performance*
   - *(c) abandonment of rights by a party*
   - *(d) cancellation of the existing contract*
5. *If a person accepts a lesser sum of money than what was contracted for in discharge of the whole debt, it is known as:*
   - *(a) Waiver*
   - *(b) Rescission*
   - *(c) Alteration*
   - *(d) Remission*

6. *Novation discharges a contract*

   (a) *No, it means, no new contract comes to existence*

   (b) *No, it means, new contract comes to existence, but old contract is not discharged*

   (c) *Yes, on novation, old contract is discharged and consequently it need not be performed*

   (d) *Yes, but only if parties agreed to discharge.*

7. *Novation and alteration are same*

   (a) *True, both result in discharging old contract.*

   (b) *False, novation discharges old contract, in alteration, the obligation remains.*

   (c) *False, however, both may have the effect of substituting a new contract for the old one*

   (d) *None of the above*

8. *A, B and C jointly promised to pay ₹60,000 to D. before performance of the contract, C dies. Here, the contract*

   (a) *Becomes void on C's death*

   (b) *Should be performed by A and B along with C's legal representatives*

   (c) *Should be performed by A and B alone*

   (d) *Should be renewed between A, B and D.*

9. *Vivaan lives on rent in a house owned by Swasti. Later he purchases the house from Swasti. The rent agreement is discharged due to:*

   (a) *Waiver of rights*

   (b) *Novation of contract*

   (c) *Merger of rights*

   (d) *Remission of contract*

10. *When prior to the due date of performance, the promisor refuses to perform the contract, it is known as:*

    (a) *Novation of the contract*

    (b) *Anticipatory breach of contract*

(c) *Actual breach of contract*

(d) *waiver of contract*

11. *A owes ₹ 15000 to B. A die leaving his estate of ₹ 12000. Legal representatives of A are:*

(a) *liable to pay ₹ 12000 to B*

(b) *liable to pay ₹ 15000 to B*

(c) *not liable to pay B*

(d) *liable to pay ₹ 3000 to B*

12. *Rani contracted to teach dance to Shruti. Shruti paid an advance of ₹ 5000 for the same. Rani met with an accident and will not be able to dance. She has a daughter as her legal representative. Shruti can*

(a) *force her daughter to teach her dance*

(b) *rescind the contract and ask for refund of money*

(c) *rescind the contract but cannot ask for refund*

(d) *can sue Rani for non-performance of contract*

Descriptive Questions

1. *X, Y and Z jointly borrowed ₹ 50,000 from A. The whole amount was repaid to A by Y. Decide in the light of the Indian Contract Act, 1872 whether:*

(i) *Y can recover the contribution from X and Z,*

(ii) *Legal representatives of X are liable in case of death of X,*

(iii) *Y can recover the contribution from the assets, in case Z becomes insolvent.*

2. *Mr. Rich aspired to get a self-portrait made by an artist. He went to the workshop of Mr. C an artist and asked whether he could sketch the former's portrait on oil painting canvass. Mr. C agreed to the offer and asked for ₹ 50,000 as full advance payment for the above creative work. Mr. C clarified that the painting shall be completed in 10 sittings and shall take 3 months.*

On reaching to the workshop for the 6th sitting, Mr. Rich was informed that Mr. C became paralyzed and would not be able to paint for near future. Mr. C had a son Mr. K who was still pursuing his studies and had not taken up his father's profession yet?

Discuss in light of the Indian Contract Act, 1872?

(i) Can Mr. Rich ask Mr. K to complete the artistic work in lieu of his father?

(ii) Could Mr. Rich ask Mr. K for refund of money paid in advance to his father?

3. *Mr. JHUTH entered into an agreement with Mr. SUCH to purchase his (Mr. SUCH's) motor car for ₹ 5,00,000/- within a period of three months. A security amount of ₹ 20,000/- was also paid by Mr. JHUTH to Mr. SUCH in terms of the agreement. After completion of three months of entering into the agreement, Mr. SUCH tried to contract Mr. JHUTH to purchase the car in terms of the agreement. Even after lapse of another three month period, Mr. JHUTH neither responded to Mr. SUCH, nor to his phone calls. After lapse of another period of six months. Mr. JHUTH contracted Mr. SUCH and denied to purchase the motor car. He also demanded back the security amount of ₹ 20,000/- from Mr. SUCH. Referring to the provisions of the Indian Contract Act, 1872, state whether Mr. SUCH is required to refund the security amount to Mr. JHUTH.*

Also examine the validity of the claim made by Mr. JHUTH, if the motor car would have destroyed by an accident within the three month's agreement period.

4. *Mr. Murari owes payment of 3 bills to Mr. Girdhari as on 31st March, 2022. (i) ₹ 12,120 which was due in May 2018. (ii) ₹ 5,650 which was due in August 2020 (iii) ₹ 9,680 which was due in May 2021. Mr. Murari made payment on 1st April 2022 as below without any notice of how to appropriate them:*

(i) A cheque of ₹ 9,680

(ii) A cheque of ₹ 15,000

Advice under the provisions of the Indian Contract Act, 1872.

5. *What will be rights with the promisor in following cases? Explain with reasons:*

(a) Mr. X promised to bring back Mr. Y to life again.

(b) A agreed to sell 50 kgs of apple to B. The loaded truck left for delivery on 15th March but due to riots in between reached A on 19th March.

(c) An artist promised to paint on the fixed date for a fixed amount of remuneration but met with an accident and lost his both hands.

(d) Abhishek entered into contract of import of toys from China. But due to disturbance in the relation of both the countries, the imports from China were banned.

ANSWER/HINTS

Answers to MCQs

1.	**(a)**	2.	**(d)**	3.	**(c)**	4.	**(d)**	5.	**(d)**	6.	**(c)**
7.	**(c)**	8.	**(b)**	9.	**(c)**	10.	**(b)**	11.	**(a)**	12.	**(b)**

Answer to the Descriptive Question

1. Section 42 of the Indian Contract Act, 1872 requires that when two or more persons have made a joint promise, then, unless a contrary intention appears from the contract, all such persons jointly must fulfill the promise. In the event of the death of any of them, his representative jointly with the survivors and in case of the death of all promisors, the representatives of all jointly must fulfill the promise.

Section 43 allows the promisee to seek performance from any of the joint promisors. The liability of the joint promisors has thus been made not only joint but "joint and several". Section 43 provides that in the absence of express agreement to the contrary, the promisee may compel any one or more of the joint promisors to perform the whole of the promise.

Section 43 deals with the contribution among joint promisors. The promisors, may compel every joint promisor to contribute equally to the performance of the promise (unless a contrary intention appears from the contract). If any one of the joint promisors makes default in such contribution the remaining joint promisors must bear the loss arising from such default in equal shares.

As per the provisions of above sections,

(i) Y can recover the contribution from X and Z because X, Y and Z are joint promisors.

(ii) Legal representative of X are liable to pay the contribution to Y. However, a legal representative is liable only to the extent of property of the deceased received by him.

(iii) Y also can recover the contribution from Z's assets.

2. A contract which involves the use of personal skill or is founded on personal consideration comes to an end on the death of the promisor. As regards any other contract the legal representatives of the deceased promisor are bound to perform it unless a contrary intention appears from the contract (Section 37 of the Indian

Contract Act, 1872). But their liability under a contract is limited to the value of the property they inherit from the deceased.

(i) In the instant case, since painting involves the use of personal skill and on becoming Mr. C paralyzed, Mr. Rich cannot ask Mr. K to complete the artistic work in lieu of his father Mr. C.

(ii) According to section 65 of the Indian Contract Act, 1872, when an agreement is discovered to be void or when a contract becomes void, any person who has received any advantage under such agreement or contract is bound to restore it, or to make compensation for it to the person from whom he received it.

Hence, in the instant case, the agreement between Mr. Rich and Mr. C has become void because of paralysis to Mr. C. So, Mr. Rich can ask Mr. K for refund of money paid in advance to his father, Mr. C.

3. In terms of the provisions of Section 65 of the Indian Contract Act, 1872, when an agreement is discovered to be void or when a contract becomes void, any person who has received any advantage under such agreement or contract is bound to restore it, or to make compensation for it to the person from whom he received it.

Referring to the above provision, we can analyse the situation as under.

The contract is not a void contract. Mr. SUCH is not responsible for Mr. JHUTH's negligence. Therefore, Mr. SUCH can rescind the contract and retain the security amount since the security is not a benefit received under the contract, it is a security that the purchaser would fulfil his contract and is ancillary to the contract for the sale of the Motor Car.

Regarding the second situation given in the question, the agreement becomes void due to the destruction of the Motor car, which is the subject matter of the agreement here. Therefore, the security amount received by Mr. SUCH is required to be refunded back to Mr. JHUTH.

4. If the performance consists of payment of money and there are several debts to be paid, the payment shall be appropriated as per provisions of Sections 59, 60 and 61. The debtor has, at the time of payment, the right of appropriating the payment. In default of debtor, the creditor has option of election and in default of either the law will allow appropriation of debts in order of time.

In the present case, Mr. Murari had made two payments by way of two cheques. One cheque was exactly the amount of the bill drawn. It would be understood even though not specifically appropriated by Mr. Murari that it will be against the bill of

exact amount. Hence cheque of ₹9,680 will be appropriated against the bill of ₹ 9,680 which was due in May 2019.

Cheque of ₹ 15000 can be appropriated against any lawful debt which is due even though the same is time-barred.

Hence, Mr. Girdhari can appropriate the same against the debt of ₹12,120 which was due in 2016 and balance against ₹ 5650 which was due in August 2018.

5. **(a)** The contract is void because of its initial impossibility of performance.

(b) Time is essence of this contract. As by the time apples reached B they were already rotten. The contract is discharged due to destruction of subject matter of contract.

(c) Such contract is of personal nature and hence cannot be performed due to occurrence of an event resulting in impossibility of performance of contract.

(d) Such contract is discharged without performance because of subsequent illegality nature of the contract.

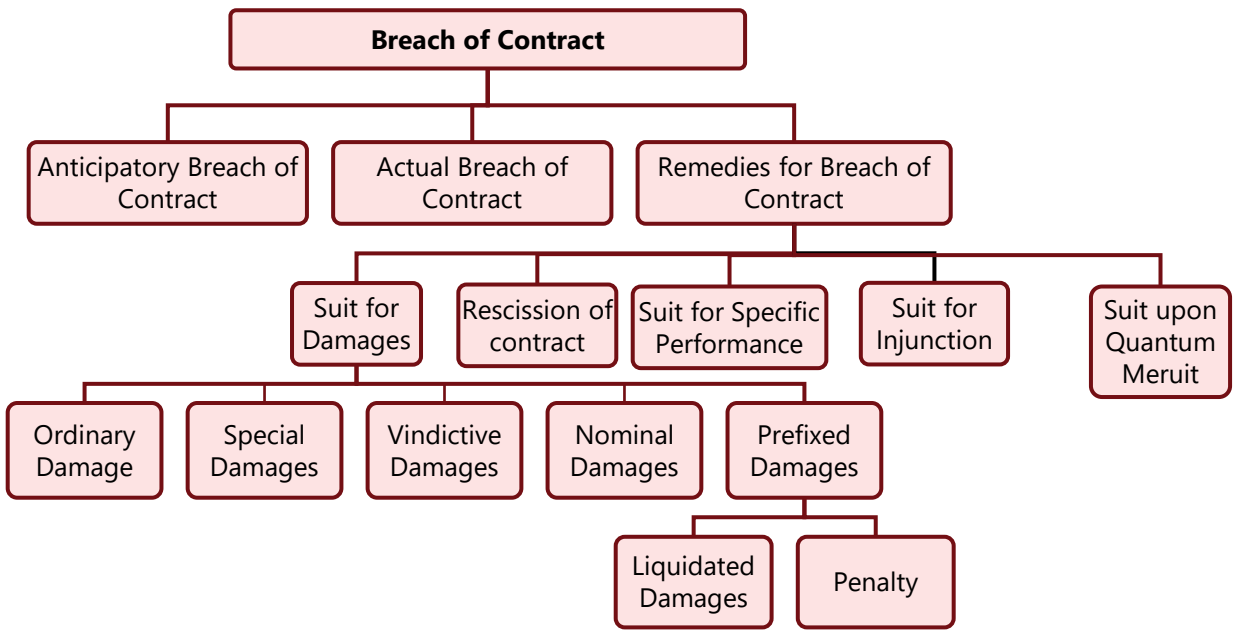
UNIT – 5: BREACH OF CONTRACT AND ITS REMEDIES

LEARNING OUTCOMES

After studying this Chapter, you will be able to understand:

- Concept of breach of contract and various modes thereof.
- How the damages are to be measured.

UNIT OVERVIEW



We have so far seen how a contract is made, the essential of a valid contract and also how a contract is to be performed as well as how a contract may be put an end. We shall now discuss about the breach of contract and also the mode in which compensation for breach of contract is estimated.

Breach means failure of a party to perform his or her obligation under a contract. Breach of contract may arise in two ways:

(1) Actual breach of contract

(2) Anticipatory breach of contract

5.1 ANTICIPATORY BREACH OF CONTRACT

An anticipatory breach of contract is a breach of contract occurring before the time fixed for performance has arrived. When the promisor refuses altogether to perform his promise and signifies his unwillingness even before the time for performance has arrived, it is called Anticipatory Breach.

Anticipatory breach of a contract may take either of the following two ways:

(a) Expressly by words spoken or written, and

(b) Impliedly by the conduct of one of the parties.

Example 1: Where A contracts with B on 15th July, 2022 to supply 10 bales of cotton for a specified sum on 14th August, 2022 and on 30th July informs B, that he will not be able to supply the said cotton on 14th August, 2022, there is an express rejection of the contract.

Example 2: Where A agrees to sell his white horse to B for ₹ 50,000/- on 10th of August, 2022, but he sells this horse to C on 1st of August, 2022, the anticipatory breach has occurred by the conduct of the promisor.

Section 39 of the Indian Contract Act deals with anticipatory breach of contract and provides as follows:

"When a party to a contract has refused to perform or disable himself from performing, his promise in its entirety, the promisee may put an end to the contract, unless he has signified, but words or conduct, his acquiescence in its continuance."

Effect of anticipatory breach: The promisee is excused from performance or from further performance. Further he gets an option:

(1) To either treat the contract as "rescinded and sue the other party for damages from breach of contract immediately without waiting until the due date of performance;

or

(2) He may elect not to rescind but to treat the contract as still operative and wait for the time of performance and then hold the other party responsible for the

consequences of non-performance. But in this case, he will keep the contract alive for the benefit of the other party as well as his own, and the guilty party, if he so decides on re-consideration, may still perform his part of the contract and can also take advantage of any supervening impossibility which may have the effect of discharging the contract.

5.2 ACTUAL BREACH OF CONTRACT

In contrast to anticipatory breach, it is a case of refusal to perform the promise on the scheduled date. The parties to a lawful contract are bound to perform their respective promises. But when one of the parties breaks the contract by refusing to perform his promise, he is said to have committed a breach. In that case, the other party to the contract obtains a right of action against the one who has refused to perform his promise.

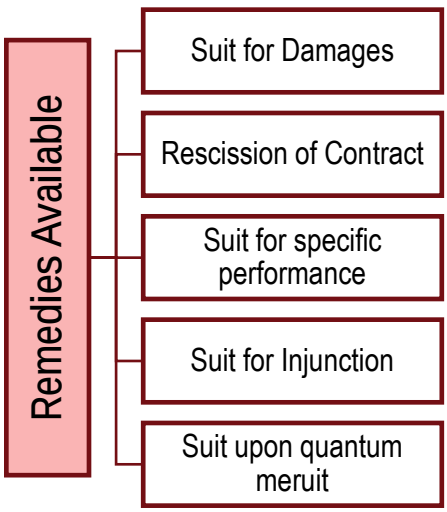
Actual breach of contract may be committed-

(a) At the time when the performance of the contract is due.

Example 3: A agrees to deliver 100 bags of sugar to B on 1st February 2022. On the said day, he failed to supply 100 bags of sugar to B. This is actual breach of contract. The breach has been committed by A at the time when the performance becomes due.

(b) During the performance of the contract: Actual breach of contract also occurs when during the performance of the contract, one party fails or refuses to perform his obligation under it by express or implied act.

Remedies for Breach of Contract



5.3 SUIT FOR DAMAGES

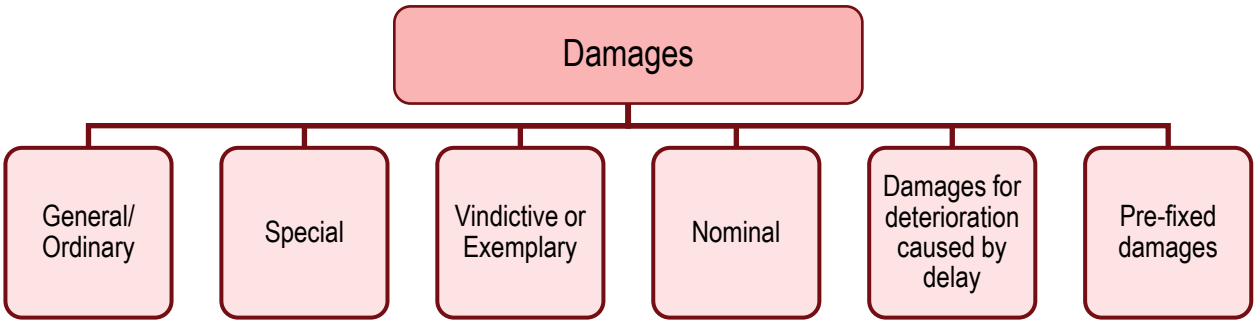
The Act in Section 73, has laid down the rules as to how the amount of compensation is to be determined. On the breach of the contract, the party who suffers from such a breach is entitled to receive, from the party who has broken the contract, compensation for any loss or damage caused to him by breach.

Compensation can be claimed for any loss or damage which naturally arises in the usual course of events.

A compensation can also be claimed for any loss or damage which the party knew when they entered into the contract, as likely to result from the breach.

That is to say, special damage can be claimed only on a previous notice. But the party suffering from the breach is bound to take reasonable steps to minimise the loss.

No compensation is payable for any remote or indirect loss.



(i) **Ordinary damages:** When a contract has been broken, the party who suffers by such breach is entitled to receive, from the party who has broken the contract, compensation for any loss or damage cause to him thereby, which naturally arose in the usual course of things from such breach, or which the parties know, when they made the contract, to be likely to result from the breach of it.

Such compensation is not to be given for any remote and indirect loss or damage sustained by reasons of the breach. ***(Section 73 of the Contract Act and the rule in Hadley vs. Baxendale).***

HADLEY vs. BAXENDALE- Facts

The crankshaft of P's flour mill had broken. He gives it to D, a common carrier who promised to deliver it to the foundry in 2 days where the new shaft was to be made. The mill stopped working, D delayed the delivery of the crankshaft so the mill remained idle for another 5 days. P received the repaired crankshaft 7 days later than he would have otherwise received. Consequently, P sued D for damages not only for

the delay in the delivering the broken part but also for loss of profits suffered by the mill for not having been worked. The count held that P was entitled only to ordinary damages and D was not liable for the loss of profits because the only information given by P to D was that the article to be carried was the broken shaft of a mill and it was not made known to them that the delay would result in loss of profits.

Example 4: A agrees to sell to B bags of rice at ₹ 5,000 per bag, delivery to be given after two months. On the date of delivery, the price of rice goes up to ₹ 5,500 per bag. A refuse to deliver the bags to B. B can claim from A ₹ 500 as ordinary damages arising directly from the breach.

(ii) **Special damages:** Where a party to a contract receives a notice of special circumstances affecting the contract, he will be liable not only for damages arising naturally and directly from the breach but also for special damages.

Example 5: 'A' delivered a machine to 'B', a common carrier, to be conveyed to 'A's mill without delay. 'A' also informed 'B' that his mill was stopped for want of the machine. 'B' unreasonably delayed the delivery of the machine, and in consequence 'A' lost a profitable contract with the Government. In this case, 'A' is entitled to receive from 'B', by way of compensation, the average amount of profit, which would have been made by running the mill during the period of delay. But he cannot recover the loss sustained due to the loss of the Government contract, as 'A's contract with the Government was not brought to the notice of 'B'.

(iii) **Vindictive or Exemplary damages**

These damages may be awarded only in two cases -

(a) for breach of promise to marry because it causes injury to his or her feelings; and

(b) for wrongful dishonour by a banker of his customer's cheque because in this case the injury due to wrongful dishonour to the drawer of cheque is so heavy that it causes loss of credit and reputation to him. A business man whose credit has suffered will get exemplary damages even if he has sustained no pecuniary loss. But a non-trader cannot get heavy damages in the like circumstances, unless the damages are alleged and proved as special damages. ***(Gibbons v West Minister Bank)***

(iv) **Nominal damages:** Nominal damages are awarded where the plaintiff has proved that there has been a breach of contract but he has not in fact suffered any real damage. It is awarded just to establish the right to decree for the breach of contract. The amount may be a rupee or even 10 paise.

(v) **Damages for deterioration caused by delay:** In the case of deterioration caused to goods by delay, damages can be recovered from carrier even without notice. The word 'deterioration' not only implies physical damages to the goods but it may also mean loss of special opportunity for sale.

(vi) **Pre-fixed damages:** Sometimes, parties to a contract stipulate at the time of its formation that on a breach of contract by any of them, a certain amount will be payable as damage. It may amount to either liquidated damages (i.e., a reasonable estimate of the likely loss in case of breach) or a penalty (i.e., an amount arbitrarily fixed as the damages payable). Section 74 provides that if a sum is named in a contract as the amount to be paid in case of a breach, the aggrieved party is entitled to receive from the party at fault a reasonable compensation not exceeding the amount so named (Section 74).

Example 6: If the penalty provided by the contract is ₹ 1,00,000 and the actual loss because of breach is ₹ 70,000, only ₹ 70,000 shall be available as damages, i.e., the amount of actual loss and not the amount stipulated. But if the loss is, say, ₹ 1,50,000, then only, ₹ 1,00,000 shall be recoverable.

Example 7: X promised Y, a priest, to pay ₹ 10,000 as charity. The priest on X's promise incurred certain liabilities towards the repairing of the temple to the extent of Rs. 7,500. Y, the priest, can recover from X ₹ 7,500.

5.4 PENALTY AND LIQUIDATED DAMAGES (SECTION 74)

The parties to a contract may provide before hand, the amount of compensation payable in case of failure to perform the contract. In such cases, the question arises whether the courts will accept this figure as the measure of damage.

English Law: According to English law, the sum so fixed in the contract may be interpreted either as liquidated damages or as a penalty.

If the sum fixed in the contract represents a genuine pre-estimate by the parties of the loss, which would be caused by a future breach of the contract it is liquidated damages. It is an assessment of the amount which in the opinion of the parties will compensate for the breach. Such a clause is effective and the amount is recoverable. But where the sum fixed in the contract is unreasonable and is used to force the other party to perform the contract; it is penalty. Such a clause of disregarded and the injured party cannot recover more than the actual loss.

Indian Law: Indian law makes no distinction between 'penalty 'and liquidated damages'. The Courts in India award only a reasonable compensation not exceeding the sum so mentioned in the contract. Section 74 of the Contract Act lays down if the parties have fixed what the damages will be, the courts will never allow more. But the court may allow less. A decree is to be passed only for reasonable compensation not exceeding the sum named by the parties. Thus, Section 74 entitles a person complaining of breach of contract to get reasonable compensation and does not entitle him to realise anything by way of penalty.

Exception: Where any person gives any bond to the Central or State government for the performance of any public duty or act in which the public are interested, on breach of the condition of any such instrument, he shall be liable to pay the whole sum mentioned therein.

Example 8: A contracts with B, that if A practices as a surgeon in Kolkata, he will pay B ₹ 50,000. A practice as a surgeon at Kolkata, B is entitled to such compensation not exceeding ₹ 50,000 as the court considers reasonable.

Example 9: A borrows ₹ 10,000 from B and gives him a bond for ₹ 20,000 payable by five yearly instalments of ₹ 4,000 with a stipulation that in default of payment, the whole shall become due. This is a stipulation by way of penalty.

Example 10: A undertakes to repay B, a loan of ₹ 10,000 by five equal monthly instalments with a stipulation that in default of payment of any instalment, the whole shall become due. This stipulation is not by way of penalty and the contract may be enforced according to its terms.

Distinction between liquidated damages and penalty

Penalty and liquidated damages have one thing in common that both are payable on the occurrence of a breach of contract. It is very difficult to draw a clear line of distinction between the two but certain principles as laid down below may be helpful.

1. If the sum payable is so large as to be far in excess of the probable damage on breach, it is certainly a penalty.
2. Where a sum is expressed to be payable on a certain date and a further sum in the event of default being made, the latter sum is a penalty because mere delay in payment is unlikely to cause damage.
3. The expression used by the parties is not final. The court must find out whether the sum fixed in the contract is in truth a penalty or liquidated damages. If the sum fixed is extravagant or exorbitant, the court will regard it is as a penalty even if, it is termed as liquidated damages in the contract.
4. The essence of a penalty is payment of money stipulated as a terrorem of the offending party. The essence of liquidated damages is a genuine pre-estimate of the damage.

5. English law makes a distinction between liquidated damages and penalty, but no such distinction is followed in India. The courts in India must ascertain the actual loss and award the same which amount must not, however exceed the sum so fixed in the contract. The courts have not to bother about the distinction but to award reasonable compensation not exceeding the sum so fixed.

Besides claiming damages as a remedy for the breach of contract, the following remedies are also available:

(i) **Rescission of contract:** When a contract is broken by one party, the other party may treat the contract as rescinded. In such a case, he is absolved of all his obligations under the contract and is entitled to compensation for any damages that he might have suffered.

Example 11: A promises B to deliver 50 bags of cement on a certain day. B agrees to pay the amount on receipt of the goods. A failed to deliver the cement on the appointed day. B is discharged from his liability to pay the price.

(ii) **Quantum Meruit:** Where one person has rendered service to another in circumstances which indicate an understanding between them that it is to be paid for although no particular remuneration has been fixed, the law will infer a promise to pay. *Quantum Meruit* i.e. as much as the party doing the service has deserved. It covers a case where the party injured by the breach had at time of breach done part but not all of the work which he is bound to do under the contract and seeks to be compensated for the value of the work done. For the application of this doctrine, two conditions must be fulfilled:

(1) It is only available if the original contract has been discharged.

(2) The claim must be brought by a party not in default.

The object of allowing a claim on quantum meruit is to recompensate the party or person for value of work which he has done. Damages are compensatory in nature while quantum merit is restitutory. It is but reasonable compensation awarded on implication of a contract to remunerate. Where a person orders only 12 bottles of a whiskey from a wine merchant but also receives 2 bottles of brandy, and the purchaser accepts them, the purchaser must pay a reasonable price for the brandy.

The claim for quantum meruit arises in the following cases:

(a) When an agreement is discovered to be void or when a contract becomes void.

(b) When something is done without any intention to do so gratuitously.

(c) Where there is an express or implied contract to render services but there is no agreement as to remuneration.

(d) When one party abandons or refuses to perform the contract.

(e) Where a contract is divisible and the party not in default has enjoyed the benefit of part performance.

(f) When an indivisible contract for a lump sum is completely performed but badly the person who has performed the contract can claim the lump sum, but the other party can make a deduction for bad work.

Example 12: X wrongfully revoked Y's (his agent) authority before Y could complete his duties. Held, Y could recover, as a quantum meruit, for the work he had done and the expenses he had incurred in the course of his duties as an agent.

Example 13: A agrees to deliver 100 bales of cottons to B at a price of ₹ 1000 per bale. The cotton bales were to be delivered in two instalments of 50 each. A delivered the first instalment but failed to supply the second. B must pay for 50 bags.

(iii) **Suit for specific performance:** Where damages are not an adequate remedy in the case of breach of contract, the court may in its discretion on a suit for specific performance direct party in breach, to carry out his promise according to the terms of the contract.

(iv) **Suit for injunction:** Where a party to a contract is negating the terms of a contract, the court may by issuing an 'injunction orders', restrain him from doing what he promised not to do.

Example 14: N, a film star, agreed to act exclusively for a particular producer, for one year. During the year she contracted to act for some other producer. Held, she could be restrained by an injunction.

Example 15: A, a singer, agreed with B to perform at his theatre for two months, on a condition that during that period, he would not perform anywhere. In this case, B could move to the Court for grant of injunction restraining A from performing in other places.

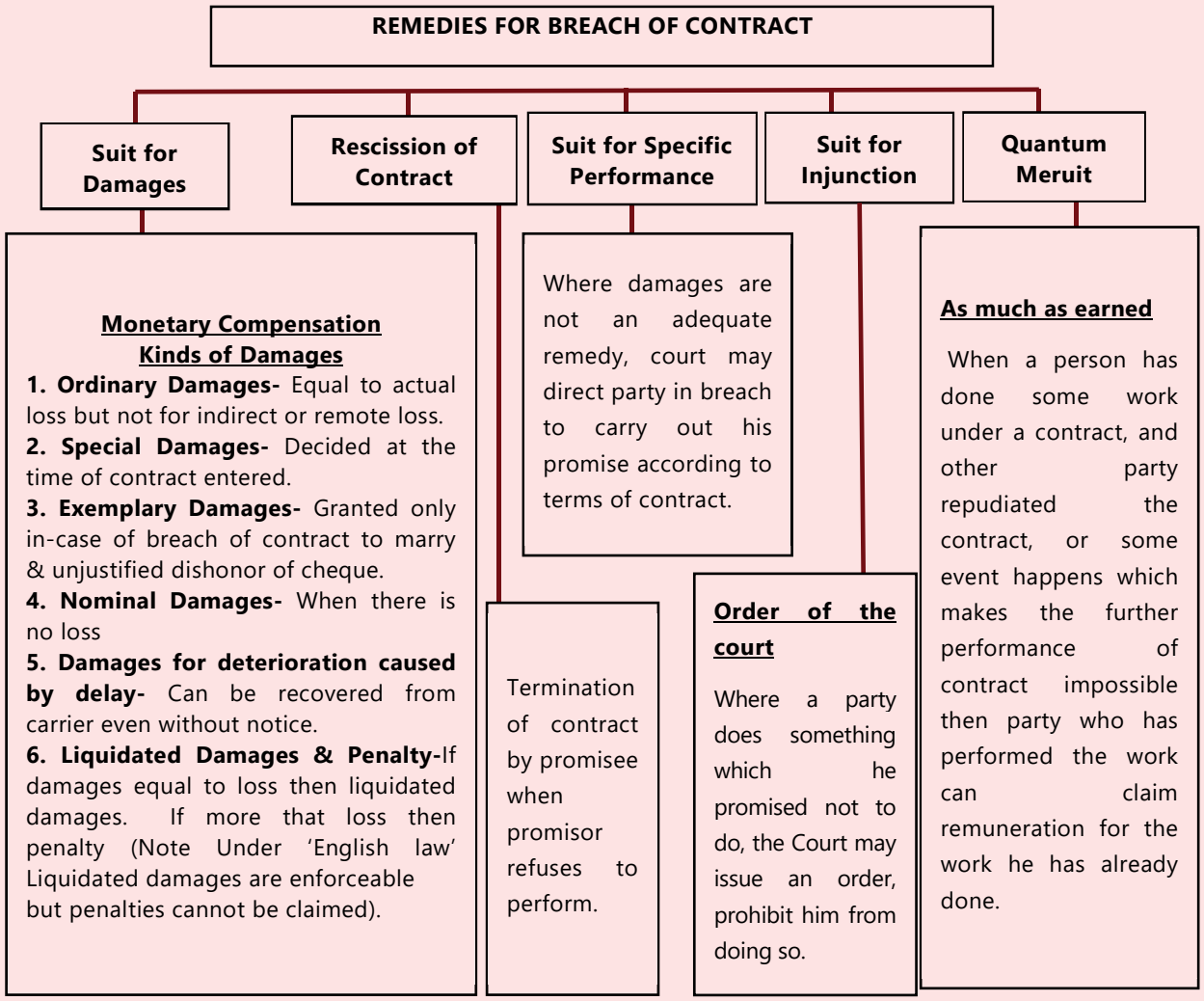
Party rightfully rescinding contract, entitled to compensation (Section 75)

A person who rightfully rescinds a contract is entitled to compensation for any damage which he has sustained through non-fulfilment of the contract.

Example 16: A, a singer, contracts with B, the manager of a theatre, to sing at his theatre for two nights in every week during the next two months, and B engages to pay her ₹ 10000 for each night's performance. On the sixth night, A wilfully absents herself from the theatre, and B, in consequence, rescinds the contract. B is entitled to claim compensation for the damage which he has sustained through the non-fulfilment of the contract.

SUMMARY

1. In case of breach of contract by one party, the other party need not perform his part of the contract and is entitled to compensation for the loss occurred to him.
2. Damages for breach of contract must be such loss or damage as naturally arise, in the usual course of things or which had been reasonably supposed to have been in contemplation of the parties when they made the contract, as the probable result of the breach.
3. Any other damages are said to be remote or indirect damages, hence, cannot be claimed.



TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *When prior to the due date of performance, the promisor absolutely refuses to perform the contract, it is known as*

   (a) abandonment of contract

   (b) remission of contract

   (c) actual breach of contract

   (d) anticipatory breach of contract

2. *In case of anticipatory breach, the aggrieved party may treat the contract*

   (a) as discharged and bring an immediate action for damages

   (b) as operative and wait till the time for performance arrives

   (c) exercise option either (a) or (b)

   (d) only option (a) is available

3. *In case of breach of contract, which of the following remedy is available to the aggrieved party?*

   (a) Suit for rescission

   (b) Suit for damages

   (c) Suit for specific performance

   (d) All of these

4. *Sometimes, a party is entitled to claim compensation in proportion to the work done by him. It is possible by a suit for*

   (a) damage

   (b) injunction

   (c) quantum meruit

   (d) none of these

5. *Generally, the following damages are not recoverable?*

   (a) Ordinary damages

   (b) Special damages

(c) *Remote damages*

(d) *Nominal damages*

6. *Damages which arise naturally in usual course of things from breach itself are called:*

(a) *Special damages*

(b) *Liquidated damages*

(c) *Nominal damages*

(d) *General damages*

7. *A contracted to supply 200 bags of rice to B on 30th December, 2021. After supplying 20 bags of rice. A informed B that he will not supply remaining bags of rice to B. In this case,*

(a) *There is anticipatory breach of contract*

(b) *There is actual breach of contract*

(c) *Both of the above*

(d) *None of the above*

8. *Where the Court orders the defaulting party to carry out the promise according to the terms of the contract, it is called*

(a) *Quantum Meruit*

(b) *Rescission*

(c) *Injunction*

(d) *Specific Performance*

9. *Quantum Meruit means*

(a) *a non-gratuitous promise*

(b) *as gratuitous promise*

(c) *as much as is earned*

(d) *as much as is paid*

10. *Wrongful dishonour of cheque by a banker having sufficient funds in the account of customer, the court may award:*

(a) *Mitigation of damages*

(b) *contemptuous damages*

(c) *Quantum Meruit*

(d) *exemplary damages*

Descriptive Questions

1. *"An anticipatory breach of contract is a breach of contract occurring before the time fixed for performance has arrived". Discuss stating also the effect of anticipatory breach on contracts.*

2. *"Liquidated damage is a genuine pre-estimate of compensation of damages for certain anticipated breach of contract whereas Penalty on the other hand is an extravagant amount stipulated and is clearly unconscionable and has no comparison to the loss suffered by the parties". Explain.*

3. *'X' entered into a contract with 'Y' to supply him 1,000 water bottles @ ₹5.00 per water bottle, to be delivered at a specified time. Thereafter, 'X' contracts with 'Z' for the purchase of 1,000 water bottles @ ₹4.50 per water bottle, and at the same time told 'Z' that he did so for the purpose of performing his contract entered into with 'Y'. 'Z' failed to perform his contract in due course and market price of each water bottle on that day was ₹5.25 per water bottle. Consequently, 'X' could not procure any water bottle and 'Y' rescinded the contract. Calculate the amount of damages which 'X' could claim from 'Z' in the circumstances? What would be your answer if 'Z' had not informed about the 'Y's contract? Explain with reference to the provisions of the Indian Contract Act, 1872.*

ANSWER/HINTS

Answers to MCQs

1.	**(d)**	2.	**(c)**	3.	**(d)**	4.	**(c)**	5.	**(c)**	6.	**(d)**
7.	**(b)**	8.	**(d)**	9.	**(c)**	10.	**(d)**				

Answer of Descriptive Questions

1. An anticipatory breach of contract is a breach of contract occurring before the time fixed for performance has arrived. When the promisor refuses altogether to perform his promise and signifies his unwillingness even before the time for performance has arrived, it is called Anticipatory Breach. The law in this regard has very well summed up in ***Frost v. Knight and Hochster v. DelaTour:***

Section 39 of the Indian Contract Act deals with anticipatory breach of contract and provides as follows: "When a party to a contract has refused to perform or disable himself from performing, his promise in its entirety, the promisee may put an end to

the contract, unless he has signified, but words or conduct, his acquiescence in its continuance."

Effect of anticipatory breach: The promisee is excused from performance or from further performance. Further he gets an option:

(1) To either treat the contract as "rescinded and sue the other party for damages from breach of contract immediately without waiting until the due date of performance; or

(2) He may elect not to rescind but to treat the contract as still operative, and wait for the time of performance and then hold the other party responsible for the consequences of non-performance. But in this case, he will keep the contract alive for the benefit of the other party as well as his own, and the guilty party, if he so decides on re-consideration, may still perform his part of the contract and can also take advantage of any supervening impossibility which may have the effect of discharging the contract.

2. **Liquidated damage** is a genuine pre-estimate of compensation of damages for certain anticipated breach of contract. This estimate is agreed to between parties to avoid at a later date detailed calculation and the necessity to convince outside parties.

Penalty on the other hand is an extravagant amount stipulated and is clearly unconscionable and has no comparison to the loss suffered by the parties.

In terms of Section 74 of the Act "where 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 contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not actual damages or loss is proved to have been caused thereby, to receive from the other party who has broken the contract, a reasonable compensation not exceeding the amount so named, or as the case may be the penalty stipulated for.

Explanation to Section 74

A stipulation for increased interest from the date of default may be a stipulation by way of penalty.

In terms of Section 74, courts are empowered to reduce the sum payable on breach whether it is 'penalty' or "liquidated damages" provided the sum appears to be unreasonably high.

Sri ChunniLal vs. Mehta & Sons Ltd (Supreme Court)

Supreme Court laid down the ratio that the aggrieved party should not be allowed to claim a sum greater than what is specific in the written agreement. But even then, the court has powers to reduce the amount if it considers it reasonable to reduce.

3. **Breach of Contract-Damages:** Section 73 of the Indian Contract Act, 1872 lays down that when a contract has been broken, the party who suffers by such breach is entitled to receive from the party who has broken the contract compensation for any loss or damage caused to him thereby which naturally arose in the usual course of things from such breach or which the parties knew when they made the contract to be likely to result from the breach of it.

The leading case on this point is *"Hadley vs. Baxendale"* in which it was decided by the Court that the special circumstances under which the contract was actually made were communicated by the plaintiff to the defendant, and thus known to both the parties to the contract, the damages resulting from the breach of such contract which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from the breach of contract under these special circumstances so known and communicated.

The problem asked in this question is based on the provisions of Section 73 of the Indian Contract Act, 1872. In the instant case 'X' had intimated to 'Z' that he was purchasing water bottles from him for the purpose of performing his contract with 'Y'. Thus, 'Z' had the knowledge of the special circumstances. Therefore, 'X' is entitled to claim from 'Z' ₹ 500/- at the rate of 0.50 paise i.e. 1000 water bottles x 0.50 paise (difference between the procuring price of water bottles and contracted selling price to 'Y') being the amount of profit 'X' would have made by the performance of his contract with 'Y'.

If 'X' had not informed 'Z' of 'Y's contract, then the amount of damages would have been the difference between the contract price and the market price on the day of default. In other words, the amount of damages would be ₹ 750/- (i.e. 1000 water bottles x 0.75 paise).

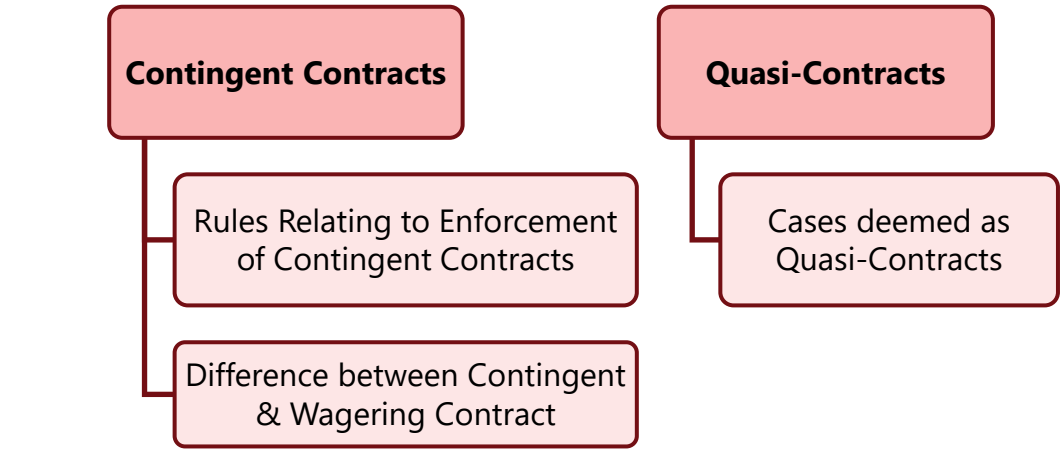
UNIT – 6: CONTINGENT AND QUASI CONTRACTS

LEARNING OUTCOMES

After studying this Chapter, you will be able to understand:

- Basic characteristics of 'Contingent contract' and 'Quasi-contract' so that you are able to distinguish between a contract of any of these types and a simple contract.
- Rules relating to enforcement of these in order to gain an understanding of rights and obligations of the parties to the contract.

UNIT OVERVIEW



6.1 CONTINGENT CONTRACTS

In this unit, we shall briefly examine what is called a 'contingent contract', its essentials and the rules regarding enforcement of this type of contracts. The Contract Act recognises certain cases in which an obligation is created without a contract. Such obligations arise out of certain relations which cannot be called as contracts in the strict sense. There is no offer, no acceptance, no *consensus ad idem* and in fact neither agreement nor promise and yet the

law imposes an obligation on one party and confers a right in favour of the other. We shall have a look on these cases of 'Quasi-contracts'.

A contract may be absolute or a contingent. An Absolute contract is one where the promisor undertakes to perform the contract in any event without any condition.

Definition of 'Contingent Contract' (Section 31)

"A contract to do or not to do something, if some event, collateral to such contract, does or does not happen".

Contracts of Insurance, indemnity and guarantee fall under this category.

Example 1: A contracts to pay B ₹ 10,00,000 if B's house is burnt. This is a contingent contract.

Example 2: A makes a contract with B to buy his house for ₹ 50,00,000 if he is able to secure to bank loan for that amount. The contract is contingent contract.

Meaning of collateral Event: ***Pollock and Mulla*** defined collateral event as "an event which is neither a performance directly promised as part of the contract, nor the whole of the consideration for a promise".

Example 3: A contracts to pay B ₹ 10,00,000 if B's house is burnt. This is a contingent contract. Here the burning of the B's house is neither a performance promised as part of the contract nor it is the consideration obtained from B. The liability of A arises only on the happening of the collateral event.

Example 4: A agrees to transfer his property to B if her wife C dies. This is a contingent contract because the property can be transferred only when C dies.

Essentials of a contingent contract

(a) **The performance of a contingent contract would depend upon the happening or non-happening of some event or condition.** The condition may be precedent or subsequent.

Example 5: 'A' promises to pay ₹ 50,000 to 'B' if it rains on first of the next month.

(b) **The event referred to as collateral to the contract.** The event is not part of the contract. The event should be neither performance promised nor a consideration for a promise.

Thus (i) where A agrees to deliver 100 bags of wheat and B agrees to pay the price only afterwards, the contract is a conditional contract and not contingent; because the event on which B's obligation is made to depend is part of the promise itself and not a collateral event. (ii) Similarly, where A promises to pay B ₹ 1,00,000 if he marries

C, it is not a contingent contract. (iii) 'A' agreed to construct a swimming pool for 'B' for ₹ 20,00,000. And 'B' agreed to make the payment only on the completion of the swimming pool. It is not a contingent contract as the event (i.e. construction of the swimming pool) is directly connected with the contract.

(c) **The contingent event should not be a mere 'will' of the promisor.** The event should be contingent in addition to being the will of the promisor.

Example 6: If A promises to pay B ₹ 100,000, if he so chooses, it is not a contingent contract. (In fact, it is not a contract at all). However, where the event is within the promisor's will but not merely his will, it may be contingent contract.

Example 7: If A promises to pay B ₹100,000 if it rains on 1st April and A leave Delhi for Mumbai on a particular day, it is a contingent contract, because going to Mumbai is an event no doubt within A's will, but raining is not merely his will.

(d) **The event must be uncertain.** Where the event is certain or bound to happen, the contract is due to be performed, then it is a not contingent contract.

Example 8: 'A' agreed to sell his agricultural land to 'B' after obtaining the necessary permission from the collector. As a matter of course, the permission was generally granted on the fulfilment of certain formalities. It was held that the contract was not a contingent contract as the grant of permission by the collector was almost a certainty.

6.2 RULES RELATING TO ENFORCEMENT

The rules relating to enforcement of a contingent contract are laid down in **sections 32, 33, 34, 35 and 36 of the Act.**

(a) **Enforcement of contracts contingent on an event happening:**

Section 32 says that "where a contingent contract is made to do or not to do anything if an uncertain future event happens, it cannot be enforced by law unless and until that event has happened. If the event becomes impossible, such contracts become void".

Example 9: A contracts to pay B a sum of money when B marries C. C dies without being married to B. The Contract becomes void.

(b) **Enforcement of contracts contingent on an event not happening:** Section 33 says that "Where a contingent contract is made to do or not do anything if an uncertain future event does not happen, it can be enforced only when the happening of that event becomes impossible and not before".

Example 10: Where 'P' agrees to pay 'Q' a sum of money if a particular ship does not return, the contract becomes enforceable only if the ship sinks so that it cannot return.

Where A agrees to pay sum of money to B if certain ship does not return however the ship returns back. Here the contract becomes void.

(c) A contract would cease to be enforceable if it is contingent upon the conduct of a living person when that living person does something to make the 'event' or 'conduct' as impossible of happening.

Section 34 says that "if a contract is contingent upon as to how a person will act at an unspecified time, the event shall be considered to have become impossible when such person does anything which renders it impossible that he should so act within any definite time or otherwise than under further contingencies".

Example 11: Where 'A' agrees to pay 'B' a sum of money if 'B' marries 'C'. 'C' marries 'D'. This act of 'C' has rendered the event of 'B' marrying 'C' as impossible; it is though possible if there is divorce between 'C' and 'D'.

In ***Frost V. Knight***, the defendant promised to marry the plaintiff on the death of his father. While the father was still alive, he married another woman. It was held that it had become impossible that he should marry the plaintiff and she was entitled to sue him for the breach of the contract.

(d) Contingent on happening of specified event within the fixed time: Section 35 says that Contingent contracts to do or not to do anything, if a specified uncertain event happens within a fixed time, becomes void if, at the expiration of time fixed, such event has not happened, or if, before the time fixed, such event becomes impossible.

Example 12: A promises to pay B a sum of money if certain ship returns within a year. The contract may be enforced if the ship returns within the year, and becomes void if the ship is burnt within the year.

(e) Contingent on specified event not happening within fixed time: Section 35 also says that - "Contingent contracts to do or not to do anything, if a specified uncertain event does not happen within a fixed time, may be enforced by law when the time fixed has expired, and such event has not happened or before the time fixed has expired, if it becomes certain that such event will not happen".

Example 13: A promises to pay B a sum of money if a certain ship does not return within a year. The contract may be enforced if the ship does not return within the year, or is burnt within the year.

(f) Contingent on an impossible event (Section 36): Contingent agreements to do or not to do anything, if an impossible event happens are void, whether the impossibility of the event is known or not to the parties to the agreement at the time when it is made.

Example 14: 'A' agrees to pay 'B' ₹one lakh if sun rises in the west next morning. This is an impossible event and hence void.

Example 15: X agrees to pay Y ₹1,00,000 if two straight lines should enclose a space. The agreement is void.

Difference between a contingent contract and a wagering contract

Basis of difference	Contingent contract	Wagering contract
Meaning	A contingent contract is a contract to do or not to do something with reference to a collateral event happening or not happening.	A wagering agreement is a promise to give money or money's worth with reference to an uncertain event happening or not happening.
Reciprocal promises	Contingent contract may not contain reciprocal promises.	A wagering agreement consists of reciprocal promises.
Uncertain event	In a contingent contract, the event is collateral.	In a wagering contract, the uncertain event is the core factor.
Nature of contract	Contingent contract may not be wagering in nature.	A wagering agreement is essentially contingent in nature.
Interest of contracting parties	Contracting parties have interest in the subject matter in contingent contract.	The contracting parties have no interest in the subject matter.
Doctrine of mutuality of lose and gain	Contingent contract is not based on doctrine of mutuality of lose and gain.	A wagering contract is a game, losing and gaining alone matters.
Effect of contract	Contingent contract is valid.	A wagering agreement is void.

6.3 QUASI CONTRACTS

A valid contract must contain certain essential elements, such as offer and acceptance, capacity to contract, consideration and free consent. But sometimes the law implies a promise imposing obligations on one party and conferring right in favour of the other even when there is no offer, no acceptance, no genuine consent, lawful consideration, etc. and in fact neither agreement nor promise. Such cases are not contract in the strict sense, but the Court recognises them as **relations resembling those of contracts** and enforces them as if they were contracts. Hence the term **Quasi –contracts (i.e. resembling a contract).** Even in the absence of a contract, certain social relationships give rise to certain specific obligations to be performed by certain persons. These are known as quasi contracts as they create same obligations as in the case of regular contract.

Quasi contracts are based on principles of equity, justice and good conscience.

A quasi or constructive contract rest upon the maxims, "No man must grow rich out of another person's loss".

Example 16: T, a tradesman, leaves goods at C's house by mistake. C treats the goods as his own. C is bound to pay for the goods.

Example 17: A pays some money to B by mistake. It is really due to C. B must refund the money to A.

Example 18: A fruit parcel is delivered under a mistake to R who consumes the fruits thinking them as birthday present. R must return the parcel or pay for the fruits. Although there is no agreement between R and the true owner, yet he is bound to pay as the law regards it a Quasi-contract.

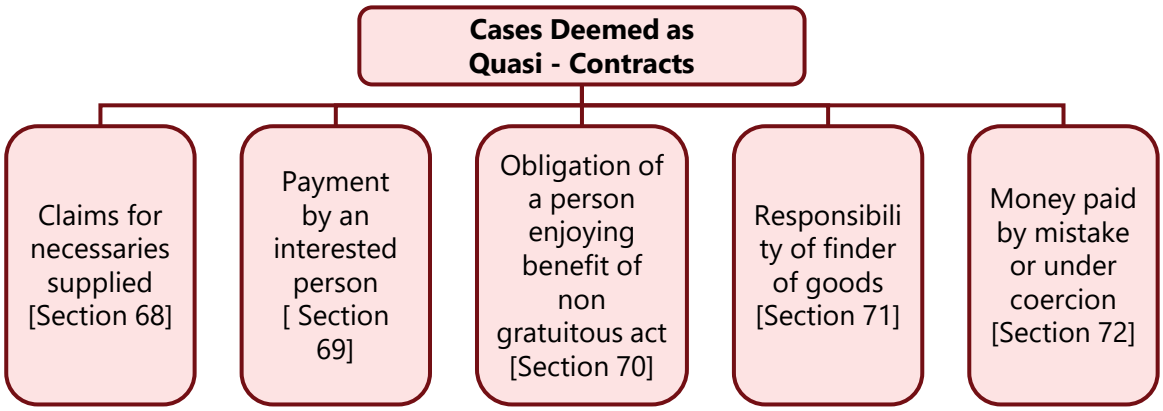
These relations are called as quasi-contractual obligations. In India it is also called as 'certain relation resembling those created by contracts.

Salient features of quasi contracts:

(a) In the first place, such a right is always a right to money and generally, though not always, to a liquidated sum of money.

(b) Secondly, it does not arise from any agreement of the parties concerned, but is imposed by the law; and

(c) Thirdly, it is a right which is available not against all the world, but against a particular person or persons only, so that in this respect it resembles a contractual right.



Under the provisions of the Indian Contract Act, the relationship of quasi contract is deemed to have come to exist in five different circumstances which we shall presently dilate upon. But it may be noted that in none of these cases there comes into existence any contract between the parties in the real sense. Due to peculiar circumstances in which they are placed, the law imposes in each of these cases the contractual liability.

(a) **Claim for necessaries supplied to persons incapable of contracting (Section 68):** If a person, incapable of entering into a contract, or anyone whom he is legally bound to support, is supplied by another person with necessaries suited to his condition in life, the person who has furnished such supplies is entitled to be reimbursed from the property of such incapable person.

Example 19: A supplies B, a lunatic, or a minor, with necessaries suitable to his condition in life. A is entitled to be reimbursed from B's property.

To establish his claim, the supplier must prove not only that the goods were supplied to the person who was minor or a lunatic but also that they were suitable to his actual requirements at the time of the sale and delivery.

(b) **Payment by an interested person (Section 69):** A person who is interested in the payment of money which another is bound by law to pay, and who therefore pays it, is entitled to be reimbursed by the other.

Example 20: B holds land in Bengal, on a lease granted by A, the zamindar. The revenue payable by A to the Government being in arrear, his land is advertised for sale by the Government. Under the revenue law, the consequence of the sale will be the annulment of B's lease. B, to prevent the sale and the consequent annulment of his own lease, pays to the government the sum due from A. A is bound to make good to B the amount so paid.

(c) Obligation of person enjoying benefits of non-gratuitous act (Section 70): In term of section 70 of the Act "where a person lawfully does anything for another person, or delivers anything to him not intending to do so gratuitously and such other person enjoys the benefit thereof, the latter is bound to pay compensation to the former in respect of, or to restore, the thing so done or delivered".

It thus follows that for a suit to succeed, the plaintiff must prove:

(i) that he had done the act or had delivered the thing lawfully;

(ii) that he did not do so gratuitously; and

(iii) that the other person enjoyed the benefit.

The above can be illustrated by a case law where 'K' a government servant was compulsorily retired by the government. He filed a writ petition and obtained an injunction against the order. He was reinstated and was paid salary but was given no work and in the meantime government went on appeal. The appeal was decided in favour of the government and 'K' was directed to return the salary paid to him during the period of reinstatement. ***[Shyam Lal vs. State of U.P. A.I.R (1968) 130]***

Example 21: A, a tradesman, leaves goods at B's house by mistake. B treats the goods as his own. He is bound to pay A for them.

(d) Responsibility of finder of goods (Section 71): 'A person who finds goods belonging to another and takes them into his custody is subject to same responsibility as if he were a bailee'.

Thus, a finder of lost goods has:

(i) to take proper care of the property as man of ordinary prudence would take

(ii) no right to appropriate the goods and

(iii) to restore the goods if the owner is found.

In ***Hollins vs. Howler L. R. & H. L.,*** 'H' picked up a diamond on the floor of 'F's shop and handed over the same to 'F' to keep till the owner was found. In spite of the best efforts, the true owner could not be traced. After the lapse of some weeks, 'H' tendered to 'F' the lawful expenses incurred by him and requested to return the diamond to him. 'F' refused to do so. ***Held,*** 'F' must return the diamond to 'H' as he was entitled to retain the goods found against everybody except the true owner.

Example 22: 'P' a customer in 'D's shop puts down a brooch worn on her coat and forgets to pick it up and one of 'D's assistants finds it and puts it in a drawer over the weekend. On Monday, it was discovered to be missing. 'D' was held to be liable in the absence of ordinary care which a prudent man would have taken.

(e) Money paid by mistake or under coercion (Section 72): "A person to whom money has been paid or anything delivered by mistake or under coercion, must repay or return it".

Every kind of payment of money or delivery of goods for every type of 'mistake' is recoverable. ***[Shivprasad Vs Sirish Chandra A.I.R. 1949 P.C. 297]***

Example 23: A payment of municipal tax made under mistaken belief or because of mis-understanding of the terms of lease can be recovered from municipal authorities. The above law was affirmed by Supreme Court in cases of ***Sales tax officer vs. Kanhaiyalal A. I. R. 1959 S. C. 835***

Similarly, any money paid by coercion is also recoverable. The word coercion is not necessarily governed by section 15 of the Act. The word is interpreted to mean and include oppression, extortion, or such other means ***[Seth Khanjelek vs National Bank of India].***

In a case where 'T' was traveling without ticket in a tram car and on checking he was asked to pay ₹5/- as penalty to compound transaction. T filed a suit against the corporation for recovery on the ground that it was extorted from him. The suit was decreed in his favour. ***[Trikamdas vs. Bombay Municipal Corporation A. I. R.1954]***

In all the above cases the contractual liability arose without any agreement between the parties.

Difference between quasi contracts and contracts

Basis of distinction	Quasi- Contract	Contract
Essential for the valid contract	The essentials for the formation of a valid contract are absent	The essentials for the formation of a valid contract are present
Obligation	Imposed by law	Created by the consent of the parties

SUMMARY

- **Contingent Contracts** are the contracts, which are conditional on some future event happening or not happening and are enforceable when the future event or loss occurs. (Section 31)

  RULES FOR ENFORCEMENT

  (a) If it is contingent on the happening of a future event, it is enforceable when the event happens. The contract becomes void if the event becomes impossible, or the event does not happen till the expiry of time fixed for happening of the event.

  (b) If it is contingent on a future event not happening. It can be enforced when happening of that event becomes impossible or it does not happen at the expiry of time fixed for non-happening of the event.

  (c) If the future event is the act of a living person, any conduct of that person which prevents the event happening within a definite time renders the event impossible.

  (d) If the future event is impossible at the time of the contract is made, the contract is void ab initio.

- Wagering Contracts are void.

- Quasi Contracts arise where obligations are created without a contract. The obligations which they give rise to are expressly enacted:

  (a) If necessaries are supplied to a person who is incapable of contracting, the supplier is entitled to claim their price from the property of such a person.

  (b) A person who is interested in the payment of money which another is bound to pay, and who therefore pays it, is entitled to be reimbursed by the other.

  (c) A person who enjoys the benefit of a non-gratuitous act is bound to make compensation.

  (d) A person who finds lost property may retain it subject to the responsibility of a bailee.

  (e) If money is paid or goods delivered by mistake or under coercion, the recipient must repay or make restoration.

CONTINGENT CONTRACT (SEC.31)

A contract to do or not to do something if some event, collateral to such contract, does or does not happen. E.G. Contracts of insurance, indemnity or guarantee.

Legal Rules

Contingent upon	When can it be enforced	When it become void?
Happening of an event	When event has happened	When event becomes impossible
Non-happening of an event	When the happening of the event becomes impossible	When event has happened.
Behavior of a person within the specified time	Such person acts in specified manner.	When such person does anything which renders it impossible
Happening of an event within the specified time	When event has happened within the specified time.	When event has not happened within the specified time OR Event becomes impossible before expiry of specified time.
Non-happening of an event within the specified time	When event has not happened within the specified time OR Event becomes impossible before expiry of specified time.	When event has happened within the specified time.
Happening of an impossible event	Void, whether the impossibility of the event is known or not known to the parties to the agreement at the time when it is made.	

QUASI CONTRACTS

Under certain special circumstances, the law creates and enforces legal rights and obligations, although the parties have never entered into a contract.

Types of Quasi Contracts

1. Claims for necessities supplied to a person incompetent to contract (but upto property of incompetent.)
2. Reimbursement to a person paying money due by another in the payment of which he is interested.
3. Obligation of a person enjoying benefits of non-gratuitous (without any cost) acts.
4. Responsibility of a finder of lost goods. His responsibility is same as that of a bailee.
5. Liability of a person to whom money is paid or goods delivered under mistake or coercion.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *A contract dependent on the happening or non-happening of future uncertain event, is*
   - *(a) Uncertain contract*
   - *(b) Contingent contract*
   - *(c) Void contract*
   - *(d) Voidable contract*
2. *A contingent contract is*
   - *(a) Void*
   - *(b) Voidable*
   - *(c) Valid*
   - *(d) Illegal*
3. *A contingent contract dependent on the happening of future uncertain even can be enforced when the event*
   - *(a) happens*
   - *(b) becomes impossible*
   - *(c) does not happen*
   - *(d) either of these*
4. *A agrees to pay ₹ One lakh to B if he brings on earth a star from sky. This is a contingent contract and*
   - *(a) Illegal*
   - *(b) Valid*
   - *(c) Voidable*
   - *(d) Void*
5. *Which of the following is not a contingent contract:*
   - *(a) A promise to pay B if he repairs his scooter.*
   - *(b) A promise to pay B ₹ 10,000 if B's scooter is stolen.*

(c) *A promise to pay B ₹ 10,000 if B's burnt his hands.*

(d) *A promise to pay B ₹ 10,000 if it rains on first of the next month.*

6. *Which of the following statements regarding Quasi-contracts is incorrect:*

(a) *It resembles a contract*

(b) *It is imposed by law*

(c) *It is based on the doctrine of unjust enrichment*

(d) *It is voluntarily created*

7. *For a contingent contract the event must be:*

(a) *Certain*

(b) *Uncertain*

(c) *Independent*

(d) *Uncertain and collateral*

8. *Which one of the following is not a characteristic of a contingent contract?*

(a) *Performance depends upon a future event*

(b) *The event must be uncertain*

(c) *The event must be collateral to the contract*

(d) *There must be reciprocal promises*

9. *Wagering contracts are:*

(a) *Void*

(b) *Voidable*

(c) *Valid*

(d) *Illegal*

10. *A contract of insurance is:*

(a) *Wagering contract*

(b) *unilateral contract*

(c) *Quasi contract*

(d) *contingent contract*

11. *Finder of goods should take care of goods as*

(a) *bailee*

(b) *owner*

(c) *insurer*

(d) *custodian*

12. *A swiggy man wrongly delivered the food to Mr. Ishaan. Ishaan who took the delivery, ate the food immediately. The swiggy boy returned soon once he got information about wrong delivery. Ishaan should make the payment as his case is deemed to be a quasi-contract under:*

(a) *Claim for necessaries supplied to persons incapable of contracting*

(b) *responsibility of finder of goods*

(c) *Payment by an interest person*

(d) *obligation of person enjoying benefits under non-gratuitous act*

Descriptive Questions

1. *Explain the-term 'Quasi Contracts' and state their characteristics.*

2. *X, a minor was studying in M.Com. in a college. On 1st July, 2021 he took a loan of ₹ 1,00,000 from B for payment of his college fees and to purchase books and agreed to repay by 31st December, 2021. X possesses assets worth ₹ 9 lakhs. On due date, X fails to pay back the loan to B. B now wants to recover the loan from X out of his (X's) assets. Referring to the provisions of Indian Contract Act, 1872 decide whether B would succeed.*

3. *P left his carriage on D's premises. Landlord of D seized the carriage against the rent due from D. P paid the rent and got his carriage released. Can P recover the amount from D?*

ANSWERS/HINTS

Answers to MCQs

1.	**(b)**	2.	**(c)**	3.	**(a)**	4.	**(d)**	5.	**(a)**	6.	**(d)**
7.	**(d)**	8.	**(d)**	9.	**(a)**	10.	**(d)**	11.	**(a)**	12.	**(d)**

Answers to Descriptive Questions

1. **Quasi Contracts:** Under certain special circumstances, obligation resembling those created by a contract are imposed by law although the parties have never entered into a contract. Such obligations imposed by law are referred to as 'Quasi-contracts'. Such a contract resembles with a contract so far as result or effect is concerned but it has little or no affinity with a contract in respect of mode of creation. These contracts are based on the doctrine that a person shall not be allowed to enrich himself unjustly at the expense of another. The salient features of a quasi-contract are:

1. It does not arise from any agreement of the parties concerned but is imposed by law.
2. Duty and not promise is the basis of such contract.
3. The right under it is always a right to money and generally though not always to a liquidated sum of money.
4. Such a right is available against specific person(s) and not against the whole world.
5. A suit for its breach may be filed in the same way as in case of a complete contract.

2. Yes, B can proceed against the assets of X. According to section 68 of Indian Contract Act, 1872, if a person, incapable of entering into a contract, or any one whom he is legally bound to support, is supplied by another person with necessaries suited to his condition in life, the person who has furnished such supplies is entitled to be reimbursed from the property of such incapable person.

Since the loan given to X is for the necessaries suited to the conditions in life of the minor, his assets can be sued to reimburse B.

3. Yes, P can recover the amount from D. Section 69 states a person who is interested in the payment of money which another person is bound by law to pay, and who therefore pays it, is entitled to get it reimbursed by the other.

In the present case, D was lawfully bound to pay rent. P was interested in making the payment to D's landlord as his carriage was seized by him. Hence being an interested party P made the payment and can recover the same from D.

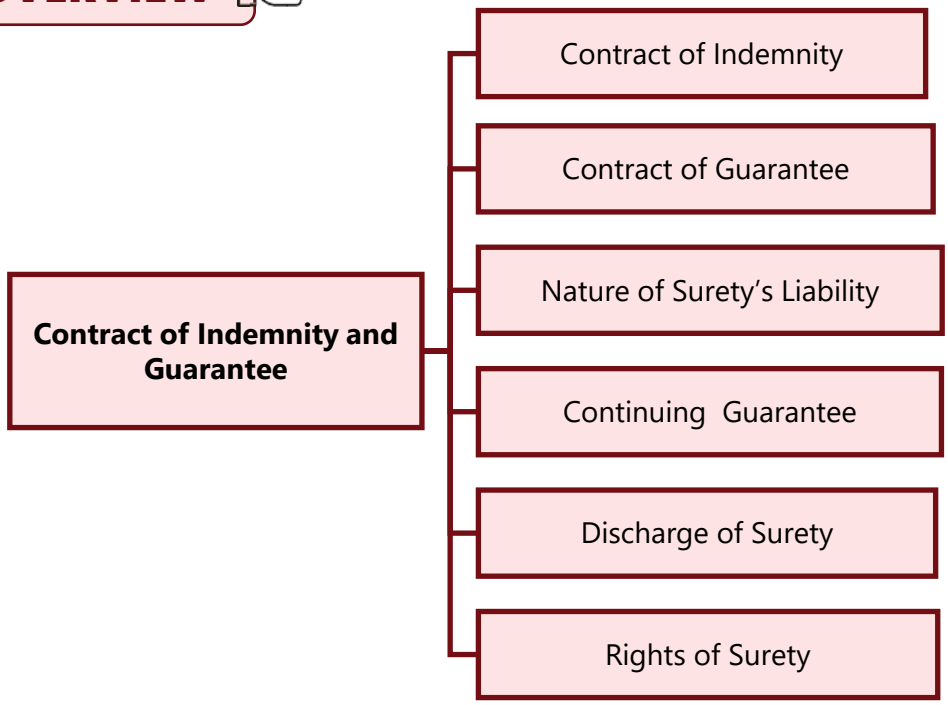
UNIT – 7: CONTRACT OF INDEMNITY AND GUARANTEE

LEARNING OUTCOMES

After studying this Chapter, you will be able to understand:

- Special type of contracts i.e. Indemnity contracts and Guarantee contracts and also the nature of obligations and rights of each of the parties to the contracts.
- Distinction between contract of indemnity and contract of guarantee.
- Mode of discharge of contract of guarantee in various circumstances.

UNIT OVERVIEW



Contract of Indemnity and Guarantee are the specific types of contracts provided under sections 124 to 147 of the Indian Contract Act, 1872. In addition to the specific provisions (i.e. Section 124 to Section 147 of the Indian Contract Act, 1872), the general principles of contracts are also applicable to such contracts. Even though both the contracts are modes of compensation based on similar principles, they differ considerably in several aspects.

In this unit, the law relating to indemnity and guarantee are discussed in detail.

7.1 CONTRACT OF INDEMNITY

The term "Indemnity" literally means "Security against loss" or "to make good the loss" or "to compensate the party who has suffered some loss".

The term "Contract of Indemnity" is defined under Section 124 of the Indian Contract Act, 1872. It is "a contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person."

Example 1: Mr. X contracts with the Government to return to India after completing his studies (which were funded by the Government) at University of Cambridge and to serve the Government for a period of 5 years. If Mr. X fails to return to India, he will have to reimburse the Government. It is a contract of indemnity.

Parties:

a. The party who promises to indemnify/ save the other party from loss- "indemnifier",

b. The party who is promised to be saved against the loss- "indemnified" or "indemnity holder".

Example 2: A may contract to indemnify B against the consequences of any proceedings which C may take against B in respect of a sum of ₹ 5000/- advanced by C to B. In consequence, when B who is called upon to pay the sum of money to C fails to do so, C would be able to recover the amount from A as provided in Section 124.

Example 3: X may agree to indemnify Y for any loss or damage that may occur if a tree on Y's neighboring property blows over. If the tree then blows over and damages Y's fence, X will be liable for the cost of fixing the fence.

However, the above definition of indemnity restricts the scope of contracts of indemnity in as much as it covers only the loss caused by:

(i) the conduct of the promisor himself, or

(ii) the conduct of any other person.

Thus, loss occasioned by an accident not caused by any person, or an act of God/ natural event, is not covered.

In case *of* ***Gajanan Moreshwar v/s Moreshwar Madan (1942),*** decision is taken on the basis of English Law. As per English Law, Indemnity means promise to save another harmless from the loss. Here it covers every loss whether due to negligence of promisee or by natural calamity or by accident.

Mode of contract of indemnity: A contract of indemnity like any other contract may be **express or implied.**

a. A contract of indemnity is said to be express when a person expressly promises to compensate the other from loss.

b. A contract of indemnity is said to be implied when it is to be inferred from the conduct of the parties or from the circumstances of the case.

A contract of indemnity is like any other contract and must fulfil all the essentials of a valid contract.

Example 4: A asks B to beat C promising to indemnify him against the consequences. The promise of A cannot be enforced. Suppose, B beats C and is fined ₹1000, B cannot claim this amount from A because the object of the agreement is unlawful.

A contract of Fire Insurance or Marine Insurance is always a contract of indemnity**.** But there is no contract of indemnity in case of contract of Life Insurance.

Rights of Indemnity-holder when sued (Section 125): The promisee in a contract of indemnity, acting within the scope of his authority, is entitled to recover from the promisor/indemnifier—

(a) all damages which he may be compelled to pay in any suit

(b) all costs which he may have been compelled to pay in bringing/ defending the suit and

(c) all sums which he may have paid under the terms of any compromise of suit.

When does the liability of an indemnifier commence?

Although the Indian Contract Act, 1872, is silent on the time of commencement of liability of indemnifier, however, on the basis of judicial pronouncements it can be stated that the liability of an indemnifier commences as soon as the liability of the indemnity-holder becomes absolute and certain. This principle has been followed by the courts in several cases.

Example 5: A promises to compensate X for any loss that he may suffer by filling a suit against Y. The court orders X to pay Y damages of ₹ 10000. As the loss has become certain, X may claim the amount of loss from A and pass it to Y.

7.2 CONTRACT OF GUARANTEE

"Contract of guarantee", "surety", "principal debtor" and "creditor" [Section 126]

Contract of guarantee: A contract of guarantee is a contract to perform the promise made or discharge the liability, of a third person in case of his default.

Three parties are involved in a contract of guarantee	**Surety**- person who gives the guarantee
	Principal debtor- person in respect of whose default the guarantee is given
	Creditor- person to whom the gurantee is given

Example 6: When A requests B to lend ₹ 10,000 to C and guarantees that C will repay the amount within the agreed time and that on C falling to do so, he (A) will himself pay to B, there is a contract of guarantee.

Here, B is the creditor, C the principal debtor and A the surety.

Example 7: X and Y go into a car showroom where X says to the dealer to supply latest model of Wagon R to Y, and agrees that if Y fails to pay he will. In case of Y's failure to pay, the car showroom will recover its money from X.

This is a contract of guarantee because X promises to discharge the liability of Y in case of his defaults.

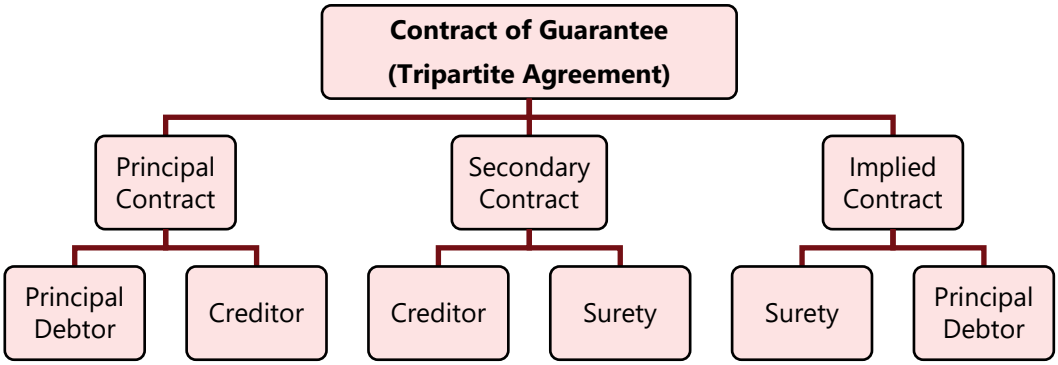
A contract of guarantee is a tripartite agreement between principal debtor, creditor and surety. There are, in effect three contracts

(i) A principal contract between the principal debtor and the creditor.

(ii) A secondary contract between the creditor and the surety.

(iii) An implied contract between the surety and the principal debtor whereby principal debtor is under an obligation to indemnify the surety; if the surety is made to pay or perform.

The right of surety is not affected by the fact that the creditor has refused to sue the principal debtor or that he has not demanded the sum due from him.



ESSENTIAL FEATURES OF A GUARANTEE

The following are the requisites of a valid guarantee:-

1. **Purpose:** The purpose of a guarantee being to secure the payment of a debt, the existence of recoverable debt is necessary. If there is no principal debt, there can be no valid guarantee.

2. **Consideration:** Like every other contract, a contract of guarantee should also be supported by some consideration. A guarantee without consideration is void, but there is no need for a direct consideration between the surety and the creditor.

   As per Section 127 consideration received by the principal debtor is sufficient consideration to the surety for giving the guarantee, but past consideration is no consideration for the contract of guarantee. Even if the principal debtor is incompetent to contract, the guarantee is valid. But, if surety is incompetent to contract, the guarantee is void.

   Example 8: B requests A to sell and deliver to him goods on credit. A agrees to do so provided C will guarantee the payment of the price of the goods. C promises to guarantee the payment in consideration of A 's promise to deliver the goods. As per Section 127, there is a sufficient consideration for C's promise. Therefore, the guarantee is valid.

   Example 9: A sells and delivers goods to B. C afterwards, without consideration, agrees to pay for them in default of B. The agreement is void.

3. **Existence of a liability:** There must be an existing liability or a promise whose performance is guaranteed. Such liability or promise must be enforceable by law. The liability must be legally enforceable and not time barred.

4. **No misrepresentation or concealment (section 142 and 143):** Any guarantee which has been obtained by the means of misrepresentation made by the creditor, or with his knowledge and assent, concerning a material part of the transaction, is invalid (section 142)

   Any guarantee which the creditor has obtained by means of keeping silence as to material circumstances, is invalid (section 143).

   Example 10: A engages B as clerk to collect money for him. B fails to account for some of his receipts, and A in consequence calls upon him to furnish security for his duly accounting. C gives his guarantee for B's duly accounting. A does not acquaint C, with his previous conduct. B afterwards make default. The guarantee is invalid.

   Example 11: A guarantees to C payment for iron to be supplied by him to B to the amount of 2,000 tons. B and C have privately agreed that B should pay rupee five per ton beyond the market price, such excess to be applied in liquidation of an old debt. This agreement is concealed from A. A is not liable as a surety.

5. **Writing not necessary:** Section 126 expressly declares that a guarantee may be either oral or written.

6. **Joining of the other co-sureties (Section 144):** Where a person gives a guarantee upon a contract that the creditor shall not act upon it until another person has joined in it as co-surety, the guarantee is not valid if that other person does not join. That implies, the guarantee by a surety is not valid if a condition is imposed by a surety that some other person must also join as a co-surety, but such other person does not join as a co-surety.

7.3 TYPES OF GUARANTEES

Guarantee may be classified under two categories:

A. **Specific Guarantee**- A guarantee which extends to a single debt/ specific transaction is called a specific guarantee. The surety's liability comes to an end when the guaranteed debt is duly discharged or the promise is duly performed.

Example 12: A guarantees payment to B of the price of the five bags of rice to be delivered by B to C and to be paid for in a month. B delivers five bags to C. C pays for them. This is a contract for specific guarantee because A intended to guarantee only for the payment of price of the first five bags of rice to be delivered one time [*Kay v Groves*]

B. **Continuing Guarantee [Section 129]** - A guarantee which extends to a series of transaction is called a continuing guarantee. A surety's liability continues until the revocation of the guarantee.

The essence of continuing guarantee is that it applies not to a specific number of transactions but to any number of transactions and makes the surety liable for the unpaid balance at the end of the guarantee.

Example 13: On A's recommendation B, a wealthy landlord employs C as his estate manager. It was the duty of C to collect rent on 1st of every month from the tenant of B and remit the same to B before 5th of every month. A, guarantee this arrangement and promises to make good any default made by C. This is a contract of continuing guarantee.

Example 14: A guarantees payment to B, a tea-dealer, to the amount of ₹ 10,000, for any tea he may from time-to-time supply to C. B supplies C with tea to above the value of ₹ 10,000, and C pays B for it. Afterwards B supplies C with tea to the value of ₹ 20,000. C fails to pay. The guarantee given by A was a continuing guarantee, and he is accordingly liable to B to the extent of ₹ 10,000.

7.4 DISTINCTION BETWEEN A CONTRACT OF INDEMNITY AND A CONTRACT OF GUARANTEE

Point of distinction	Contract of Indemnity	Contract of Guarantee
Number of party/parties to the contract	There are only **two parties** namely the indemnifier [promisor] and the indemnified [promisee]	There are **three parties**- creditor, principal debtor and surety.
Nature of liability	The liability of the indemnifier is primary and unconditional.	The liability of the surety is secondary and conditional as the primary liability is that of the principal debtor.
Time of liability	The liability of the indemnifier arises only on the happening of a contingency.	The liability arises only on the non-performance of an existing promise or non-payment of an existing debt.
Time to Act	The indemnifier need not act at the request of indemnity holder.	The surety acts at the request of principal debtor.

Right to sue third party	Indemnifier cannot sue a third party for loss in his own name as there is no privity of contract. Such a right would arise only if there is an assignment in his favour.	Surety can proceed against principal debtor in his own right because he gets all the right of a creditor after discharging the debts.
Purpose	Reimbursement of loss	For the security of the creditor
Competency to contract	All parties must be competent to contract.	In the case of a contract of guarantee, where a minor is a principal debtor, the contract is still valid.

7.5 NATURE AND EXTENT OF SURETY'S LIABILITY [SECTION 128]

(i) The liability of the surety is co-extensive with that of the principal debtor unless it is otherwise provided by the contract. [Section 128]

(ii) Liability of surety is of secondary nature as he is liable only on default of principal debtor.

(iii) Where a debtor cannot be held liable on account of any defect in the document, the liability of the surety also ceases.

(iv) A creditor may choose to proceed against a surety first, unless there is an agreement to the contrary.

Example 15: A guarantees to B the payment of a bill of exchange by C, the acceptor. The bill is dishonoured by C. A is liable not only for the amount of the bill but also for any interest and charges which may have become due on it.

7.6 LIABILITY OF TWO PERSONS, PRIMARILY LIABLE, NOT AFFECTED BY ARRANGEMENT BETWEEN THEM THAT ONE SHALL BE SURETY ON OTHER'S DEFAULT

Where two persons contract with a third person to undertake a certain liability, and also contract with each other that one of them shall be liable only on the default of the other, the third person not being a party to such contract, the liability of each of such two persons to the third person under the first contract is not affected by the existence of the second contract, although such third person may have been aware of its existence. (Section 132)

Example 16: A and B make a joint and several promissory note to C. A makes it, in fact, as surety for B, and C knows this at the time when the note is made. The fact that A, to the knowledge of C, made the note as surety for B, is no answer to a suit by C against A upon the note.

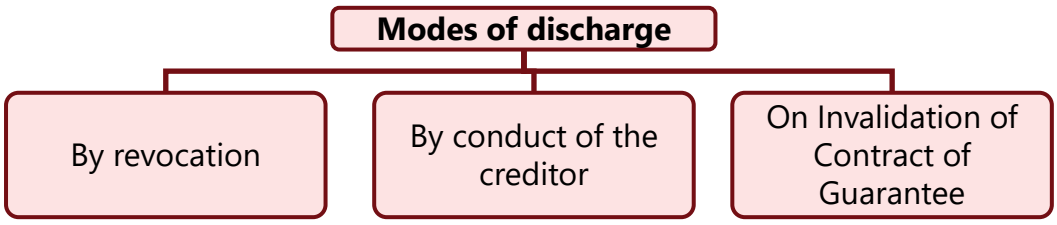
7.7 DISCHARGE OF A SURETY

A surety is said to be discharged when his liability as surety comes to an end. The various modes of discharge of surety are discussed below:

(i) By revocation of the contract of guarantee.

(ii) By the conduct of the creditor, or

(iii) By the invalidation of the contract of guarantee.



By revocation of the Contract of Guarantee

(a) **Revocation of continuing guarantee by Notice (Section 130):** The continuing guarantee may at any time be revoked by the surety as to future transactions by notice to the creditors. Once the guarantee is revoked, the surety is not liable for any future transaction however he is liable for all the transactions that happened before the notice was given.

A specific guarantee can be revoked only if liability to principal debtor has not accrued.

Example 17: Arun promises to pay Rama for all groceries bought by Carol for a period of 12 months if Carol fails to pay. In the next three months, Carol buys ₹ 2000/- worth of groceries. After 3 months, Arun revokes the guarantee by giving a notice to Rama. Carol further purchases ₹ 1000 of groceries. Carol fails to pay. Arun is not liable for ₹ 1000/- of purchase that was made after the notice but he is liable for ₹ 2000/- of purchase made before the notice.

(b) **Revocation of continuing guarantee by surety's death (Section 131):** In the absence of any contract to the contrary, the death of surety operates as a revocation of a continuing guarantee as to the future transactions taking place after the death of surety. However, the surety's estate remains liable for the past transactions which have already taken place before the death of the surety.

Example 18: 'S' guarantees 'C' for the transaction to be done between 'C' & 'P' for next month. After 5 days 'S' died. Now guarantee is revoked for future transactions but 'S's estate is still liable for transactions done during previous five days.

(c) **By novation [Section 62]:** The surety under original contract is discharged if a fresh contract is entered into either between the same parties or between the other parties, the consideration being the mutual discharge of the old contract.

Example 19: 'S' guarantees 'C' for the payment of the supply of wheat to be done by 'C' & 'P' for next month. After 5 days, the contract is changed. Now 'S' guarantees 'C' for the payment of the supply of rice to be done by 'C' & 'P' for rest of next month. Here, guarantee is revoked for supply of wheat. But 'S' is still liable for supply of wheat done during previous five days.

By conduct of the creditor

(a) **By variance in terms of contract (Section 133):** Where there is any variance in the terms of contract between the principal debtor and creditor without surety's consent, it would discharge the surety in respect of all transactions taking place subsequent to such variance.

Example 20: A becomes surety to C for B's conduct as a manager in C's bank. Afterwards, B and C contract, without A's consent, that B's salary shall be raised, and that he shall become liable for one-fourth of the losses on overdrafts. B allows a customer to overdraw, and the bank loses a sum of money. A is discharged from his suretyship by the variance made without his consent and is not liable to make good this loss.

(b) **By release or discharge of principal debtor (Section 134):** The surety is discharged if the creditor:

i. enters into a fresh/ new contract with principal debtor; by which the principal debtor is released, or

ii. does any act or omission, the legal consequence of which is the discharge of the principal debtor.

Example 21: A contracts with B for a fixed price to build a house for B within a stipulated time, B supplying the necessary timber. C guarantees A's performance of the contract. B omits to supply the timber. C is discharged from his suretyship.

Example 22: A gives a guarantee to C for goods to be delivered to B. Later on, B contracts with C to assign his property to C in lieu of the debt. B is discharged of his liability and A is discharged of his liability.

(c) **Discharge of surety when creditor compounds with, gives time to, or agrees not to sue, principal debtor [Sector 135]:** A contract between the creditor and the principal debtor, by which the creditor makes a composition with, or promises to give time to, or promises not to sue, the principal debtor, discharges the surety, unless the surety assents to such contract.

i. *Composition:* If the creditor makes a composition with the principal debtor, without consulting the surety, the latter is discharged. Composition inevitably involves variation of the original contract, and, therefore, the surety is discharged.

ii. *Promise to give time:* When the time for the payment of the guaranteed debt comes, the surety has the right to require the principal debtor to pay off the debt. Accordingly, it is one of the duties of the creditor towards the surety not to allow the principal debtor more time for payment.

iii. *Promise not to sue:* If the creditor under an agreement with the principal debtor promises not to sue him, the surety is discharged. The main reason is that the surety is entitled at any time to require the creditor to call upon the principal debtor to pay off the debt when it is due and this right is positively violated when the creditor promises not to sue the principal debtor.

Cases where surety not discharged

i. **Surety not discharged when agreement made with third person to give time to principal debtor [Section 136]:** Where a contract to give time to the principal debtor is made by the creditor with a third person, and not with the principal debtor, the surety is not discharged.

Example 23: C, the holder of an overdue bill of exchange drawn by A as surety for B, and accepted by B, contracts with M to give time to B. A is not discharged.

ii. **Creditor's forbearance to sue does not discharge surety [Section 137]:** Mere forbearance on the part of the creditor to sue the principal debtor or to enforce any other remedy against him does not in the absence of any provision in the guarantee to the contrary, discharge the surety.

Example 24: B owes to C a debt guaranteed by A. The debt becomes payable. C does not sue B for a year after the debt has become payable. A is not discharged from his suretyship.

(d) **Discharge of surety by creditor's act or omission impairing surety's eventual remedy [Section 139]:** If the creditor does any act which is inconsistent with the rights of the surety or omits to do any act which his duty to the surety requires him to do, and the eventual remedy of the surety himself against the principal debtor is thereby impaired, the surety is discharged.

In a case before the Supreme Court of India, "A bank granted a loan on the security of the stock in the godown. The loan was also guaranteed by the surety. The goods were lost from the godown on account of the negligence of the bank officials. The surety was discharged to the extent of the value of the stock so lost." *[State bank of Saurashtra V Chitranjan Rangnath Raja (1980) 4 SCC 516]*

Example 25: A puts M as apprentice to B and gives a guarantee to B for M's fidelity. B promises on his part that he will, at least once a month, see that M make up the cash. B omits to see this done as promised, and M embezzles. A is not liable to B on his guarantee.

By the invalidation of the contract of guarantee

(a) **Guarantee obtained by misrepresentation [Section 142]:** Any guarantee which has been obtained by means of misrepresentation made by the creditor, or with his knowledge and assent, concerning a material part of the transaction, is invalid.

Example 26: 'C' sells AC to 'P' on misrepresenting that it is made of copper while it is made of aluminum. 'S' guarantees for the same as surety without the knowledge of fact that it is made of aluminum. Here, 'S' will not be liable.

(b) **Guarantee obtained by concealment [Section 143]:** Any guarantee which the creditor has obtained by means of keeping silence as to material circumstances is invalid.

Example 27: A engages B as a clerk to collect money for him, B fails to account for some of his receipts, and A in consequence calls upon him to furnish security for his duly accounting. C gives his guarantee for B's duly accounting. A does not acquaint C with B's previous conduct. B afterwards makes default. The guarantee is invalid.

Example 28: A guarantees to C payment for iron to be supplied by him to B for the amount of ₹ 2,00,000 tons. B and C have privately agreed that B should pay five rupees per ton beyond the market price, such excess to be applied in liquidation of an old debt. This agreement is concealed from A. A is not liable as a surety.

(c) Guarantee on contract that creditor shall not act on it until co-surety joins (Section 144): Where a person gives a guarantee upon a contract that the creditor shall not act upon it until another person has joined in it as co-surety, the guarantee is not valid if that other person does not join.

Example 29: 'S1' guarantees 'C' for payment to be done by 'P' to 'C' on the condition that 'S1' will be liable only if 'S2' joins him for such guarantee. 'S2' does not give his consent. Here, 'S1' will not be liable.

7.8 RIGHTS OF A SURETY

The surety enjoys the following rights against the creditor:

(a) Rights against the creditor,

(b) Rights against the principal debtor,

(c) Rights against co-sureties.

Right against the principal debtor

(a) Rights of subrogation [Section 140]: 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 had against the principal debtor.

This right is known as right of subrogation. It means that on payment of the guaranteed debt, or performance of the guaranteed duty, the surety steps into the shoes of the creditor.

Example 30: 'Raju' has taken a housing loan from Canara Bank. 'Pappu' has given guarantee for repayment of such loan. Besides, there was a condition that if 'Raju' does not repay the loan within time, the bank can auction his property by giving 15 days notice to 'Raju'. On due date 'Raju' does not repay, hence Pappu being a surety

has to repay the loan. Now 'Pappu' can take the house from bank and has a right to auction the house by giving 15 days notice to 'Raju'.

(b) **Implied promise to indemnify surety [Section 145]:** In every contract of guarantee there is an implied promise by the principal debtor to indemnify the surety. The surety is entitled to recover from the principal debtor whatever sum he has rightfully paid under the guarantee, but not sums which he paid wrongfully.

Example 31: B is indebted to C and A is surety for the debt. Upon default, C sues A. A defends the suit on reasonable grounds but is compelled to pay the amount. A is entitled to recover from B the cost as well as the principal debt.

In the same case above, if A did not have reasonable grounds for defence, A would still be entitled to recover principal debt from B but not any other costs.

Right against the Creditor

(a) **Surety's right to benefit of creditor's securities [Section 141]:** 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.

Example 32: C advances to B, his tenant, 2,00,000 rupees on the guarantee of A. C has also a further security for the 2,00,000 rupees by a mortgage of B's furniture. C cancels the mortgage. B becomes insolvent, and C sues A on his guarantee. A is discharged from liability to the amount of the value of the furniture.

(b) **Right to set off:** If the creditor sues the surety, for payment of principal debtor's liability, the surety may have the benefit of the set off, if any, that the principal debtor had against the creditor

Example 33: 'X' took a loan of ₹ 50,000 from 'Y' which was guaranteed by 'Z'. There was one another contract between 'X' and 'Y' in which 'Y' had to pay ₹ 10,000 to 'X'. On default by 'X', 'Y' filed suit against 'Z'. Now 'Z' is liable to pay ₹ 40,000 (₹ 50,000 – ₹ 10,000).

(c) **Right to share reduction:** The surety has right to claim proportionate reduction in his liability if the principal debtor becomes insolvent.

Example 34: 'X' took a loan of ₹ 50,000 from 'Y' which was Guaranteed by 'Z'. 'X' became insolvent and only 25% is realised from his property against liabilities. Now 'Y' will receive ₹ 12,500 from 'X' and Now 'Z' is liable to pay ₹ 37,500 (₹ 50,000 – ₹ 12,500).

Rights against co-sureties

"Co-sureties (meaning)- When the same debt or duty is guaranteed by two or more persons, such persons are called co-sureties"

(a) **Co-sureties liable to contribute equally (Section 146):** Unless otherwise agreed, each surety is liable to contribute equally for discharge of whole debt or part of the debt remains unpaid by debtor.

Example 35: A, B and C are sureties to D for the sum of 3,00,000 rupees lent to E. E makes default in payment. A, B and C are liable, as between themselves, to pay 1,00,000 rupees each.

Example 36: A, B and C are sureties to D for the sum of 1,00,000 rupees lent to E, and there is a contract between A, B and C that A is to be responsible to the extent of one-quarter, B to the extent of one-quarter, and C to the extent of one- half. E makes default in payment. As between the sureties, A is liable to pay 25,000 rupees, B 25,000 rupees, and C 50,000 rupees.

(b) **Liability of co-sureties bound in different sums (Section 147):** The principal of equal contribution is, however, subject to the maximum limit fixed by a surety to his liability. Co-sureties who are bound in different sums are liable to pay equally as far as the limits of their respective obligations permit.

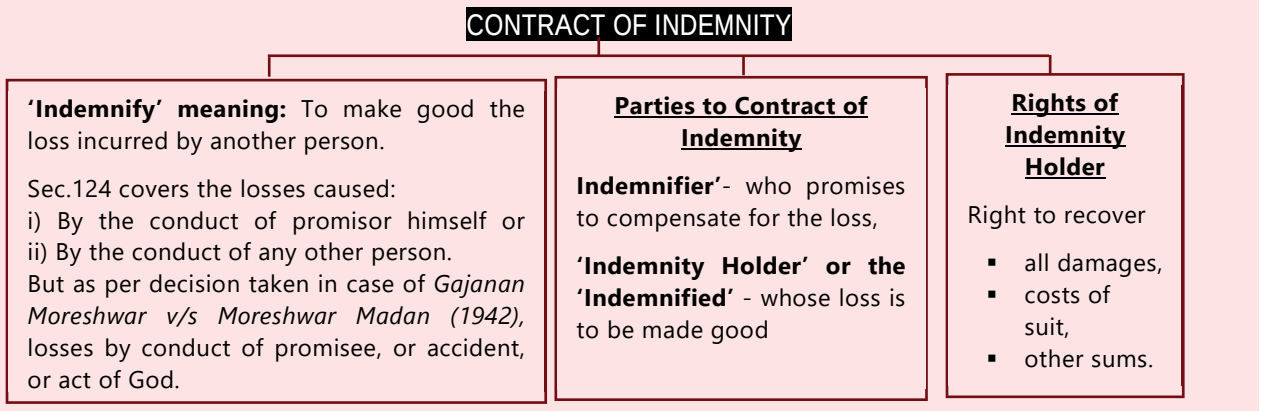
Example 37: A, B and C, as sureties for D, enter into three several bonds, each in a different penalty, namely, A in the penalty of 1,00,000 rupees, B in that of 2,00,000 rupees, C in that of 4,00,000 rupees, conditioned for D's duly accounting to E. D makes default to the extent of 3,00,000 rupees. A, B and C are each liable to pay 1,00,000 rupees.

Example 38: A, B and C, as sureties for D, enter into three several bonds, each in a different penalty, namely, A in the penalty of 1,00,000 rupees, B in that of 2,00,000 rupees, C in that of 4,00,000 rupees, conditioned for D's duly accounting to E. D makes default to the extent of 4,00,000 rupees; A is liable to pay 1,00,000 rupees, and B and C 1,50,000 rupees each.

Example 39: A, B and C, as sureties for D, enter into three several bonds, each in a different penalty, namely, A in the penalty of 1,00,000 rupees, B in that of 2,00,000 rupees, C in that of 4,00,000 rupees, conditioned for D's duly accounting to E. D makes default to the extent of 7,00,000 rupees. A, B and C have to pay each the full penalty of his bond.

SUMMARY

- **A contract of indemnity-** A contract where one party promises to indemnify the other from loss caused to him by the conduct of the promisor or by the conduct of any other person.
- **A contract of guarantee-** 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 for whom the guarantee is given is called the Principal Debtor, and the person to whom the guarantee is given is called the Creditor.
- Contract of guarantee must be supported by consideration. The consideration received by the principal debtor may be sufficient consideration to the surety for giving guarantee.
- The liability of surety is co-extensive with that of principle debtor. In certain cases surety will be liable even though the principal debtor is not liable-(i) Principal debtor is incompetent to contract. (ii) Principal debtor is adjudged insolvent. (iii) The debts become time-barred.
- The rights of a surety can be divided into 3 heads: (i) Right against the principal debtor; (ii) Right against the creditor; (iii) Right against the co- sureties.
- The surety is discharged from its liability (i) By revocation of the contract of guarantee. (ii) By the conduct of the creditor, or (iii) By the invalidation of the contract of guarantee.
- **Specific/simple guarantee:** Guarantee for single debt/particular transaction.
- **Continuing guarantee:** Guarantee that extends to a series of transactions.



CONTRACT OF GUARANTEE

'Guarantee' meaning: Contract to perform the promise; or discharge the liability, of a third person in case of his default.

Parties to Contract of Guarantee

Surety: Who gives the guarantee,

Principal Debtor: In respect of whose default the guarantee is given,

Creditor: To whom the guarantee is given

Essential Features

1. Purpose: To secure the payment of a debt.

2. Consideration: Must be there, may be direct or indirect.

3. Existence of liability: Liability must be legally enforceable, not time barred.

4. No misrepresentation or concealment

5. May be oral or written.

6. Joining of co-sureties must be if provided in contract.

Types of Guarantee

Specific Guarantee

1. Guarantee which extends to a single debt/ specific transaction,

2. Surety's liability comes to an end when guaranteed debt is duly discharged.

Continue Guarantee

1. Guarantee which extends to a series of transaction,

2. Surety's liability continues until the revocation of the guarantee,

Modes of Discharge of Surety

By Revocation

1. By Notice,

2. By surety's death,

3. By Novation,

By Conduct of Creditors

1. By variance in terms,

2. By release or discharge of PD,

3. Composition with PD,

4. Impairing surety's remedy,

On Invalidation of Contract of Guarantee

1. Guarantee obtained by misrepresentation,

2. Guarantee obtained by concealment,

3. Guarantee on contract that creditor shall not act on it until co-surety joins

Rights of Surety

Against Principal Debtor

1. Right of Subrogation,

2. Right of Indemnity,

Against Creditor

1. Right to Security

2. Right to Set Off

3. Right to share reduction

Against Co-Surities

1. Right to claim contribution equally,

2. Right to claim contribution only agreed sum

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any other person is called*

   (a) Surety contract

   (b) Simple contract

   (c) Contract of indemnity

   (d) None of above

2. *X, a shareholder of a company lost his share certificate. He applied for the duplicate. The company agreed to issue the same on the term that X will compensate the company against the loss where any holder produces the original certificate. This is called:*

   (a) Contract of indemnity

   (b) Contract of Guarantee

   (c) Quasi Contract

   (d) None of the above

3. *Section 124 to 125, of the Contract Act, deals with:*

   (a) Contracts of indemnity

   (b) Contracts of guarantee

   (c) Both (a) and (b)

   (d) None of above

4. *Where 'A' obtains housing loan from LIC Housing and if 'B' promises to pay LIC Housing in the event of 'A' failing to repay, it is a contract of-*

   (a) Indemnity

   (b) Guarantee

   (c) Wagering

   (d) None of the above

5. *A guarantees payment to B of the price of five sacks of flour to be delivered by B to C and to be paid for in a month. B delivers five sacks to C. C pays for them. Afterwards B delivers four sacks to C, which C does not pay for. Whether-*

   (a) A is liable for the price of the four sacks.

   (b) A is not liable for the price of the four sacks.

   (c) A is liable for the price of the two sacks only.

   (d) A is liable for the price of the one sack only.

6. *X gives guarantee to the extent of ₹ 50,000 for the loans given from time to time by A to B. A gave a loan of ₹ 10,000 to B. Afterwards, X gives notice of revocation. Which is the correct option?*

   (a) X is discharged from all liability to A for any loan granted.

   (b) X is liable to A for ₹ 10,000 on default of B.

   (c) X is liable to A for ₹ 50,000 on default of B.

   (d) X is liable to A for ₹ 40,000 on default of B.

7. *The guarantee is valid even if ____ is incompetent to contract:*

   (a) Principal Debtor

   (b) Surety

   (c) Both a & b

   (d) None of these

8. *Section 143 of the Contract Act 1872 deals with*

   (a) Guarantee obtained by free consent

   (b) Guarantee obtained by fraud

   (c) Guarantee obtained by concealment

   (d) None of above

9. *A surety has a right of indemnity and right of subrogation against_____*

   (a) Principal Debtor

   (b) Creditor

   (c) Co-Sureties

   (d) All of these

10. *In contract of guarantee for whom guarantee given is called*

    (a) Surety holder

    (b) Principal debtor

    (c) Both (a) and (b)

    (d) None of above

Descriptive Questions

1. *What are the rights of the indemnity-holder when sued?*

2. *Define contract of indemnity and contract of guarantee and state the conditions when guarantee is considered invalid?*

3. *Mr. X, is employed as a cashier on a monthly salary of ₹ 12,000 by ABC bank for a period of three years. Y gave surety for X's good conduct. After nine months, the financial position of the bank deteriorates. Then X agrees to accept a lower salary of ₹ 10,500/- per month from Bank. Two months later, it was found that X has misappropriated cash since the time of his appointment. What is the liability of Y?*

4. *A contracts with B for a fixed price to construct a house for B within a stipulated time. B would supply the necessary material to be used in the construction. C guarantees A's performance of the contract. B does not supply the material as per the agreement. Is C discharged from his liability.*

5. *Mr. D was in urgent need of money amounting to ₹ 5,00,000. He asked Mr. K for the money. Mr. K lent the money on the sureties of A, B and N without any contract between them in case of default in repayment of money by D to K. D makes default in payment. B refused to contribute, examine whether B can escape liability?*

6. *Mr. Chetan was appointed as Site Manager of ABC Constructions Company on a two years' contract at a monthly salary of ₹ 50,000. Mr. Pawan gave a surety in respect of Mr. Chetan's conduct. After six months the company was not in position to pay ₹ 50,000 to Mr. Chetan because of financial constraints. Chetan agreed for a lower salary of ₹ 30,000 from the company. This was not communicated to Mr. Pawan. Three months afterwards it was discovered that Chetan had been doing fraud since the time of his appointment. What is the liability of Mr. Pawan during the whole duration of Chetan's appointment.*

7. *A agrees to sell goods to B on the guarantee of C for the payment of the price of goods in default of B. Is the agreement of guarantee valid in each of the following alternate cases:*

   Case 1. If A is a Minor

   Case 2: If B is a Minor

   Case 3: If C is a minor.

8. *S asks R to beat T and promises to indemnify R against the consequences. R beats T and is fined ₹ 50,000. Can R claim ₹ 50,000 from S.*

9. *Manoj guarantees for Ranjan, a retail textile merchant, for an amount of ₹ 1,00,000, for which Sharma, the supplier may from time to time supply goods on credit basis to Ranjan during the next 3 months.*

   After 1 month, Manoj revokes the guarantee, when Sharma had supplied goods on credit for ₹ 40,000. Referring to the provisions of the Indian Contract Act, 1872, decide whether Manoj is discharged from all the liabilities to Sharma for any subsequent credit supply. What would be your answer in case Ranjan makes default in paying back Sharma for the goods already supplied on credit i.e. ₹ 40,000?

10. *'C' advances to 'B', ₹ 2,00,000 on the guarantee of 'A'. 'C' has also taken a further security for the same borrowing by mortgage of B's furniture worth ₹ 2,00,000 without knowledge of 'A'. C' cancels the mortgage. After 6 months 'B' becomes insolvent and 'C' 'sues 'A' his guarantee. Decide the liability of 'A' if the market value of furniture is worth ₹ 80,000, under the Indian Contract Act, 1872.*

ANSWERS/HINTS

Answers to MCQs

1.	**(c)**	2.	**(a)**	3.	**(a)**	4.	**(b)**	5.	**(b)**	6.	**(b)**
7.	**(a)**	8.	**(c)**	9.	**(a)**	10.	**(b)**				

Answers to the Descriptive Questions

1. **Rights of Indemnity- holder when sued (Section 125):** The promisee in a contract of indemnity, acting within the scope of his authority, is entitled to recover from the promisor—

   (a) all damages which he may be compelled to pay in any suit

(b) all costs which he may have been compelled to pay in bringing/ defending the suit and

(c) all sums which he may have paid under the terms of any compromise of suit.

It may be understood that the rights contemplated under section 125 are not exhaustive. The indemnity holder/ indemnified has other rights besides those mentioned above. If he has incurred a liability and that liability is absolute, he is entitled to call upon his indemnifier to save him from the liability and to pay it off.

2. Section 124 of the Indian Contract Act, 1872 states that "A contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or the conduct of any person", is called a "contract of indemnity".

Section 126 of the Indian Contract Act, 1872 states that "A contract to perform the promise made or discharge liability incurred by a third person in case of his default" is called a "contract of guarantee".

The conditions under which the guarantee is invalid or void is provided in section 142, 143 and 144 of the Indian Contract Act. These include:

(i) Guarantee obtained by means of misrepresentation.

(ii) Guarantee obtained by means of keeping silence as to material circumstances.

(iii) When contract of guarantee is entered into on the condition that the creditor shall not act upon it until another person has joined in it as co-surety and that other party fails to join as such.

3. According to section 133 of the Indian Contract Act, 1872, where there is any variance in the terms of contract between the principal debtor and creditor without surety's consent, it would discharge the surety in respect of all transactions taking place subsequent to such variance.

In the instant case, the creditor has made variance (i.e. change in terms) without the consent of surety. Thus, surety is discharged as to the transactions subsequent to the change.

Hence, Y is liable as a surety for the loss suffered by the bank due to misappropriation of cash by X during the first nine months but not for misappropriations committed after the reduction in salary.

4. According to Section 134 of the Indian Contract Act, 1872, the surety is discharged by any contract between the creditor and the principal debtor by which the principal debtor is discharged or by any act or omission for the creditor the legal consequence of which is the discharge of the principal debtor.

In the given case, B omits to supply the necessary construction material. Hence, C is discharged from his liability.

5. **Co-sureties liable to contribute equally (Section 146 of the Indian Contract act, 1872):** Equality of burden is the basis of Co-suretyship. This is contained in section 146 which states that "when two or more persons are co-sureties for the same debt, or duty, either jointly, or severally and whether under the same or different contracts and whether with or without the knowledge of each other, the co-sureties in the absence of any contract to the contrary, are liable, as between themselves, to pay each an equal share of the whole debt, or of that part of it which remains unpaid by the principal debtor".

   Accordingly, on the default of D in payment, B cannot escape from his liability. All the three sureties A, B and N are liable to pay equally, in absence of any contract between them.

6. As per the provisions of Section 133 of the Indian Contract Act, 1872, if the creditor makes any variance (i.e. change in terms) without the consent of the surety, then surety is discharged as to the transactions subsequent to the change.

   In the instant case, Mr. Pawan is liable as a surety for the loss suffered by ABC Constructions company due to misappropriation of cash by Mr. Chetan during the first six months but not for misappropriations committed after the reduction in salary.

   Hence, Mr. Pawan, will be liable as a surety for the act of Mr. Chetan before the change in the terms of the contract i.e., during the first six months. Variation in the terms of the contract (as to the reduction of salary) without consent of Mr. Pawan, will discharge Mr. Pawan from all the liabilities towards the act of the Mr. Chetan after such variation.

7. **Case 1:** The agreement of guarantee is void because the creditor is incompetent to contract.

   Case 2: The agreement of guarantee is valid because the capability of the principal debtor does not affect the validity of the agreement of the guarantee.

   Case 3: The agreement of guarantee is void because the surety is incompetent to contract.

8. R cannot claim ₹ 50,000 from S because the object of the agreement was unlawful. A contract of indemnity to be valid must fulfil all the essentials of a valid contract.

9. **Discharge of Surety by Revocation:** As per section 130 of the Indian Contract Act, 1872, a continuing guarantee may, at any time, be revoked by the surety, as to future

transactions, by notice to the creditor, but the surety remains liable for transactions already entered into.

As per the above provisions, liability of Manoj is discharged with relation to all subsequent credit supplies made by Sharma after revocation of guarantee, because it is a case of continuing guarantee.

However, liability of Manoj for previous transactions (before revocation) i.e. for ₹ 40,000 remains. He is liable for payment of ₹ 40,000 to Sharma because the transaction was already entered into before revocation of guarantee.

10. **Surety's right to benefit of creditor's securities**: According to section 141 of the Indian Contract Act, 1872, 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.

In the instant case, C advances to B, ₹ 2,00,000 rupees on the guarantee of A. C has also taken a further security for ₹ 2,00,000 by mortgage of B's furniture without knowledge of A. C cancels the mortgage. B becomes insolvent, and C sues A on his guarantee. A is discharged from liability to the amount of the value of the furniture i.e. ₹ 80,000 and will remain liable for balance ₹ 1,20,000.

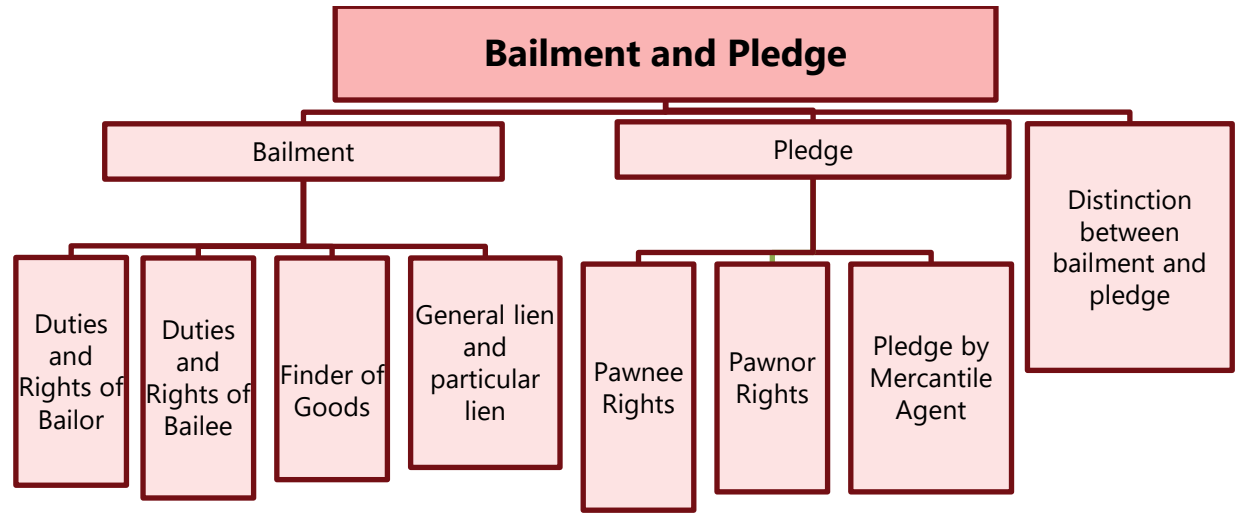
UNIT–8: BAILMENT AND PLEDGE

LEARNING OUTCOMES

After studying this unit, you would be able to understand:

- The general principles underlying contracts of bailment and pledge.
- Duties and rights of the parties to the contracts.

UNIT OVERVIEW



8.1 WHAT IS BAILMENT?

The word "Bailment" has been derived from the **French word "*ballier*"** which means "to deliver". Bailment etymologically means 'handing over' or 'change of possession'.

As per Section 148 of the Act, bailment is the delivery of goods by one person to another for some purpose, upon a contract, that the goods shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them.

Parties to bailment:

(a) **Bailor**: The person delivering the goods.

(b) **Bailee**: The person to whom the goods are delivered.

Example 1: Where 'X' delivers his car for repair to 'Y', 'X' is the bailor and 'Y' is the bailee.

Example 2: X delivers a piece of cloth to Y, a tailor, to be stitched into a suit. It is contract for bailment.

Example 3: Goods given to a friend for his own use, without any charge.

Example 4: X delivers goods to blue dart for carriage.

Essential Elements:

The **essential elements** of a contract of bailment are—

(a) **Contract:** Bailment is based upon a contract. The contract may be express or implied. No consideration is necessary to create a valid contract of bailment.

(b) **Delivery of goods:** It involves the delivery of goods from one person to another for some purposes. Bailment is only for moveable goods and never for immovable goods or money. The delivery of the possession of goods is of the following kinds:

i. **Actual Delivery**: When goods are physically handed over to the bailee by the bailor. Eg: delivery of a car for repair to workshop

ii. **Constructive Delivery**: Where delivery is made by doing anything that has the effect of putting goods in the possession of the bailee or of any person authorized to hold them on his behalf. Eg: Delivery of the key of car to a workshop dealer for repair of the car.

(c) **Purpose**: The goods are delivered for some purpose. The purpose may be express or implied.

(d) **Possession:** In bailment, possession of goods changes. Change of possession can happen by physical delivery or by any action which has the effect of placing the goods in the possession of bailee. The change of possession does not lead to change of ownership. In bailment, bailor continues to be the owner of goods. Where a person is in custody without possession he does not become a bailee.

For **example**, servant of a master who is in custody of goods of the master does not become a bailee.

Similarly, depositing ornaments in a bank locker is not bailment, because ornaments are kept in a locker whose key are still with the owner and not with the bank. The ornaments are in possession of the owner though kept in a locker at the bank.

(e) **Return of goods:** Bailee is obliged to return the goods physically to the bailor. The goods should be returned in the same form as given or may be altered as per bailor's direction. It should be noted that exchange of goods should not be allowed. The bailee cannot deliver some other goods, even not those of higher value.

Deposit of money in a bank is not bailment since the money returned by the bank would not be identical currency notes.

Types of bailment

1. **On the basis of benefit, bailment can be classified into three types:**

a. ***For the exclusive benefit of bailor:***

Example 5: The delivery of some valuables to a neighbour for safe custody, without charge.

b. ***For the exclusive benefit of bailee:***

Example 6: The lending of a bicycle to a friend for his use, without charge.

c. ***For mutual benefit of bailor and bailee:***

Example 7: Giving of a watch for repair.

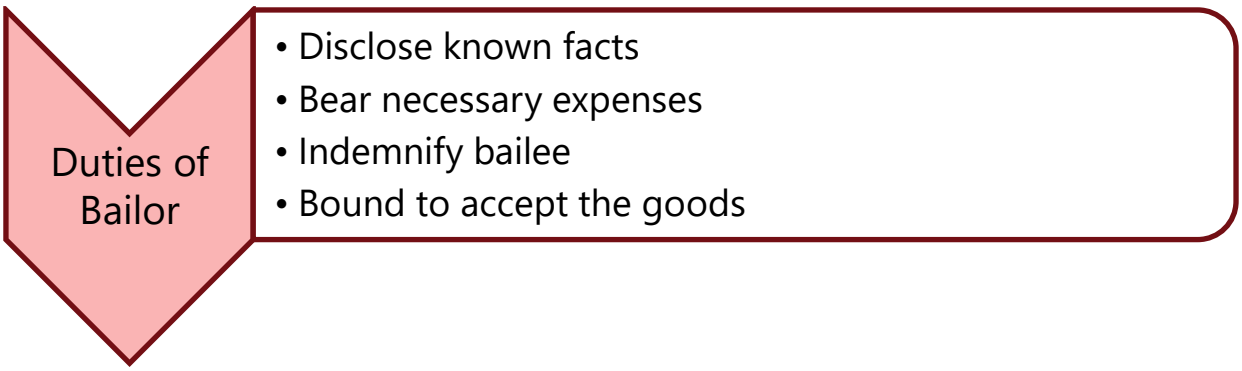
2. **On the basis of reward, bailment can be classified into two types:**

a. ***Gratuitous Bailment***: The word gratuitous means free of charge. So, a gratuitous bailment is one when the provider of service does it gratuitously i.e. free of charge. Such bailment would be either for the exclusive benefits of bailor or bailee.

b. ***Non-Gratuitous Bailment:*** Non gratuitous bailment means where both the parties get some benefit i.e. bailment for the benefit of both bailor & bailee

8.2 DUTIES OF A BAILOR

Duties of Bailor: The duties of bailor are spelt out in a number of Sections [Section 150, 158, 159, 164]. These are categorized under the following headings:



These are enumerated hereunder:

(i) Bailor's duty to disclose faults in goods bailed [Section 150]:

a. **In case of gratuitous bailment:** The bailor is bound to disclose to the bailee faults in the goods bailed, of which the bailor is aware, and which materially interfere with the use of them, or expose the bailee to extraordinary risks; and if he does not make such disclosure, he is responsible for damage arising to the bailee directly from such faults.

Example 8: A lends a horse, which he knows to be vicious, to B. He does not disclose the fact that the horse is vicious. The horse runs away. B is thrown and injured. A is responsible to B for damage sustained.

b. **In case of non- gratuitous bailment:** If the goods are bailed for hire, the bailor is responsible for such damage, whether he was or was not aware of the existence of such faults in the goods bailed.

Example 9: A hires a carriage of B. The carriage is unsafe, though B is not aware of it, and A is injured. B is responsible to A for the injury.

In *Hyman & Wife v. Nye & Sons (1881)*, A hired from B a carriage along with a pair of horses and a driver for a specific journey. During the journey a bolt in the under-part of the carriage broke away. As a result of this, the carriage became upset and A was injured. *It was held that B was liable to pay damages to A for the injury sustained by him. The court observed that it was the bailor's duty to supply a carriage fit for the purpose for which it was hired.*

Sometimes, the goods bailed are of dangerous nature (e.g., explosives). In such cases it is the duty of the bailor to disclose the nature of goods. *[Great Northern Ry' case (1932)]*

(ii) Duty to pay necessary expenses [Section 158]:

a. **In case of Gratuitous bailment**: Where, by the conditions of the bailment, the goods are to be kept or to be carried, or to have work done upon them by the bailee for the bailor, and the bailee is to receive no remuneration (gratuitous bailment), the bailor shall repay to the bailee the necessary expenses incurred by him and any extraordinary expenses incurred by him for the purpose of the bailment.

b. **In case of non-gratuitous bailment** the bailor is liable to pay the extraordinary expenses incurred by the bailee.

Example 10: A hired a taxi from B for the purpose of going to Gurgaon from Noida. During the journey, a major defect occurred in the engine. A had to pay ₹ 5000 as

repair charges. These are the extraordinary expenses and it is the bailor's duty to bear such expenses. However, the usual and ordinary expenses for petrol, toll tax etc. are to be borne by the bailee itself.

(iii) **Duty to indemnify the Bailee for premature termination [Section 159]:** The bailor must compensate the bailee for the loss or damage suffered by the bailee that is in excess of the benefit received, where he had lent the goods gratuitously and decides to terminate the bailment before the expiry of the period of bailment.

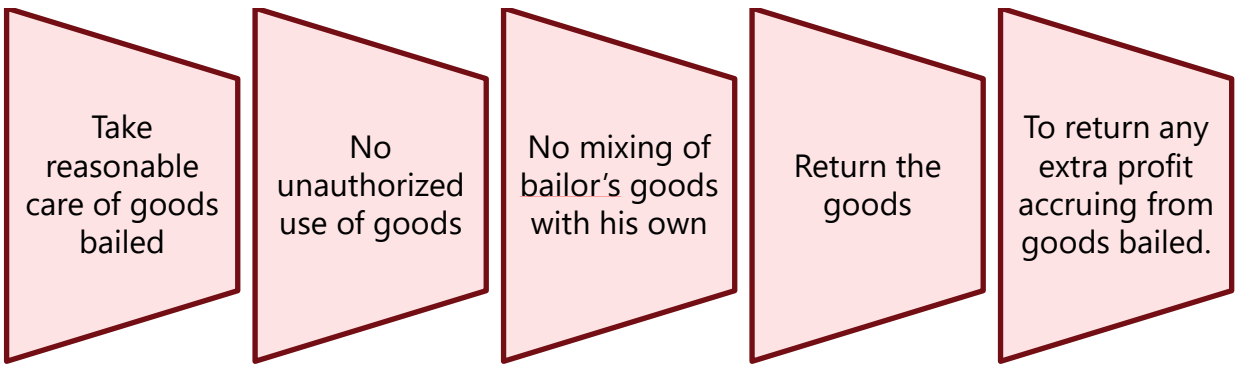
(iv) **Bailor's responsibility to bailee [Section 164]:** The bailor is responsible to the bailee for the following:

a. **Indemnify for any loss** which the bailee may sustain by reason that the bailor was not entitled to make the bailment, or to receive back the goods or to give directions, respecting them (defective title in goods).

b. It is the duty of the bailor **to receive back the goods** when the bailee returns them after the time of bailment has expired or the purpose of bailment has been accomplished. If the bailor refuses to take delivery of goods when it is offered at the proper time the bailee can claim compensation for all necessary expenses incurred for the safe custody.

Example 11: X delivered his car to S for five days for safe keeping. However, X did not take back the car for one month. In this case, S can claim the necessary expenses incurred by him for the custody of the car.

8.3 DUTIES OF A BAILEE



1. **Take reasonable care of the goods (Section 151 & 152):** In all cases of bailment, the bailee is bound to take as much care of the goods bailed to him as a man of ordinary prudence would, under similar circumstances, take care of his own goods of the same bulk, quality and value, as the goods bailed.

Example 12: If X bails his ornaments to 'Y' and 'Y' keeps these ornaments in his own locker at his house along with his own ornaments and if all the ornaments are lost/stolen in a riot 'Y' will not be responsible for the loss to 'X'. If on the other hand 'X' specifically instructs 'Y' to keep them in a bank, but 'Y' keeps them at his residence, then 'Y' would be responsible for the loss caused on account of riot.

Example 13: A deposited his goods in B's warehouse. On account of unprecedented floods, a part of the goods were damaged. It was held that, B is not liable for the loss *(Shanti Lal V. Takechand)*.

Exception: Bailee when not liable for loss, etc., of thing bailed [Section 152]: The bailee, in the absence of any special contract, is not responsible for the loss, destruction or deterioration of the thing bailed, if he has taken reasonable care as required under section 151.

2. **Not to make inconsistent use of goods (section 153 & 154):** As per Section 154, if the bailee makes any use of the goods bailed, which is not according to the terms and conditions of the bailment, he is liable to compensate the bailor for any loss or destruction of goods**.**

Example 14: A lends a horse to B for his own riding only. B allows C, a member of his family, to ride the horse. C rides with care, but the horse accidentally falls and is injured. B is liable to make compensation to A for the injury done to the horse.

Example 15: 'A' hires a horse in Kolkata from B expressly to march to Varanasi. 'A' rides with due care, but marches to Cuttack instead. The horse accidentally falls and is injured. 'A' is liable to make compensation to B for the injury to the horse.

As per Section 153, a contract of bailment is voidable at the option of the bailor, if the bailee does not use the goods according to the terms and conditions of bailment.

Example 16: A lends to B, a horse for his own riding. B gives the horse to C for riding. This contract is voidable at the option of A, bailor.

3. **Not to mix the goods (Section 155, 156 and 157):**

   i. If the Bailee, mixes the goods bailed with his own goods, with the consent of the bailor, both the parties shall have an interest in proportion to their respective shares in the mixture thus produced (Section 155).

   ii. If the bailee, without the consent of the bailor, mixes the goods bailed with his own goods and the goods can be separated or divided, the property in the goods remains in the parties respectively; but the bailee is bound to bear the expense of separation or division and any damage arising from the mixture (Section 156).

Example 17: A bails 100 bales of cotton marked with a particular mark to B. B, without A's consent, mixes the 100 bales with other bales of his own, bearing a different mark; A is entitled to have his 100 bales returned, and B is bound to bear all the expenses incurred in the separation of the bales, and any other incidental damage.

iii. If the bailee, without the consent of the bailor mixes the goods of the bailor with his own goods in such a manner that it is impossible to separate the goods bailed from the other goods and to deliver them back, the bailor is entitled to be compensated by the bailee for loss of the goods (Section 157).

Example 18: A bails a barrel of Cape flour worth ₹ 4500 to B. B, without A's consent, mixes the flour with country flour of his own, worth only ₹ 2500 a barrel. B must compensate A for the loss of his flour.

4. **Return the goods (Section 160 & 161):** It is the duty of bailee to return, or deliver according to the bailor's directions, the goods bailed without demand, as soon as the time for which they were bailed, has expired, or the purpose for which they were bailed has been accomplished. [Section 160]

If, by the default of the bailee, the goods are not returned, delivered or tendered at the proper time, he is responsible to the bailor for any loss, destruction or deterioration of the goods from that time. [Section 161]

Example 19: X delivered books to Y to be bound. Y promised to return the books within a reasonable time. X pressed for the return of the book. But Y, failed to deliver them back even after the expiry of reasonable time. Subsequently the books were burnt in an accidental fire at the premises of Y. In this case Y was held liable for the loss.

5. **Return an accretion from the Goods [Section 163]:** In the absence of any contract to the contrary, the bailee is bound to deliver to the bailor, or according to his directions, any increase or profit which may have accrued from the goods bailed.

Example 20: A leaves a cow in the custody of B. The cow gives birth to a calf. B is bound to deliver the calf along with the cow, to A.

6. **Not to setup Adverse Title**: Bailee must not set up a title adverse to that of the bailor. He must hold the goods on behalf of and for the bailor. He cannot deny the title of the bailor.

8.4 RIGHTS OF A BAILOR

Rights of Bailor: The following are the rights of bailor:-

- Right to terminate the bailment
- Right to demand back the goods at any time
- Right to file a suit against any wrong doer
- Right to file a suit for enformcement of duties imposed upon a bailee.
- Right to claim compensation

(i) **Right to terminate the bailment [Section 153]:** A contract of bailment is voidable at the option of the bailor, if the bailee does any act with regard to the goods bailed, inconsistent with the conditions of the bailment.

Termination of bailment has been discussed in next pages.

(ii) **Right to demand back the goods (Section 159)**: When the goods are lent gratuitously, the bailor can demand back the goods at any time even before the expiry of the time fixed or the achievement of the object.

Example 21: A, while going out of station delivered his ornaments to B for safe custody for one month. But A returned to station after one week. He may demand the return of his ornaments even though the time of one month has not expired.

However, due to the premature return of the goods, if the bailee suffers any loss, which is more than the benefit actually obtained by him from the use of the goods bailed, the bailor has to compensate the bailee.

(iii) **Right to file a suit against a wrong doer** [Section 180 and section 181] (discussed in next pages)

(iv) **Right to sue the bailee**: The bailor has a right to sue the bailee for enforcing all the liabilities and duties of him.

(v) **Right to compensation**: If any damage is caused to the goods bailed because of the unauthorized use of the goods or unauthorized mixing of the goods, the bailor has a right to claim compensation for the same.

8.5 RIGHTS OF A BAILEE

Rights of bailee: The following are the rights of the bailee:-

1. **Right to Deliver the Goods to any one of the joint bailors [Section 165]**

   If several joint owners bailed the goods, the bailee has a right to deliver them to any one of the joint owners unless there was a contract to the contrary.

   Example 22: A, B and C are the joint owners of a harvesting combine. They delivered it on hire to D for one month. After the expiry of one month, D may return the "combine" to any one of the joint owners namely, A, B or C.

2. **Right to indemnity (Section 166):** Bailee is entitled to be indemnified by the bailor for any loss arising to him by reasons that the bailor was not entitled to make the bailment or to receive back the goods or to give directions in respect to them. If the bailor has no title to the goods, and the bailee in good faith, delivers them back to, or according to the directions of the bailor, the bailee shall not be responsible to the owner in respect of such delivery. Bailee can also claim all the necessary expenses incurred by him for the purpose of gratuitous bailment.

3. **Right to claim compensation in case of faulty goods (Section 150):** A bailee is entitled to receive compensation from the bailor or any loss caused to him due to the failure of the bailor to disclose any faults in the goods known to him. If the bailment is for hire, the bailor will be liable to compensate even though he was not aware of the existence of such faults.

4. **Right to claim necessary expenses (Section 158)**: In case of gratuitous bailment, the bailor shall repay to the bailee the necessary expenses incurred by him and any extraordinary expenses incurred by him for the purpose of the bailment.

5. **Right to Apply to Court to Decide the Title to the Goods [Section 167]:** If the goods bailed are claimed by the person other than the bailor, the bailee may apply to the court to stop its delivery and to decide the title to the goods.

   Example 23: A, a dealer in T.V. delivered a T.V. to B for using in summer vacation. Subsequently, C claimed that the T.V. belonged to him as it was delivered only for repairs, to A and thus, B should deliver it to him. In this case, B may apply to the Court to decide the question of ownership of the T.V. so that he may deliver it to the right owner.

6. **Right of particular lien for payment of services [Section 170]:** (Discussed in next pages)

7. **Right of general lien (Sec. 171):** (Discussed in next pages)

8.6 RIGHTS OF BAILOR AND BAILEE AGAINST ANY WRONG DOER (THIRD PARTY)

Suit by bailor & bailee against wrong doers [Section 180]: If a third person wrongfully deprives the bailee of the use or possession of the goods bailed, or does them any injury, the bailee is entitled to use such remedies as the owner might have used in the like case if no bailment had been made; and either the bailor or the bailee may bring a suit against a third person for such deprivation or injury.

Apportionment of relief or compensation obtained by such suits [Section 181]: Whatever is obtained by way of relief or compensation in any such suit shall, as between the bailor and the bailee, be dealt with according to their respective interests.

8.7 TERMINATION OF BAILMENT

A contract of bailment shall terminate in the following circumstances:

1. **On expiry of stipulated period**: If the goods were given for a stipulated period, the contract of bailment shall terminate after the expiry of such period.

   Example 24: X gives his motorcycle to Y for a month. The bailment terminates after 1 month.

2. **On fulfillment of the purpose**: If the goods were delivered for a specific purpose, a bailment shall terminate on the fulfillment of that purpose.

   Example 25: X hires certain tents and crockery on marriage of his daughter. The bailment terminates after marriage.

3. **By Notice:**

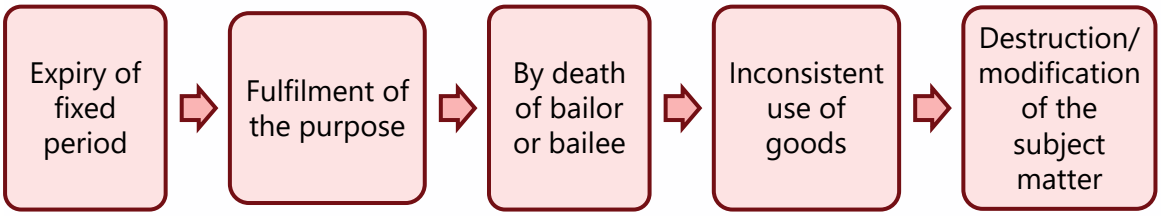
   (a) Where the bailee acts in a manner which is inconsistent with the terms of the bailment, the bailor can always terminate the contract of bailment by giving a notice to the bailee.

   (b) A gratuitous bailment can be terminated by the bailor at any time by giving a notice to the bailee. However, the termination should not cause loss to the bailee in excess of the benefit derived by him. In case the loss exceeds the benefit derived by the bailee, the bailor must compensate the bailee for such a loss (Sec. 159).

4. **By death**: A gratuitous bailment terminates upon the death of either the bailor or the bailee.

5. **Destruction of the subject matter**: A bailment is terminated if the subject matter of the bailment is destroyed or there is a change is in the nature of goods which makes it impossible to be used for the purpose of bailment.

Example 26: X gives his cycle to Y on hire. Cycle damaged beyond repairs. Bailment ends.



8.8 FINDER OF LOST GOODS

Right of finder of lost goods- may sue for specific reward offered [Section 168]: A person who finds some goods which do not belong to him, is called the finder of the goods. It is the duty of the finder of goods to find the true owner and surrender the goods to him. However, the finder of goods has no right to sue the owner for compensation for trouble and expense voluntarily incurred by him in finding the owner and preserving the goods found. But he has a right to retain the goods against the owner until he receives such compensation; and, where the owner has offered a specific reward on the lost goods, the finder may sue the owner for such reward, and may retain the goods until then.

When finder of thing commonly on sale may sell it [Section 169]: When a thing which is commonly the subject of sale if lost, if the owner cannot with reasonable diligence be found, or if he refuses, upon demand, to pay the lawful charges of the finder, the finder may sell it—

(1) when the thing is in danger of perishing or of losing the greater part of its value, or

(2) when the lawful charges of the finder in respect of the thing found amount to two-thirds of its value.

8.9 RIGHT OF LIEN

RIGHT OF LIEN

Lien is the right of a person

- to retain the goods belonging to another

- until his claim is satisfied or
- some debt due to him is repaid.

Types of Lien: Lien may be of two types:

a. Particular Lien

b. General Lien

Particular Lien: It is a right to retain only the particular goods in respect of which the claim is due.

Section 170 provides, where the bailee has, in accordance with the purpose of the bailment, rendered any service involving the exercise of labour or skill in respect of the goods bailed, he has, in the absence of a contract to the contrary, a right to retain such goods until he receives due remuneration for the services he has rendered in respect of them.

Example 27: 'A' gives cloth to 'B', a tailor, to make into a coat. 'B' is entitled to retain the coat until he is paid.

Example 28: If in the above example, 'B' takes 15 days time to make the coat, right of lien will be applicable after 15 days.

Example 29: A delivers a rough diamond to B, a jeweller, to be cut and polished, which is accordingly done. B is entitled to retain the stone till he is paid for the services he has rendered.

General Lien: It is a right to retain the goods not only for demands arising out of the goods retained but for a general balance of account in favour of certain persons (in the absence of a contract to the contrary). Section 171 provides this right is available to Bankers, factors, wharfingers, policy brokers and attorneys of law.

Example 30: 'A' borrows ₹ 500/- from the bank without security and subsequently again borrows another ₹ 1000/- but with security of say certain jewellery. In this illustration, even where 'A' has returned ₹ 1000/- being the second loan, the banker can retain the jewellery given as security to the second loan towards the first loan which is yet to be repaid.

Under the right of general lien the goods cannot be sold but can only be retained for dues. The right of lien can be waived through a contract.

Difference between Bailee's General and Particular Lien

General lien	Particular lien
Section 171 of the Indian Contract Act, 1872 confer on Bailee the right of General Lien.	Section 170 of the Indian Contract Act, 1872 confers on the Bailee, the right of particular lien.

General lien alludes to the right to keep possession of goods belonging to other against general balance of account.	Particular lien implies a right of the bailee to retain specific goods bailed for non-payment of amount.
A general lien is not automatic but is recognized through on agreement. It is exercised by the bailee only by name.	It is automatic.
It can be exercised against goods even without involvement of labor or skill.	It comes into play only when some labor or skill is involved has been expended on the goods, resulting in an increase in value of goods.
Only such persons as are specified under section 171, e.g., Bankers, factors, wharfingers, policy brokers etc. are entitled to general lien.	Bailee, finder of goods, pledgee, unpaid seller, agent, partner etc. are entitled to particular lien.

8.10 PLEDGE

"Pledge", "pawnor" and "pawnee" defined [Section 172]: The bailment of goods as security for payment of a debt or performance of a promise is called **"pledge".** The bailor is in this case called the **"pawnor".** The bailee is called the **"pawnee".**

Section 172 to 182 of the Indian Contract Act, 1872 deal with the contract of pledge.

Example 31: A lends money to B against the security of jewellery deposited by B with him. This bailment of jewellery is a pledge as security for lending the money. B is a pawnor/ pledger and A is a pawnee/ pledgee.

ESSENTIALS OF CONTRACT OF PLEDGE: Since pledge is a special kind of bailment, therefore all the essentials of bailment are also the essentials of the pledge. Apart from that, the other essentials of the pledge are:

- There shall be a bailment for security against payment or performance of the promise,
- The subject matter of pledge is goods,
- Goods pledged for shall be in existence,
- There shall be the delivery of goods from pledger to pledgee

RIGHTS OF A PAWNEE/ PLEDGEE: Rights of Pawnee can be classified as under the following headings:

(a) **Right to retain the pledged goods [Section 173]:** The pawnee may retain the goods pledged, not only for payment of the debt or the performance of the promise, but for the interest, of the debt, and all necessary expenses incurred by him in respect of the possession or for the preservation of the goods pledged.

Example 32: Where 'M' pledges stock of goods for certain loan from a bank, the bank has a right to retain the stock not only for adjustment of the loan but also for payment of interest.

(b) **Right to retention of subsequent debts [Section 174]:** The Pawnee can retain the goods pledged for any debt or promise other than the debt or promise for which they are pledged. But he can exercise this right only when there is a contract to this effect. i.e. a right to retain goods for subsequent debts can be exercised only when it has been provided for in a contract to this effect.

(c) **Pawnee's right to extraordinary expenses incurred [Section 175]:** The pawnee is entitled to receive from the pawnor extraordinary expenses incurred by him for the preservation of the goods pledged. For such expenses, however, he does not have the right to retain the goods, but he can sue the pawnor for such expenses.

(d) **Pawnee's right where pawnor makes default [Section 176]:** If the pawnor makes default in payment of the debt, or performance, at the stipulated time of the promise, in respect of which the goods were pledged, the pawnee has the following rights:

i. the pawnee may bring a suit against the pawnor upon the debt or promise, and retain the goods pledged as a collateral security; or

ii. he may sell the thing pledged on giving the pawnor reasonable notice of the sale.

If the proceeds of such sale are less than the amount due in respect of the debt or promise, the pawnor is still liable to pay the balance. If the proceeds of the sale are greater than the amount so due, the pawnee shall pay over the surplus to the pawnor.

Rights of a pawnor

As the bailor of goods, pawnor has all the rights of the bailor. Along with that he also has the right of redemption to the pledged goods which is enumerated under section 177 of the Act.

Right to redeem [Section 177]: If a time is stipulated for the payment of the debt, or performance of the promise, for which the pledge is made, and the pawnor makes default in payment of the debt or performance of the promise at the stipulated time, he may redeem the goods pledged at any subsequent time before the actual sale of them; but he must, in that case, pay, in addition, any expenses which have arisen from his default.

Note: Redemption means to recover back the goods by making of the payment of debt or performance of promise.

Duties of the Pawnee

Pawnee has the following duties:

a. Duty to take reasonable care of the pledged goods.

b. Duty not to make unauthorized use of pledged goods.

c. Duty to return the goods when the debt has been repaid or the promise has been performed.

d. Duty not to mix his own goods with goods pledged.

e. Duty not to do any act which is inconsistent with the terms of the pledge.

f. Duty to return accretion to the goods, if any.

Duties of a Pawnor

Pawnor has the following duties:

a. The pawnor is liable to pay the debt or perform the promise as the case may be.

b. It is the duty of the pawnor to compensate the pawnee for any extraordinary expenses incurred by him for preserving the goods pawned.

c. It is the duty of the pawnor to disclose all the faults which may put the pawnee under extraordinary risks.

d. If loss occurs to the pawnee due to defect in pawnor's title to the goods, the pawnor must indemnify the pawnee.

e. If the pawnee sells the good due to default by the pawnor, the pawnor must pay the deficit.

8.11 PLEDGE BY NON-OWNERS

Ordinarily, it is the owner of the goods, or any person authorized by him in that behalf, who can pledge the goods. But in order to facilitate mercantile transactions, the law has recognised certain exceptions. These exceptions are for bonafide pledges made by those persons who are not the actual owners of the goods, but in whose possession the goods have been left.

a. Pledge by mercantile agent [Section 178]:

A mercantile agent, who is in the possession of goods or document of title, with the consent of owner, can pledge them while acting in the ordinary course of business as a Mercantile Agent.

Such Pledge shall be valid as if were made with the authority of the owner of goods. Provided, Pawnee acted in good faith and had no notice that Pawnor has no authority to pledge.

b. Pledge by person in possession under voidable contract [Section 178A]: When the pawnor has obtained possession of the goods pledged by him under a contract voidable under section 19 or section 19A (contracts where consent has been obtained by fraud, coercion, misrepresentation, undue influence), but the contract has not been rescinded at the time of the pledge, the pawnee acquires a good title to the goods, provided he acts in good faith and without notice of the pawnor's defect of title.

c. Pledge where pawnor has only a limited interest [Section 179]: Where a person pledges goods in which he has only a limited interest i.e. pawnor is not the absolute owner of goods, the pledge is valid to the extent of that interest.

Example 33: Mr. X finds a defective mobile phone lying on the road. He picks it up, gets it repaired for ₹ 5000. He later pledges the mobile phone for ₹ 2,000. The true owner can recover the mobile phone only on paying ₹ 5,000.

Example 34: 'A' pledges his jewellery worth ₹ 1,00,000 with 'B' for a advance of ₹ 70,000. 'B' pledges the same for ₹ 90,000 with 'C'. Now this pledge is valid upto ₹ 70,000 plus interest due thereon.

d. Pledge by a co-owner in possession: Where the goods are owned by many person and with the consent of other owners, the goods are left in the possession of one of the co-owners. Such a co-owner may make a valid pledge of the goods in his possession.

e. **Pledge by seller or buyer in possession**: A seller, in whose possession, the goods have been left after sale or a buyer who with the consent of the seller, obtains possession of the goods, before sale, can make a valid pledge, provided the pawnee acts in good faith and he has no knowledge of the defect in title of the pawnor.

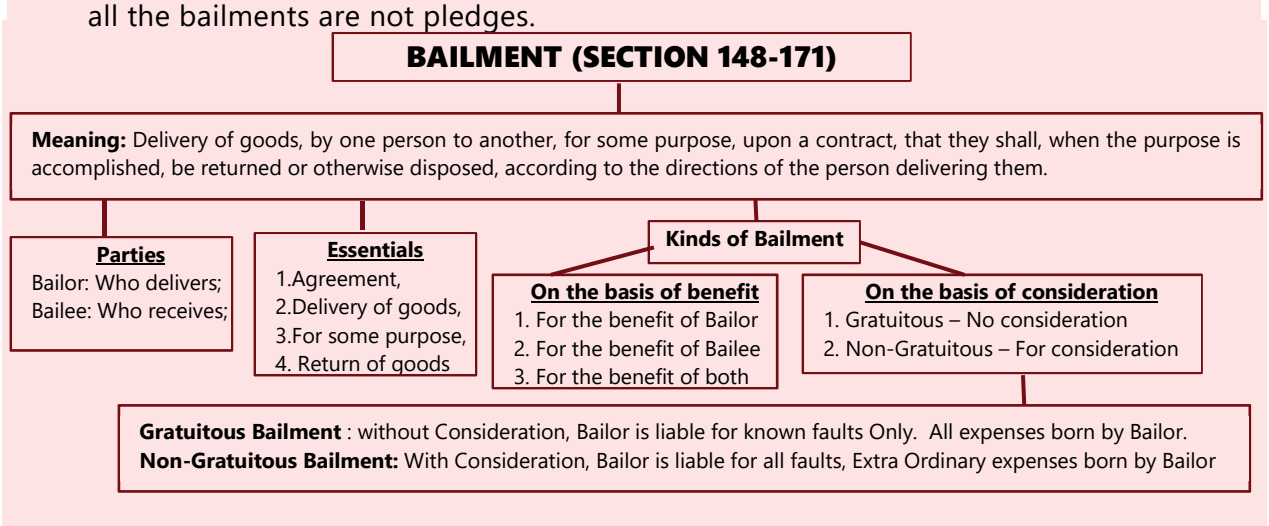
Example 35: A buys a cycle from B. But leaves the cycle with the seller. B then pledges the cycle with C, who does not know of sale to A, and acted in good faith. This is valid pledge.

8.12 DISTINCTION BETWEEN BAILMENT AND PLEDGE

Basis of Distinction	Bailment	Pledge
Meaning	Transfer of goods by one person to another for some specific purpose is known as bailment.	Transfer of goods from one person to another as security for repayment of debt is known as the pledge.
Parties	The person delivering the goods under a contract of bailment is called as "Bailor". The person to whom the goods are delivered under a contract of bailment is called as "Bailee".	The person who delivers the good as security is called the "Pawnor". The person to whom the goods are delivered as security is called the "pawnee".
Purpose	Bailment may be made for any purpose (as specified in the contract of bailment, eg: for safe custody, for repairs, for processing of goods).	Pledge is made for the purpose of delivering the goods as security for payment of a debt, or performance of a promise.
Consideration	The bailment may be made for consideration or without consideration.	Pledge is always made for a consideration.
Right to sell the goods	The bailee has no right to sell the goods even if the charges of bailment are not paid to him. The bailee's rights are limited to suing the bailor for his dues or to exercise lien on the goods bailed.	The pawnee has right to sell the goods if the pawnor fails to redeem the goods.
Right to use of goods	Bailee can use the goods only for a purpose specified in the contract of bailment and not otherwise.	Pledgee or Pawnee cannot use the goods pledged.

SUMMARY

- **Bailment**-Delivery of goods by one person to another for some purpose upon a contract that they shall be returned after the purpose is over or disposed off according to the directions of the person delivering them.
- **Bailor-** Person who delivers the goods for bailment.
- **Bailee**- Person to whom goods are delivered under the contract of bailment.
- **Depositing currency notes in a bank**- It is not a bailment as currency notes or moneys are not goods as per the definition of goods given under the Sale of Goods Act, 1930 and also same currency notes are not returned to the depositor by the bank.
- **Keeping of ornaments/valuables in a bank locker**- It's not a bailment as there is no transfer of possession of ornaments or valuables.
- **Gratuitous bailment-** No consideration passes between the bailor and the bailee and the bailor is not responsible for the damages in respect of the faults which were not known to him.
- **Pledge-** Bailment of goods as security for payment of a debt/performance of a promise.
- **Pawnor-** Person who pledges goods as security.
- **Pawnee-** Person who receives the goods as security.
- Some non-owners may also create a valid pledge of goods, such as- Mercantile agents, co-owner, by person having a limited interest, by person having a possession of goods under voidable contract.
- **Basic distinction between bailment and pledge-** All the pledges are bailments but all the bailments are not pledges.



Duties & Rights

Duties of Bailor

1. Disclose known faults,
2. Bear expenses,
3. Indemnify Bailee,
4. Receive back goods.

Rights of Bailor

1. Terminate bailment,
2. Demand return of goods any time,
3. Claim accretion,
4. Right against third party.

.

Duties of Bailee

1. Take care of the goods bailed,
2. No unauthorized use of goods,
3. Not mix goods with own goods,
4. Return the goods,
5. Return accretions to goods,
6. Not to set up adverse title

Rights of Bailee

1. Delivery to any of joint bailors,
2. Right to compensation,
3. Claim necessary expenses,
4. Action for wrongful deprivation of goods,
5. Right of lien

Termination of Bailment

1. On expiry of stipulated period,
2. Accomplishment of Specified purpose,
3. Doing anything inconsistent with conditions,
4. Gratuitous Bailment (Any time),
5. By Death,
6. Destruction of subject-matter,

Finder of Lost Goods

Duties: Same as of Bailee,

Rights: Lien, Sue for Reward, Sale of Goods,

Lien

Meaning: To retain the goods belonging to another until his claim is satisfied or some debt due to him is repaid,

General Lien: Right to retain any goods in respect of any debt.

Particular Lien: Right to retain any goods in respect of concerned debt only.

PLEDGE (SECTION 171 – 181)

Meaning: Bailment of goods as security for payment of a debt or performance of a promise.

Parties: Bailor – Pawnor; Bailee – Pawnee

Duties & Rights

Duties of Pawnor

1. Pay Debt,
2. Indemnify Pawnee,
3. Disclose all the faults,
4. Pay extra ordinary expenses,
5. Pay deficit if Pawnee sells goods due to default by Pawnor

Rights of Pawnor

Same as that of Bailor alongwith right of redemption *(to recover back the goods by making of the payment of debt)*

Duties of Pawnee

1. Take care of the goods bailed,
2. No unauthorized use of goods,
3. Not mix goods with own goods,
4. Return the goods,
5. Return accretions to the goods,
6. Not to set up adverse title

Rights of Pawnee

1. Retain the Pledged Goods,
2. Retention for Subsequent Debts,
3. Recover Extraordinary Expenses,
4. Right on Default by Pawnor

Pledge by Non-owner

1. Pledge by Mercantile Agent,
2. Pledge by Person in Possession under voidable contract,
3. Pledge where Pawnor has only a Limited Interest,
4. Pledge by co-owner in possession,
5. Pledge by buyer or seller in possession

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *Bailment means .....*
   - *(a) temporary delivery of goods.*
   - *(b) permanent delivery of goods.*
   - *(c) partly delivery of goods.*
   - *(d) None*
2. *Which is not essential element of contract of bailment .....*
   - *(a) doing contract.*
   - *(b) Purchase of goods.*
   - *(c) delivery of goods.*
   - *(d) return of goods in specific time.*
3. *In the contract of bailment the person to whom goods is delivered, called .....*
   - *(a) seller*
   - *(b) bailee*
   - *(c) bailor*
   - *(d) agent*
4. *Bailee should care the goods as per .....*
   - *(a) as a man of ordinary prudence*
   - *(b) as owner*
   - *(c) as principal*
   - *(d) as a servant*
5. *Lien means .....*
   - *(a) to retain goods in his possession*
   - *(b) rights to sell the goods.*
   - *(c) right to purchase the goods.*
   - *(d) right to destroy the goods.*

6. *In case there are two or more joint owners of the goods, the Bailee has to deliver them back to _____ , in the absence of any agreement to the contrary :*
   - *(a) Any of the Joint owners.*
   - *(b) Such joint owner for which all the joint owners have consented.*
   - *(c) All the Joint owners collectively.*
   - *(d) None of these.*

7. *A finder of goods is subject to the same responsibility as that of a .....*
   - *(a) bailee*
   - *(b) bailor*
   - *(c) surety*
   - *(d) purchaser*

8. *The bailment of goods as security for payment of a debt is called .....*
   - *(a) pledge*
   - *(b) bailment*
   - *(c) mortgage*
   - *(d) none of these*

9. *What is an essential element of a valid pledge?*
   - *(a) Delivery of goods*
   - *(b) Delivery of bills*
   - *(c) Price*
   - *(d) None of these*

10. *The pledge is a contract of .....*
    - *(a) bailment*
    - *(b) agency*
    - *(c) guarantee*
    - *(d) mortgage*

Descriptive Questions

1. *State the essential elements of a contract of bailment.*
2. *Give differences between Bailment and Pledge.*

3. *Examine whether the following constitute a contract of 'Bailment' under the provisions of the Indian Contract Act, 1872:*

   (i) V parks his car at a parking lot, locks it, and keeps the keys with himself.

   (ii) Seizure of goods by customs authorities.

4. *A hires a carriage from B and agrees to pay ₹ 500 as hire charges. The carriage is unsafe, though B is unaware of it. A is injured and claims compensation for injuries suffered by him. B refuses to pay. Discuss the liability of B.*

5. *A bails his jewellery with B on the condition to safeguard it in a bank's safe locker. However, B kept it in safe locker at his residence, where he usually keeps his own jewellery. After a month all jewellery was lost in a religious riot. A filed a suit against B for recovery. Referring to provisions of the Indian Contract Act, 1872, state whether A will succeed.*

6. *R gives his umbrella to M during raining season to be used for two days during Examinations. M keeps the umbrella for a week. While going to R's house to return the umbrella, M accidently slips and the umbrella is badly damaged. Who bear the loss and why?*

7. *Amar bailed 50 kg of high quality sugar to Srijith, who owned a kirana shop, promising to give ₹ 200 at the time of taking back the bailed goods. Srijith's employee, unaware of this, mixed the 50 kg of sugar belonging to Amar with the sugar in the shop and packaged it for sale when Srijith was away. This came to light only when Amar came asking for the sugar he had bailed with Srijith, as the price of the specific quality of sugar had trebled. What is the remedy available to Amar?*

8. *Mrs. A delivered her old silver jewellery to Mr. Y a Goldsmith, for the purpose of making new a silver bowl out of it. Every evening she used to receive the unfinished good (silver bowl) to put it into box kept at Mr. Y's Shop. She kept the key of that box with herself. One night, the silver bowl was stolen from that box. Was there a contract of bailment? Whether the possession of the goods (actual or constructive) delivered, constitute contract of bailment or not?*

9. *Srushti acquired valuable diamond at a very low price by a voidable contract under the provisions of the Indian Contract Act, 1872. The voidable contract was not rescinded. Srushti pledged the diamond with Mr. VK. Is this a valid pledge under the Indian Contract Act, 1872?*

ANSWERS/HINTS

Answers to MCQs

1.	**(a)**	2.	**(b)**	3.	**(b)**	4.	**(a)**	5.	**(a)**	6.	**(a)**
7.	**(a)**	8.	**(a)**	9.	**(a)**	10.	**(a)**				

Answers to the Descriptive Questions

1. **Essential elements of a contract of bailment:** Section 148 of the Indian Contract Act, 1872 defines the term 'Bailment'. A 'bailment' is the delivery of goods by one person to another for some purpose upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them. The essential elements of the contract of the bailment are:

(i) *Delivery of goods*—The essence of bailment is delivery of goods by one person to another.

(ii) *Bailment is a contract*—In bailment, the delivery of goods is upon a contract that when the purpose is accomplished, the goods shall be returned to the bailor.

(iii) *Return of goods in specific*—The goods are delivered for some purpose and it is agreed that the specific goods shall be returned.

(iv) *Ownership of goods*—In a bailment, it is only the possession of goods which is transferred, and the bailor continues to be the owner of the goods.

(v) *Property must be movable*—Bailment is only for movable goods and never for immovable goods or money.

2. **Distinction between bailment and pledge: The following are the distinction between bailment and pledge:**

(a) **As to purpose:** Pledge is a variety of bailment. Under pledge goods are bailed as a security for a loan or a performance of a promise. In regular bailment the goods are bailed for other purpose than the two referred above. The bailee takes them for repairs, safe custody etc.

(b) **As to right of sale:** The pledgee enjoys the right to sell only on default by the pledgor to repay the debt or perform his promise, that too only after giving due notice. In bailment the bailee, generally, cannot sell the goods. He can either retain or sue for non-payment of dues.

(c) **As to right of using goods:** Pledgee has no right to use goods. A bailee can, if the terms so provide, use the goods.

(d) **Consideration:** In pledge there is always a consideration whereas in a bailment there may or may not be consideration.

(e) **Discharge of contract:** Pledge is discharged on the payment of debt or performance of promise whereas bailment is discharged as the purpose is accomplished or after specified time.

3. As per Section 148 of the Act, bailment is the delivery of goods by one person to another for some purpose, upon a contract, that the goods shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them.

For a bailment to exist the bailor must give possession of the bailed property and the bailee must accept it. There must be a transfer in ownership of the goods.

(i) No. Mere custody of goods does not mean possession. In the given case, since the keys of the car are with V, Section 148, of the Indian Contract Act, 1872 shall not applicable.

(ii) Yes, the possession of the goods is transferred to the custom authorities. Therefore, bailment exists and section 148 is applicable.

4. Problem asked in the question is based on the provisions of the Indian Contract Act, 1872 as contained in Section 150. The section provides that if the goods are bailed for hire, the bailor is responsible for such damage, whether he was or was not aware of the existence of such faults in the goods bailed. Accordingly, applying the above provisions in the given case, B is responsible to compensate A for the injuries sustained even if he was not aware of the defect in the carriage.

5. According to section 152 of the Indian Contract Act, 1872, the bailee, in the absence of any special contract, is not responsible for the loss, destruction or deterioration of the thing bailed, if he has taken reasonable care as required under section 151.

Here, A and B agreed to keep the jewellery at the Bank's safe locker and not at the latter's residence (i.e. B's residence). Thus, B is liable to compensate A for his negligence to keep jewellery at his (B's) residence.

6. M shall have to bear the loss since he failed to return the umbrella within the stipulated time and Section 161 clearly says that where a bailee fails to return the goods within the agreed time, he shall be responsible to the bailor for any loss, destruction or deterioration of the goods from that time notwithstanding the exercise of reasonable care on his part.

7. According to section 157 of the Contract Act, 1872, if the bailee, without the consent of the bailor, mixes the goods of the bailor with his own goods, in such a manner that it is impossible to separate the goods bailed from the other goods and deliver them back, the bailor is entitled to be compensated by the bailee for the loss of the goods.

In the given question, Srijith's employee mixed high quality sugar bailed by Amar and then packaged it for sale. The sugars when mixed cannot be separated. As Srijith's employee has mixed the two kinds of sugar, he (Srijith) must compensate Amar for the loss of his sugar.

8. Section 148 of Indian Contract Act 1872 defines 'Bailment' as the delivery of goods by one person to another for some purpose, upon a contract that they shall, when the purpose is accomplished, be returned or otherwise disposed of according to the direction of the person delivering them.

According to Section 149 of the Indian Contract Act, 1872, the delivery to the bailee may be made by doing anything which has the effect of putting the goods in the possession of the intended bailee or of any person authorised to hold them on his behalf. Thus, delivery is necessary to constitute bailment.

Thus, the mere keeping of the box at Y's shop, when A herself took away the key cannot amount to delivery as per the meaning of delivery given in the provision in section 149. Therefore, in this case there is no contract of bailment as Mrs. A did not deliver the complete possession of the good by keeping the keys with herself.

9. Pledge by person in possession under voidable contract [Section 178A of the Indian Contract Act, 1872]: When the pawnor has obtained possession of the goods pledged by him under a contract voidable under section 19 or section 19A, but the contract has not been rescinded at the time of the pledge, the pawnee acquires a good title to the goods, provided he acts in good faith and without notice of the pawnor's defect of title.

Therefore, the pledge of diamond by Srushti with Mr. VK is valid.

UNIT–9: AGENCY

LEARNING OUTCOMES

After studying this unit, you would be able to understand:

- The relationship between agent and principal and the intention behind adoption of such course of agency.
- Rights and obligations of an agent as well as the circumstances under which the agent is personally liable for the acts done by him on behalf of the principal and the legal position of the agent, the principal and the third parties involved.
- Terms 'sub-agent' and 'substituted agent' and to distinguish between the two.

UNIT OVERVIEW

A relationship of agency is established when one party (agent) is authorized by another party (principal) to act on his/ her behalf. Such relationships are initiated when one party desires to extend his/her activities beyond his/her present limits or capacity. In modern life, it would be impossible for a man to do everything by himself. Thus, he needs agents, to perform activities. A relationship of agency is commonly visible in all business transactions. These include hiring employees or retaining the services of other professionals such as an attorney, design professional, software developer etc. An agent has the potential to form contracts on behalf of the principal and in doing so, will bind the principal. As a result, the relationship of agency is one of trust and confidence and an agent must perform his/her activities in a capable and conscientious manner. The law of agency is contained in sections 182 to 238 of the Indian Contract Act, 1872.

9.1 WHAT IS AGENCY?

The Indian Contract Act, 1872 does not define the word 'Agency'. However, section 182 of the Indian Contract Act, 1872 defines Agent and Principal as:

Agent means a person employed to do any act for another or to represent another in dealing with the third persons and

The principal means a person for whom such act is done or who is so represented.

Test of Agency

(a) Whether the person has the capacity to bind the principal and make him answerable to the third party.

(b) Whether he can establish privity of contract between the principal and third parties.

If the answer to these questions is in affirmative (Yes), then there is a relationship of agency.

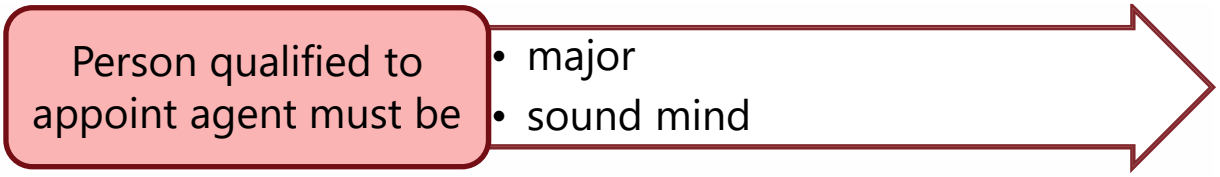
Thus, 'Agency' is a comprehensive word used to describe the relationship between one person and another, where the first mentioned person brings the second mentioned person into legal relation with others.

The Rule of Agency is based on the maxim *"Qui facit per alium, facit per se"* i.e., he who acts through an agent is himself acting.

Qui facit per alium, facit per se

9.2 APPOINTMENT AND AUTHORITY OF AGENTS

Who may employ an agent: According to Section 183, "any person who has attained majority according to the law to which he is subject, and who is of sound mind, may employ an agent." Thus, a minor or a person of unsound mind cannot appoint an agent.



Who may be an agent:

According to Section 184 of the Act any person may become an agent i.e. even a minor or a person of unsound mind may become an agent and the principal shall be bound by his acts. But as a rule of caution, a minor or a person of unsound mind should not be appointed as an agent because he is incompetent to contract and in case of his misconduct or negligence, the principal shall not be able to proceed against him.

Example 1: P appoints Q, a minor, to sell his car for not less than ₹ 2,50,000. Q sells it for ₹ 2,00,000. P will be held bound by the transaction and further shall have no right against Q for claiming the compensation for having not obeyed the instructions, since Q is a minor and a contract with a minor is 'void-ab-initio'.

Consideration not necessary: According to Section 185, no consideration is necessary to create an agency. The acceptance of the office of an agent is regarded as a sufficient consideration for the appointment.

9.3 CREATION OF AGENCY

In the words of Desai J, of the Supreme Court of India "The relation of agency arises whenever one person called the agent has the authority to act on behalf of another called the principal and consents to act. The relationship has genesis in a contract".

The relationship of the principal and the agent may be created in any of the following ways —

The authority may be express or implied: According to Section 186, the authority of an agent may be express or implied.

1. **Definitions of express and implied authority [Section 187]**

   Express Authority: An authority is said to be express when it is given by words, spoken or written.

Example 2: A is residing in Delhi and he has a house in Kolkata. A authorizes B under a power of attorney, as caretaker of his house. Agency is created by express agreement.

Example 3: If a customer of a bank wishes to transact his banking business through an agent, the bank will require written evidence of the appointment of the agent and will normally ask to see the registered power of attorney appointing the agent.

2. **Implied Authority:** An authority is said to be implied when it is to be inferred from the circumstances of the case, conduct of the parties and things spoken or written, or in the ordinary course of dealing, may be accounted from the circumstances of the case.

If a person realises rent and gives it to the landlord, he impliedly acts for the landlord as an agent.

Example 5: A owns a shop in Selampur, living himself in Kolkata and visiting the shop occasionally. The shop is managed by B, and he is in the habit of ordering goods from C in the name of A for the purposes of the shop, and of paying for them out of A's funds with A's knowledge. B has an implied authority from A to order goods from C in the name of A for the purposes of the shop.

Implied Agency includes:-

a. **Agency by Estoppel [Section 237]:** Where the principal by his conduct or statement willfully induces another person to believe that a certain person is his agent, he is subsequently prevented or estopped from denying the fact of agency.

According to section 237 of the Contract Act, an agency by estoppel may be created when following essentials are fulfilled:

1. the principal must have made a representation;
2. the representation may be express or implied;
3. The representation must state that the agent has an authority to do certain act although really he has no authority;
4. The principal must have induced the third person by such representation; and
5. The third person must have believed the representation and made the contract on the belief of such representation.

Example 6: A consigns goods to B for sale and gives him instructions not to sell below a fixed price. C being ignorant of B's instruction enters into a contract with B to buy the goods at a price lower than the reserved price. A is bound by the contract. A cannot plead that he had given instructions to B to not sell the goods below certain price. An agency by estoppel is, consequently, deemed between A and B.

Example 7: If Piyal (the principal) has for several months permitted Sunil to buy goods on credit from Prasad and has paid for the goods bought by Sunil, Piyal cannot later refuse to pay Prasad who had supplied goods on credit to Sunil in the belief that he was Piyal's agent and was buying the goods on behalf of Piyal. Piyal is estopped from now asserting that Sunil is not his agent because on earlier occasions he permitted Prasad to believe that Sunil was his agent and Prasad had acted in that belief.

b. **Agency by Necessity:** An agency of necessity arises due to some emergent circumstances. In emergency a person is authorised to do what he cannot do in ordinary circumstances. Thus, where an agent is authorised to do certain act, and while doing such an act, an emergency arises, he acquires an extra-ordinary or special authority to prevent his principal from loss**.**

Example 8: Raja has a large farm on which Shyam is the caretaker. When Raja is in Canada, there is a huge fire on the farm. Shyam becomes an agent of necessity for Raja so as to save the property from being destroyed by fire. Raja (the principal) will be liable for any expenses, Shyam (his agent of necessity) incurred to put out the fire and save the farm from destruction during Raja's absence from the country.

3. **Agency by Operation of Law:** When law treats one person as an agent of other. For example, a partner is the agent of the firm for the purposes of the business of the firm.

4. **Rights of person as to acts done for him without his authority, Effect of ratification [Section 196]:** Where acts are done by one person on behalf of another, but without his knowledge or authority, he may elect to ratify or to disown such acts. If he ratifies them, the same effects will follow as if they had been performed by his authority. In simple words, "Ratification" means approving a previous act or transaction. Ratification may be express or implied by the conduct of the person on whose behalf the act was done.

Example 9: X who is Y's agent has on 10th January 2022 purchases goods from Z on credit without Y's permission. After the purchase, on 20th January 2022, Y tells X that he will accept responsibility to pay for the purchases although at the time of purchase the agent had no authority to buy on credit. Y's subsequent statement on 20th January 2022 amounts to a ratification of the agent's (X's) purchase of goods on 10th January 2022.

Essentials of a valid Ratification

a. **Ratification may be expressed or Implied [Section 197]:** Ratification may be expressed or may be implied in the conduct of the person on whose behalf the acts are done.

Example 10: A, without authority, buys goods for B. Afterwards B sells them to C on his own account; B's conduct implies a ratification of the purchase made for him by A.

Example 11: A, without B's authority, lends B's money to C. Afterwards B accepts interests on the money from C. B's conduct implies a ratification of the loan.

b. **Knowledge requisite for valid ratification [Section 198]:** No valid ratification can be made by a person whose knowledge of the facts of the case is materially defective.

Example 12: A has an authority from P to buy certain goods at the market rate. He buys at a higher rate but P accepts the purchase. Afterwards P comes to know that the goods purchased by A for P belonged to A himself. The ratification is not binding on P.

c. **The whole transaction must be ratified [Section 199]:** There can be ratification of an act in entirely or its rejection in entirely. The principal cannot ratify a part of the transaction which is beneficial to him and reject the rest.

d. **Ratification cannot injure third person [Section 200]:** When the interest of third parties is affected, the principle of ratification does not apply. Ratification cannot relate back to the date of contract if third party has in the intervening time acquired rights.

Example 13: A, not being authorized thereto by B, demands on behalf of B, the delivery of a chattel, the property of B, from C, who is in possession of it. This demand cannot be ratified by B, so as to make C liable for damages for his refusal to deliver.

Example 14: A holds a lease from B, terminable on three months' notice. C, an unauthorized person, gives notice of termination to A. The notice cannot be ratified by B, so as to be binding on A.

e. **Ratification within reasonable time:** Ratification must be made within a reasonable period of time.

f. **Communication of Ratification:** Ratification must be communicated to the other party.

g. **Act to be ratified must be valid:** Act to be ratified should not be void or illegal, for e.g. payment of dividend out of capital, forgery of signatures, any other criminal offence, or anything which is not permitted under law.

9.4 EXTENT OF AGENT'S AUTHORITY

The agent's authority is governed by two principles, namely (a) in normal circumstances and (b) in emergency.

(a) **Agent's authority in normal circumstances [Section 188]:** An agent having an authority to do an act has authority to do every lawful thing which is necessary in order to do such act.

An agent having an authority to carry on a business has authority to do every lawful thing necessary for the purpose, or usually done in the course, of conducting such business.

Example 15: A is employed by B, residing in London, to recover at Mumbai a debt due to B. A may adopt any legal process necessary for the purpose of recovering the debt and may give a valid discharge for the same.

Example 16: A constitutes B as his agent to carry on his business of a shipbuilder. B may purchase timber and other materials, and hire workmen, for the purposes of carrying on the business.

(b) **Agent's authority in an emergency [Section 189]:** An agent has authority, in an emergency, to do all such acts for the purpose of protecting his principal from loss as would be done by a person of ordinary prudence, in his own case, under similar circumstances.

To constitute a valid agency in an emergency, following conditions must be satisfied.

(i) Agent should not be a in a position or have any opportunity to communicate with his principal within the time available.

(ii) There should have been actual and definite commercial necessity for the agent to act promptly.

(iii) the agent should have acted bonafide and for the benefit of the principal.

(iv) the agent should have adopted the most reasonable and practicable course under the circumstances, and

(v) the agent must have been in possession of the goods belonging to his principal and which are the subject of contract.

Example 17: An agent who has authority for sale of goods may repair it if necessary.

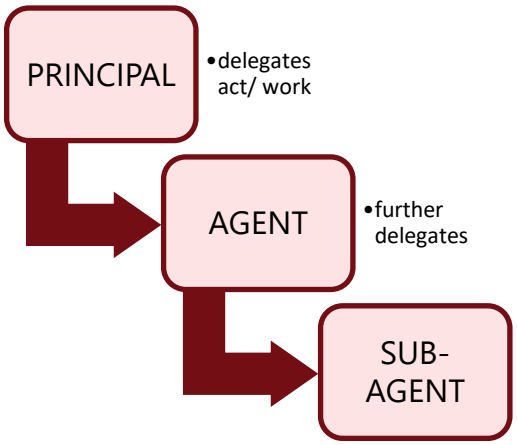
Example 18: A consigns perishable goods to B at Srinagar, with directions to send them immediately to C at Tamandu. B may sell the good if they begin to perish before reaching its destination.

9.5 SUB-AGENTS

When agent cannot delegate [Section 190]: An agent cannot lawfully employ another to perform acts which he has expressly or impliedly undertaken to perform personally, unless by the ordinary custom of trade a sub-agent may, or from the nature of the agency, a sub-agent must, be employed.

"Sub-agent" defined [Section 191]: A "Sub-agent" is a person employed by, and acting under the control of, the original agent in the business of the agency.

Analysis: Sub agency refers to case where an agent appoints another agent. The appointment of sub agent is not lawful, because the agent is a delegatee and a delegatee cannot further delegate. This is based on the Latin principle **"delegatus non potest delegare".**



A contract of agency is of a fiduciary character. It is based on the confidence reposed by the principal in the agent and that is why a delegatee cannot further delegate.

Exception where an agent can appoint Sub-agent:

(1) The appointment of a sub agent would be valid if the terms of appointment originally contemplated it.

(2) Sometimes **customs of the trade** may provide for appointment of sub agents.

In both these cases the sub agent would be treated as the agent of the principal.

(3) Where in the course of the agent's employment, **unforeseen emergency** arise making it necessary for him to delegate the authority that was given to him by the principal.

Representation of principal by sub-agent properly appointed [Section 192]: Where a sub-agent is properly appointed,

(1) Principal is liable to third parties for the acts of the sub-agent.

(2) **Agents responsibility for sub agents:** The agent is responsible to the principal for the acts of the sub-agent.

(3) **Sub-agents liability to principal:** The sub-agent is responsible for his acts to the agent, but not to the principal, except in case of fraud or willful wrong.

Agent's responsibility for sub-agent appointed without authority [Section 193]: Where an agent, without having authority to do so, has appointed a person to act as a sub-agent,

(1) the agent is responsible for his acts both to the principal and to third persons;

(2) the principal is responsible for the acts of the sub agent,

(3) the sub agent is not responsible to the principal at all. He is answerable only to the agent.

Example 19: A, a carrier, agreed to carry 60 bags of cotton waste from Morvi to Bhavnagar by a truck. A asked B, another carrier, to carry the goods. The goods were damaged in transit. Held, A was liable even though it was proved that B was the carrier.

9.6 SUBSTITUTED AGENT

Substituted Agent is a person appointed by the agent to act for the principal, in the business of agency, with the knowledge and consent of the principal. Substituted agents are not sub agents. They are agents of the principal.

Relation between principal and person duly appointed by agent to act in business of agency [Section 194]: Where an agent, holding an express or implied authority to name another person to act for the principal in the business of the agency, has named another person accordingly, such person is not a sub-agent, but an agent of the principal for such part of the business of the agency as is entrusted to him.

Example 20: A directs B, his solicitor, to sell his estate by auction, and to employ an auctioneer for the purpose. B names C, an auctioneer, to conduct the sale. C is not a sub-agent, but is A's agent for the conduct of the sale.

Example 21: A authorizes B, a merchant in Kolkata, to recover the moneys due to A from C & Co. B instructs D, a solicitor, to take legal proceedings against C & Co. for the recovery of the money. D is not a sub-agent, but is a solicitor for A.

Agent's duty in naming such person [Section 195]: In selecting such agent for his principal, an agent is bound to exercise the same amount of discretion as a man of ordinary prudence would exercise in his own case; and, if he does this, he is not responsible to the principal for the acts or negligence of the agent so selected.

Example 22: A instructs B, a merchant, to buy a ship for him. B employs a ship surveyor of good reputation to choose a ship for A. The surveyor makes the choice negligently and the ship turns out to be unseaworthy and is lost. B is not, but the surveyor is, responsible to A.

Example 23: A consigns goods to B, a merchant, for sale. B in due course, employs an auctioneer in good credit to sell the goods of A, and allows the auctioneer to receive the proceeds of the sale. The auctioneer afterwards becomes insolvent without having accounted for the proceeds. B is not responsible to A for the proceeds.

9.7 DIFFERENCE BETWEEN A SUB-AGENT AND A SUBSTITUTED AGENT

Both a sub-agent and a substituted agent are appointed by the agent. But, however, the following are the points of distinction between the two.

S.no	Sub Agent	Substituted Agent
1.	A sub-agent does his work under the control and directions of agent.	A substituted agent works under the instructions of the principal.
2.	The agent not only appoints a sub-agent but also delegates to him a part of his own duties.	The agent does not delegate any part of his task to a substituted agent.
3.	There is no privity of contract between the principal and the sub-agent.	Privity of contract is established between a principal and a substituted agent.
4.	The sub-agent is responsible to the agent alone and is not generally responsible to the principal.	A substituted agent is responsible to the principal and not to the original agent who appointed him
5.	The agent is responsible to the principal for the acts of the sub-agent.	The agent is not responsible to the principal for the acts of the substituted agent.

6.	The sub-agent has no right of action against the principal for remuneration due to him.	The substituted agent can sue the principal for remuneration due to him.
7.	Sub-agents may be improperly appointed.	Substituted agents can never be improperly appointed.
8.	The agent remains liable for the acts of the sub-agent as long as the sub-agency continues.	The agent's duty ends once he has named the substituted agent.

9.8 DUTIES AND OBLIGATIONS OF AN AGENT

(i) **Duty to follow instructions or customs:** According to Section 211 an agent is bound to conduct the business of his principal according to the direction given by the principal, or, in the absence of any such directions, according to the customs which prevails in doing business of the same kind at the place where the agent conducts such business. When the agent acts otherwise and any loss is sustained by the Principal, he must indemnify him, and, if any profit accrues, he must account for it.

Example 24: A, an agent is engaged for managing the business of B, in which it is a custom to invest money at hand for interest. If A omits to make such investment he must indemnify B for the losses i.e. for the interest B would have obtained for such investment.

Example 25: B, a broker, in whose business it is not the custom to sell on credit, sells goods of A on credit to C. C, before payment, becomes insolvent. B will have to indemnify A for the losses.

(ii) **Duty of reasonable care and skill:** According to section 212, an agent is bound to conduct the business of the principal with as much skill as is generally possessed by persons engaged in similar business, unless the principal has notice of his want of skill.

The agent is always bound to act with reasonable diligence, and to use such skill as he possesses; and to make compensation to his principal in respect of the direct consequences of his own neglect, want of skill or misconduct, but not in respect of loss of damage which are indirectly or remotely caused by such neglect, want of skill or misconduct.

Example 26: A, a merchant in Kolkata, has an agent, B, in London, to whom a sum of money is paid on A's account, with orders to remit. B retains the money for a considerable time. A, in consequence of not receiving the money, becomes insolvent.

B is liable for the money and interest from the day on which it ought to have been paid, according to the usual rate, and for any further direct loss- e.g. by variation of rate of exchange-but not further.

Example 27: A, an agent for the sale of goods, having authority to sell on credit, sells to B on credit, without making the proper and usual enquiries as to the solvency of B. B, at the time of such sale is insolvent. A must compensate his principal for the loss sustained by him.

Example 28: A, an insurance-broker, employed by B to effect an insurance on a ship, omits to see that the "usual clauses" are inserted in the policy. The ship is afterwards lost. In consequence of the omission nothing can be recovered from the underwriters. A is bound to make good the loss to B.

Example 29: A, a merchant in England, directs B, his agent at Mumbai, who accepts the agency, to send him 100 bales of cotton by a certain ship. B, having it in his power to send the cotton, omits to do so. The ship arrives safely in England. Soon after her arrival the price of cotton rises. B is bound to make good to A the profit which he might have made by the 100 bales of cotton at the time the ship arrived, but not any profit he might have made by the subsequent rise.

(iii) **Duty to render proper accounts [Section 213]:** An agent is bound to render proper accounts to his principal on demand. Rendering accounts does not mean showing the accounts but the accounts supported by vouchers. *(Anandprasad vs. Dwarkanath)*

(iv) **Agent's duty to communicate with principal [Section 214]:** It is the duty of an agent, in cases of difficulty, to use all reasonable diligence in communicating with his principal, and in seeking to obtain his instructions.

(v) **Duty not to deal on his own account**: Agent should not deal on his own account without first obtaining the consent of the principal, otherwise the principal may—

(a) repudiate the transaction, (Section 215)

(b) claim from the agent any benefit which may have resulted to him from the transaction. (Section 216)

Example 30: A directs B to sell A's estate. B buys the estate for himself in the name of C. A, on discovering that B has bought the estate for himself, may repudiate the sale if he can show that B has dishonestly concealed any material fact, or that the sale has been disadvantageous to him.

Example 31: A directs B to sell A's estate. B, on looking over the estate before selling it, finds a mine on the estate which is unknown to A. B informs A that he wishes to buy the estate for himself, but conceals the discovery of the mine. A allow B to buy,

in ignorance of the existence of the mine. A, on discovering that B knew of the mine at the time he bought the estate, may either repudiate or accept the sale at his option.

Example 32: A directs B, his agent, to buy a certain house for him. B tells A it cannot be bought and buys the house for himself. A may, on discovering that B has bought the house, compel him to sell it to A at the price he gave for it.

(vi) **Duty not to make secret profits**: It is the duty of an agent not to make any secret profit in the business of agency. His relationship with the principal is of fiduciary nature and this requires absolute good faith in the conduct of agency**.**

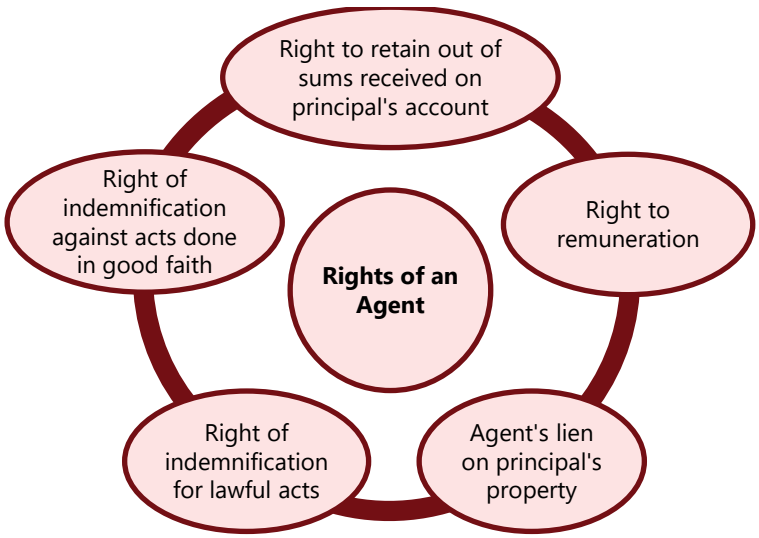
Secret Profit means any advantage obtained by the agent over and above his agreed remuneration and which he would not have been able to make but for his position as agent.

(vii) **Duty not to delegate:** According to section 190, an agent cannot lawfully employ to perform acts which he has expressly or impliedly undertaken to perform personally, unless by the ordinary custom of trade a sub-agent may, or, from the nature of agency, a sub- agent, must be employed.

(viii) **Agent's duty to pay sums received for principal [Section 218]:** Subject to such deductions, the agent is bound to pay to his principal all sums received on his account.

(ix) **Duty not to use any confidential information received in the course of agency against the principal.**

9.9 RIGHTS OF AN AGENT



(i) **Right of retain out of sums received on principal's account [Section 217]:** This section empowers the agent to retain, out of any sums received on account of the principal in the business of the agency for the following payments:

(a) all moneys due to himself in respect of advances made

(b) in respect of expenses properly incurred by him in conducting such business

(c) such remuneration as may be payable to him for acting as agent.

The right can be exercised on any sums received on account of the principal in the business of agency.

(ii) **Right to remuneration [Section 219]:** The agent in the normal course is entitled for remuneration as per the contract. In the absence of any agreed amount of remuneration, he is entitled for usual remuneration which is customary in the business. However, an agent who is guilty of misconduct in the business of the agency is not entitled to any remuneration in respect of that part of the business which he has misconducted [Section 220].

Example 33: A employs B to recover ₹1,00,000 from C, and invest it in securities that give good returns. B recovers the amount and lays out ₹ 90,000 on good securities but lays out ₹ 10,000 on securities which he ought to provide poor returns, whereby A loses ₹ 2,000. B is entitled to remuneration for recovering the ₹ 1,00,000 and for investing the ₹ 90,000. He is not entitled to any remuneration for investing the ₹ 10,000, and he must indemnify A for ₹ 2000.

Example 34: A employs B to recover ₹ 1,00,000 from C. Because of B's misconduct the money is not recovered. B is entitled to no remuneration for his services and must make good the loss.

(iii) **Agent's lien on principal's property [Section 221]:** In the absence of any contract to the contrary**,** an agent is entitled to retain the goods, papers and other property, whether movable or immovable, of the principal received by him, until the amount due to himself for commission, disbursement and services in respect of the same has been paid or accounted for him.

The conditions of this right are:

a. The agent should be lawfully entitled to receive from the principal a sum of money by way of commission earned or disbursement made or services rendered in the proper execution of the business of agency.

b. The property over which the lien is to be exercised should belong to the principal and it should have been received by the agent in his capacity and during the course of his ordinary duties as an agent. If the agent obtains possession of the property by unlawful means, he cannot exercise particular lien.

The agent's right to lien is lost in the following cases:

(a) When the possession of the property is lost.

(b) When the agent waives his right. Waiver may arise out of agreement express or implied.

(c) The agent's lien is subject to a contract to the contrary.

(iv) Right to indemnity:

a. Right of indemnification for lawful acts [Section 222]: The principal is bound to indemnify the agent against all consequences of lawful acts done in exercise of his authority.

Example 35: 'A' residing in Delhi appoints 'B' from Mumbai as an agent to sell his merchandise. As a result 'B' contracts to deliver the merchandise to various parties. But A fails to send the merchandise to B and B faces litigations for non- performance. Here, A is bound to protect B against the litigations and all costs, expenses arising of that.

b. Right of indemnification against acts done in good faith [Section 223]: Where the agent acts in good faith on the instruction of principal, agent is entitled for indemnification of any loss or damage from the principal.

Example 36: Where P appoints A as his agent and directs him to sell certain goods which in fact turned out to be not those belonging to P and if third parties sue A for this act, A is entitled for reimbursement and indemnification for such act done in good faith.

However, the agent cannot claim any reimbursement or indemnification for any loss etc. arising out of acts done by him in violation of any penal laws of the country.

c. Non-liability of employer of agent to do a criminal act: According to section 224, where one person employs another to do an act which is criminal, the employer is not liable to the agent, either upon an express or an implied promise, to indemnify him against the consequences of that act.

Example 37: A employs B to beat C and agrees to indemnify him against all consequences of the act. B thereupon beats C and has to pay damages to C for so doing. A is not liable to indemnify B for those damages.

Example 38: B, the proprietor of a newspaper, publishes, at A's request, a libel upon C in the paper, and A agrees to indemnify B against the consequences of the publication, and all costs and damages of any action in respect thereof. B is sued by C and has to pay damages, and also incurs expenses. A is not liable to indemnify B.

(v) Right to compensation for injury caused by principal's neglect [Section 225]: Section 225 provides that the principal must compensate his agent in respect of injury caused to such agent due to principal's neglect or want of skill. Thus, every principal owes to his agent the duty of care, and not to expose him to unreasonable risks.

Example 39: A employs B as a bricklayer in building a house and puts up the scaffolding himself. The scaffolding is unskillfully put up, and B is in consequence hurt. A must compensate B.

9.10 PRINCIPAL'S LIABILITY TO THIRD PARTIES

An agent does all acts on behalf of the principal but incurs no personal liability. The liability remains that of the principal unless there is a contract to the contrary. This is because there is no privity of contract and passing of consideration between the agent and third party. An agent also cannot personally enforce contracts entered into by him on behalf of the principal.

(i) Principal's liability for the Acts of the Agent [Section 226]: Principal liable for the acts of agents which are within the scope of his authority.

Example 40: A buys goods from B, knowing that he is an agent for their sale, but not knowing who is the principal. B's principal is the person entitled to claim from A the price of the goods, and A cannot, in a suit by the principal, set off against that claim a debt due to himself from B.

Example 41: A, being B's agent with authority to receive money on his behalf, receives from C, a sum of money due to B. C is discharged of his· obligation to pay the sum in question to B.

(ii) Principal's liability when agent exceeds authority [Section 227]: When an agent does more than he is authorised to do, and when the part of what he does, which is within his authority, can be separated from the part which is beyond his authority, so

much only of what he does as is within his authority is binding as between him and his principal.

Example 42: A, being owner of a ship and cargo, authorizes B to procure an insurance for ₹ 4,00,000 on the ship. B procures a policy for ₹ 4,00,000 on the ship, and another for the like sum on the cargo. A is bound to pay the premium for the policy on the ship, but not the premium for the policy on the cargo.

Principal not bound when excess of agent's authority is not separable [Section 228]: Where an agent does more than he is authorized to do, and what he does beyond the scope of his authority cannot be separated from what is within it, the principal is not bound to recognize the transaction.

Example 43: A authorizes B to buy 500 sheep for him. B buys 500 sheep and 200 lambs for one sum of ₹ 6,00,000. A may repudiate the whole transaction.

Example 44: A authorizes B to draw bills to the extent ₹ 200 each. B draws bills in the name of A for ₹ 1,000 each. A may repudiate the whole transaction.

Exception: Liability of principal inducing belief that agent's unauthorized acts were authorized [Section 237]: When an agent has, without authority, done acts or incurred obligations to third persons on behalf of his principal, the principal is bound by such acts or obligations, if he has by his words or conduct induced such third persons to believe that such acts and obligations were within the scope of the agent's authority.

Example 45: A consigns goods to B for sale, and gives him instructions not to sell under a fixed price. C, being ignorant of B's instructions, enters into a contract with B to buy the goods at a price lower than the reserved price. A is bound by the contract.

Example 46: A entrusts B with negotiable instruments endorsed in blank. B sells them to C in violation of private orders from A. The sale is good.

(iii) **Consequences of notice given to agent [Section 229]:** Any notice given to or information obtained by the agent, provided it be given or obtained in the course of the business transacted by him for the principal, shall, as between the principal and third parties, have the same legal consequence as if it had been given to or obtained by the principal.

Example 47: A is employed by B to buy from C certain goods of which C is the apparent owner, and buys them accordingly. In the course of the treaty for the sale, A learns that the goods really belonged to D, but B is ignorant of that fact. B is not entitled to set off a debt owing to him from C against the price of the goods. Thus, the knowledge of the agent is treated as the knowledge of the principal.

(iv) **Principal's liability for the agent's fraud, misrepresentation or torts [Section 238]:** Misrepresentations made, or frauds committed, by agents acting in the course of their business for their principals, have the same effect on agreements made by such agents as if such misrepresentations or frauds had been made, or committed, by the principals; but misrepresentations made, or frauds committed, by agents, in matters which do not fall within their authority, do not affect their principals.

Example 48: A, being B's agent for the sale of goods, induces C to buy them by a misrepresentation, which he was not authorized by B to make. The contract is voidable, as between B and C, at the option of C.

Example 49: A, the captain of B's ship, signs bills of lading without having received on board the goods mentioned therein. The bills of lading are void as between B and the pretended consignor.

9.11 PERSONAL LIABILITY OF AGENT TO THIRD PARTIES

Agent cannot personally enforce, nor be bound by, contracts on behalf of principal [Section 230]: In the absence of any contract to that effect, an agent cannot personally enforce contracts entered into by him on behalf of his principal, nor is he personally bound by them. He can neither sue nor be sued on contracts made by him on his principal's behalf.

EXCEPTIONS: In the following exceptional cases, the agent is presumed to have agreed to be personally bound:

(1) Where the contract is made by an agent for the sale or purchase of goods for a **merchant resident abroad/foreign principal**: – When an agent has entered into a contract for the sale or purchase of goods on behalf of a principal resident abroad, the presumption is that the agent undertakes to be personally liable for the performances of such contract.

(2) Where the agent **does not disclose the name of his principal or undisclosed principal;** (Principal unnamed): when the agent does not disclose the name of the principal then there arises a presumption that he himself undertakes to be personally liable.

(3) **Non-existent or incompetent principal:** Where the principal, though disclosed, cannot be sued, the agent is presumed to be personally liable.

Example 50: An agent who contracts for a minor, the minor being not liable, the agent becomes personally liable. This result, may not, however, follow where the other party already knows that the principal is a minor.

(4) **Pretended agent** – if the agent pretends but is not an actual agent, and the principal does not rectify the act but disowns it, the pretended agent will be himself liable (Section 235).

(5) **When agent exceeds authority**- When the agent exceeds his authority, misleads the third person in believing that the agent he has the requisite authority in doing the act, then the agent can be made liable personally for the breach of warranty of authority.

RIGHTS OF THIRD PARTIES

i. **Rights of parties to a contract made by undisclosed agent [Section 231]:** If an agent makes a contract with a person who neither knows, nor has reason to suspect, that he is an agent, his principal may require the performance of the contract; but the other contracting party has, as against the principal, the same right as he would have had as against the agent if the agent had been the principal.

If the principal discloses himself before the contract is completed, the other contracting party may refuse to fulfill the contract, if he can show that, if he had known who was the principal in the contract, or if he had known that the agent was not a principal, he would not have entered into the contract.

Example 51: SS bought for himself a ticket of IPL match at Wankahde Stadium through AB because on personal grounds Stadium management would not have issued the ticket to SS. Stadium management may repudiate the contract and refuse SS to enter the stadium.

ii. **Performance of contract with agent supposed to be principal [Section 232]:** When agent does not disclosed that he is acting as an agent and the principal requires the performance of the contract then the principal can obtain such performance subject to the rights and obligations subsisting between the agent and the other party to the contract.

Example 52: A, who owes 50,000 rupees to B, sells 1,00,000 rupees worth of rice to B. A is acting as agent for C in the transaction, but B has no knowledge nor reasonable ground of suspicion that such is the case. C cannot compel B to take the rice without allowing him to set off A's debt.

iii. **Option to Third Person- sue the Agent or the Principal:**

a. **Right of person dealing with agent personally liable [Section 233]:** In cases where the agent is personally liable, a person dealing with him may hold either him or his principal, or both of them, liable.

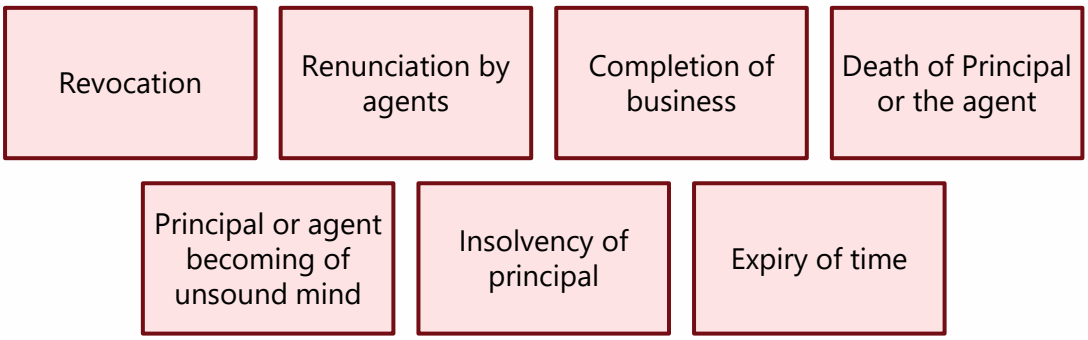
Example 53: A enters into a contract with B to sell him 100 bales of cotton, and afterwards discovers that B was acting as agent for C. A may sue either B or C, or both, for the price of the cotton.

b. **Consequence of inducing agent or principal to act on belief that principal or agent will be held exclusively liable [Section 234]:** When a person who has made a contract with an agent induces the agent to act upon the belief that the principal only will be held liable, or induces the principal to act upon the belief that the agent only will be held liable, he cannot afterwards hold liable the agent or principal respectively.

9.12 REVOCATION OF AUTHORITY

Termination of agency [Section 201]

Termination of agency means putting an end to the legal relationship between principal and agent. Section 201 provides for the following modes of termination:



a. **Revocation:** An agency may be terminated by the principal revoking the authority of the agent. Principal may revoke the authority given to his agent at any time before the authority has been exercised so as to bind the principal [Section 203]. However, the principal cannot revoke the authority given to his agent after the authority has been partly exercised so far as regards such acts and obligations as arise for acts already done in the agency. [Section 204]

Example 54: A authorizes B to buy 1,000 bales of cotton on account of A, and to pay for it out of A's money remaining in B's hands. B buys 1,000 bales of cotton in his own name, so as to make himself personally liable for the price. A cannot revoke B's authority so far as regards payment for the cotton.

Example 55: A authorizes B to buy 1,000 bales of cotton on account of A, and to pay for it out of A's money remaining in B's hands. B buys 1,000 bales of cotton in A's

name, and so as not to render himself personally liable for the price. A can revoke B's authority to pay for the cotton.

Compensation for revocation by principal [Section 205]: If there is premature revocation of agency without sufficient cause, the principal must compensate the agent, for such revocation.

Notice of revocation [Section 206]: When the principal, having justification to do so, revokes the authority, he must give reasonable notice of such revocation to the agent, otherwise, he can be liable to pay compensation for any damage caused to the agent (Section 206).

Revocation and renunciation may be expressed or implied [Section 207]: Revocation of agency may be expressed or implied in the conduct of the principal.

Example 56: A empowers B to let A's house. Afterwards A lets it himself. This is an implied revocation of B's authority.

b. **Renunciation by agent [Section 206]:** An agent may renounce the business of agency in the same manner in which the principal has the right of revocation. In the first place, if the agency is for a fixed period, the agent would have to compensate the principal for any premature renunciation without sufficient cause. [Section 205] Secondly, a reasonable notice of renunciation is necessary. Length of notice (time period of notice) is to be determined by the same principles which apply to revocation by the principal. If the agent renounces without proper notice, he shall have to make good any damage thereby resulting to the principal. [Section 206]

c. **Completion of business:** An agency is automatically and by operation of law terminated when its business is completed. Thus, for example, the authority of an agent appointed to sell goods ceases to be exercisable when the sale is completed.

d. **Death or insanity:** An agency is determined automatically on the death or insanity of the principal or the agent. Winding up of a company or dissolution of partnership has the same effect. Act done by agent before death would remain binding.

e. **Principal's insolvency:** An agency ends on the principal being adjudicated insolvent.

f. **On expiry of time:** Where an agent has been appointed for a fixed term, the expiration of the term puts an end to the agency, whether the purpose of agency has been accomplished or not. An agency comes to an automatic end on expiry of its term.

When the agency is irrevocable?

When the agent is personally interested in the subject matter of agency the agency becomes irrevocable. **Section 202** states that "where the agent has himself an interest in the property which forms the subject matter of the agency, the agency cannot, in the absence of an express contract, be terminated to the prejudice of such interest."

Example 57: A gives authority to B to sell A's land, and to pay himself, out of the proceeds, the debts due to him from A. A cannot revoke this authority, nor can it be terminated by his insanity or death.

Example 58: A consigns 1000 bales of cotton to B, who has made advances to him on such cotton, and desires B to sell the cotton, and to repay himself, out of the price, the amount of his own advances. A cannot revoke this authority, nor it is terminated by his insanity or death.

Effects of Termination [Section 208]

When termination of agent's authority takes effect as to agent, and as to third persons [Section 208]: The termination of the authority of an agent does not, so far as regards the agent, take effect before it becomes known to him, or, so far as regards third persons, before it becomes known to them.

Example 59: A directs B to sell goods for him and agrees to give B five per cent commission on the price fetched by the goods. A afterwards, by letter, revokes B's authority. B, after the letter is sent, but before he receives it sells the goods for ₹ 1,00,000. The sale is binding on A, and B is entitled to ₹ 5,000 as his commission.

Example 60: A, at Chennai, by letter directs B to sell for him some cotton lying in a warehouse in Mumbai, and afterwards, by letter, revokes his authority to sell, and directs B to send the cotton to Chennai. B, after receiving the second letter, enters into a contract with C, who knows of the first letter, but not of the second, for the sale to him of the cotton. C pays B the money, with which B absconds. C's payment is good as against A.

Example 61: A directs B, his agent, to pay certain money to C. A dies, and D takes out probate to his will. B, after A's death, but before hearing of it, pays the money to C. The payment is good as against D, the executor.

Agent's duty on termination of agency by principal's death or insanity [Section 209]: When an agency is terminated by the principal dying or becoming of unsound mind, the agent is bound to take on behalf of the representatives of his late principal, all reasonable steps for the protection and preservation of the interests entrusted to him.

Termination of sub-agent's authority [Section 210]

The termination of the authority of an agent causes the termination (subject to the rules herein contained regarding the termination of an agent's authority) of the authority of all sub-agents appointed by him.

SUMMARY

Agency: Relation between an agent and his principal created by an express/ implied agreement authorising an agent by his principal to create contractual relations with third parties. Person so appointed to represent the principal is called as agent whereas a person who appoints an agent to represent him as per his directions and authority is called as principal.

- Agency can be either expressed or implied.
- **Sub-agent:** Person appointed by the original agent in the business of agency under his direction and control and being responsible to the principal for acts of a sub-agent.
- **Substituted agent:** Person is named by the agent expressly or impliedly to act for the principal in the business of agency.
- **Ratification:** Where acts are done by one person on behalf of another, but without his knowledge or authority, he may elect to ratify or to disown such acts. If he ratifies them, the same effects will follow as if they had been performed by his authority. Ratification may be expressed or may be implied in the conduct of the person on whose behalf the acts are done.
- **Revocation of authority:** An Agency is terminated (a) by the principal revoking his authority; or (b) by the agent renouncing the business of the agency; or (c) by the business of the agency being completed; or (d) by either the principal or agent dying or becoming of unsound mind; or (e) by either the principal or agent dying or becoming of unsound mind.
- **Duties and obligations of an Agent:** (a) Conduct the business according to principal's directions (b) Conduct the business with the skill and diligence (c) Render proper accounts (d) Communicate with principal in cases of difficulty (e) Repudiation of the transaction by principal (f) Not to deal on his own account (g) Agent's duty to pay sums received for principal.
- **Rights of an Agent:** (a) Right of retain out of sums received on principal's account (b) Right to remuneration (c) Agent's particular lien on principal's property (d) Right

of indemnification for lawful acts (e) Right of indemnification against acts done in good faith.

AGENCY (SECTION 172-238)

Agency: Relation between an agent and his principal created by an express/ implied agreement authorising an agent by his principal to create contractual relations with third parties.

Agent: Person employed to do any act for another, or to represent another.

Who can be Agent: any person including minor, Person of unsound mind

Principal: person for whom such act is done or who is so represented.

Who can appoint an Agent: Major, Person of sound mind

Modes of creation of Agency

- By Express Agreement
- **By Implied Agreement** — *a. Agency by Estoppel or holding out, b. By Necessity*
- By Operation of Law
- By Ratification

Essentials for Valid Ratification

a. May be express or implied; **b.** Full knowledge of facts; **c.** Whole transaction must be ratified; **d.** Ratification not put a third party to damages; **e.** Within reasonable time; **f.** Communication; **g.** Act to be ratified must be valid

Extent of Agent's Authority

1. An agent, having an authority to do an act, has authority to do every lawful thing which is necessary in order to do such act.

2. An agent having an authority to carry on a business has authority to do every lawful thing necessary for the purpose, or usually done in the course, of conducting such business.

3. In emergency, an agent has authority to do all such acts for the purpose of protecting his principal from loss.

Sub- Agent

A person who is appointed by and acts under the control and direction of original agent.

Rules of Sub-Agent

1. Work under control and directions of agent.

2. Agent delegates a part of his own duties to Sub Agent.

3. No privity of contract between principal and sub-agent.

4. Sub-agent is responsible to the agent only.

5. Agent is responsible to the principal for the acts of the sub- agent.

6. Sub-agent has no right of action against the principal for remuneration due to him.

Substituted Agent

A person appointed by agent to act for principal with knowledge and consent of principal.

Rules of Substituted Agent

1. Works under the instructions of the principal.

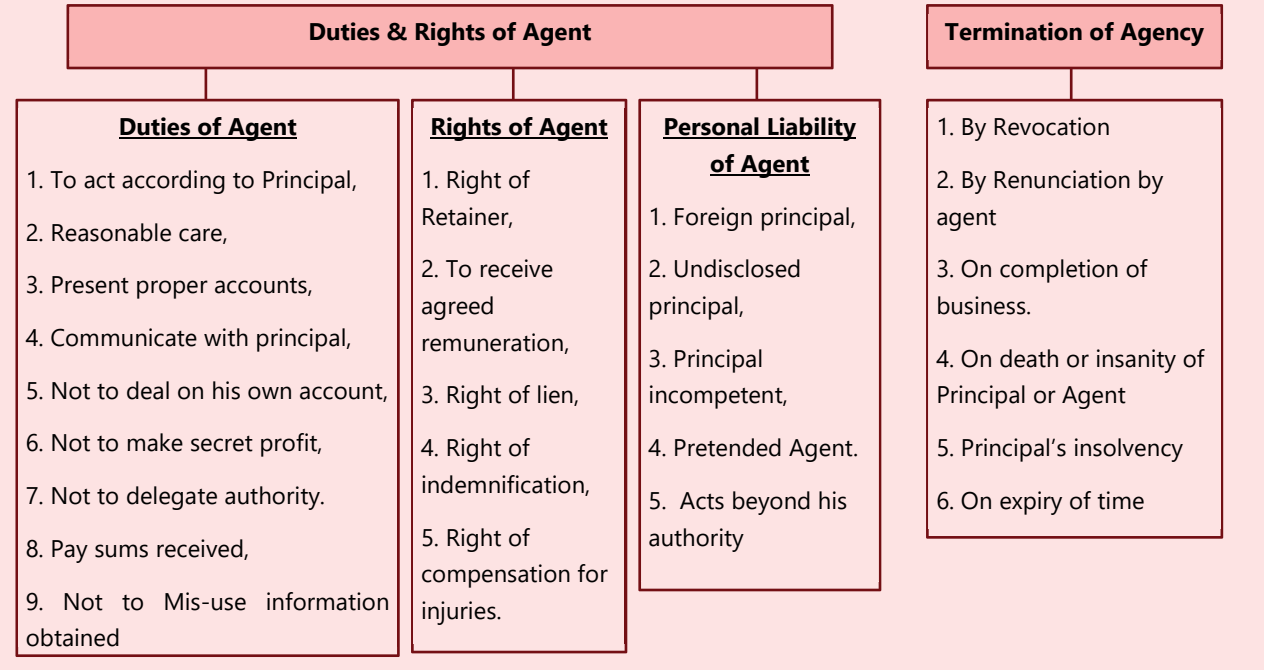
2. Agent does not delegate any part of his task to a substituted agent.

3. Privity of contract exists between a principal and a substituted agent.

4. Responsible to the principal.

5. Agent is not responsible to the principal for the acts of the substituted agent.

6. Substituted agent can sue the principal for remuneration due to him.



TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *A person employed to do any act and represent is called .....*
   - *(a) agent*
   - *(b) principal*
   - *(c) owner*
   - *(d) servant*
2. *Who can become an agent?*
   - *(a) Both Minor & Adult*
   - *(b) Minor*
   - *(c) Adult person*
   - *(d) Dead person*
3. *To create an agency, which is not required?*
   - *(a) Principal*
   - *(b) consideration*

(c) agent

(d) third party

4. _____ is a person employed by, and acting under the control of original agent in the business of agency

(a) A substituted agent

(b) A sub agent

(c) A mercantile agent

(d) An universal agent

5. A substituted agent acts on behalf of _____

(a) Principal

(b) Sub-agent

(c) Agent

(d) None of these

6. The power given to agent is .....

(a) reasonable & unreasonable

(b) expressed & implied

(c) legal & illegal

(d) all above

7. On whose insolvency the agency is terminated?

(a) Sub agent

(b) Agent

(c) Principal

(d) Del credere

8. Under which circumstances agent become personally responsible?

(a) beyond authority

(b) fraudulent transactions

(c) fraud

(d) All of above

9. *It is the duty of the agent to protect and preserve the interest on behalf of the principal's representative in case of _____*

   (a) Death of the principal

   (b) Insolvency of the principal

   (c) Both (a) & (b)

   (d) None of these

10. *Agent should not to deal on his own account without first obtaining the consent of the principal, otherwise the principal may—*

   (a) repudiate the transaction,

   (b) claim from the agent any benefit which may have resulted to him from the transaction,

   (c) Either (a) or (b)

   (d) Both (a) & (b)

Descriptive Questions

1. *A appoints M, a minor, as his agent to sell his watch for cash at a price not less than ₹ 700. M sells it to D for ₹ 350. Is the sale valid? Explain the legal position of M and D, referring to the provisions of the Indian Contract Act, 1872.*

2. *State with reason whether the following statement is correct or incorrect: Ratification of agency is valid even if knowledge of the principal is materially defective.*

3. *Rahul, a transporter was entrusted with the duty of transporting tomatoes from a rural farm to a city by Aswin. Due to heavy rains, Rahul was stranded for more than two days. Rahul sold the tomatoes below the market rate in the nearby market where he was stranded fearing that the tomatoes may perish. Can Aswin recover the loss from Rahul on the ground that Rahul had acted beyond his authority?*

4. *Mr. Ahuja of Delhi engaged Mr. Singh as his agent to buy a house in West Extension area. Mr. Singh bought a house for ₹ 20 lakhs in the name of a nominee and then purchased it himself for ₹ 24 lakhs. He then sold the same house to Mr. Ahuja for ₹ 26 lakhs. Mr. Ahuja later comes to know the mischief of Mr. Singh and tries to recover the excess amount paid to Mr. Singh. Is he entitled to recover any amount from Mr. Singh? If so, how much? Explain.*

5. *Comment on the statement 'Principal is not always bound by the acts of a sub-agent'.*

6. *ABC Ltd. sells its products through some agents and it is not the custom in their business to sell the products on credit. Mr. Pintu, one of the agents sold goods of ABC Ltd. to M/s. Parul Pvt. Ltd. (on credit) which was insolvent at the time of such sale. ABC Ltd. sued Mr. Pintu for compensation towards the loss caused due to sale of products to M/s. Parul Pvt. Ltd. Will ABC Ltd. succeed in its claim?*

7. *R is the wife of P. She purchased sarees on credit from Nalli. Nalli demanded the amount from P. P refused. Nalli filed a suit against P for the said amount. Decide in the light of provisions of the Indian Contract Act, 1872, whether Nalli would succeed.*

8. *Bhupendra borrowed a sum of ₹ 3 lacs from Atul. Bhupendra appointed Atul as his agent to sell his land and authorized him to appropriate the amount of loan out of the sale proceeds. Afterward, Bhupendra revoked the agency.*

   Decide under the provisions of the Indian Contract Act, 1872 whether the revocation of the said agency by Bhupendra is lawful.

ANSWERS/HINTS

Answers to MCQs

1.	**(a)**	2.	**(a)**	3.	**(b)**	4.	**(b)**	5.	**(a)**	6.	**(b)**
7.	**(c)**	8.	**(d)**	9.	**(c)**	10.	**(d)**				

Answers to the Descriptive Questions

1. According to the provisions of Section 184 of the Indian Contract Act, 1872, as between the principal and a third person, any person, even a minor may become an agent. But no person who is not of the age of majority and of sound mind can become an agent, so as to be responsible to his principal. Thus, if a person who is not competent to contract is appointed as an agent, the principal is liable to the third party for the acts of the agent. Thus, in the given case, D gets a good title to the watch. M is not liable to A for his negligence in the performance of his duties.

2. **Incorrect:** Section 198 of the Indian Contract Act, 1872 provides that for a valid ratification, the person who ratifies the already performed act must be without defect and have clear knowledge of the facts of the case. If the principal's knowledge is materially defective, the ratification is not valid and hence no agency.

3. **Agent's authority in an emergency (Section 189 of the Indian Contract Act, 1872):** An agent has authority, in an emergency, to do all such acts for the purpose of protecting his principal from loss as would be done by a person of ordinary prudence, in his own case, under similar circumstances.

In the instant case, Rahul, the agent, was handling perishable goods like 'tomatoes' and can decide the time, date and place of sale, not necessarily as per instructions of the Aswin, the principal, with the intention of protecting Aswin from losses.

Here, Rahul acts in an emergency as a man of ordinary prudence, so Aswin will not succeed against him for recovering the loss.

4. The problem in this case, is based on the provisions of the Indian Contract Act, 1872 as contained in Section 215 read with Section 216. The two sections provide that where an agent without the knowledge of the principal, deals in the business of agency on his own account, the principal may:

(1) repudiate the transaction, if the case shows, either that the agent has dishonestly concealed any material fact from him, or that the dealings of the agent have been disadvantageous to him.

(2) claim from the agent any benefit, which may have resulted to him from the transaction.

Therefore, based on the above provisions, Mr. Ahuja is entitled to recover ₹ 6 lakhs from Mr. Singh being the amount of profit earned by Mr. Singh out of the transaction.

5. **The statement is correct.** Normally, a sub-agent is not appointed, since it is a delegation of power by an agent given to him by his principal. The governing principle is, a delegate cannot delegate'. (Latin version of this principle is, "***delegates non potest delegare***"). However, there are certain circumstances where an agent can appoint sub-agent.

In case of proper appointment of a sub-agent, by virtue of Section 192 of the Indian Contract Act, 1872 the principal is bound by and is held responsible for the acts of the sub-agent. Their relationship is treated to be as if the sub-agent is appointed by the principal himself.

However, if a sub-agent is not properly appointed, the principal shall not be bound by the acts of the sub-agent. Under the circumstances the agent appointing the sub-agent shall be bound by these acts and he (the agent) shall be bound to the principal for the acts of the sub-agent.

6. **To conduct the business of agency according to the principal's directions (Section 211 of the Indian Contract Act, 1872):** An agent is bound to conduct the business of his principal according to the direction given by the principal, or, in the absence of any such directions, according to the custom which prevails in doing business of the same kind at the place where the agent conducts such business. When the agent acts otherwise, if any loss be sustained, he must make it good to his principal, and, if any profit accrues, he must account for it.

In the present case, Mr. Pintu, one of the agents, sold goods of ABC Ltd. to M/s Parul Pvt. Ltd. (on credit) which was insolvent at the time of such sale. Also, it is not the custom in ABC Ltd. to sell the products on credit.

Hence, Mr. Pintu must make good the loss to ABC Ltd.

7. The position of husband and wife is special and significant case of implied authority. According to the Indian Contract Act 1872, where the husband and wife are living together in a domestic establishment of their own, the wife shall have an implied authority to pledge the credit of her husband for necessaries. However, the implied authority can be challenged by the husband only in the following circumstances.

(1) The husband has expressly forbidden the wife from borrowing money or buying goods on credit.

(2) The articles purchased did not constitute necessities.

(3) Husband had given sufficient funds to the wife for purchasing the articles she needed to the knowledge of the seller.

(4) The creditor had been expressly told not to give credit to the wife.

Further, where the wife lives apart from husband without any of her fault, she shall have an implied authority to bind the husband for necessaries, if he does not provide for her maintenance.

Since, none of the above criteria is being fulfilled; Nalli would be successful in recovering its money.

8. According to Section 202 of the Indian Contract Act, 1872 an agency becomes irrevocable where the agent has himself an interest in the property which forms the subject-matter of the agency, and such an agency cannot, in the absence of an express provision in the contract, be terminated to the prejudice of such interest.

In the instant case, the rule of agency coupled with interest applies and does not come to an end even on death, insanity or the insolvency of the principal.

Thus, when Bhupendra appointed Atul as his agent to sell his land and authorized him to appropriate the amount of loan out of the sale proceeds, interest was created in favor of Atul and the said agency is not revocable. The revocation of agency by Bhupendra is not lawful.

NOTES

CHAPTER 3

THE SALE OF GOODS ACT, 1930

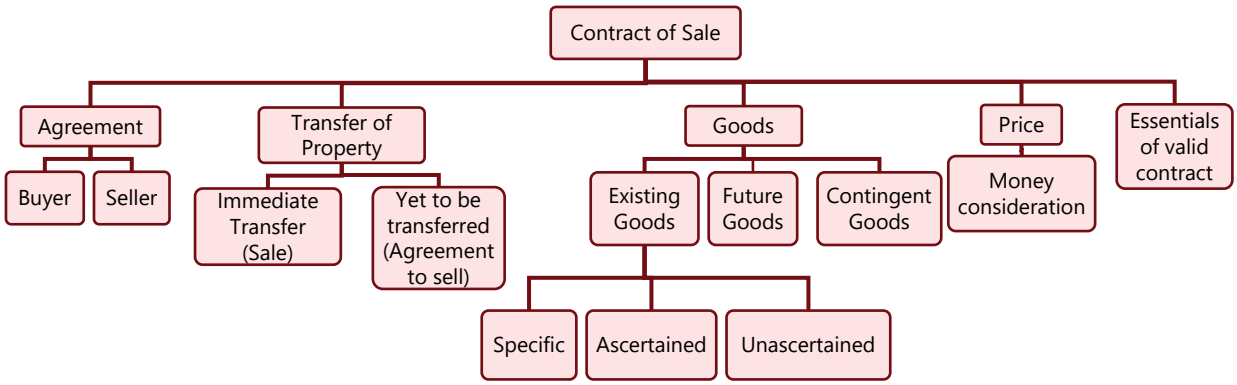
UNIT -1: FORMATION OF THE CONTRACT OF SALE

LEARNING OUTCOMES

After studying this unit, you would be able to understand-

- Scope of the Act
- Definitions of certain terms.
- Meaning of contract of sale.
- Distinctions of sale from other similar contracts.
- Formalities of contract of sale.
- Subject matter of contract of sale.
- Ascertainment of price for the contract of sale.

UNIT OVERVIEW



Sale of Goods before Sale of Goods Act, 1930

The Sale of Goods Act, 1930 deals with the laws relating to sale of goods in India. This Act is mainly based on English Sale of Goods Act, 1893. Before the Sale of Goods Act, 1930, all the provisions relating to sale of goods was covered under the Chapter VII of Indian Contract Act, 1872. A strong need was felt to have an independent Sale of Goods Act and consequently a new act called the Sale of Goods Act, 1930 was passed. The Act came into force from 1st July 1930 and extends to whole of India.

INTRODUCTION

Sale of goods is one of the specific forms of contracts recognized and regulated by law in India. Sale is a typical bargain between the buyer and the seller. The Sale of Goods Act, 1930 allows the parties to modify the provisions of the law by express stipulations. However, in some cases, this freedom is severely restricted.

Sale of Goods Act, 1930 is an Act to define and amend the law relating to the sale of goods.

1.1 SCOPE OF THE ACT

The provisions of the Act are applicable to the contracts related to the sale of goods which means movable properties. The Act is not applicable for the sale of immovable properties like land, fields, shop or house etc. For immovable property, Transfer of Property Act, 1882 is applicable. Sale of Goods Act, 1930 deals only with movable property.

The general provisions of the Indian Contract Act, 1872 apply to a Contract of Sale of Goods as far as they are not inconsistent with the express provisions of the Sale of Goods Act.

The expressions used but not defined in the Sales of Goods Act, 1930 and defined in the Indian Contract Act, 1872 have the meanings assigned to them in that Act.

The customs and usages will bind both the parties if these are reasonable and are known to the parties at the time of entering the contract of sale.

1.2 DEFINITIONS

The Sale of Goods Act, 1930 defines the terms which have been frequently used in the Act, which are as follows –

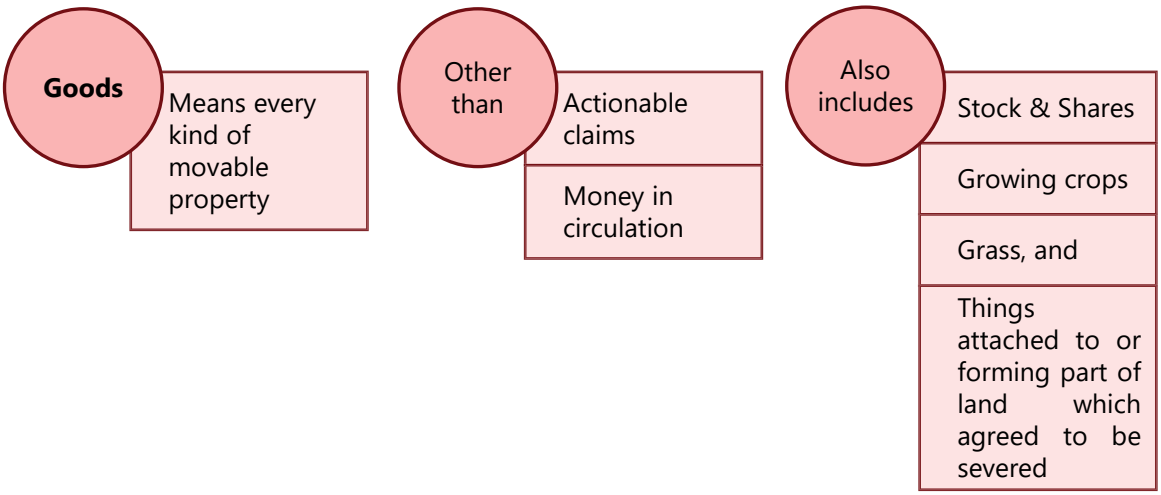
(A) **Buyer and Seller:** ***'Buyer'*** means a person who buys or agrees to buy goods [Section 2(1)]. ***'Seller'*** means a person who sells or agrees to sell goods [Section 2(13)]. The two terms, 'buyer' and 'seller' are complementary and represent the two parties to a contract of sale of goods. Both the terms are, however, used in a sense wider than their common meaning. Not only the person who buys but also the one who agrees to buy is a buyer. Similarly, a 'seller' means not only a person who sells but also a person who agrees to sell.

(B) **Goods and other related terms:**

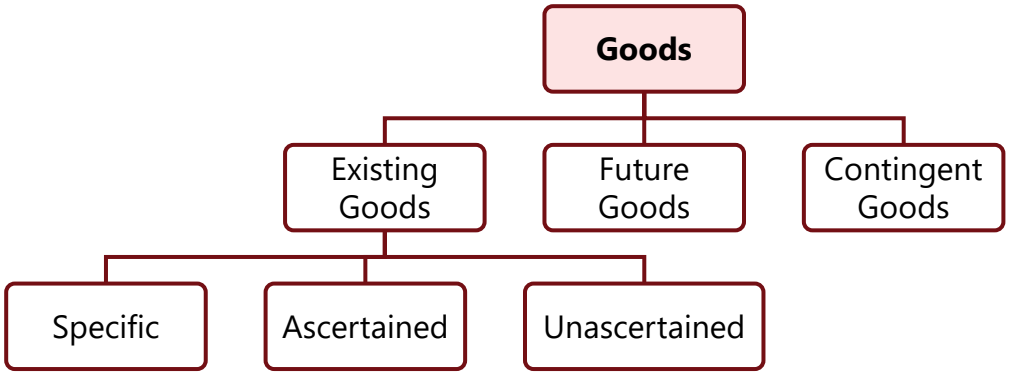
"Goods" means every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land, which are agreed to be severed/ separated from the land before sale or under the contract of sale. [Section 2(7)]

'Actionable claims' are claims, which can be enforced only by an action or suit, e.g., debt. A debt is not a movable property or goods. Even the Fixed Deposit Receipts (FDR) are considered as goods under Section 176 of the Indian Contract Act read with Section 2(7) of the Sales of Goods Act.

"Goods" include both tangible goods and intangible goods like goodwill, copyrights, patents, trademarks etc. Stock and shares, gas, steam, water, electricity and decree of the court are also considered to be goods.



Classification of Goods



(i) **EXISTING GOODS** are such goods which are in existence at the time of the contract of sale, i.e., those owned or possessed or acquired by the seller at the time of contract of sale (Section 6).

The existing goods may be of following kinds:

(a) **Specific goods mean goods identified and agreed upon at the time a contract of sale is made [Section 2(14)].**

Example 1: Any specified and finally decided goods like a Samsung Galaxy S7 Edge, Whirlpool washing machine of 7 kg etc.

Example 2: 'A' had five cars of different models. He agreed to sell his 'Santro' car to 'B' and 'B' agreed to purchase the same 'Santro' car. In this case, the sale is for specific goods as the car has been identified and agreed at the time of the contract of sale.

(b) **Ascertained Goods** are those goods which are identified in accordance with the agreement after the contract of sale is made. This term is not defined in the Act but has been judicially interpreted. In actual practice, the term 'ascertained goods' is used in the same sense as 'specific goods.' When out of a lot or out of large quantity of unascertained goods, the number or quantity contracted for is identified, such identified goods are called ascertained goods.

Example 3: A wholesaler of cotton has 100 bales in his godown. He agrees to sell 50 bales and these bales were selected and set aside. On selection, the goods become ascertained. In this case, the contract is for the sale of ascertained goods, as the cotton bales to be sold are identified and agreed after the formation of the contract. It may be noted that before the ascertainment of the goods, the contract was for the sale of unascertained goods.

(c) **Unascertained goods** are the goods which are not specifically identified or ascertained at the time of making of the contract. They are indicated or defined only by description or sample.

Example 4: If A agrees to sell to B one packet of salt out of the lot of one hundred packets lying in his shop, it is a sale of unascertained goods because it is not known which packet is to be delivered. As soon as a particular packet is separated from the lot, it becomes ascertained or specific goods.

Example 5: X has ten horses. He promises to sell one of them but does not specify which horse he will sell. It is a contract of sale of unascertained goods.

(ii) **FUTURE GOODS means goods to be manufactured or produced or acquired by the seller after making the contract of sale [Section 2(6)].**

A contract for the sale of future goods is always an agreement to sell. It is never actual sale because a person cannot transfer what is not in existence.

Example 6: 1,000 quintals of potatoes to be grown on A's field is an example of agreement to sell.

Example 7: P agrees to sell to Q all the milk that his cow may yield during the coming year. This is a contract for the sale of future goods.

Example 8: T agrees to sell to S all the oranges which will be produced in his garden this year. It is contract of sale of future goods, amounting to 'an agreement to sell.'

(iii) **CONTINGENT GOODS:** The acquisition of goods which depends upon an uncertain contingency (uncertain event) are called 'contingent goods' [Section 6(2)].

Contingent goods also operate as 'an agreement to sell' and not a 'sale' so far as the question of passing of property to the buyer is concerned. In other words, like the future goods, in the case of contingent goods also, the property does not pass to the buyer at the time of making the contract.

Example 9: A agrees to sell to B a Picasso painting provided he is able to purchase it from its present owner. This is a contract for the sale of contingent goods.

Example 10: P contracts to sell 50 pieces of particular article provided the ship which is bringing them reaches the port safely. This is an agreement for the sale of contingent goods.

(C) **Delivery - its forms and derivatives:** Delivery means voluntary transfer of possession from one person to another [Section 2(2)]. As a general rule, delivery of goods may be made by doing anything, which has the effect of putting the goods in the possession of the buyer, or any person authorized to hold them on his behalf.

Forms of delivery: Following are the kinds of delivery for transfer of possession:

Delivery of Goods

Voluntary transfer of possession by one person to another		
Actual delivery	Constructive delivery	Symbolic delivery

(i) **Actual delivery:** When the goods are physically delivered to the buyer. Actual delivery takes place when the seller transfers the physical possession of the goods to the buyer or to a third person authorised to hold goods on behalf of the buyer. This is the most common method of delivery.

(ii) **Constructive delivery:** When transfer of goods is effected without any change in the custody or actual possession of the thing as in the case of delivery by attornment (acknowledgement)

Example 11: Where a warehouseman holding the goods of A agrees to hold them on behalf of B, at A's request.

Constructive delivery takes place when a person in possession of the goods belonging to the seller acknowledges to the buyer that he holds the goods on buyer's behalf.

(iii) **Symbolic delivery:** When there is a delivery of a thing in token of a transfer of something else, i.e., delivery of goods in the course of transit may be made by handing over documents of title to goods, like bill of lading or railway receipt or delivery orders or the key of a warehouse containing the goods is handed over to buyer. Where actual delivery is not possible, there may be delivery of the means of getting possession of the goods.

Goods are said to be in a deliverable state when they are in such a condition that the buyer would, under the contract, be bound to take delivery of them [Section 2(3)].

Example 12: When A contracts to sell timber and make bundles thereof, the goods will be in a deliverable state after A has put the goods in such a condition.

(D) **"Document of title to goods"** includes bill of lading, dock-warrant, warehouse keeper's certificate, wharfingers' certificate, railway receipt, multimodal transport document, warrant or order for the delivery of goods and any other document used in the ordinary course of business as proof of the possession or control of goods or is for authorizing or purporting to authorize, either by endorsement or by delivery, the possessor of the document to transfer or receive goods thereby represented. [Section 2(4)]

Example 13: Bill of lading, dock warrant, warehouse keeper's certificate, wharfinger's certificate, railway receipt, warrant, an order of delivery of goods.

The list is only illustrative and not exhaustive. Any other document which has the above characteristics also will fall under the same category. Though a bill of lading is a document of title, a mate's receipt is not; it is regarded at law as merely an acknowledgement for the receipt of goods. A document amounts to a document of title only where it shows an unconditional undertaking to deliver the goods to the holder of the document.

However, there is a **difference between a 'document showing title' and 'document of title'.** A share certificate is a 'document' showing title but not a document of title. It merely shows that the person named in the share certificate is entitled to the share represented by it, but it does not allow that person to transfer the share mentioned therein by mere endorsement on the back of the certificate and the delivery of the certificate.

(E) **Mercantile Agent [Section 2(9)]:** It means an agent who in the customary course of business has, as such agent, authority either to sell goods or to consign goods for the purpose of sale or to buy goods or to raise money on the security of the goods. Mercantile agent can borrow money by pledging the goods.

Example 14: Such kind of agents are auctioneers or brokers, etc.

(F) **Property [Section 2(11)]: '**Property' here means 'ownership' or general property. In every contract of sale, the ownership of goods must be transferred by the seller to the buyer, or there should be an agreement by the seller to transfer the ownership to the buyer. It means the general property (right of ownership-in-goods) and not merely a special property.

The property in the goods means the general property i.e., all ownership right of the goods. Note that the 'general property' in goods is to be distinguished from a 'special property'. It is quite possible that the general property in a thing may be in one person and a special property in the same thing may be in another e.g., when an article is pledged, the special property gets transferred and not the general property. The general property in a thing may be transferred, subject to the special property continuing to remain with another person i.e., the pledgee who has a right to retain the goods pledged till payment of the stipulated dues.

Example 15: If A who owns certain goods pledges them to B, A has general property in the goods, whereas B has special property or interest in the goods to the extent of the amount of advance he has made. In case A fails to repay the amount borrowed on pledging the goods, then B may sell his goods but not otherwise.

(G) **Insolvent [Section 2(8)]:** A person is said to be insolvent when he ceases to pay his debts in the ordinary course of business, or cannot pay his debts as they become due, whether he has committed an act of insolvency or not.

(H) **Price [Section 2(10)]:** Price means the money consideration for a sale of goods. It is the value of goods expressed in monetary terms. It is the essential requirement to make a contract of sale of goods.

(I) **Quality of goods** includes their state or condition**. [Section 2(12)]**

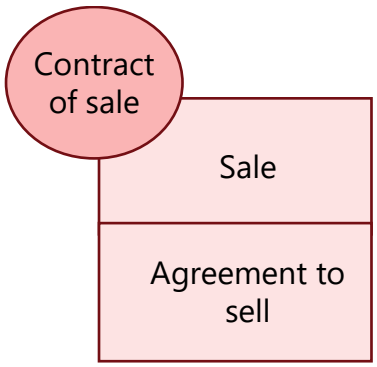
1.3 SALE AND AGREEMENT TO SELL (SECTION 4)

According to section 4(1), "A contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price". There may be a contract of sale between one part-owner and another.

A contract of sale may be absolute or conditional. **[Section 4(2)]**

Where under a contract of sale, the property in the goods is transferred from the seller to the buyer, the contract is called a sale, but where the transfer of the property in the goods is to take place at a future time or subject to some condition thereafter to be fulfilled, it is called an agreement to sell. **[Section 4(3)]**

An agreement to sell becomes a sale when the time elapses or the conditions are fulfilled subject to which the property in the goods is to be transferred. **[Section 4(4)]**



Sale: In Sale, the property in goods is transferred from seller to the buyer immediately. The term sale is defined in the Section 4(3) of the Sale of Goods Act, 1930 as – "where under a contract of sale the property in the goods is transferred from the seller to the buyer, the contract is called a sale."

Agreement to Sell: In an agreement to sell, the ownership of the goods is not transferred immediately. It is intending to transfer at a future date upon the completion of certain conditions thereon. The term is defined in Section 4(3) of the Sale of Goods Act, 1930, as – "where the transfer of the property in the goods is to take place at a future time or subject to some condition thereafter to be fulfilled, it is called an agreement to sell."

Thus, whether a contract of sale of goods is an absolute sale or an agreement to sell, depends on the fact whether it contemplates immediate transfer from the seller to the buyer or the transfer is to take place at a future date.

Example 16: X agrees with Y on 10th October, 2022 that he will sell his car to Y on 10th November, 2022 for a sum of ₹ 7 lakhs. It is an agreement to sell.

When agreement to sell becomes sale: An agreement to sell becomes a sale when the time elapses or the conditions are fulfilled subject to which the property in the goods is to be transferred.

The following **elements must co-exist** so as to constitute a contract of sale of goods under the Sale of Goods Act, 1930:

(i) There must be at least two parties, the seller and the buyer and the two must be different persons. A person cannot be both the seller and the buyer and sell his goods to himself.

(ii) The subject matter of the contract must necessarily be goods covering only movable property. It may be either existing goods, owned or possessed by the seller or future goods.

(iii) A price in money (not in kind) should be paid or promised. But there is nothing to prevent the consideration from being partly in money and partly in kind.

(iv) A transfer of property in goods from seller to the buyer must take place. The contract of sale is made by an offer to buy or sell goods for a price by one party and the acceptance of such offer by other.

(v) A contract of sale may be absolute or conditional.

(vi) All other essential elements of a valid contract must be present in the contract of sale, e.g. free consent of parties, competency of parties, legality of object and consideration etc.

1.4 DISTINCTION BETWEEN SALE AND AN AGREEMENT TO SELL

The differences between the two are as follows:

Basis of difference	Sale	Agreement to sell
Transfer of property	The property in the goods passes to the buyer immediately.	Property in the goods passes to the buyer on future date or on fulfilment of some condition.
Nature of contract	It is an executed contract i.e. contract for which consideration has been paid.	It is an executory contract i.e. contract for which consideration is to be paid at a future date.
Remedies for breach	The seller can sue the buyer for the price of the goods because of the passing of the property therein to the buyer.	The aggrieved party can sue for damages only and not for the price, unless the price was payable at a stated date.

Liability of parties	A subsequent loss or destruction of the goods is the liability of the buyer.	Such loss or destruction is the liability of the seller.
Burden of risk	Risk of loss is that of buyer since risk follows ownership.	Risk of loss is that of seller.
Nature of rights	Creates Jus in rem means right against the whole world.	Creates Jus in personam means rights against a particular party to the contract
Right of resale	The seller cannot resell the goods.	The seller may sell the goods since ownership is with the seller.
In case of insolvency of seller	The official assignee will not be able to take over the goods but will recover the price from the buyer.	The official assignee will acquire control over the goods but the price will not be recoverable.
In case of insolvency of buyer	The official assignee will have control over the goods.	The official assignee will not have any control over the goods.

1.5 SALE DISTINGUISHED FROM OTHER SIMILAR CONTRACTS

(i) **Sale and Hire Purchase:** Contract of sale resembles with contracts of hire purchase very closely, and indeed the real object of a contract of hire purchase is the sale of the goods ultimately.

Hire purchase agreements are governed by the Hire-purchase Act, 1972. Term "hire-purchase agreement" means an agreement under which goods are let on hire and under which the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which—

(a) Possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalments, and

(b) The property in the goods is to pass to such person on the payment of the last of such instalments, and

(c) Such person has a right to terminate the agreement at any time before the property so passes;

Nonetheless, a sale has to be distinguished from a hire purchase as their legal incidents are quite different.

The main points of distinction between the 'sale' and 'hire-purchase' are as follows:

Basis of difference	Sale	Hire- Purchase
Time of passing property	Property in the goods is transferred to the buyer immediately at the time of contract.	The property in goods passes to the hirer upon payment of the last instalment.
Position of the party	The position of the buyer is that of the owner of the goods.	The position of the hirer is that of a bailee till he pays the last instalment.
Termination of contract	The buyer cannot terminate the contract and is bound to pay the price of the goods.	The hirer may, if he so likes, terminate the contract by returning the goods to its owner without any liability to pay the remaining instalments.
Burden of Risk of insolvency of the buyer	The seller takes the risk of any loss resulting from the insolvency of the buyer.	The owner takes no such risk, for if the hirer fails to pay an instalment, the owner has right to take back the goods.
Transfer of title	The buyer can pass a good title to a bona fide purchaser from him.	The hirer cannot pass any title even to a bona fide purchaser untill he pays the last instalment.
Resale	The buyer in sale can resell the goods.	The hire purchaser cannot resell unless he has paid all the instalments.

(ii) **Sale and Bailment:** A 'bailment' is the delivery of goods for some specific purpose under a contract on the condition that the same goods are to be returned when the purpose is accomplished to the bailor or are to be disposed of according to the

directions of the bailor. Provisions related to bailment are regulated by the Indian Contract Act, 1872.

The difference between bailment and sale may be clearly understood by studying the following:

Basis of difference	Sale	Bailment
Transfer of property	The property in goods is transferred from the seller to the buyer. So, it is transfer of general property.	There is only transfer of possession of goods from the bailor to the bailee for any of the reasons like safe custody, carriage etc. So, it is transfer of special property.
Return of goods	The return of goods in contract of sale is not possible.	The bailee must return the goods to the bailor on the accomplishment of the purpose for which the bailment was made.
Consideration	The consideration is the price in terms of money.	The consideration may be gratuitous or non-gratuitous.

(iii) **Sale and contract for work and labour:** A contract of sale of goods is one in which some goods are sold or are to be sold for a price. But where no goods are sold, and there is only the doing or rendering of some work of labour, then the contract is only of work and labour and not of sale of goods.

Example 17: Where gold is supplied to a goldsmith for preparing an ornament or when an artist is asked to paint a picture. Here, the basic substance of the contract is the exercise of skill and labour, therefore it is contract for work and labour.

1.6 CONTRACT OF SALE HOW MADE (SECTION 5)

According to Section 5(1), A contract of sale may be made in any of the following modes:

(i) Contract of sale is made by an offer to buy or sell goods for a price and acceptance of such offer.

(ii) There may be immediate delivery of the goods; or

(iii) There may be immediate payment of price, but it may be agreed that the delivery is to be made at some future date; or

(iv) There may be immediate delivery of the goods and an immediate payment of price; or

(v) It may be agreed that the delivery or payment or both are to be made in instalments; or

(vi) It may be agreed that the delivery or payment or both are to be made at some future date.

Example 18: R agrees to deliver his old motorcycle valued at ₹ 55,000 to S in exchange for a new motorcycle and agrees to pay the difference in cash, it is a Contract of Sale.

1.7 SUBJECT MATTER OF CONTRACT OF SALE

Existing or future goods (section 6):

(1) The goods which form the subject matter of a contract of sale may be either existing goods that are acquired, owned or possessed by the seller, or future goods.

(2) There may be a contract for the sale of goods, the acquisition of which by the seller depends upon a contingency which may or may not happen.

Example 19: A contract for sale of certain cloth to be manufactured by a certain mill is a valid contract. Such contacts are called contingent contracts.

(3) There may be a contract of sale, where the seller purports to effect a present sale of future goods, such contract operates as an agreement to sell the goods.

Goods perishing before making of contract (Section 7): Where there is a contract for the sale of specific goods, the contract is void if the goods without the knowledge of the seller have, at the time when the contract was made, perished or become so damaged that they no longer answer to their description given in the contract.

Example 20: A agrees to sell B 50 bags of wheat stored in the A's godown. Due to water logging, all the goods stored in the godown were destroyed. At the time of agreement, neither parties were aware of the fact. The agreement is void.

Goods perishing before sale but after agreement to sell (Section 8): Where there is an agreement to sell specific goods, and subsequently the goods without any fault on the part of the seller or buyer perish or become so damaged that they no longer answer to their description in the agreement before the risk passes to the buyer, the agreement is thereby avoided or becomes void.

Perishing of future goods: If the future goods are specific, the destruction of such goods will amount to supervening impossibility and the contract shall become void.

Example 21: A agrees to sell B 100 tons of tomatoes grown on his land next year. But the crop failed due to some disease in plants and A could only deliver 80 tons of tomatoes to B. It was held A was not liable as the performance of contract became impossible due to supervening impossibility.

1.8 ASCERTAINMENT OF PRICE (SECTION 9 & 10)

Ascertainment of price (Section 9):

'Price' means the monetary consideration for sale of goods [Section 2 (10)]. By virtue of Section 9, the price in the contract of sale may be-

(1) fixed by the contract, or

(2) agreed to be fixed in a manner provided by the contract, e.g., by a valuer, or

(3) determined by the course of dealings between the parties.

Agreement to sell at valuation (Section 10):

Section 10 provides for the determination of price by a third party.

1. Where there is an agreement to sell goods on the terms that price has to be fixed by the third party and he either does not or cannot make such valuation, the agreement will be void.

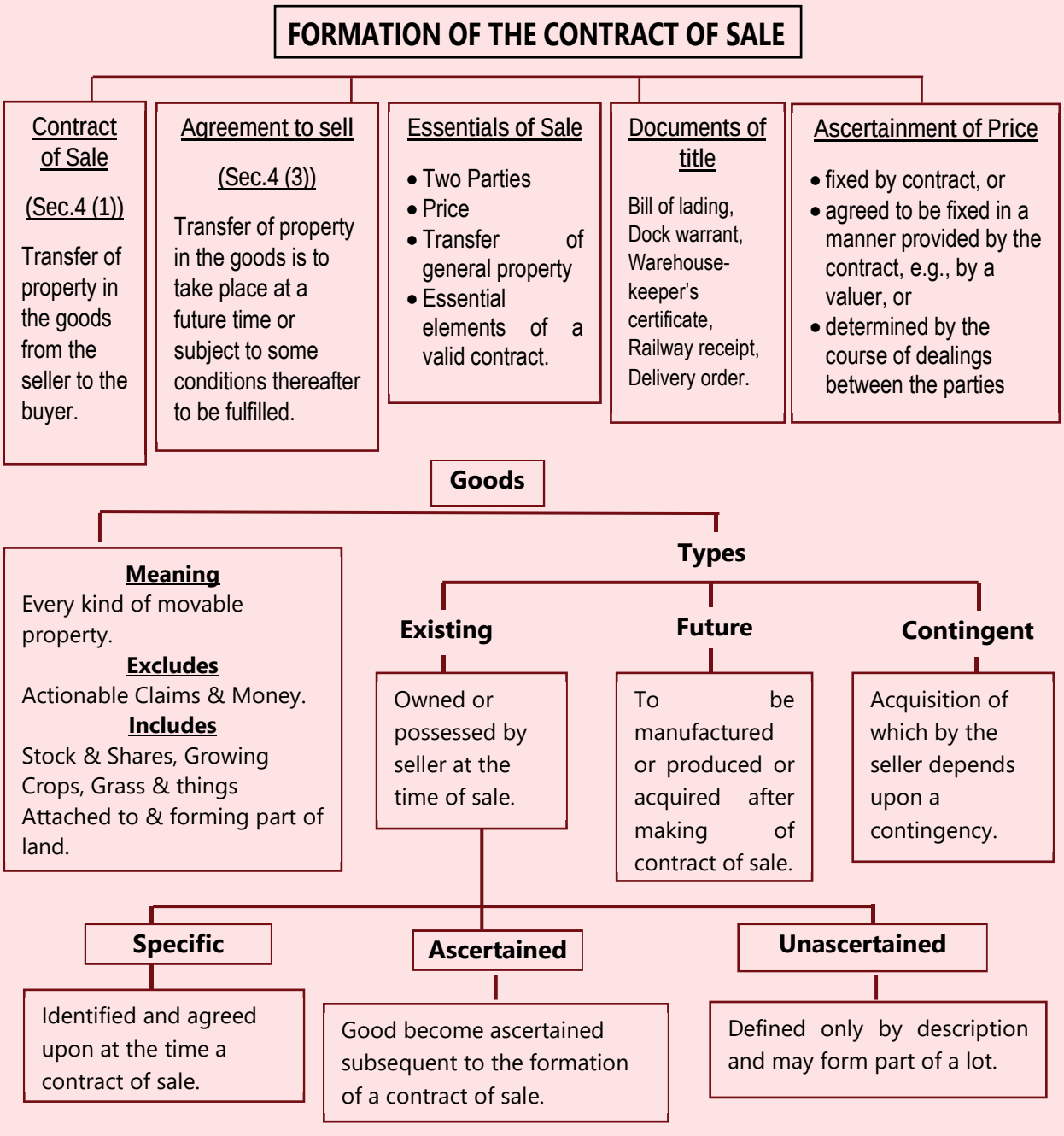
2. In case the third party is prevented by the default of either party from fixing the price, the party at fault will be liable to the damages to the other party who is not at fault.

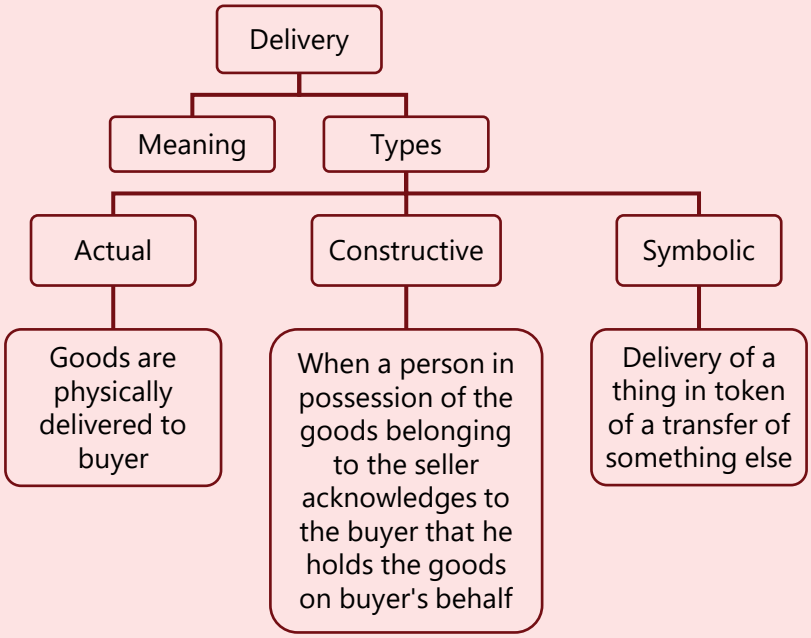
3. However, a buyer who has received and appropriated the goods must pay a reasonable price for them in any eventuality.

Example 22: P is having two bikes. He agrees to sell both of the bikes to S at a price to be fixed by the Q. He gives delivery of one bike immediately. Q refuses to fix the price. As such P ask S to return the bike already delivered while S claims for the delivery of the second bike too. In the given instance, buyer S shall pay reasonable price to P for the bike already taken. As regards the Second bike, the contract can be avoided as the third party Q refuses to fix the price

SUMMARY

In nutshell, contract of sale of goods is a contract where the seller transfers or agrees to transfer the property in goods to the buyer for a price. Where, however, the transfer of property in goods is to take place at a future date or subject to some conditions to be fulfilled, the contract is called 'agreement to sell'. The subject matter of such contract must always be goods. Price for goods may be fixed by the contract or may be agreed to be fixed later on in a specific manner.





TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *A contract for the sale of goods where property would pass to the buyer on payment of total price would be;*

   (a) sale

   (b) agreement to sell

   (c) hire-purchase contract.

   (d) sale on approval.

2. *The term "goods" under Sale of Goods Act, 1930 does not include*

   (a) goodwill.

   (b) actionable claims.

   (c) stocks and shares.

   (d) harvested crops.

3. *A contract for the sale of "future goods" is*

   (a) sale

   (b) agreement to sell.

(c) *void.*

(d) *hire-purchase contract.*

4. *The sale of Goods Act, 1930 deals with the*

(a) *movable goods only.*

(b) *immovable goods only.*

(c) *both movable and immovable goods.*

(d) *all goods except ornaments.*

5. *Under Sale of Goods Act, 1930 the terms "Goods" means every kind of movable property and it includes*

(a) *stock and share.*

(b) *growing crops, grass*

(c) *both (a) and (b).*

(d) *none of the above*

6. *The Sale of Goods Act, 1930 deals with*

(a) *sale*

(b) *mortgage.*

(c) *pledge.*

(d) *all of the above.*

7. *Which one of the following is true?*

(a) *the provisions of Sale of Goods were originally with the Indian Contract Act, 1872.*

(b) *the Sale of Goods Act, 1930 deals with mortgage.*

(c) *the Sale of Goods Act restricts the parties to modify the provisions of law.*

(d) *none of the above.*

8. *Goods which are in existence at the time of the Contract of Sale is known as*

(a) *present Goods.*

(b) *existing Goods.*

(c) *specific Goods.*

(d) *none of the above.*

9. *Which of the following is not a form of delivery?*

   (a) constructive delivery.

   (b) structured delivery.

   (c) actual delivery.

   (d) symbolic delivery.

10. *Which one of the following is/are document of title to goods?*

   (a) railway receipt.

   (b) wharfinger's certificate.

   (c) warehouse keeper's certificate.

   (d) all of the above

11. *Which one of the following is not true?*

   (a) document showing title is different from document of title.

   (b) bill of lading is a document of title to goods.

   (c) specific goods can be identified and agreed upon at the time of the Contract of Sale.

   d) none of the above.

12. *Mercantile Agent is having an authority to*

   (a) sell or consign goods.

   (b) raise money on the security of goods.

   c) sell or buy goods.

   (d) any of the above.

13. *Contract of Sale is*

   (a) executory Contract.

   (b) executed Contract.

   (c) both of the above.

   (d) none of the above.

14. *In which form of the contract, the property in the goods passes to the buyer immediately:*

    (a) agreement to sell.

    (b) hire purchase.

    (c) sale

    (d) instalment to sell.

15. *In case of hire purchase the hirer can pass title to a bona fide purchaser.*

    (a) true.

    (b) false.

16. *In a contract of sale, the agreement may be expressed or implied from the conduct of the parties.*

    (a) true.

    (b) false.

17. *In a contract of sale, subject matter of contract must always be money.*

    (a) true.

    (b) false.

18. *If a seller handed over the keys of a warehouse containing the goods to the buyer results in*

    (a) constructive delivery

    (b) actual delivery

    (c) symbolic delivery

    (d) none of the above

19. *If A agrees to deliver 100 kg of sugar to B in exchange of 15 mts of cloth, then it is*

    (a) Contract of sale.

    (b) Agreement to sell.

    (c) Sale on Approval.

    (d) Barter.

20. *In a hire-purchase agreement, the hirer*

(a) *has an option to buy the goods.*

(b) *must buy the goods.*

(c) *must return the goods.*

(d) *is not given the possession of goods.*

21. *A agrees to deliver his old car valued at ₹1, 80,000 to B, a car dealer, in exchange for a new car, and agrees to pay the difference in cash it is*

(a) *Contract of sale.*

(b) *Agreement to sell.*

(c) *Exchange.*

(d) *Barter.*

22. *Legally, a contract of sale includes*

(a) *sale.*

(b) *agreement to Sell.*

(c) *barter.*

(d) *both (a) and (b)*

23. *The Sale of Goods Act, 1930 came into force on*

(a) *15th March, 1930.*

(b) *1st July, 1930.*

(c) *30th July, 1930.*

(d) *30th June, 1930.*

24. *The person who buys or agrees to buy goods is known as*

(a) *consumer.*

(b) *buyer.*

(c) *both (a) and (b)*

(d) *none of the above.*

25. *Voluntary transfer of possession by one person to another is popularly known as*

(a) *transfer.*

(b) *possession.*

(c) *delivery.*

(d) *none of the above.*

26. *If X commissioned Y, an artist, to paint a portrait of A for 200 dollars & Y uses his own canvas & paint then it is*

(a) *Contract of sale.*

(b) *Contract of work & materials.*

(c) *Sale on approval.*

(d) *Hire-Purchase agreement.*

27. *The property in the goods means the*

(a) *possession of goods.*

(b) *custody of goods.*

(c) *ownership of goods.*

(d) *both (a) and (b)*

28. *The goods are at the risk of a party who has the*

(a) *Ownership of goods.*

(b) *Possession of goods.*

(c) *Custody of goods.*

(d) *both (b) and (c)*

29. *In case of sale of standing trees, the property passes to the buyer when trees are*

(a) *felled and ascertained.*

(b) *not felled but earmarked.*

(c) *counted and ascertained.*

(d) *both (b) and (c)*

30. *In case the delivery of goods is delayed due to the fault of party, the goods shall be at the risk of defaulting party even though the ownership is with the other party.*

    (a) True, if there is a provision to this effect.

    (b) False, as it is against the general rule.

31. *Which of the following modes of delivery of goods is considered effective for a valid contract of sale?*

    (a) Actual delivery.

    (b) symbolic delivery.

    (c) Constructive delivery.

    (d) all of these.

Descriptive questions

1. *A agrees to buy a new TV from a shop keeper for ₹ 30,000 payable partly in cash of ₹ 20,000 and partly in exchange of old TV set. Is it a valid Contract of Sale of Goods? Give reasons for your answer.*

2. *A agrees to sell to B 100 bags of sugar arriving on a ship from Australia to India within next two months. Unknown to the parties, the ship has already sunk. Does B have any right against A under the Sale of Goods Act, 1930?*

3. *X contracted to sell his car to Y. They did not discuss the price of the car at all. X later refused to sell his car to Y on the ground that the agreement was void being uncertain about price. Can Y demand the car under the Sale of Goods Act, 1930?*

4. *Classify the following transactions according to the types of goods they are:*

    (i) A wholesaler of cotton has 100 bales in his godown. He agrees to sell 50 bales and these bales were selected and set aside.

    (ii) A agrees to sell to B one packet of sugar out of the lot of one hundred packets lying in his shop.

    (iii) T agrees to sell to S all the apples which will be produced in his garden this year.

ANSWERS/HINTS

Answers to MCQs

1.	**(b)**	2.	**(b)**	3.	**(b)**	4.	**(a)**	5.	**(c)**	6.	**(a)**
7.	**(a)**	8.	**(b)**	9.	**(b)**	10.	**(d)**	11.	**(d)**	12.	**(d)**
13.	**(b)**	14.	**(c)**	15.	**(b)**	16.	**(a)**	17.	**(b)**	18.	**(c)**
19.	**(d)**	20.	**(a)**	21.	**(a)**	22.	**(d)**	23.	**(b)**	24.	**(b)**
25.	**(c)**	26.	**(b)**	27.	**(c)**	28.	**(a)**	29.	**(a)**	30.	**(a)**
31.	**(d)**										

Answers to Descriptive Questions

1. It is necessary under the Sales of Goods Act, 1930 that the goods should be exchanged for money. If the goods are exchanged for goods, it will not be called a sale. It will be considered as barter. However, a contract for transfer of movable property for a definite price payable partly in goods and partly in cash is held to be a contract of Sale of Goods.

In the given case, the new TV set is agreed to be sold for ₹ 30,000 and the price is payable partly in exchange of old TV set and partly in cash of ₹ 20,000. So, in this case, it is a valid contract of sale under the Sales of Goods Act, 1930.

2. In this case, B, the buyer has no right against A the seller. Section 8 of the Sales of Goods Act, 1930 provides that where there is an agreement to sell specific goods and the goods without any fault of either party perish, damaged or lost, the agreement is thereby avoided. This provision is based on the ground of supervening impossibility of performance which makes a contract void.

So, all the following conditions required to treat it as a void contract are fulfilled in the above case:

(i) There is an agreement to sell between A and B

(ii) It is related to specific goods

(iii) The goods are lost because of the sinking of ship before the property or risk passes to the buyer.

(iv) The loss of goods is not due to the fault of either party.

3. Payment of the price by the buyer is an important ingredient of a contract of sale. If the parties totally ignore the question of price while making the contract, it would not become an uncertain and invalid agreement. It will rather be a valid contract and the buyer shall pay a reasonable price.

In the give case, X and Y have entered into a contract for sale of car but they did not fix the price of the car. X refused to sell the car to Y on this ground. Y can legally demand the car from X and X can recover a reasonable price of the car from Y.

4. **(i)** A wholesaler of cotton has 100 bales in his godown. So, the goods are existing goods. He agrees to sell 50 bales and these bales were selected and set aside. On selection, the goods becomes ascertained. In this case, the contract is for the sale of ascertained goods, as the cotton bales to be sold are identified and agreed after the formation of the contract.

(ii) If A agrees to sell to B one packet of sugar out of the lot of one hundred packets lying in his shop, it is a sale of existing but unascertained goods because it is not known which packet is to be delivered.

(iii) T agrees to sell to S all the apples which will be produced in his garden this year. It is contract of sale of future goods, amounting to 'an agreement to sell.'

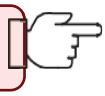
UNIT – 2: CONDITIONS & WARRANTIES

LEARNING OUTCOMES

After studying this unit, you would be able to understand:

- About Stipulation as to time
- Conditions and warranties in a contract of Sale
- About the implied conditions and warranties.
- The doctrine of 'caveat emptor'.

UNIT OVERVIEW



Stipulation with Reference to Goods	
Condition	**Warranty**
Essential to main purpose of the contract	Collateral to main purpose of the contract
Breach-repudiation	Breach-claim for damages

2.1 STIPULATION AS TO TIME (SECTION 11)

As regard to time for the payment of price, unless a different intention appears from the terms of contract, stipulation as regard this, is not deemed to be of the essence of a contract of sale. But delivery of goods must be made without delay. Whether or not such a stipulation is of the essence of a contract depends on the terms agreed upon.

Price for goods may be fixed by the contract or may be agreed to be fixed later on in a specific manner. Stipulation as to time of delivery are usually the essence of the contract.

2.2 INTRODUCTION - CONDITIONS AND WARRANTIES

At the time of selling the goods, a seller usually makes certain statements or representations with a view to induce the intending buyer to purchase the goods. Such representations are generally about the nature and quality of goods, and about their fitness for buyer's purpose.

When these statements or representations do not form a part of the contract of sale, they are not relevant and have no legal effects on the contract. But when these form part of the contract of sale and the buyer relies upon them, they are relevant and have legal effects on the contract of sale.

A representation which forms a part of the contract of sale and affects the contract, is called a stipulation. However, every stipulation is not of equal importance. Some of these may be very vital while others may be of somewhat lesser significance. The more significant stipulations contained in a contract of sale of goods have been called as "Conditions", while the less significant stipulation have been given the name "Warranties".

Condition and warranty (Section 12): A stipulation in a contract of sale with reference to goods which are the subject thereof may be a condition or a warranty. [Sub-section (1)]

"A **condition** is a stipulation essential to the main purpose of the contract, the breach of which gives rise to a right to treat the contract as repudiated". [Sub-section (2)]

Example 1: P wants to purchase a car from Q, which can have a mileage of 20 km/litre. Q pointing at a particular vehicle says "This car will suit you." Later P buys the car but finds out later on that this car only has a top mileage of 15 km/ litre. This amounts to a breach of condition because the seller made the stipulation which forms the essence of the contract. In this case, the mileage was a stipulation that was essential to the main purpose of the contract and hence its breach is a breach of condition.

"A **warranty** is a stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim for damages but not to a right to reject the goods and treat the contract as repudiated". [Sub-section (3)].

Whether a stipulation in a contract of sale is a condition or a warranty depends in each case on the construction of the contract. A stipulation may be a condition, though called a warranty in the contract. [Sub-section (4)]

Example 2: Ram consults Shyam, a motor-car dealer for a car suitable for touring purposes to promote the sale of his product. Shyam suggests 'Maruti' and Ram accordingly buys it from Shyam. The car turns out to be unfit for touring purposes. Here, the term that the 'car should be suitable for touring purposes' is a condition of the contract. It is so vital that its non-fulfilment defeats the very purpose for which Ram purchases the car. Ram is therefore entitled to reject the car and have refund of the price.

Let us assume, Ram buys a new Maruti car from the show room and the car is guaranteed against any manufacturing defect under normal usage for a period of one year from the date of original purchase and in the event of any manufacturing defect there is a warranty for replacement of defective part if it cannot be properly repaired. After six months, Ram finds that the horn of the car is not working, here in this case he cannot terminate the contract. The manufacturer can either get it repaired or replaced it with a new horn. Ram gets a right to claim for damages, if any, suffered by him but not the right of repudiation.

Difference between conditions and warranties:

The following are important differences between conditions and warranties.

Point of differences	Condition	Warranty
Meaning	A condition is a stipulation essential to the main purpose of the contract.	A warranty is a stipulation collateral to the main purpose of the contract.
Right in case of breach	The aggrieved party can repudiate the contract or claim damages or both in the case of breach of condition.	The aggrieved party can claim only damages in case of breach of warranty.
Conversion of stipulations	A breach of condition may be treated as a breach of warranty.	A breach of warranty cannot be treated as a breach of condition.

2.3 WHEN CONDITION IS TO BE TREATED AS WARRANTY (SECTION 13)

Section 13 specifies cases where a breach of condition be treated as a breach of warranty. As a result of which the buyer loses his right to rescind the contract and can claim damages only.

In the following cases, a contract is not avoided even on account of a breach of a condition:

(i) Where the buyer altogether waives the performance of the condition. A party may for his own benefit, waive a stipulation. It should be a voluntary waiver by buyer.

(ii) Where the buyer elects to treat the breach of the conditions, as one of a warranty. That is to say, he may claim only damages instead of repudiating the contract. Here, the buyer has not waived the condition but decided to treat it as a warranty.

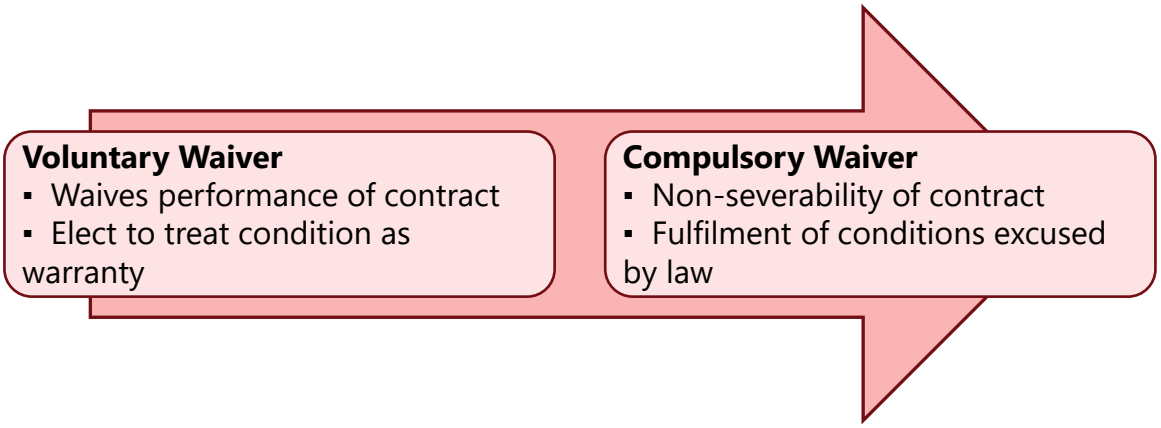
Example 3: A agrees to supply B 10 bags of first quality sugar @ ₹ 625 per bag but supplies only second quality sugar, the price of which is ₹ 600 per bag. There is a breach of condition and the buyer can reject the goods. But if the buyer so elects, he

may treat it as a breach of warranty, hence he may accept the second quality sugar and claim damages @ ₹ 25 per bag.

(iii) Where the contract is non-severable and the buyer has accepted either the whole goods or any part thereof. For Eg. If basmati rice and lower quality rice mixed together, the contract becomes non severable.

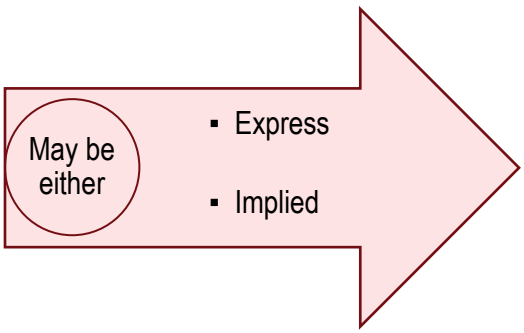
(iv) Where the fulfilment of any condition or warranty is excused by law by reason of impossibility or otherwise.

Waiver of conditions



2.4 EXPRESS AND IMPLIED CONDITIONS AND WARRANTIES (SECTION 14-17)

Condition and Warranty

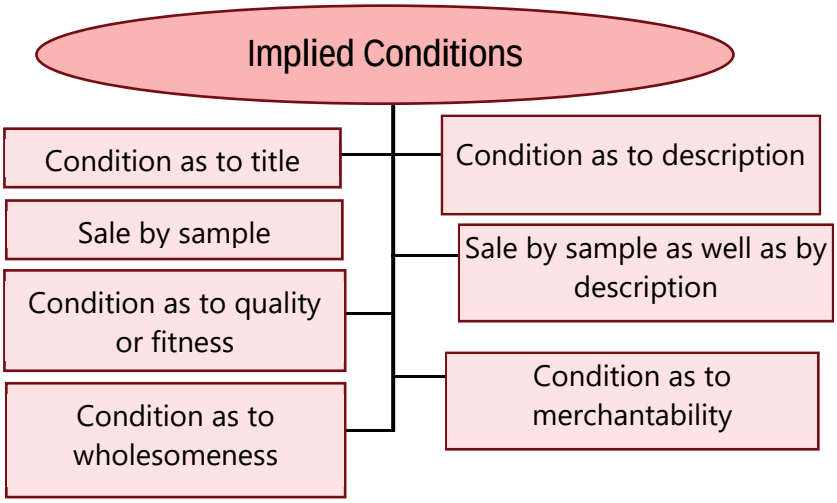


'Conditions' and 'Warranties' may be either **express or implied**. They are "express" when the terms of the contract expressly state them. They are implied when, not being expressly provided for. Implied conditions are incorporated by law in the contract of sale.

Express conditions are those, which are agreed upon between the parties at the time of contract and are expressly provided in the contract.

Implied conditions, on the other hand, are those, which are presumed by law to be present in the contract. It should be noted that an implied condition may be negated or waived by an express agreement.

Following conditions are implied in a contract of sale of goods unless the circumstances of the contract show a different intention.



(i) **Condition as to title [Section 14(a)].** In every contract of sale, unless there is an agreement to the contrary, the first implied condition on the part of the seller is that

(a) in case of a sale, he has a right to sell the goods, and

(b) in the case of an agreement to sell, he will have right to sell the goods at the time when the property is to pass.

In simple words, the condition implied is that the seller has the right to sell the goods (means he should be the real owner) at the time when the property is to pass. If the seller's title/ownership turns out to be defective, the buyer must return the goods to the true owner and recover the price from the seller.

Example 4: A purchased a tractor from B who had no title to it. After 2 months, the true owner spotted the tractor and demanded it from A. Held that A was bound to hand over the tractor to its true owner and that A could sue B, the seller without title, for the recovery of the purchase price.

Example 5: If A sells to B tins of condensed milk labelled 'C.D.F. brand', and this is proved to be an infringement of N Company's trade mark, it will be a breach of implied condition that A had the right to sell. B in such a case will be entitled to reject the goods or take off the labels, and claim damages for the reduced value. If the seller has no title and the buyer has to make over the goods to the true owner, he will be entitled to refund of the price.

(ii) **Sale by description [Section 15]:** Where there is a contract of sale of goods by description, there is an implied condition that the goods shall correspond with the description. This rule is based on the principle that "if you contract to sell peas, you cannot compel the buyer to take beans." The buyer is not bound to accept and pay for the goods which are not in accordance with the description of goods.

Thus, it has to be determined whether the buyer has undertaken to purchase the goods by their description, i.e., whether the description was essential for identifying the goods where the buyer had agreed to purchase. If that is required and the goods tendered do not correspond with the description, it would be breach of condition entitling the buyer to reject the goods.

It is a condition which goes to the root of the contract and the breach of it entitles the buyer to reject the goods whether the buyer is able to inspect them or not.

Example 6: A at Kolkata sells to B twelve bags of "waste silk" on its way from Murshidabad to Kolkata. There is an implied condition that the silk shall be such as is known in the market as "Waste Silk". If it not, B is entitled to reject the goods.

Example 7: A ship was contracted to be sold as "copper-fastened vessel" but actually it was only partly copper-fastened. Held that goods did not correspond to description and hence could be returned or if buyer took the goods, he could claim damages for breach.

The Act, however, does not define 'description'.

(i) where the class or kind to which the goods belong has been specified, e.g., 'Egyptian cotton', "java sugar", etc., defining the category of good

(ii) where the goods have been described by certain characteristics essential to their identification, e.g., jute bales of specified shipment, steel of specific dimension, etc.

It may be noted that the description in these cases assumes that form of a statement or representation as regards the identity of particular goods by reference to the place of origin or mode of packing, etc. Whether or not such a statement or representation is essential to the identity of the goods is a question of fact depending, in each case, on the construction of the contract.

(iii) **Sale by sample [Section 17]:** In a contract of sale by sample, there is an implied condition that

(a) the bulk shall correspond with the sample in quality;

(b) the buyer shall have a reasonable opportunity of comparing the bulk with the sample,

Example 8: In a case of sale by sample of two parcels of wheat, the seller allowed the buyer an inspection of the smaller parcel but not of the larger parcel. In this case, it was held that the buyer was entitled to refuse to take the parcels of wheat.

(c) the goods shall be free from any defect rendering them un-merchantable, which would not be apparent on reasonable examination of the sample. This condition is applicable only with regard to defects, which could not be discovered by an ordinary examination of the goods. If the defects are latent, then the buyer can avoid the contract. This simply means that the goods shall be free from any latent defect i.e. a hidden defect.

Example 9: A company sold certain shoes made of special sole by sample for the French Army. The shoes were found to contain paper not discoverable by ordinary inspection. Held, the buyer was entitled to the refund of the price plus damages.

(iv) Sale by sample as well as by description [Section 15]: Where the goods are sold by sample as well as by description the implied condition is that the bulk of the goods supplied shall correspond both with the sample and the description. In case the goods correspond with the sample but do not tally with description or vice versa or both, the buyer can repudiate the contract.

Example 10: A agreed with B to sell certain oil described as refined sunflower oil, warranted only equal to sample. The goods tendered were equal to sample but contained a mixture of hemp oil along with sunflower oil. Hence, B can reject the goods because the goods were as per sample but do not correspond to the description.

(v) Condition as to quality or fitness [Section 16(1)]: Ordinarily, there is no implied condition as to the quality or fitness of the goods sold for any particular purpose.

However, the condition as to the reasonable fitness of goods for a particular purpose may be implied if the buyer had made known to the seller the purpose of his purchase and relied upon the skill and judgment of the seller to select the best goods and the seller has ordinarily been dealing in those goods. This implied condition will not apply if the goods have been sold under a trademark or a patent name.

There is implied condition of the part of the seller that the goods supplied shall be reasonably fit for the purpose for which the buyer wants them, provided the following conditions are fulfilled:

(a) The buyer should have made known to the seller the particular purpose for which goods are required.

(b) The buyer should rely on the skill and judgement of the seller.

(c) The goods must be of a description dealt in by the seller, whether he be a manufacturer or not.

In some cases, the purpose may be ascertained from the conduct of the parties or form the nature of the goods sold. Where the goods can be used for only one purpose, the buyer need not tell the seller the purpose for which he requires the goods.

Example 11: 'A' bought a set of false teeth from 'B', a dentist. But the set was not fit for 'A's mouth. 'A' rejected the set of teeth and claimed the refund of price. It was held that 'A' was entitled to do so as the only purpose for which he wanted the set of teeth was not fulfilled.

Example 12: 'A' went to 'B's shop and asked for a 'Merrit' sewing machine. 'B' gave 'A' the same and 'A' paid the price. 'A' relied on the trade name of the machine rather than on the skill and judgement of the seller 'B'. In this case, there is no implied condition as to fitness of the machine for buyer's particular purpose.

As a general rule, it is the duty of the buyer to examine the goods thoroughly before he buys them in order to satisfy himself that the goods will be suitable for his purpose for which he is buying them. This is known as rule of caveat emptor which means "Let the buyer beware".

(vi) Condition as to Merchantability [Section 16(2)]: Where goods are bought by description from a seller who deals in goods of that description (whether he is the manufacturer or producer or not), there is an implied condition that the goods shall be of merchantable quality.

There are two requirements for this condition to apply:

(a) Goods should be bought by description.

(b) The seller should be a dealer in goods of that description.

Provided that, if the buyer has examined the goods, there shall be no implied condition as regards defects which such examination ought to have revealed.

The expression "merchantable quality", though not defined, nevertheless connotes goods of such a quality and in such a condition a man of ordinary prudence would accept them as goods of that description. It does not imply any legal right or legal title to sell.

Example 13: If a person orders motor horns from a manufacturer of horns, and the horns supplied are scratched and damaged owing to bad packing, he is entitled to reject them as unmerchantable.

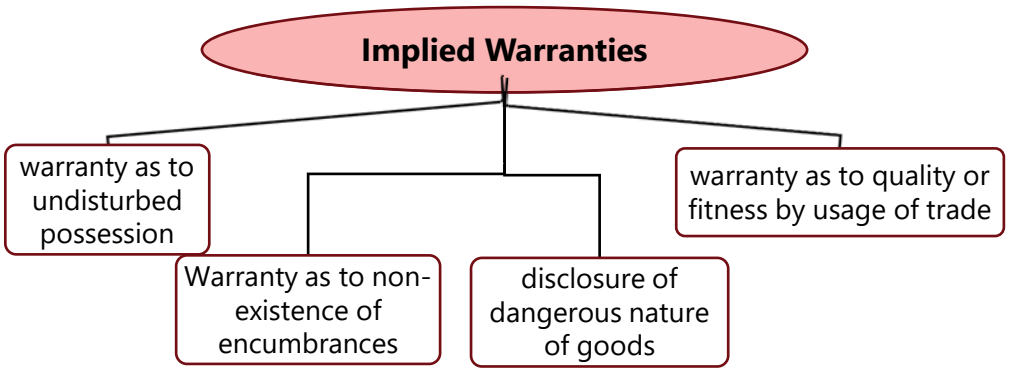
Example 14: A bought a black velvet cloth from C and found it to be damaged by white ants. Held, the condition as to merchantability was broken.

(vii) Condition as to wholesomeness: In the case of eatables and provisions, in addition to the implied condition as to merchantability, there is another implied condition that the goods shall be wholesome.

Example 15: A supplied F with milk. The milk contained typhoid germs. F's wife consumed the milk and was infected and died. Held, there was a breach of condition as to fitness and A was liable to pay damages.

Implied Warranties: It is a warranty which the law implies into the contract of sale. In other words, it is the stipulation which has not been included in the contract of sale in express words. But the law presumes that the parties have incorporated it into their contract. It will be interesting to know that implied warranties are read into every contract of sale unless they are expressly excluded by the express agreement of the parties.

These may also be excluded by the course of dealings between the parties or by usage of trade (Section 62).



The examination of Sections 14 and 16 of the Sale of Goods Act, 1930 discloses the following implied warranties:

1. **Warranty as to undisturbed possession [Section 14(b)]:** An implied warranty that the buyer shall have and enjoy quiet possession of the goods. That is to say, if the buyer having got possession of the goods, is later on disturbed in his possession, he is entitled to sue the seller for the breach of the warranty.

Example 16: X buys a laptop from Y. After the purchase, X spends some money on its repair and uses it for some time. Unknown to the parties, it turns out that the laptop was stolen and was taken from X and delivered to its rightful owner. Y shall be held responsible for a breach and X is entitled to damages of not only the price but also the cost of repairs.

2. **Warranty as to non-existence of encumbrances [Section 14(c)]:** An implied warranty that the goods shall be free from any charge or encumbrance in favour of any third party not declared or known to the buyer before or at the time the contract is entered into.

Example 17: A pledges his car with C for a loan of ₹15,0000 and promises him to give its possession the next day. A, then sells the car immediately to B, who purchased it on good faith, without knowing the fact. B, may either ask A to clear the loan or himself may pay the money and then, file a suit against A for recovery of the money with interest.

3. **Warranty as to quality or fitness by usage of trade [Section 16(3)]:** An implied warranty as to quality or fitness for a particular purpose may be annexed or attached by the usage of trade.

Regarding implied condition or warranty as to the quality or fitness for any particular purpose of goods supplied, the rule is 'let the buyer beware' i.e., the seller is under no duty to reveal unflattering truths about the goods sold, but this rule has certain exceptions.

4. **Disclosure of dangerous nature of goods:** Where the goods are dangerous in nature and the buyer is ignorant of the danger, the seller must warn the buyer of the probable danger. If there is a breach of warranty, the seller may be liable in damages.

2.5 CAVEAT EMPTOR

In case of sale of goods, the doctrine 'Caveat Emptor' means 'let the buyer beware'. When sellers display their goods in the open market, it is for the buyers to make a proper selection or choice of the goods. If the goods turn out to be defective, he cannot hold the seller liable. The seller is in no way responsible for the bad selection of the buyer. The seller is not bound to disclose the defects in the goods which he is selling.

It is the duty of the buyer to satisfy himself before buying the goods that the goods will serve the purpose for which they are being bought. If the goods turn out to be defective or do not serve his purpose or if he depends on his own skill or judgment, the buyer cannot hold the seller responsible.

The rule of Caveat Emptor is laid down in the Section 16, which states that, "subject to the provisions of this Act or of any other law for the time being in force, there is no implied warranty or condition as to the quality or fitness for any particular purpose of goods supplied under a contract of sale".

Following are the conditions to be satisfied:

- if the buyer had made known to the seller the purpose of his purchase, and
- the buyer relied on the seller's skill and judgement, and
- seller's business to supply goods of that description (Section 16).

Example 18: A sold pigs to B. These pigs being infected, caused typhoid to other healthy pigs of the buyer. It was held that the seller was not bound to disclose that the pigs were unhealthy. The rule of the law being "Caveat Emptor".

Example 19: A purchases a horse from B. A needed the horse for riding but he did not mention this fact to B. The horse is not suitable for riding but is suitable only for being driven in the carriage. Caveat emptor rule applies here and so A can neither reject the horse nor can claim compensation from B.

Exceptions: The doctrine of Caveat Emptor is, however, subject to the following exceptions:

1. **Fitness as to quality or use**: Where the buyer makes known to the seller the particular purpose for which the goods are required, so as to show that he relies on the seller's skill or judgment and the goods are of a description which is in the course of seller's business to supply, it is the duty of the seller to supply such goods as are reasonably fit for that purpose [Section 16 (1)].

   Example 20: An order was placed for some trucks to be used for heavy traffic in a hilly country. The trucks supplied by the seller were unfit for this purpose and broke down. There is a breach of condition as to fitness.

   In ***Priest vs. Last,*** P, a draper, purchased a hot water bottle from a retail chemist, P asked the chemist if it would stand boiling water. The Chemist told him that the bottle was meant to hold hot water. The bottle burst when hot water was poured into it and injured his wife. It was held that the chemist shall be liable to pay damages to P, as he knew that the bottle was purchased for the purpose of being used as a hot water bottle.

   Where the article can be used for only one particular purpose, the buyer need not tell the seller the purpose for which he required the goods. But where the article can be used for a number of purposes, the buyer should tell the seller the purpose for which he requires the goods, if he wants to make the seller responsible.

   In ***Bombay Burma Trading Corporation Ltd. vs. Aga Muhammad,*** timber was purchased for the express purpose of using it as railways sleepers and when it was found to be unfit for the purpose, the Court held that the contract could be avoided.

2. **Goods purchased under patent or brand name:** In case where the goods are purchased under its patent name or brand name, there is no implied condition that the goods shall be fit for any particular purpose [Section 16(1)]. Here, the buyer is relying on the particular brand name.

3. **Goods sold by description:** Where the goods are sold by description there is an implied condition that the goods shall correspond with the description [Section 15]. If it is not so, then seller is responsible.

4. **Goods of Merchantable Quality:** Where the goods are bought by description from a seller who deals in goods of that description there is an implied condition that the goods shall be of merchantable quality. The rule of Caveat Emptor is not applicable for latent defects. But where the buyer has examined the goods, this rule shall apply if the defects were such which ought to have not been revealed by ordinary examination [Section 16(2)].

5. **Sale by sample:** Where the goods are bought by sample, this rule of Caveat Emptor does not apply if the bulk does not correspond with the sample [Section 17].

6. **Goods by sample as well as description:** Where the goods are bought by sample as well as description, the rule of Caveat Emptor is not applicable in case the goods do not correspond with both the sample and description or either of the condition [Section 15].

7. **Trade Usage:** An implied warranty or condition as to quality or fitness for a particular purpose may be annexed by the usage of trade and if the seller deviates from that, this rule of Caveat Emptor is not applicable [Section 16(3)].

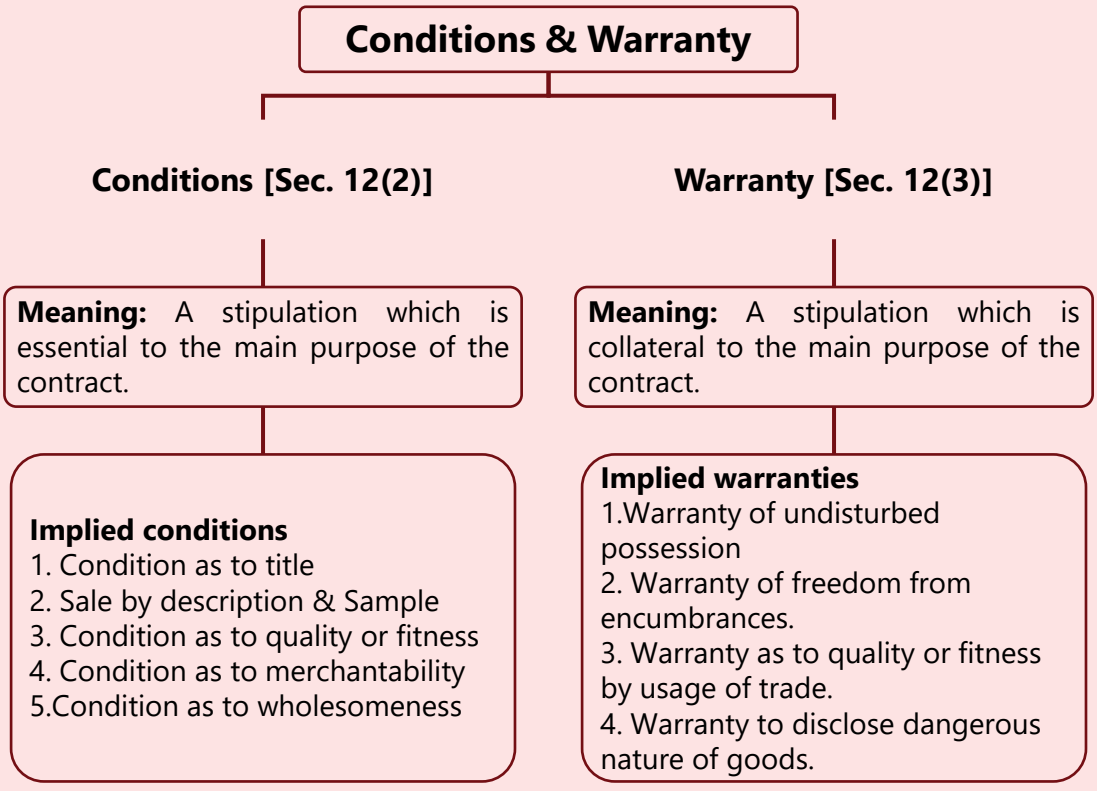
Example 21: In readymade garment business, there is an implied condition by usage of trade that the garments shall be reasonably fit on the buyer.

8. **Seller actively conceals a defect or is guilty of fraud:** Where the seller sells the goods by making some misrepresentation or fraud and the buyer relies on it or when the seller actively conceals some defect in the goods so that the same could not be discovered by the buyer on a reasonable examination, then the rule of Caveat Emptor will not apply. In such a case the buyer has a right to avoid the contract and claim damages.

SUMMARY

While entering into a contract of sale, certain stipulations are put by both the parties i.e. the buyer and the seller. These stipulations with reference to goods may be 'conditions' or 'warranties' depending upon the construction of the contract. A stipulation essential to the main purpose of the contract is a 'condition' whereas collateral stipulations are called warranties. Breach of a 'condition' gives right to repudiate the contract and to claim damages whereas Breach of a 'Warranty' gives right to claim damages only. Every contract of sales have certain conditions and warranties implied by law. Besides, the parties may provide for 'conditions' and 'warranties' by an express agreement.

Regarding implied condition or warranty as to the quality of fitness for any particular purpose of goods supplied, the rule is 'let the buyer beware' i.e., the seller is under no duty to reveal unflattering truths about the goods sold, but this rule has certain exceptions.



Note: 1. If there is a breach of a condition, the aggrieved party can repudiate the contract of sale; in case of a breach of a warranty, the aggrieved party can claim damages only.
2. A breach of a condition may be treated as a breach of a warranty (by voluntary waiver or by accepting the goods by buyer) but a breach of a warranty, however, cannot be treated as a breach of a condition.

When Condition treated as Warrnty

As a result of which the buyer loses his right to rescind the contract and can claim damages only

- **Voluntary Waiver**
  - Waives performance of contract
  - Elect to treat condition as warranty
- **Compulsory Waiver**
  - Non-severability of contract
  - Fulfillment of conditions excused by

Caveat Emptor

This means "***let the buyer beware*",** i.e. its buyer's duty to examine thoroughly when he buys the goods

Exceptions

- Buyer makes known the particular purpose.
- Goods purchased under its patent name or brand name.
- For merchant able quality of goods.
- Sale by descripti on & Sample.
- In case of condition implied by custom.
- Consent of the buyer, in a contract or sale, is obtained by the seller by fraud.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *A stipulation which is essential to the main purpose of the contract is called-*
   - *(a) Warranty*
   - *(b) Guarantee*
   - *(c) Condition*
   - *(d) Indemnity*
2. *Breach of condition gives the aggrieved party-*
   - *(a) Right to sue for damages*
   - *(b) Right to repudiate the contract*
   - *(c) Both (a) and (b)*
   - *(d) None of these*
3. *Condition may be treated as a warranty when there is –*
   - *(a) Waiver of condition by the buyer*
   - *(b) Buyer elects to treat breach of condition as a breach of warranty*
   - *(c) Acceptance of goods by the buyer in case of non-severable of contract of sale*
   - *(d) All of the above*
4. *The doctrine of Caveat Emptor does not apply, when*
   - *(a) the goods are bought by sample.*
   - *(b) the goods are bought by sample as well as description.*
   - *(c) The exact purpose is known to the seller and is a regular dealer*
   - *(d) All of the above*
5. *Which of the following is not an implied condition in a contract of sale?*
   - *(a) condition as to title.*
   - *(b) condition as to description*
   - *(c) condition as to free from encumbrance.*
   - *(d) condition as to sample.*

6. *The conditions and warranties may be in the form of*

   (a) express.

   (b) implied.

   (c) either (a) or (b).

   (d) none of the above.

7. *Which one of the following is not an implied warranty*

   (a) warranty as to undisturbed possession.

   (b) warranty as to existence of encumbrance.

   (c) disclosure of dangerous nature of goods.

   (d) warranty as to quality or fitness by usage of trade.

8. *In case of goods sold by sample, the goods should correspond with the sample other wise*

   (a) buyer can reject the goods.

   (b) buyer cannot reject the goods.

   (c) contract is automatically terminated.

   (d) seller is liable to punishment.

9. *M, a shopkeeper, sold a Television set to N, who purchased it in good faith. The set had some manufacturing defect and it did not work after a few days in spite of repairs. In this case, the television was not merchantable as it was not fit for ordinary purpose.*

   (a) the buyer has no right to reject the television.

   (b) the buyer has the right to reject the television and to have refund of the price.

   (c) both of the above.

   (d) none of the above [(a) & (b)]

10. *Where the buyer is deprived to goods by their true owner, then the buyer*

    (a) may recover the price for breach of the condition as to title.

    (b) can not recover the price for breach of the condition as to title.

    (c) either (a) or (b)

    (d) none of the above.

11. *Where goods are bought by description from a seller who deals in goods of that description, what is the implied condition?*

    (a) That goods shall be of merchantable equality

    (b) That the buyer shall have reasonable opportunity of comparing the bulk with the sample

    (c) The goods shall be of excellent quality

    (d) The goods shall be free from defects

12. *A warranty is stipulation*

    (a) Essential to the main purpose of the contract

    (b) Collateral to the main purpose of the contract

    (c) Very important to the seller

    (d) Very important to the buyer

13. *In a sale by sample and description, there is an implied condition*

    (a) That bulk of the goods correspond with the sample

    (b) That bulk of goods must correspond to the description as well as the sample thereof

    (c) The bulk of goods must correspond either to the description or to the sample

    (d) The bulk of goods must correspond to the description only

Descriptive Questions

1. *M/s Woodworth & Associates, a firm dealing with the wholesale and retail buying and selling of various kinds of wooden logs, customized as per the requirement of the customers. They dealt with Rose wood, Mango wood, Teak wood, Burma wood etc.*

   Mr. Das, a customer came to the shop and asked for wooden logs measuring 4 inches broad and 8 feet long as required by the carpenter. Mr. Das specifically mentioned that he required the wood which would be best suited for the purpose of making wooden doors and window frames. The Shop owner agreed and arranged the wooden pieces cut into as per the buyers requirements.

   The carpenter visited Mr. Das's house next day, and he found that the seller has supplied Mango Tree wood which would most unsuitable for the purpose. The carpenter asked Mr. Das to return the wooden logs as it would not meet his requirements.

The Shop owner refused to accept return of the wooden logs on the plea that logs were cut to specific requirements of Mr. Das and hence could not be resold.

(i) Explain the duty of the buyer as well as the seller according to the doctrine of "Caveat Emptor".

(ii) Whether Mr. Das would be able to get the money back or the right kind of wood as required serving his purpose?

2. *Mrs. Geeta went to the local rice and wheat wholesale shop and asked for 100 kgs of Basmati rice. The Shopkeeper quoted the price of the same as ₹ 125 per kg to which she agreed. Mrs. Geeta insisted that she would like to see the sample of what will be provided to her by the shopkeeper before she agreed upon such purchase. The shopkeeper showed her a bowl of rice as sample. The sample exactly corresponded to the entire lot.*

The buyer examined the sample casually without noticing the fact that even though the sample was that of Basmati Rice but it contained a mix of long and short grains. The cook on opening the bags complained that the dish if prepared with the rice would not taste the same as the quality of rice was not as per requirement of the dish. Now Mrs. Geeta wants to file a suit of fraud against the seller alleging him of selling mix of good and cheap quality rice. Will she be successful?

Decide the fate of the case and options open to the buyer for grievance redressal as per the provisions of Sale of Goods Act, 1930?

What would be your answer in case Mrs. Geeta specified her exact requirement as to length of rice?

3. *X consults Y, a motor-car dealer for a car suitable for touring purposes to promote the sale of his product. Y suggests 'Santro' and X accordingly buys it from Y. The car turns out to be unfit for touring purposes. What remedy X is having now under the Sale of Goods Act, 1930?*

4. *Mrs. G bought a tweed coat from P. When she used the coat she got rashes on her skin as her skin was abnormally sensitive. But she did not make this fact known to the seller i.e. P. Mrs. G filled a case against the seller to recover damages. Can she recover damages under the Sale of Goods Act, 1930?*

5. *Certain goods were sold by sample by A to B, who in turn sold the same goods by sample to C and C by sample sold the goods to D. The goods were not according to the sample. Therefore, D who found the deviation of the goods from the sample rejected the goods and gave a notice to C. C sued B and B sued A. Advise B and C under the Sale of Goods Act, 1930.*

6. *A person purchased bread from a baker's shop. The piece of bread contained a stone in it which broke buyer's tooth while eating. What are the rights available to the buyer against the seller under the Sale of Goods Act, 1930?*

7. *Q asked P, the seller for washing machine which is suitable for washing woollen clothes. Mr. P showed him a particular machine which Mr. Q liked and paid for it. Later on, machine delivered and was found unfit for washing woollen clothes. He immediately informed Mr. P about the delivery of wrong machine. Mr. P refused to exchange the same, saying that the contract was complete after the delivery of washing machine and payment of price. With reference to the provisions of Sale of Goods Act,1930 discuss whether Mr. P is right in refusing to exchange the washing machine?*

ANSWERS/HINTS

Answers to MCQs

1.	**(c)**	2.	**(c)**	3.	**(d)**	4.	**(d)**	5.	**(c)**	6.	**(c)**
7.	**(b)**	8.	**(a)**	9.	**(b)**	10.	**(a)**	11.	**(a)**	12.	**(b)**
13.	**(b)**										

Answer to Descriptive Questions

1. (i) **Duty of the buyer according to the doctrine of "Caveat Emptor"**: In case of sale of goods, the doctrine 'Caveat Emptor' means 'let the buyer beware'. When sellers display their goods in the open market, it is for the buyers to make a proper selection or choice of the goods. If the goods turn out to be defective he cannot hold the seller liable. The seller is in no way responsible for the bad selection of the buyer. The seller is not bound to disclose the defects in the goods which he is selling.

Duty of the seller according to the doctrine of "Caveat Emptor": The following exceptions to the Caveat Emptor are the duties of the seller:

1. Fitness as to quality or use
2. Goods purchased under patent or brand name
3. Goods sold by description
4. Goods of Merchantable Quality
5. Sale by sample

6. Goods by sample as well as description

7. Trade usage

8. Seller actively conceals a defect or is guilty of fraud

(ii) As Mr. Das has specifically mentioned that he required the wood which would be best suited for the purpose of making wooden doors and window frames but the seller supplied Mango tree wood which is most unsuitable for the purpose. Mr. Das is entitled to get the money back or the right kind of wood as required serving his purpose. It is the duty of the seller to supply such goods as are reasonably fit for the purpose mentioned by buyer. [Section 16(1) of the Sale of Goods Act, 1930]

2. As per the provisions of Sub-Section (2) of Section 17 of the Sale of Goods Act, 1930, in a contract of sale by sample, there is an implied condition that:

(a) the bulk shall correspond with the sample in quality;

(b) the buyer shall have a reasonable opportunity of comparing the bulk with the sample.

(i) In the instant case, in the light of the provisions of Sub-Clause (b) of Sub-Section (2) of Section 17 of the Act, Mrs. Geeta will not be successful as she casually examined the sample of rice (which exactly corresponded to the entire lot) without noticing the fact that even though the sample was that of Basmati Rice but it contained a mix of long and short grains.

(ii) In the instant case, the buyer does not have any option available to her for grievance redressal.

(iii) In case Mrs. Geeta specified her exact requirement as to length of rice, then there is an implied condition that the goods shall correspond with the description. If it is not so, then the seller will be held liable.

3. Condition and warranty (Section 12): A stipulation in a contract of sale with reference to goods which are the subject thereof may be a condition or a warranty. [Sub-section (1)]

"A condition is a stipulation essential to the main purpose of the contract, the breach of which gives rise to a right to treat the contract as repudiated". [Sub-section (2)]

In the instant case, the term that the 'car should be suitable for touring purposes' is a condition of the contract. It is so vital that its non-fulfilment defeats the very purpose for which X purchases the car.

X is therefore entitled to reject the car and have refund of the price.

4. According to Section 16(1) of Sales of Goods Act, 1930, normally in a contract of sale there is no implied condition or warranty as to quality or fitness for any particular purpose of goods supplied. The general rule is that of "Caveat Emptor" that is "let the buyer beware". But where the buyer expressly or impliedly makes known to the seller the particular purpose for which the goods are required and also relies on the seller's skill and judgement and that this is the business of the seller to sell such goods in the ordinary course of his business, the buyer can make the seller responsible.

In the given case, Mrs. G purchased the tweed coat without informing the seller i.e. P about the sensitive nature of her skin. Therefore, she cannot make the seller responsible on the ground that the tweed coat was not suitable for her skin. Mrs. G cannot treat it as a breach of implied condition as to fitness and quality and has no right to recover damages from the seller.

5. In the instant case, D who noticed the deviation of goods from the sample can reject the goods and treat it as a breach of implied condition as to sample which provides that when the goods are sold by sample the goods must correspond to the sample in quality and the buyer should be given reasonable time and opportunity of comparing the bulk with the sample. Whereas C can recover only damages from B and B can recover damages from A. For C and B it will not be treated as a breach of implied condition as to sample as they have accepted and sold the goods according to Section 13(2) of the Sales of Goods Act, 1930. Hence, they cannot reject the goods, but claim the damages.

6. This is a case related to implied condition as to wholesomeness which provides that the eatables and provisions must be wholesome that is they must be fit for human consumption. In this case, the piece of bread contained a stone which broke buyer's tooth while eating, thereby considered unfit for consumption. Hence, the buyer can treat it as breach of implied condition as to wholesomeness and can also claim damages from the seller.

7. According to Section 15 of the Sale of Goods Act, 1930, whenever the goods are sold as per sample as well as by description, the implied condition is that the goods must correspond to both sample as well as description. Further under Sale of Goods Act, 1930 when the buyer makes known to the seller the particular purpose for which the goods are required and he relies on his judgment and skill of the seller, it is the duty of the seller to supply such goods which are fit for that purpose. Mr. Q has informed to Mr. P that he wanted the washing machine for washing woollen clothes. However, the machine which was delivered by Mr. P was unfit for the purpose for which Mr. Q wanted the machine. Therefore, Mr. Q can either repudiate the contract or claim the refund of the price paid by him.

UNIT – 3: TRANSFER OF OWNERSHIP AND DELIVERY OF GOODS

LEARNING OUTCOMES

After studying this unit, you would be able to understand-

- How and at what point of time the ownership in goods which are the subject matter of a contract of sale passes to the buyer from the seller.
- About what appropriation of goods is and how it affects the passing of property in goods.
- Distinction between passing of property and passing of title.
- The rule of *'nemo dat quod non habet'* (no one can give what he has not got) and exceptions thereof.
- The rules relating to delivery of goods and acceptance of goods.

UNIT OVERVIEW

A contract of sale of goods involves transfer of ownership in three stages:

INTRODUCTION

Sale of goods involves transfer of ownership of property from seller to buyer. It is essential to determine the time at which the ownership passes from the seller to the buyer.

Importance of the time of transfer

The general rule is that risk prima facie passes with the property. In case where goods are lost or damaged, the burden of loss will be borne by the person who is the owner at the time when the goods are lost or damaged. Where the goods are damaged by the act of the third party, it is the owner who can take action. Suit for price by the seller can be filed only when the property has passed to the buyer.

3.1 PASSING OF PROPERTY (SECTIONS 18 – 26)

Passing or transfer of property constitutes the most important element and factor to decide legal rights and liabilities of sellers and buyers. Passing of property implies passing of ownership. If the property has passed to the buyer, the risk in the goods sold is that of buyer and not of seller, though the goods may still be in the seller's possession.

The rules regarding transfer of property in goods from the seller to the buyer depend on two basic factors:

(a) **Identification of Goods**: Section 18 provides that where there is a contract of safe for unascertained goods, the property in goods cannot pass to the buyer unless and until the goods are ascertained. The buyer can get the ownership right on the goods only when the goods are specific and ascertained.

(b) **Intentions of parties**: The property in goods is transferred to the buyer at such time as the parties to the contract intend it to be transferred. [section 19(1)]

Section 19(2) further provides that for the purpose of ascertaining the intention of the parties regard shall be:

(i) To the terms of the contract

(ii) To the conduct of the parties and

(iii) To the circumstances of the case

The primary rules determining the passing of property from seller to buyer are as follows:

Passing of property

- **Specific or Ascertained Goods**
- **Passing of Unascertained Goods**
- **Goods sent on approval or "on sale or return"**
- **Transfer of property in case of reservation of right to disposal.**

A. Property (Specific or ascertained goods) passes when intended to pass (Section 19):

Where there is a contract for the sale of specific or ascertained goods, the property in them is transferred to the buyer at such time as the parties to the contract intend it to be transferred. **[sub-section (1)]**

For the purpose of ascertaining the intention of the parties, regard shall be had to the terms of the contract, the conduct of the parties and the circumstances of the case. **[sub-section (2)]**

Unless a different intention appears, the rules contained in Sections 20 to 24 are rules for ascertaining the intention of the parties as to the time at which the property in the goods is to pass to the buyer. **[sub-section (3)]**

Stages of goods while passing of property

Specific goods in a deliverable state

Specific goods to be put into a deliverable state

Specific goods in a deliverable state when seller has to ascertain price.

1. Specific goods in a deliverable state (Section 20): Where there is an unconditional contract for the sale of specific goods in a deliverable state, the property in the goods passes to the buyer when the contract is made, and it is immaterial whether the time of payment of the price or the time of delivery of the goods, or both, is postponed. Here, the condition is goods must be ready for delivery.

Example 1: X goes into a shop and buys a television and asks the shopkeeper for its home delivery. The shopkeeper agrees to do it. The television immediately becomes the property of X.

2. **Specific goods to be put into a deliverable state (Section 21):** Where there is a contract for the sale of specific goods and the seller is bound to do something to the goods for the purpose of putting them into a deliverable state, the property does not pass until such thing is done and the buyer has notice thereof.

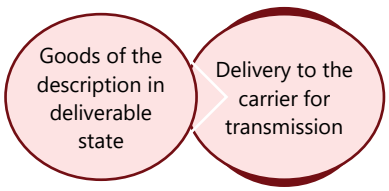
Example 2: Peter buys a laptop from an electronics store and asks for a home delivery. The shopkeeper agrees to it. However, the laptop does not have a Windows operating system installed. The shopkeeper promises to install it and call Peter before making the delivery. In this case, the property transfers to Peter only after the shopkeeper has installed the OS making the laptop ready for delivery and intimated the buyer about it.

3. **Specific goods in a deliverable state, when the seller has to do anything thereto in order to ascertain price (Section 22):** Where there is a contract for the sale of specific goods in a deliverable state, but the seller is bound to weigh, measure, test or do some other act or thing with reference to the goods for the purpose of ascertaining the price, the property does not pass until such act or thing is done and the buyer has notice thereof.

Example 3: A sold carpets to the Company which were required to be laid. The carpet was delivered to the company's premises but was stolen before it could be laid. It was held that the carpet was not in deliverable state as it was not laid, which was part of the contract and hence, the property had not passed to the buyer company.

B. Unascertained goods

Where there is a contract for the sale of unascertained goods, no property in the goods is transferred to the buyer unless and until the goods are ascertained. **[Section 18]**



The rules in respect of passing of property of unascertained goods are as follows:

1. **Sale of unascertained goods by description and Appropriation [Section 23(1)]:** Appropriation of goods involves selection of goods with the intention of using them in performance of the contract and with the mutual consent of the seller and the buyer.

   The essentials are:

   (a) There is a contract for the sale of unascertained or future goods.

   (b) The goods should conform to the description and quality stated in the contract.

   (c) The goods must be in a deliverable state.

   (d) The goods must be unconditionally (as distinguished from an intention to appropriate) appropriated to the contract either by delivery to the buyer or his agent or the carrier.

   (e) The appropriation must be made by:

      (i) the seller with the assent of the buyer; or

      (ii) the buyer with the assent of the seller.

   (f) The assent may be express or implied.

   (g) The assent may be given either before or after appropriation.

2. **Delivery of the goods to the carrier [Section 23(2)]:** Where, in pursuance of the contract, the seller delivers the goods to the buyer or to a carrier or other bailee (whether named by the buyer or not) for the purpose of transmission to the buyer, and does not reserve the right of disposal, he is deemed to have unconditionally appropriated the goods to the contract.

Example 4: A bill of lading of railway parcel is made out in the name of the buyer and is sent to him, the ownership in the goods passes from the seller to the buyer. In case the goods are subjected to accidental loss or by theft, the seller will not be liable.

Example 5: M places an order for book with a book seller in Mumbai. He asks him to send the book by courier. Payment of the book was to be made by cheque. The seller sends the book by courier. The book is lost in the way. The seller wants the buyer to bear the loss. According to Section 23(2), it is an unconditional appropriation of goods because of which buyer M has become the owner of the goods. Therefore, he will bear the risk of loss of the book in the way.

C. Goods sent on approval or "on sale or return" (Section 24)

When goods are delivered to the buyer on approval or "on sale or return" or other similar terms, the property therein passes to the buyer-

(a) when he signifies his approval or acceptance to the seller or does any other act adopting the transaction;

(b) if he does not signify his approval or acceptance to the seller but retains the goods without giving notice of rejection, then, if a time has been fixed for the return of the goods, on the expiration of such time, and, if no time has been fixed, on the expiration of a reasonable time; or

(c) he does something to the good which is equivalent to accepting the goods e.g. he pledges or sells the goods.

Example 6: P brought a musical instrument from a musical shop on a condition that he will purchase it, if he likes that instrument. After a week he has informed the shop owner that he has agreed to purchase the musical instrument. The ownership is transferred when he has decided to purchase the instrument as his own.

A buyer under a contract on the basis of 'sale or return' is deemed to have exercised his option when he does any act exercising domination over the goods showing an unequivocal intention to buy, example, if he pledges the goods with a third party. Failure or inability to return the goods to the seller does not necessarily imply selection to buy.

Example 7: 'A' delivered some jewellery to 'B' on sale or return basis. 'B' pledged the jewellery with 'C'. It was held that the ownership of the jewellery had been transferred to 'B' as he had adopted the transaction by pledging the jewellery with 'C'. In this case, 'A' has no right against 'C'. He can only recover the price of the jewellery from 'B'.

Example 8: A sends to B a water motor on approval or return in March, 2020. B to return it after trial in August, 2020. The water motor has not been returned within a reasonable time, and therefore, A is not bound to accept it and B must pay the price.

Sale for cash only or Return

It may be noted that where the goods have been delivered by a person on "sale or return" on the terms that the goods were to remain the property of the seller till they are paid for, the property therein does not pass to the buyer until the terms are complied with, i.e., cash is paid for.

Example 9: 'A' delivered his jewellery to 'B' on sale for cash only or return basis. It was expressly provided in the contract that the jewellery shall remain 'A's property until the price is paid. Before the payment of the price, 'B' pledged the jewellery with 'C'. It was held that at the time of pledge, the ownership was not transferred to 'B'. Thus, the pledge was not valid and 'A' could recover the jewellery from 'C'.

D. Reservation of right of disposal (Section 25)

This section preserves the right of disposal of goods to secure that the price is paid before the property in goods passes to the buyer.

Where there is contract of sale of specific goods or where the goods have been subsequently appropriated to the contract, the seller may, by the terms of the contract or appropriation, as the case may be, reserve the right to dispose of the goods, until certain conditions have been fulfilled. In such a case in spite of the fact that the goods have already been delivered to the buyer or to a carrier or other bailee for the purpose of transmitting the same to the buyer, the property therein will not pass to the buyer till the condition imposed, if any, by the seller has been fulfilled. (sub-section1)

Example 10: X sends furniture to a company by a truck and instructs the driver not to deliver the furniture to the company until the payment is made by company to him. The property passes only when the payment is made.

Circumstances under which the right to disposal may be reserved: In the following circumstances, seller is presumed to have reserved the right of disposal:

(1) If the goods are shipped or delivered to a railway administration for carriage and by the bill of lading or railway receipt, as the case may be, the goods are deliverable to the order of the seller or his agent, then the seller will be prima facie deemed to have reserved to the right of disposal. (sub section 2)

(2) Where the seller draws a bill on the buyer for the price and sends to him the bill of exchange together with the bill of lading or (as the case may be) the railway receipt to secure acceptance or payment thereof, the buyer must return the bill of lading, if he does not accept or pay the bill.

And if he wrongfully retains the bill of lading or the railway receipt, the property in the goods does not pass to him. (sub section 3)

It should be noted that Section 25 deals with "conditional appropriation" as distinguished from 'unconditional appropriation' dealt with under Section 23 (2).

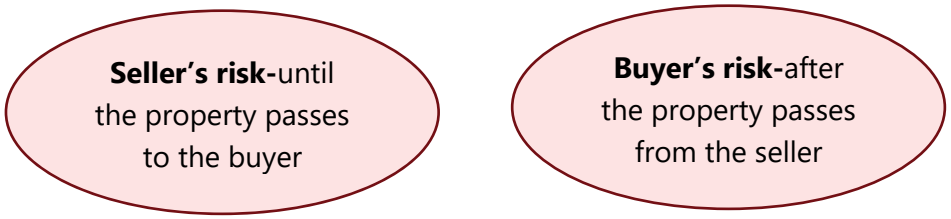
3.2 RISK PRIMA FACIE PASSES WITH PROPERTY (SECTION 26)

According to section 26, "unless otherwise agreed, the goods remain at the seller's risk until the property therein is transferred to the buyer, but when the property therein is transferred to the buyer, the goods are at the buyer's risk whether delivery has been made or not".

However, Section 26 also lays down an exception to the rule that 'risk follows ownership.' It provides that where delivery of the goods has been delayed through the fault of either buyer or seller, the goods are at the risk of the party in fault as regards any loss which might not have occurred but for such fault.

Thus, in ordinary circumstances, risk is borne by the buyer only when the property in the goods passes over to him. However, the parties may by special agreement stipulate that 'risk' will pass sometime after or before the 'property' has passed.

Risk *prima facie* passes with ownership: The owner of goods must bear the loss or damage of goods unless otherwise is agreed to. Under Section 26 of the Sale of Goods Act, unless otherwise agreed, the goods remain at the seller's risk until property therein has passed to the buyer. After that event they are at the buyer's risk, whether delivery has been made or not.



Example 11: A bids for an antique painting at a sale by auction. After the bid, when the auctioneer struck his hammer to signify acceptance of the bid, he hit the antique which gets damaged. The loss will have to be borne by the seller, because the ownership of goods has not yet passed from the seller to the buyer.

The aforesaid rule is, however, subject to two qualifications:

(i) If delivery has been delayed by the fault of the seller or the buyer, the goods shall be at the risk of the party in default, as regards loss which might not have arisen but for the default.

(ii) The duties and liabilities of the seller or the buyer as bailee of goods for the other party remain unaffected even when the risk has passed generally.

Example 12: A contracted to sell 100 bales of cotton to B to be delivered in February. B took the delivery of the part of the cotton but made a default in accepting the remaining bales. Consequently, the cotton becomes unfit for use. The loss will have to be borne by the buyer. It should, however, be remembered that the general rule shall not affect the duties or liabilities of either seller or buyer as a bailee of goods for the other, even when the risk has passed. It is their duty to take care of the goods as a man of ordinary prudence would have done.

As noted above, the risk (i.e., the liability to bear the loss in case property is destroyed, damaged or deteriorated) passes with ownership. The parties may, however, agree to the contrary. For instance, the parties may agree that risk will pass sometime after or before the property has passed from the seller to the buyer.

3.3 TRANSFER OF TITLE BY NON-OWNERS (SECTIONS 27 – 30)

Sale by person not the owner (Section 27): In general, the seller can sell only such goods of which he is the absolute owner. But sometimes a person may sell goods of which he is not the owner, then the question arises as to what is the position of the buyer who has bought the goods by paying price. The general rule regarding the transfer of title is that the seller cannot transfer a better title to the buyer for goods than he himself has. If the seller is not the owner of goods, then the buyer also will not become the owner i.e. the title of the buyer shall be the same as that of the seller. This rule is expressed in the Latin maxim *"Nemo dat quod non habet"* which means that no one can give what he has not got.

Example 13: If A sells some stolen goods to B, who buys them in good faith, B will get no title to that and the true owner has a right to get back his goods from B.

Example 14: P, the hirer of vehicle under a hire purchase agreement, sells them to Q. Q, though a bona fide purchaser, does not acquire the ownership in the vehicle. At the most he acquires the same right as that of the hirer.

If this rule is enforced rigidly then the innocent buyers may be put to loss in many cases. Therefore, to protect the interests of innocent buyers, a number of exceptions have been provided to this rule.

Exceptions: In the following cases, a non-owner can convey better title to the bona fide purchaser of goods for value.

(1) **Sale by a Mercantile Agent:** A sale made by a mercantile agent of the goods for document of title to goods would pass a good title to the buyer in the following circumstances; namely;

(a) If he was in possession of the goods or documents with the consent of the owner;

(b) If the sale was made by him when acting in the ordinary course of business as a mercantile agent; and

(c) If the buyer had acted in good faith and has at the time of the contract of sale, no notice of the fact that the seller had no authority to sell **(Proviso to Section 27).**

Mercantile Agent means an agent having in the customary course of business as such agent authority either to sell goods, or to consign goods for the purposes of sale, or to buy goods, or to raise money on the security of goods [Section 2(9)].

(2) Sale by one of the joint owners (Section 28): If one of several joint owners of goods has the sole possession of goods by permission of the co-owners, the property in the goods is transferred to any person who buys them from such joint owner in good faith and has not at the time of the contract of sale notice that the seller has no authority to sell.

Example 15: A, B, and C are three brothers and joint owners of a T.V and VCR and with the consent of B and C, the VCR and T.V was kept in possession of A. A sells the T.V and VCR to P who buys it in good faith and without notice that A had no authority to sell. P gets a good title to VCR and T.V.

(3) Sale by a person in possession under voidable contract: A buyer would acquire a good title to the goods sold to him by a seller who had obtained possession of the goods under a contract voidable on the ground of coercion, fraud, misrepresentation or undue influence provided that the contract had not been rescinded until the time of the sale **(Section 29).**

Example 16: X fraudulently obtains a diamond ring from Y. This contract is voidable at the option of Y. But before the contract could be terminated, X sells the ring to Z, an innocent purchaser. Z gets the good title and Y cannot recover the ring from Z even if the contract is subsequently set aside.

(4) Sale by one who has already sold the goods but continues in possession thereof: If a person has sold goods but continues to be in possession of them or of the documents of title to them, he may sell them to a third person, and if such person obtains the delivery thereof in good faith and without notice of the previous sale, he would have good title to them, although the property in the goods had passed to the first buyer earlier. A pledge or other disposition of the goods or documents of title by the seller in possession are equally valid **[Section 30(1)].**

Example 17: During IPL matches, P buys a TV set from R. R agrees to deliver the same to P after some days. In meanwhile R sells the same to S, at a higher price, who buys in good faith and without knowledge about the previous sale. S gets a good title.

(5) **Sale by buyer obtaining possession before the property in the goods has vested in him:** Where a buyer with the consent of the seller obtains possession of the goods before the property in them has passed to him, he may sell, pledge or otherwise dispose of the goods to a third person, and if such person obtains delivery of the goods in good faith and without notice of the lien or other right of the original seller in respect of the goods, he would get a good title to them **[Section 30(2)].**

Example 18: Furniture was delivered to B under an agreement that price was to be paid in two instalments, the furniture to become property of B on payment of second instalment. B sold the furniture before second instalment was paid. It was held that the buyer acquired a good title. (*Lee Vs Butler)*

However, a person in possession of goods under a 'hire-purchase' agreement which gives him only an option to buy is not covered within the section unless it amounts to a sale.

Example 19: A took a car from B on this condition that A would pay a monthly instalment of ₹ 5,000 as hire charges with an option to purchase it by payment of ₹ 1,00,000 in 24 instalments.

After the payment of few instalments, A sold the car to C. B can recover the car from C since A had neither bought the car, nor had agreed to buy the car. He had only an option to buy the car.

(6) **Effect of Estoppel:** Where the owner is estopped by the conduct from denying the seller's authority to sell, the transferee will get a good title as against the true owner. But before a good title by estoppel can be made, it must be shown that the true owner had actively suffered or held out the other person in question as the true owner or as a person authorized to sell the goods.

Example 20: 'A' said to 'B', a buyer, in the presence of 'C' that he (A) is the owner of the horse. But 'C' remained silent though the horse belonged to him. 'B' bought the horse from 'A'. Here the buyer (B) will get a valid title to the horse even though the seller (A) had no title to the horse. In this case, 'C', by his own conduct, is prevented from denying 'A's authority to sell the horse. Here, 'C''s silence has induced 'B' to believe that 'A' is the owner of the horse.

(7) **Sale by an unpaid seller:** Where an unpaid seller who had exercised his right of lien or stoppage in transit resells the goods, the buyer acquires a good title to the goods as against the original buyer **[Section 54 (3)].**

(8) Sale under the provisions of other Acts:

(i) Sale by an Official Receiver or Liquidator of the Company will give the purchaser a valid title.

(ii) Purchase of goods from a finder of goods will get a valid title under circumstances [Section 169 of the Indian Contract Act, 1872]

(iii) A sale by pawnee can convey a good title to the buyer [Section 176 of the Indian Contract Act, 1872]

3.4 PERFORMANCE OF THE CONTRACT OF SALE (SECTIONS 31 – 44)

The performance of a contract of sale implies delivery of goods by the seller and acceptance of the delivery of goods and payment of price for them by the buyer in accordance of the terms of the contract.

Definition of Delivery [Section 2(2)]: Delivery means voluntary transfer of possession from one person to another. For delivery, physical possession is not important. The buyer should be placed in a position so that he can exercise his right over the goods.

Thus, if the possession is taken through unfair means, there is no delivery of the goods. Delivery of goods sold may be made by doing anything which the parties agree, shall be treated as delivery or putting the goods in the possession of the buyer or of any person authorised to hold them on his behalf.

Delivery of goods is of three types:

(a) Actual Delivery

(b) Symbolic delivery

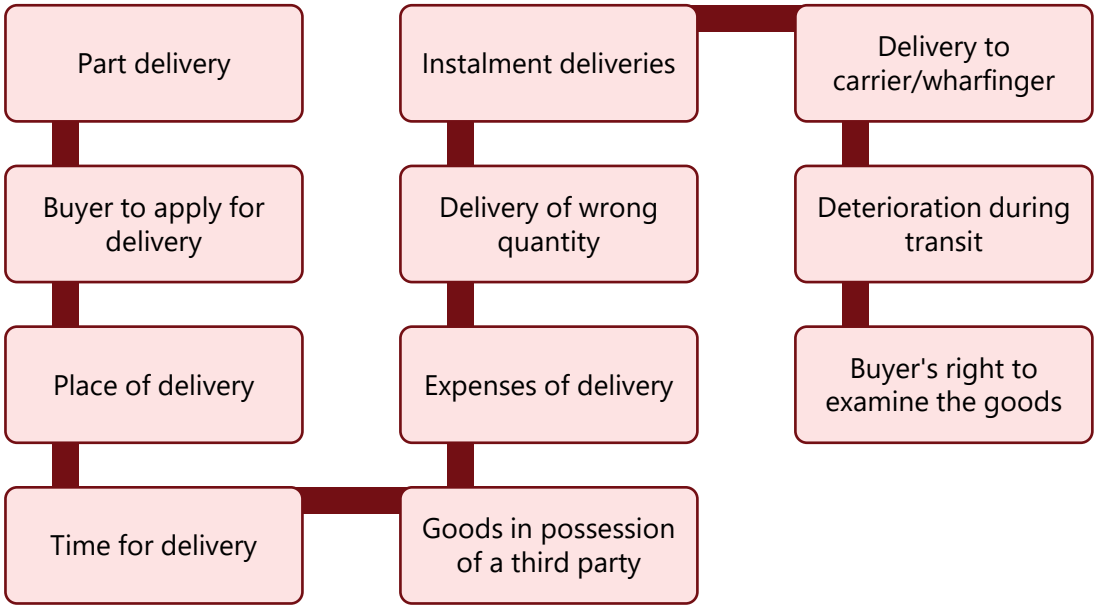
(c) Constructive Delivery

Duties of seller and buyer (Section 31): It is the duty of the seller to deliver the goods and of the buyer to accept and pay for them, in accordance with the terms of the contract of sale.

Payment and delivery are concurrent conditions (Section 32): Unless otherwise agreed, delivery of the goods and payment of the price are concurrent conditions, that is to say, the seller shall be ready and willing to give possession of the goods to the buyer in exchange for the price, and the buyer shall be ready and willing to pay the price in exchange for possession of the goods.

Rules Regarding Delivery of goods (Section 33-41)

The Sale of good Act, 1930 prescribes the following rules of delivery of goods:



(i) **Delivery (Section 33):** Delivery of goods sold may be made by doing anything which the parties agree shall be treated as delivery or which has the effect of putting the goods in the possession of the buyer or of any person authorised to hold them on his behalf.

(ii) **Effect of part delivery:** A delivery of part of goods, in progress of the delivery of the whole has the same effect, for the purpose of passing the property in such goods, as a delivery of the whole; but a delivery of part of the goods, with an intention of severing it from the whole, does not operate as a delivery of the remainder. **(Section 34)**

Example 21: Certain goods lying at wharf were sold in a lot. The seller instructed the wharfinger to deliver them to the buyer who had paid for them and the buyer, thereafter, accepted them and took away part. Held, there was delivery of the whole.

(iii) **Buyer to apply for delivery:** Apart from any express contract, the seller of goods is not bound to deliver them until the buyer applies for delivery. **(Section 35)**

(iv) **Place of delivery:** Whether it is for the buyer to take possession of the goods or for the seller to send them to the buyer is a question depending in each case on the contract, express or implied, between the parties. Apart from any such contract,

- goods sold are to be delivered at the place at which they are at the time of the sale, and
- goods agreed to be sold are to be delivered at the place at which they are at the time of the agreement to sell or

- ♦ if goods are not then in existence, at the place at which they are manufactured or produced. **[Section 36(1)]**

(v) **Time of delivery:** Where under the contract of sale, the seller is bound to send the goods to the buyer, but no time for sending them is fixed, the seller is bound to send them within a reasonable time. **[Section 36(2)]**

(vi) **Goods in possession of a third party:** Where the goods at the time of sale are in possession of a third person, there is no delivery unless and until such third person acknowledges to the buyer that he holds the goods on his behalf. Provided that nothing in this section shall affect the operation of the issue or transfer of any document of title to goods. **[Section 36(3)]**

(vii) **Time for tender of delivery:** Demand or tender of delivery may be treated as ineffectual unless made at a reasonable hour. What is reasonable hour is a question of fact. **[Section 36(4)].**

(viii) **Expenses for delivery:** The expenses of and incidental to putting the goods into a deliverable state must be borne by the seller in the absence of a contract to the contrary. **[Section 36(5)].**

(ix) **Delivery of wrong quantity [Section 37]:** Where the seller delivers to the buyer a quantity of goods less than he contracted to sell, the buyer may reject them, but if the buyer accepts the goods so delivered he shall pay for them at the contract rate. [Sub-section (1)]

Where the seller delivers to the buyer a quantity of goods larger than he contracted to sell, the buyer may accept the goods included in the contract and reject the rest, or he may reject the whole. If the buyer accepts the whole of the goods so delivered, he shall pay for them at the contract rate. [Sub-section (2)]

Where the seller delivers to the buyer the goods he contracted to sell mixed with goods of a different description not included in the contract, the buyer may accept the goods which are in accordance with the contract and reject, or may reject the whole. [Sub-section (3)]

The provisions of this section are subject to any usage of trade, special agreement or course of dealing between the parties. [Sub-section (4)]

Example 22: A agrees to sell 100 quintals of wheat to B at ₹ 1,000 per quintal. A delivers 1,100 quintals. B may reject the whole lot or accept only 1,000 quintals and reject the rest or accept the whole lot and pay for them at the contract of sale.

(x) **Instalment deliveries:** Unless otherwise agreed, the buyer is not bound to accept delivery in instalments. The rights and liabilities in cases of delivery by instalments and payments thereon may be determined by the parties of contract. **(Section 38)**

Example 23: There was sale of 100 tons of paper to be shipped in November. The seller shipped 80 tons in November and 20 tons in December. The buyer was entitled to reject the whole 100 tons.

(xi) **Delivery to carrier:** Subject to the terms of contract, the delivery of the goods to the carrier for transmission to the buyer, is *prima facie* deemed to be delivery to the buyer. **[Section 39(1)]**

(xii) **Deterioration during transit:** Where goods are delivered at a distant place, the liability for deterioration necessarily incidental to the course of transit will fall on the buyer, though the seller agrees to deliver at his own risk. **(Section 40)**

Example 24: P sold to Q a certain quantity of iron rods which were to be sent by proper vessel. It was rusted before it reached the buyer. The rust of the rod was so minimal and was not effecting the merchantable quality and the deterioration was not necessarily incidental to its transmission. It was held that Q was bound to accept the goods.

(xiii) **Buyer's right to examine the goods:** Where goods are delivered to the buyer, who has not previously examined them, he is entitled to a reasonable opportunity of examining them in order to ascertain whether they are in conformity with the contract. Unless otherwise agreed, the seller is bound, on request, to afford the buyer a reasonable opportunity of examining the goods. **(Section 41)**

Rule related to Acceptance of Delivery of Goods (Section 42):

Acceptance is deemed to take place when the buyer-

(a) intimates to the seller that he had accepted the goods; or

(b) does any act to the goods, which is inconsistent with the ownership of the seller; or

(c) retains the goods after the lapse of a reasonable time, without intimating to the seller that he has rejected them.

Buyer not bound to return rejected goods (Section 43): Unless otherwise agreed, where goods are delivered to the buyer and he refuses to accept them, having the right so to do, he is not bound to return them to the seller, but it is sufficient if he intimates to the seller that he refuses to accept them.

Liability of buyer for neglecting or refusing delivery of goods (Section 44): When the seller is ready and willing to deliver the goods and requests the buyer to take delivery, and the buyer does not within a reasonable time after such request take delivery of the goods, he is liable to the seller for any loss occasioned by his neglect or refusal to take delivery and also for a reasonable charge for the care and custody of the goods.

Provided further that nothing in this section shall affect the rights of the seller where the neglect or refusal of the buyer to take delivery amounts to a repudiation of the contract.

SUMMARY

The property in the goods or beneficial right in the goods passes to the buyer at a point of time depending upon ascertainment, appropriation and delivery of goods. Risk of loss of goods *prima facie* follows the passing of property in goods. Goods remain at the seller's risk unless the property therein is transferred to the buyer, but after transfer of property therein to the buyer the goods are at the buyer's risk whether delivery has been made or not. An important rule regarding passing of title in goods is that the purchaser does acquire no better title to the goods than what the seller had.

This rule again is not applicable under certain circumstances.

Delivery of goods denotes the voluntary transfer of possession, which may be actual or even in some constructive form and which is again subject to various rules which help in deciding when the delivery becomes effective.

Transfer of Ownership & Delivery of Goods

Passing of Property	**Passing of Risk**
1. No property in the goods is transferred to the buyer unless and until the goods are ascertained. 2. Where there is a contract for the sale of specific or ascertained goods, the property in them passes to the buyer at the time when the parties intend it to pass. 3. Goods should be in a deliverable state.	Unless otherwise agreed, risk follows ownership whether delivery has been made or not and whether price has been paid or not. *Thus, the risk of loss as a rule lies on the owner.*

Sale by Non-Owner

"Nemo dat quad non habet *i.e.* "no one can give that which one has not got"

Exceptions (*i.e. Non owner can sale***)**

- Sale by a mercantile agent
- Sale by a person in possession under a voidable contract
- Sale by buyer in possession before property passed to him.
- Sale by an unpaid seller
- Sale by one of joint owners
- Sale by seller in possession after sale
- Effect of estoppels
- Other Acts (E.g. finder of lost goods, pawner, Official Receiver or Liquidator).

Delivery of Goods

"Voluntary transfer of possession of goods from one person to another."

Types

1. Actual delivery.
2. Symbolic delivery.
3. Constructive delivery or delivery by attornment.

Acceptance of Delivery

Acceptance is deemed to take place when buyer:

- intimates that he has accepted the goods.
- uses the goods in a manner proper only for the owner, makes some alternation in the goods.
- Retains the goods after the lapse of a reasonable time.

Rules as to delivery of goods

1. Delivery and payment must be according to the terms of the contract.
2. Effect of part delivery - same effect for the purpose of passing the property in such goods.
3. Buyer to apply for delivery.
4. Place of delivery - if no contract, place where they were at the time of sale.
5. Time of delivery - if no contract, within a reasonable time.
6. Goods in possession of a third party - no delivery until such third party acknowledges to the buyer that he holds them on his behalf.
7. Time for tender of delivery – at a reasonable hour.
8. Cost of delivery - borne by the seller (unless otherwise agreed).
9. Delivery of wrong quantity – Buyer may accept or reject the goods.
10. Installment deliveries - buyer is not bound to accept the goods.
11. Delivery to a carrier - deemed to be a delivery to the buyer.
12. Deterioration during transit – liability will fall on buyer.
13. Buyer's right to examine the goods.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *The property in the goods means-*

   (a) Possession of the goods

   (b) Ownership of the goods

   (c) Custody of the goods

   (d) Both (a) and (c)

2. *In case of sale on approval, the ownership is transferred to the buyer when he-*

   (a) Accepts the goods

   (b) Adopts the transaction

   (c) Fails to return the goods

   (d) In all the above cases

3. *If a seller hands over the keys of a ware house containing goods to the buyer, it results in-*

   (a) Constructive delivery

   (b) Actual delivery

   (c) Symbolic delivery

   (d) None of these

4. *A sell to B 100 bags of wheat lying in C's warehouse. A orders to C to deliver the wheat to B. C agrees to hold the 100 bags on behalf of B and makes the necessary entry in his books. This is a –*

   (a) Actual delivery

   (b) Constructive delivery

   (c) Symbolic delivery

   (d) None of the above

5. *Selection of goods with the intention of using them in performance of the contract and with the mutual consent of the seller and the buyer is known as-*

   (a) distribution

   (b) appropriation

   (c) amortization

   (d) storage

6. *In contract of sale of goods, if the seller is not the owner of goods, then the title of the buyer shall-*

   (a) Not be same as that of the seller

   (b) Be same as that of the seller

   (c) Be better than that of the seller

   (d) None of the above

7. *Nemo dat quad non habet means-*

   (a) One cannot give what one does not have

   (b) Let the buyer be beware

   (c) Whatever is paid, is paid according to the intention or manner of the party paying

   (d) None of these

8. *The goods are at the risk of the party who has the-*

   (a) Ownership of the goods

   (b) Possession of the goods

   (c) Custody of the goods

   (d) Both (b) and (c)

9. *If the seller delivers to the buyer a quantity less than he contracted to sell, the buyer may*

   (a) Reject the goods,

   (b) Accept the goods

   (c) Either 'a' or 'b'

   (d) Neither 'a' or 'b'

10. *Appropriation of goods means*

    (a) *Separating the goods sold from other goods*

    (b) *Putting the quantity of goods sold in suitable receptacles*

    (c) *Delivering the goods to the carrier or other bailee for the purpose of transmission to the buyer without reserving the right of disposal*

    (d) *All of the above*

11. *Which of the following is true as regards delivery of goods in instalments as provided under Sale of Goods Act:*

    (a) *The buyer is bound to accept the instalment deliveries only in case of perishable goods*

    (b) *The buyer is bound to accept the instalment deliveries only in case of sale of goods by description*

    (c) *The buyer is bound to accept the instalment deliveries only if agreed between the parties*

    (d) *Delivery of goods can't be made in instalments*

Descriptive questions

1. *"Nemo Dat Quod Non Habet" – "None can give or transfer goods what he does not himself own." Explain the rule and state the cases in which the rule does not apply under the provisions of the Sale of Goods Act, 1930.*

2. *J the owner of a Fiat car wants to sell his car. For this purpose, he hand over the car to P, a mercantile agent for sale at a price not less than ₹ 50,000. The agent sells the car for ₹ 40,000 to A, who buys the car in good faith and without notice of any fraud. P misappropriated the money also. J sues A to recover the Car. Decide giving reasons whether J would succeed.*

3. *Mr. S agreed to purchase 100 bales of cotton from V, out of his large stock and sent his men to take delivery of the goods. They could pack only 60 bales. Later on, there was an accidental fire and the entire stock was destroyed including 60 bales that were already packed. Referring to the provisions of the Sale of Goods Act, 1930 explain as to who will bear the loss and to what extent?*

4. *Ms. Preeti owned a motor car which she handed over to Mr. Joshi on sale or return basis. After a week, Mr. Joshi pledged the motor car to Mr. Ganesh. Ms. Preeti now claims back the motor car from Mr. Ganesh. Will she succeed? Referring to the provisions of the Sale of Goods Act, 1930, decide and examine what recourse is available to Ms. Preeti.*

5. *A, B and C were joint owner of a truck and the possession of the said truck was with B. X purchased the truck from B without knowing that A and C were also owners of the truck. Decide in the light of provisions of Sales of Goods Act 1930, whether the sale between B and X is valid or not?*

6. *X agreed to purchase 300 tons of wheat from Y out of a larger stock. X sent his men with the sacks and 150 tons of wheat were put into the sacks. Then there was a sudden fire and the entire stock was gutted. Who will bear the loss and why?*

7. *The buyer took delivery of 20 tables from the seller on sale or return basis without examining them. Subsequently, he sold 5 tables to his customers. The customer lodged a complaint of some defect in the tables. The buyer sought to return tables to the seller. Was the buyer entitled to return the tables to the seller under the provisions of the Sale of Goods Act, 1930?*

8. *A delivered a horse to B on sale and return basis. The agreement provided that B should try the horse for 8 days and return, if he did not like the horse. On the third day the horse died without the fault of B. A file a suit against B for the recovery of price. Can he recover the price?*

ANSWER/HINTS

Answer to MCQs

1.	**(b)**	2.	**(d)**	3.	**(c)**	4.	**(b)**	5.	**(b)**	6.	**(b)**
7.	**(a)**	8.	**(a)**	9.	**(c)**	10.	**(d)**	11.	**(c)**		

Answers to Descriptive questions

1. **Exceptions to the Rule *Nemo dat Quod Non Habet*:** The term means, "none can give or transfer goods what he does not himself own". Exceptions to the rule and the cases in which the Rule does not apply under the provisions of the Sale of Goods Act, 1930 are enumerated below:

(i) **Sale by a Mercantile Agent:** A sale made by a mercantile agent of the goods or document of title to goods would pass a good title to the buyer in the following circumstances, namely;

(a) if he was in possession of the goods or documents with the consent of the owner;

(b) if the sale was made by him when acting in the ordinary course of business as a mercantile agent; and

(c) if the buyer had acted in good faith and has at the time of the contract of sale, no notice of the fact that the seller had no authority to sell. (Proviso to Section 27).

Mercantile agent means an agent having in the customary course of business as such agent authority either to sell goods, or to consign goods for the purposes of sale, or to buy goods, or to raise money on the security of goods. [section 2(9)]

(ii) **Sale by one of the joint owners:** If one of the several joint owners of goods has the sole possession of them with the permission of the others the property in the goods may be transferred to any person who buys them from such a joint owner in good faith and does not at the time of the contract of sale have notice that the seller has no authority to sell. (Section 28)

(iii) **Sale by a person in possession under voidable contract:** A buyer would acquire a good title to the goods sold to him by seller who had obtained possession of the goods under a contract voidable on the ground of coercion, fraud, misrepresentation or undue influence provided that the contract had not been rescinded until the time of the sale (Section 29).

(iv) **Sale by one who has already sold the goods but continues in possession thereof:** If a person has sold goods but continues to be in possession of them or of the documents of title to them, he may sell them to a third person, and if such person obtains the delivery thereof in good faith without notice of the previous sale, he would have good title to them, although the property in the goods had passed to the first buyer earlier. A pledge or other deposition of the goods or documents of title by the seller in possession are equally valid. [Section 30(1)]

(v) **Sale by buyer obtaining possession before the property in the goods has vested in him:** Where a buyer with the consent of seller obtains possession of the goods before the property in them has passed to him, he may sell, pledge or otherwise dispose of the goods to a third person, and if such person obtains delivery of the goods in good faith and without notice of the lien or other right of the original seller in respect of the goods in good faith and without notice of the lien or other right of the original seller in respect of the goods, he would get a good title to them. [Section 30(2)].

(vi) **Sale by an unpaid seller:** Where on unpaid seller who had exercised his right of lien or stoppage in transit resells the goods, the buyer acquires a good title to the goods as against the original buyer [Section 54(3)].

(vii) **Sale under the provisions of other Acts:**

(i) Sale by an official Receiver or liquidator of the company will give the purchaser a valid title.

(ii) Purchase of goods from a finder of goods will get a valid title under circumstances.

(iii) Sale by a pawnee under default of pawnor will give valid title to the purchaser.

2. The problem in this case is based on the provisions of the Sale of Goods Act, 1930 contained in the proviso to Section 27. The proviso provides that a mercantile agent is one who in the customary course of his business, has, as such agent, authority either to sell goods, or to consign goods, for the purpose of sale, or to buy goods, or to raise money on the security of goods [Section 2(9)]. The buyer of goods from a mercantile agent, who has no authority from the principal to sell, gets a good title to the goods if the following conditions are satisfied:

(1) The agent should be in possession of the goods or documents of title to the goods with the consent of the owner.

(2) The agent should sell the goods while acting in the ordinary course of business of a mercantile agent.

(3) The buyer should act in good faith.

(4) The buyer should not have at the time of the contract of sale notice that the agent has no authority to sell.

In the instant case, P, the agent, was in the possession of the car with J's consent for the purpose of sale. We assume the agent P acted in the ordinary course of business and sold the car to buyer A in good faith. Therefore A, the buyer obtained a good title to the car. Hence, J in this case, cannot recover the car from A.

3. Section 26 of the Sale of Goods Act, 1930 provides that unless otherwise agreed, the goods remain at the seller's risk until the property therein is transferred to the buyer, but when the property therein is transferred to the buyer, the goods are at buyer's risk whether delivery has been made or not. Further Section 18 read with Section 23 of the Act provide that in a contract for the sale of unascertained goods, no property in the goods is transferred to the buyer, unless and until the goods are ascertained. Also where there is contract for the sale of unascertained or future goods by description,

the property in the goods thereupon passes to the buyer. when goods of that description are put in a deliverable state and are unconditionally appropriated to the contract, either by the seller with the assent of the buyer or by the buyer with the assent of the seller, Such assent may be express or implied.

Applying the aforesaid law to the facts of the case in hand, it is clear that Mr. S has the right to select the goods out of the bulk and he has sent his men for the same purpose.

Hence the problem can be answered based on the following two assumptions and the answer will vary accordingly.

(i) Where the bales have been selected with the consent of the buyer's representatives:

In this case, the property in the 60 bales has been transferred to the buyer and goods have been appropriated to the contract. Thus, loss arising due to fire in case of 60 bales would be borne by Mr. S. As regards 40 bales, the loss would be borne by Mr. V, since the goods have not been identified and appropriated.

(ii) Where the bales have not been selected with the consent of buyer's representatives:

In this case, the property in the goods has not been transferred at all and hence the loss of 100 bales would be borne by Mr. V completely.

4. As per the provisions of section 24 of the Sale of Goods Act, 1930, when goods are delivered to the buyer on approval or "on sale or return" or other similar terms, the property therein passes to the buyer-

(a) when the buyer signifies his approval or acceptance to the seller or does any other act adopting the transaction;

(b) if he does not signify his approval or acceptance to the seller but retains the goods without giving notice of rejection, then, if a time has been fixed for the return of the goods, on the expiration of such time, and, if no time has been fixed, on the expiration of a reasonable time; or

(c) he does something to the good which is equivalent to accepting the goods e.g. he pledges or sells the goods.

Referring to the above provisions, we can analyse the situation given in the question.

Since, Mr. Joshi, who had taken delivery of the Motor car on Sale or Return basis and pledged the motor car to Mr. Ganesh, has attracted the third condition that he has done something to the good which is equivalent to accepting the goods e.g. he pledges or sells the goods. Therefore, the property therein (Motor car) passes to Mr.

Joshi. Now in this situation, Ms. Preeti cannot claim back her Motor Car from Mr. Ganesh, but she can claim the price of the motor car from Mr. Joshi only.

5. According to Section 28 of the Sales of Goods Act, sale by one of the several joint owners is valid if the following conditions are satisfied:-

(i) One of the several joint owners has the sole possession of them.

(ii) Possession of the goods is by the permission of the co-owners.

(iii) The buyer buys them in good faith and has not at the time of contract of sale knowledge that the seller has no authority to sell.

In the above case, A, B and C were the joint owners of the truck and the possession of the truck was with B. Now B sold the said truck to X. X without knowing this fact purchased the truck from B.

The sale between B and X is perfectly valid because Section 28 of the Sales of Goods Act provides that in case one of the several joint owners has the possession of the goods by the permission of the co-owners and if the buyer buys them in good faith without the knowledge of the fact that seller has no authority to sell, it will give rise to a valid contract of sale.

6. According to Section 21 of the Sales of Goods Act, 1930, if the goods are not in a deliverable state and the contract is for the sale of specific goods, the property does not pass to the buyer unless:-

(i) The seller has done his act of putting the goods in a deliverable state and

(ii) The buyer has knowledge of it.

Sometimes the seller is required to do certain acts so as to put the goods in deliverable state like packing, filling in containers etc. No property in goods passes unless such act is done and buyer knows about it.

In the given case, X has agreed to purchase 300 tons of wheat from Y out of a larger stock. X sent his men (agent) to put the wheat in the sacks. Out of 300 tones only 150 tons were put into the sacks. There was a sudden fire and the entire stock was gutted. In this case, according to the provisions of law, for 150 tons of wheat, sale has taken place. So, buyer X will be responsible to bear the loss. The loss of rest of the wheat will be that of the seller Y.

The wheat which was put in the sacks fulfils both the conditions that are:-

(1) The wheat is put in a deliverable state in the sacks.

(2) The buyer is presumed to have knowledge of it because the men who put the wheat in the sacks are that of the buyer.

7. According to Section 24 of the Sales of Goods Act, 1930, in case of delivery of goods on approval basis, the property in goods passes from seller to the buyer:-

(i) When the person to whom the goods are given either accepts them or does an act which implies adopting the transaction.

(ii) When the person to whom the goods are given retains the goods without giving his approval or giving notice of rejection beyond the time fixed for the return of goods and in case no time is fixed after the lapse of reasonable time.

In the given case, seller has delivered 20 tables to the buyer on sale or return basis. Buyer received the tables without examining them. Out of these 20 tables, he sold 5 tables to his customer. It implies that he has accepted 5 tables out of 20.

When the buyer received the complaint of some defect in the tables, he wanted to return all the tables to the seller. According to the provisions of law he is entitled to return only 15 tables to the seller and not those 5 tables which he has already sold to his customer. These 5 tables are already accepted by him so the buyer becomes liable under the doctrine of "Caveat Emptor".

8. A delivered the horse to B on sale or return basis. It was decided between them that B will try the horse for 8 days and in case he does not like it, he will return the horse to the owner A. But on the third day the horse died without any fault of B. The time given by the seller A to the buyer B has not expired yet. Therefore, the ownership of the horse still belongs to the seller A. B will be considered as the owner of the horse only when B does not return the horse to A within stipulated time of 8 days.

The suit filed by A for the recovery of price from B is invalid and he cannot recover the price from B. [Section 24].

Had the horse died after the expiry of given time i.e. 8 days, then B would have been held liable (if the horse was still with him) but not before that time period.

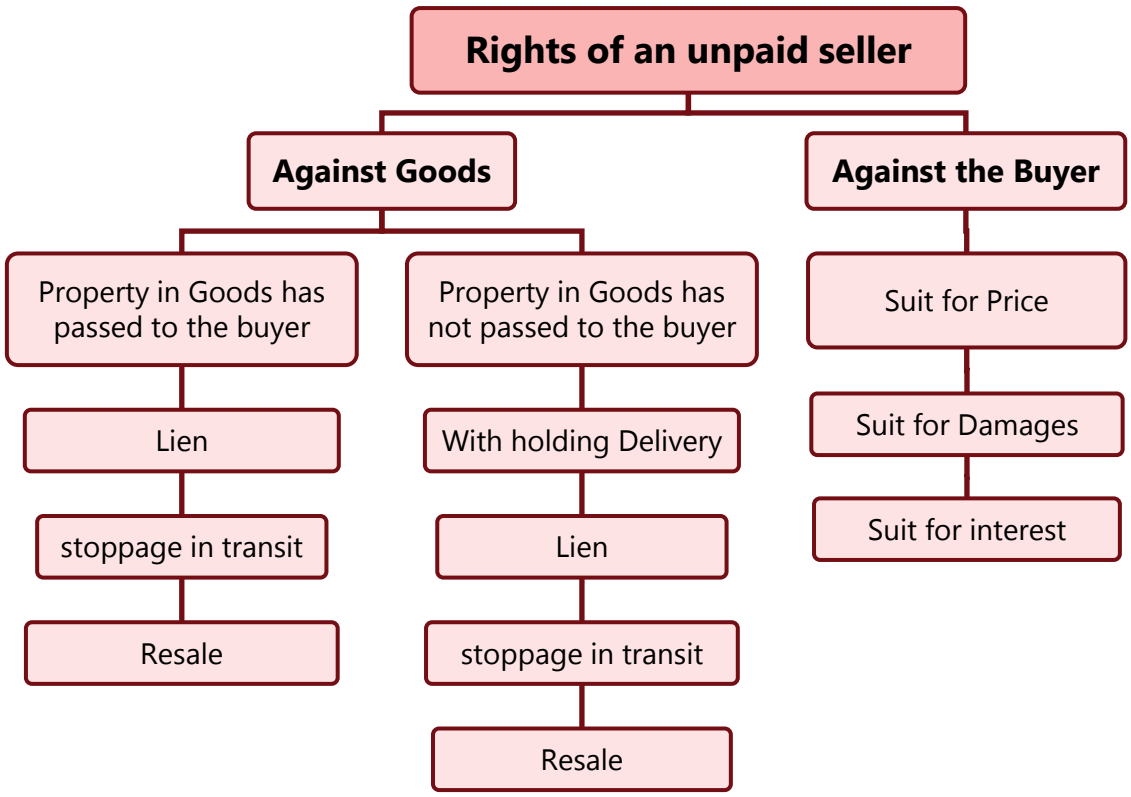
UNIT – 4: UNPAID SELLER

LEARNING OUTCOMES

After studying this unit, you would be able to understand-

- The concept of Unpaid Seller
- The rights of Unpaid Seller
- Effect of sub-sale or pledge by the buyer
- Distinction between the right of lien and right of stoppage in transit
- Rights of parties in case of breach of contract
- Concept of sale by auction.

UNIT OVERVIEW



4.1 UNPAID SELLER

A contract comprises of reciprocal promises. In a contract of sale, if seller is under an obligation to deliver goods, buyer has to pay for it. In case buyer fails or refuses to pay, the seller, as an unpaid seller, shall have certain rights.

According to Section 45(1) of the Sale of Goods Act, 1930, the seller of goods is deemed to be an 'Unpaid Seller' when-

(a) The whole of the price has not been paid or tendered and the seller had an immediate right of action for the price.

(b) When a bill of exchange or other negotiable instrument has been received as conditional payment, and the condition on which it was received has not been fulfilled by reason of the dishonour of the instrument or otherwise.

The term 'seller' here includes any person who is in the position of a seller, as, for instance, an agent of the seller to whom the bill of lading has been endorsed, or a consignor or agent who has himself paid, or is directly responsible for, the price [Section 45(2)].

Example 1: X sold certain goods to Y for ₹ 50,000. Y paid ₹ 40,000 but fails to pay the balance. X is an unpaid seller.

Example 2: P sold some goods to R for ₹ 60,000 and received a cheque for a full price. On presentment, the cheque was dishonoured by the bank. P is an unpaid seller.

4.2 RIGHTS OF AN UNPAID SELLER

Unpaid seller's right (Section 46): Subject to the provisions of this Act and of any law for the time being in force, notwithstanding that the property in the goods may have passed to the buyer, the unpaid seller of goods, as such, has by implication of law-

(a) a lien on the goods for the price while he is in possession of them;

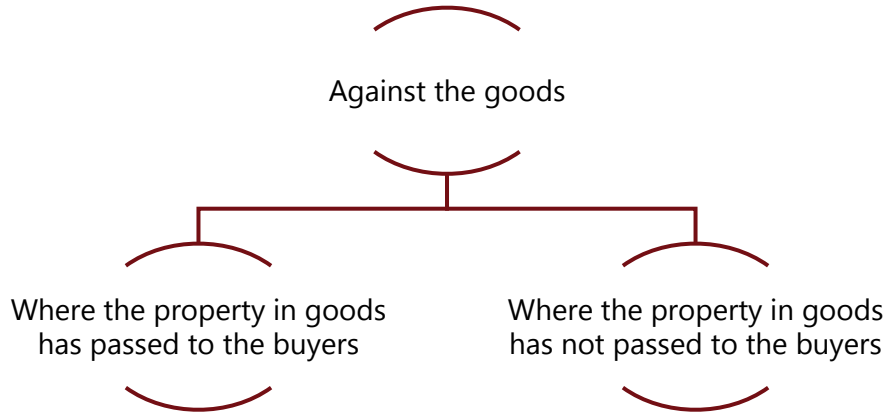
(b) in case of the insolvency of the buyer a right of stopping the goods in transit after he has parted with the possession of them;

(c) a right of re-sale as limited by this Act. [Sub-section (1)]

Where the property in goods has not passed to the buyer, the unpaid seller has, in addition to his other remedies, a right of withholding delivery similar to and co-extensive with his rights of lien and stoppage in transit where the property has passed to the buyer. [Sub-section (2)]

An unpaid seller has been expressly given the rights against the goods as well as the buyer personally which are discussed as under:

(a) Rights of an unpaid seller against the goods: The right of unpaid seller against goods can be categorized under two headings.



4.3 RIGHT OF UNPAID SELLER AGAINST THE GOODS

The unpaid seller has the following rights against the goods:

(1) Seller's lien (Section 47)

Rights of lien: An unpaid seller has a right of lien on the goods for the price while he is in possession, until the payment or tender of the price of such goods. It is the right to retain the possession of the goods and refusal to deliver them to the buyer until the price due in respect of them is paid or tendered.

The unpaid seller's lien is a possessory lien i.e. the lien can be exercised as long as the seller remains in possession of the goods.

Exercise of right of lien: This right can be exercised by him in the following cases only:

(a) where goods have been sold without any stipulation of credit; (i.e., on cash sale)

(b) where goods have been sold on credit but the term of credit has expired; or

(c) where the buyer becomes insolvent.

Example 3: A sold certain goods to B for a price ₹ 50,000 and allowed him to pay the price within one month. B becomes insolvent during this period of credit. A, the unpaid seller, can exercise his right of lien.

Seller may exercise his right of lien even where he is in possession of the goods as agent or bailee for the buyer.

The term insolvent refers to "a person is said to be insolvent who has ceased to pay his debts in the ordinary course of business, or cannot pay his debts as they become due, whether he has committed an act of insolvency or not".

Part delivery (Section 48): Where an unpaid seller has made part delivery of the goods, he may exercise his right of lien on the remainder, unless such part delivery has been made under such circumstances as to show an agreement to waive the lien.

Termination of lien (Section 49): The unpaid seller loses his right of lien under the following circumstances:

(i) When he delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer without reserving the right of disposal of the goods.

(ii) Where the buyer or his agent lawfully obtains possession of the goods.

(iii) Where seller has waived the right of lien.

(iv) By Estoppel i.e., where the seller so conducts himself that he leads third parties to believe that the lien does not exist.

Exception: The unpaid seller of the goods, having a lien thereon, does not lose his lien by reason only that he has obtained a decree for the price of the goods. (This means even if the seller has taken a price for the goods under a court case, he can still exercise his right to lien on those goods.)

Example 4: A, sold a car to B for ₹ 1,00,000 and delivered the same to the railways for the purpose of transmission to the buyer. The railway receipt was taken in the name of B and sent to B. Now A cannot exercise the right of lien.

(2) Right of stoppage in transit (Section 50 to 52):

Meaning of right of stoppage in transit (Section 50): The right of stoppage in transit means the right of stopping the goods while they are in transit, to regain the possession and to retain them till the full price is paid.

When the unpaid seller has parted with the goods to a carrier and the buyer has become insolvent, he can exercise this right of asking the carrier to return the goods back, or not to deliver the goods to the buyer.

This right is the extension of the right of lien because it entitles the seller to regain possession even when the seller has parted with the possession of the goods.

However, the right of stoppage in transit is exercised only when the following conditions are fulfilled:

(a) The seller must be unpaid.

(b) He must have parted with the possession of goods.

(c) The goods are in transit.

(d) The buyer has become insolvent.

(e) The right is subject to provisions of the Act. [Section 50]

Example 5: A of Mumbai sold certain goods to B of Delhi. He delivered the goods to C, a common carrier for the purpose of transmission of these goods to B. Before the goods could reach him, B became insolvent and A came to know about it. A can stop the goods in transit by giving a notice of it to C.

Duration of transit (Section 51): The goods are deemed to be in course of transit from the time when they are delivered to a carrier or other bailee for the purpose of transmission to the buyer, until the buyer or his agent on that behalf takes delivery of them from such carrier or other bailee.

When does the transit come to an end?

The right of stoppage in transit is lost when transit comes to an end. Transit comes to an end in the following cases:

- When the buyer or other bailee obtains delivery.
- Buyer obtains delivery before the arrival of goods at destination. It is also called interception by the buyer which can be with or without the consent of the carrier.
- Where the carrier or other bailee acknowledges to the buyer or his agent that he holds the goods as soon as the goods are loaded on the ship, unless the seller has reserved the right of disposal of the goods.
- If the carrier wrongfully refuses to deliver the goods to the buyer.
- Where goods are delivered to the carrier hired by the buyer, the transit comes to an end.
- Where the part delivery of the goods has been made to the buyer, the transit will come to an end for the remaining goods which are yet in the course of transmission.
- Where the goods are delivered to a ship chartered by the buyer, the transit comes to an end. [section 51]

How stoppage in transit is effected (Section 52):

(1) The unpaid seller may exercise his right of stoppage in transit either by taking actual possession of the goods, or by giving notice of his claim to the carrier or

other bailee in whose possession the goods are. Such notice may be given either to the person in actual possession of the goods or to his principal. In the latter case, the notice, to be effectual, shall be given at such time and in such circumstances, that the principal, by the exercise of reasonable diligence, may communicate it to his servant or agent in time to prevent a delivery to the buyer.

(2) When notice of stoppage in transit is given by the seller to the carrier or other bailee in possession of the goods, he shall re-deliver the goods to, or according to the directions of, the seller. The expenses of such re-delivery shall be borne by the seller.

Stoppage in transit

By taking actual possession of goods
By giving notice to the carrier not to deliver the goods.

Distinction between Right of Lien and Right of Stoppage in Transit

(i) The essence of a right of lien is to retain possession whereas the right of stoppage in transit is right to regain possession.

(ii) Seller should be in possession of goods under lien while in stoppage in transit (i) seller should have parted with the possession (ii) possession should be with a carrier & (iii) buyer has not acquired the possession.

(iii) Right of lien can be exercised even when the buyer is not insolvent but it is not the case with right of stoppage in transit.

(iv) Right of stoppage in transit begins when the right of lien ends. Thus, the end of the right of lien is the starting point of the right of stoppage in transit.

(v) Right of lien comes to an end as soon as the goods go out of the possession of the seller but the right of stopping in transit comes to an end as soon as the goods are delivered to the buyer.

Sometimes it is said that right of stopping the goods in transit is nothing but an extension of right of lien.

Effects of sub-sale or pledge by buyer (Section 53): The right of lien or stoppage in transit is not affected by the buyer selling or pledging the goods unless the seller has assented to it. This is based on the principle that a second buyer cannot stand in a better position than his seller. (The first buyer).

Example 6: A sold certain goods to B of Mumbai and the goods are handed over to railways for transmission to B. In the mean time, B sold these goods to C for consideration. B becomes insolvent. A can still exercise his right of stoppage in transit. Here we assume that seller did not give his assent for sub sale, therefore he can still exercise his right of stoppage in transit.

The right of stoppage is defeated if the buyer has transferred the document of title or pledges the goods to a sub-buyer in good faith and for consideration.

Exceptions where unpaid seller's right of lien and stoppage in transit are defeated:

(a) When the seller has assented to the sale, mortgage or other disposition of the goods made by the buyer.

Example 7: A entered into a contract to sell cartons in possession of a wharfinger to B and agreed with B that the price will be paid to A from the sale proceeds recovered from his customers. Now B sold goods to C and C duly paid to B. But anyhow B failed to make the payment to A. A wanted to exercise his right of lien and ordered the wharfinger not to make delivery to C. Held that the seller had assented to the resale of the goods by the buyer to the sub-buyers. As a result, A's right to lien is defeated ***(Mount D. F. Ltd. vs Jay & Jay (Provisions) Co. Ltd).***

(b) When a document of title to goods has been transferred to the buyer and the buyer transfers the documents to a person who has bought goods in good faith and for value i.e. for price, then, the proviso of sub-section (1) stipulates as follows:

(i) If the last-mentioned transfer is by way of sale, right of lien or stoppage in transit is defeated, or

(ii) If the last mentioned transfer is by way of pledge, unpaid seller's right of lien or stoppage only be exercised, subject to the rights of the pledgee.

However, the pledgee may be required by the unpaid seller to use in the first instance, other goods or securities of the pledger available to him to satisfy his claims. [Sub-section (2)].

Effect of stoppage: The contract of sale is not rescinded when the seller exercises his right of stoppage in transit. The contract still remains in force and the buyer can ask for delivery of goods on payment of price.

Right of re-sale [Section 54]: The right of resale is a very valuable right given to an unpaid seller. In the absence of this right, the unpaid seller's other rights against the goods that is lien and the stoppage in transit would not have been of much use because these rights only entitled the unpaid seller to retain the goods until paid by the buyer.

The unpaid seller can exercise the right to re-sell the goods under the following conditions:

(i) **Where the goods are of a perishable nature:** In such a case, the buyer need not be informed of the intention of resale.

(ii) **Where he gives notice to the buyer of his intention to re-sell the goods:** If after the receipt of such notice the buyer fails within a reasonable time to pay or tender the price, the seller may resell the goods.

It may be noted that in such cases, on the resale of the goods, the seller is also entitled to:

(a) Recover the difference between the contract price and resale price, from the original buyer, as damages.

(b) Retain the profit if the resale price is higher than the contract price.

It may also be noted that the seller can recover damages and retain the profits only when the goods are resold after giving the notice of resale to the buyer. Thus, if the goods are resold by the seller without giving any notice to the buyer, the seller cannot recover the loss suffered on resale. Moreover, if there is any profit on resale, he must return it to the original buyer, i.e. he cannot keep such surplus with him [Section 54(2)].

(iii) **Where an unpaid seller who has exercised his right of lien or stoppage in transit resells the goods:** The subsequent buyer acquires the good title thereof as against the original buyer, despite the fact that the notice of re-sale has not been given by the seller to the original buyer.

(iv) **A re-sale by the seller where a right of re-sale is expressly reserved in a contract of sale:** Sometimes, it is expressly agreed between the seller and the buyer that in case the buyer makes default in payment of the price, the seller will resell the goods to some other person. In such cases, the seller is said to have reserved his right of resale, and he may resell the goods on buyer's default.

It may be noted that in such cases, the seller is not required to give notice of resale. He is entitled to recover damages from the original buyer even if no notice of resale is given.

(v) **Where the property in goods has not passed to the buyer:** The unpaid seller has in addition to his remedies a right of withholding delivery of the goods. This right is similar to lien and is called "quasi-lien". This is the additional right used in case of agreement to sell.

4.4 RIGHTS OF UNPAID SELLER AGAINST THE BUYER (SECTIONS 55-61)

Rights of unpaid seller against the buyer personally: An unpaid seller can enforce certain rights against the goods as well as against the buyer personally. Rights of unpaid seller against the buyer are otherwise known as seller's remedies for breach of contract of sale. The rights of the seller against the buyer personally are called rights in personam and are in addition to his rights against the goods.

The right against the buyer are as follows:

1. **Suit for price (Section 55)**

   (a) Where under a contract of sale, the property in the goods has passed to the buyer and the buyer wrongfully neglects or refuses to pay for the goods according to the terms of the contract, the seller may sue him for the price of the goods. [Section 55(1)] *(This is the case of contract of sale)*

   (b) Where under a contract of sale, the price is payable on a certain day irrespective of delivery and the buyer wrongfully neglects or refuses to pay such price, the seller may sue him for the price although the property in the goods has not passed and the goods have not been appropriated to the contract. [Section 55(2)]. *(This is the case of agreement to sell)*

2. **Suit for damages for non-acceptance (Section 56):** Where the buyer wrongfully neglects or refuses to accept and pay for the goods, the seller may sue him for damages for non-acceptance. As regards measure of damages, Section 73 of the Indian Contract Act, 1872 applies in this case.

3. **Repudiation of contract before due date (Section 60):** Where the buyer repudiates the contract before the date of delivery, the seller may treat the contract as rescinded and sue damages for the breach. This is known as the 'rule of anticipatory breach of contract'.

4. **Suit for interest [Section 61]:** Where there is specific agreement between the seller and the buyer as to interest on the price of the goods from the date on which payment

becomes due, the seller may recover interest from the buyer. If, however, there is no specific agreement to this effect, the seller may charge interest on the price when it becomes due from such day as he may notify to the buyer.

In the absence of a contract to the contrary, the Court may award interest to the seller in a suit by him at such rate as it thinks fit on the amount of the price from the date of the tender of the goods or from the date on which the price was payable.

4.5 REMEDIES OF BUYER AGAINST THE SELLER

Breach of contract by seller

Breach of contract by seller, where he-
• Fails to deliver the goods at the time or in manner prescribed • Repudiates the contract • Deliver non-conforming goods and buyer rejects and revokes acceptance

If the seller commits a breach of contract, the buyer gets the following rights against the seller:

Rights of buyer

- Damages for non-delivery
- Suit for specific performance
- Suit for breach of warranty
- Suit for anticipatory breach
- Suit for interest

1. **Damages for non-delivery [Section 57]:** Where the seller wrongfully neglects or refuses to deliver the goods to the buyer, the buyer may sue the seller for damages for non-delivery.

Example 8: A' a shoe manufacturer, agreed to sell 100 pairs of shoes to 'B' at the rate of ₹ 10,500 per pair. 'A' knew that 'B' wanted the shoes for the purpose of further reselling them to 'C' at the rate of ₹ 11,000/- per pair. On the due date of delivery, 'A' failed to deliver the shoes to 'B'. In consequence, 'B' could not perform his contract with 'C' for the supply of 100 pairs of shoes. In this case, 'B' can recover damages from 'A' at the rate of ₹ 500/- per pair (the difference between the contract price and resale price).

2. **Suit for specific performance (Section 58):** Where the seller commits of breach of the contract of sale, the buyer can appeal to the court for specific performance. The court can order for specific performance only when the goods are ascertained or specific.

This remedy is allowed by the court subject to these conditions:

(a) The contract must be for the sale of specific and ascertained goods.

(b) The power of the court to order specific performance is subject to provisions of Specific Relief Act of 1963.

(c) It empowers the court to order specific performance where damages would not be an adequate remedy.

(d) It will be granted as remedy if goods are of special nature or are unique.

Example 9: 'A' agreed to sell a rare painting of Mughal period to 'B'. But on the due date of delivery, 'A' refused to sell the same. In this case, 'B' may file a suit against 'A' for obtaining an order from the Court to compel 'A' to perform the contract (i.e. to deliver the painting to 'B' at the agreed price).

3. **Suit for breach of warranty (Section 59):** Where there is breach of warranty on the part of the seller, or where the buyer elects to treat breach of condition as breach of warranty, the buyer is not entitled to reject the goods only on the basis of such breach of warranty. But he may –

(i) set up against the seller the breach of warranty in diminution or extinction of the price; or

(ii) sue the seller for damages for breach of warranty.

4. **Repudiation of contract before due date (Section 60):** Where either party to a contract of sale repudiates the contract before the date of delivery, the other may either treat the contract as subsisting and wait till the date of delivery, or he may treat the contract as rescinded and sue for damages for the breach.

5. **Suit for interest:**

(1) Nothing in this Act shall affect the right of the seller or the buyer to recover interest or special damages, in any case where by law interest or special damages may be recoverable, or to recover the money paid where the consideration for the payment of it has failed.

(2) In the absence of a contract to the contrary, the court may award interest at such rate as it thinks fit on the amount of the price to the buyer in a suit filed by him for the refund of the price (in a case of a breach of the contract on the part of the seller) from the date on which the payment was made.

Example 10: In case of a sale of cigarettes which turned out to be mildewed and unfit for consumption, damages were awarded on the basis of the difference between the contract price and the price released.

Example 11: In case of absence of transfer of title or registration, the purchaser cannot claim damages for breach of conditions and warranties relating to sale.

4.6 AUCTION SALE (SECTION 64)

An 'Auction Sale' is a mode of selling property by inviting bids publicly and the property is sold to the highest bidder. An auctioneer is an agent governed by the Law of Agency. When he sells, he is only the agent of the seller. He may, however, sell his own property as the principal and need not disclose the fact that he is so selling.

Legal Rules of Auction sale: Section 64 of the Sale of Goods Act, 1930 provides following rules to regulate the sale by auction:

(a) **Where goods are sold in lots:** Where goods are put up for sale in lots, each lot is *prima facie* deemed to be subject of a separate contract of sale.

(b) **Completion of the contract of sale:** The sale is complete when the auctioneer announces its completion by the fall of hammer or in any other customary manner. Until such announcement is made, any bidder may retract from his bid.

(c) **Right to bid may be reserved:** Right to bid may be reserved expressly by or on behalf of the seller and where such a right is expressly reserved, but not otherwise, the seller or any one person on his behalf may bid at the auction.

(d) **Where the sale is not notified by the seller:** Where the sale is not notified to be subject to a right to bid on behalf of the seller, it shall not be lawful for the seller to bid himself or to employ any person to bid at such sale, or for the auctioneer knowingly to take any bid from the seller or any such person; and any sale contravening this rule may be treated as fraudulent by the buyer.

(e) **Reserved price:** The sale may be notified to be subject to a reserve or upset price; and

(f) **Pretended bidding:** If the seller makes use of pretended bidding to raise the price, the sale is voidable at the option of the buyer.

Example 12: P sold a car by auction. It was knocked down to Q who was only allowed to take it away on giving a cheque for the price and signing an agreement that ownership should not pass until the cheque was cleared. In the meanwhile till the cheque was cleared, Q sold the car to R. It was held that the property was passed on the fall of the hammer and therefore R had a good title to the car. Both sale and sub sale are valid in favour of Q and R respectively.

4.7 INCLUSION OF INCREASED OR DECREASED TAXES IN CONTRACT OF SALE (SECTION 64A)

Where after a contract has been made but before it has been performed, tax revision takes place. Where tax is being imposed, increased, decreased or remitted in respect of any goods without any stipulations to the payment of tax, the parties would become entitled to read just the price of the goods accordingly. Following taxes are applied on the sale or purchase of goods:

- Any duty of customs or excise on goods,
- Any tax on the sale or purchase of goods

The buyer would have to pay the increased price where the tax increases and may derive the benefit of reduction if taxes are curtailed. Thus, seller may add the increased taxes in the price. The effect of provision can, however, is excluded by an agreement to the contrary. It is open to the parties to stipulate anything regard to taxation.

SUMMARY

A seller is called an 'unpaid seller' when either he has not been paid the whole price or the buyer has failed to meet at maturity the bill of exchange or any other negotiable instrument which was accepted by the seller as conditional payment. In such a circumstance the buyer may exercise lien on goods if he is in possession of them. If goods are in transit to the buyer, he may stop the goods in transit and obtain the possession of the goods.

When the unpaid seller has exercised right of lien or stoppage in transit, he may sell the goods after giving a notice to the buyer of his intent to resell. The new buyer shall have a good title on good s as against the original buyer even if the notice of resale has not been given by the seller to the original buyer.

If the seller neglects to deliver the goods the buyer may sue him for damages, or he may sue the seller for specific performance if the property in goods had not been transferred to the buyer. Where the buyer neglects to pay the price, the seller may sue him for the price as well as exercise lien on goods. Where the buyer wrongfully neglects to accept and pay for the goods, the seller may sue him for damages for non-acceptance.

Unpaid Seller

Meaning

A seller of goods is deemed to be an unpaid seller when-

- Whole of the price has not been paid or tendered;
- A BOE or other negotiable instrument has been received as a conditional payment and the condition on which it was received has not been fulfilled by reason of the dishonour of the instrument or otherwise.

Buyer's Rights for Breach of Contract of Sale

a. Suit for damages for non-delivery of goods.
b. Suit for specific performance.
c. Suit for breach of warranty.
d. Suit for anticipatory warranty.

Rights of an unpaid seller

1. Against the goods:
- Right of lien.
- Right of stoppage in transit
- Right of re-sale

2. Against the buyer:
- Suit for price
- Suit for damages for non-acceptance
- Repudiation of contract before due date
- Suit for interest on the price

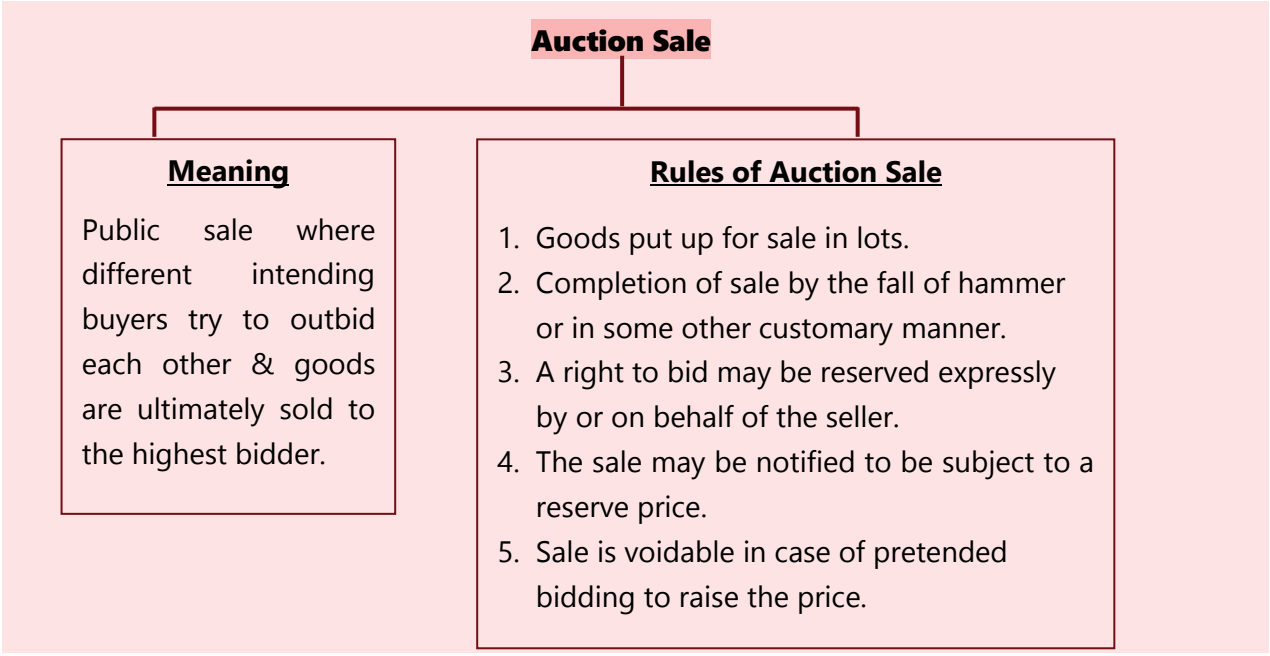
Effect of Sub-Sale or Pledge by Buyer (Sec. 53)

The unpaid seller's right of lien or stoppage in transit is to not affected by any sale or pledge of the goods which the buyer may have made, **unless**

- Seller has assented to it.

Or

- A document of title to goods has been transferred to buyer, and the buyer transfers the document to a person who bought it in good faith and for consideration.



TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *The unpaid seller has right of stoppage of goods in transit only where the buyer*
   - *(a) become insolvent.*
   - *(b) refuses to pay price.*
   - *(c) acts fraudulently.*
   - *(d) all of these.*
2. *An unpaid seller is having rights against*
   - *(a) goods only.*
   - *(b) the buyer only.*
   - *(c) both goods and buyer.*
   - *(d) none of the above.*
3. *Under which of the circumstances unpaid seller loses his right of lien*
   - *(a) by estoppel.*
   - *(b) where seller waived the right of lien.*
   - *(c) where the buyer or his agent lawfully obtains possession of the goods.*
   - *(d) any of the above.*

4. *When the unpaid seller has parted with the goods to a carrier and the buyer has become insolvent, he can exercise*

   (a) right of lien.

   (b) right of stoppage in transit.

   (c) right of resale.

   (d) none of the above.

5. *The essence of a right of lien is to*

   (a) deliver the goods.

   (b) retain the possession.

   (c) regain the possession.

   (d) none of the above

6. *Which of the following right can be exercised by an unpaid seller against the buyer, who is not insolvent*

   (a) right of lien.

   (b) right of stoppage in transit.

   (c) both (a) and (b).

   (d) none of the above.

7. *Which of the following is a buyer's right against the seller in case of breach of contract?*

   (a) suit for non-delivery.

   (b) suit for specific performance.

   (c) suit for damages for breach of warranty.

   (d) all of the above.

8. *An auction sale is complete on the*

   (a) delivery of goods

   (b) payment of price

   (c) fall of hammer

   (d) none of the above.

9. *Seller has right of resale where*

   (a) *goods are perishable.*

   (b) *seller has reserved such right.*

   (c) *seller gives notice.*

   (d) *all of these.*

10. *The aggrieved party can claim only damages in case of breach of warranty.*

   (a) *true.*

   (b) *false.*

11. *Under which circumstances, the right of stoppage can be exercised by an unpaid seller*

   (a) *the buyer has become insolvent.*

   (b) *the goods are in transit.*

   (c) *the seller must be unpaid.*

   (d) *all of the above.*

12. *Under which circumstances the unpaid seller can exercise right of re-sale*

   (a) *when the goods are of perishable nature.*

   (b) *when he gives notice to the buyer.*

   (c) *when he gives notice to the buyer of his intention to re-sale and the buyer does not within a reasonable time pay the price.*

   (d) *both (a) and (c)*

13. *Where the seller wrongfully neglects to deliver the goods to the buyer, then the buyer*

   (a) *cannot sue the seller for damages for non-delivery.*

   (b) *may sue the seller for damages for non-delivery.*

   (c) *either (a) or (b)*

   (d) *none of the above.*

14. *Where the buyer is deprived to goods by their true owner, then the buyer*

   (a) *may recover the price for breach of the condition as to title.*

   (b) *cannot recover the price for breach of the condition as to title.*

   (c) *either (a) or (b)*

   (d) *none of the above.*

15. *Where the buyer wrongfully neglects or refuses to accept and pay for the goods,*

(a) *the seller may sue buyer for damages for non-acceptance.*

(b) *the seller cannot sue buyer for damages for non-acceptance.*

(c) *the seller can sue buyers' banker for damages.*

(d) *none of the above.*

16. *In an auction sale, the property shall be sold to the*

(a) *Lowest bidder.*

(b) *Highest bidder.*

(c) *All bidders*

(d) *None of the above.*

17. *In an auction sale, if the seller makes use of pretended bidding to raise the price, then the sale is*

(a) *valid.*

(b) *void.*

(c) *voidable.*

(d) *illegal.*

18. *In which of the following cases, the unpaid seller loses his right of lien?*

(a) *delivery of goods to buyer.*

(b) *delivery of goods to carrier.*

(c) *tender of price by buyer.*

(d) *all of these.*

19. *The bidder at an auction sale can withdraw his bid*

(a) *any time during auction.*

(b) *before fall of hammer.*

(c) *before payment of price.*

(d) *none of these.*

20. *Where in an auction sale, the seller appoints more than one bidder, the sale is*

(a) *void.*

(b) *illegal.*

(c) *conditional.*

(d) *voidable.*

21. *Where in an auction sale notified with reserve price, the auctioneer mistakenly knocks down the goods for less than the reserve price, then the auctioneer is*

(a) *bound by auction.*

(b) *not bound by auction.*

(c) *liable for damages.*

(d) *both (a) and (c)*

Descriptive questions

1. *When can an unpaid seller of goods exercise his right of lien over the goods under the Sale of Goods Act? Can he exercise his right of lien even if the property in goods has passed to the buyer? When such a right is terminated? Can he exercise his right even after he has obtained a decree for the price of goods from the court?*

2. *Mr. D sold some goods to Mr. E for ₹ 5,00,000 on 15 days credit. Mr. D delivered the goods. On due date, Mr. E refused to pay for it. State the position and rights of Mr. D as per the Sale of Goods Act, 1930.*

3. *Ram sells 200 bales of cloth to Shyam and sends 100 bales by lorry and 100 bales by Railway. Shyam receives delivery of 100 bales sent by lorry, but before he receives the delivery of the bales sent by railway, he becomes bankrupt. Can Ram exercise right of stopping the goods in transit?*

4. *Suraj sold his car to Sohan for ₹ 75,000. After inspection and satisfaction, Sohan paid ₹ 25,000 and took possession of the car and promised to pay the remaining amount within a month. Later on, Sohan refuses to give the remaining amount on the ground that the car was not in a good condition. Advise Suraj as to what remedy is available to him against Sohan.*

5. *A agrees to sell certain goods to B on a certain date on 10 days credit. The period of 10 days expired and goods were still in the possession of A. B has also not paid the price of the goods. B becomes insolvent. A refuses to deliver the goods to exercise his right of lien on the goods. Can he do so under the Sale of Goods Act, 1930?*

6. *A, who is an agent of a buyer, had obtained the goods from the Railway Authorities and loaded the goods on his truck. In the meantime, the Railway Authorities received a notice from B, the seller for stopping the goods in transit as the buyer has become insolvent.*

Referring to the provisions of Sale of Goods Act, 1930, decide whether the Railway Authorities can stop the goods in transit as instructed by the seller?

7. *J sold a machine to K. K gave a cheque for the payment. The cheque was dishonoured. But J handed over a delivery order to K. K sold the goods to R on the basis of the delivery order. J wanted to exercise his right of lien on the goods. Can he do so under the provisions of the Sale of Goods Act, 1930?*

ANSWERS/HINTS

Answers to MCQ'S

1	**(a)**	2.	**(c)**	3.	**(d)**	4.	**(b)**	5.	**(b)**	6.	**(a)**
7.	**(d)**	8.	**(c)**	9.	**(d)**	10.	**(a)**	11.	**(d)**	12.	**(d)**
13.	**(b)**	14.	**(a)**	15.	**(a)**	16.	**(b)**	17.	**(c)**	18.	**(d)**
19.	**(b)**	20.	**(d)**	21.	**(b)**						

Answer to Descriptive Questions

1. A lien is a right to retain possession of goods until the payment of the price. It is available to the unpaid seller of the goods who is in possession of them where-

(i) the goods have been sold without any stipulation as to credit;

(ii) the goods have been sold on credit, but the term of credit has expired;

(iii) the buyer becomes insolvent.

The unpaid seller can exercise 'his right of lien even if the property in goods has passed on to the buyer. He can exercise his right even if he is in possession of the goods as agent or bailee for the buyer.

Termination of lien: An unpaid seller losses his right of lien thereon-

(i) When he delivers the goods to a carrier or other bailee for the purpose of transmission to the buyer without reserving the right of disposal of the goods;

(ii) When the buyer or his agent lawfully obtains possession of the goods;

Yes, he can exercise his right of lien even after he has obtained a decree for the price of goods from the court.

2. **Position of Mr. D:** Mr. D sold some goods to Mr. E for ₹ 5,00,000 on 15 days credit. Mr. D delivered the goods. On due date Mr. E refused to pay for it. So, Mr. D is an unpaid seller as according to Section 45(1) of the Sale of Goods Act, 1930 the seller of goods is deemed to be an 'Unpaid Seller' when the whole of the price has not been paid or tendered and the seller had an immediate right of action for the price.

Rights of Mr. D: As the goods have parted away from Mr. D and already delivered to E, therefore, Mr. D cannot exercise the right against the goods, he can only exercise his rights against the buyer i.e. Mr. E which are as under:

(i) **Suit for price (Section 55):** In the mentioned contract of sale, the price is payable after 15 days and Mr. E refuses to pay such price, Mr. D may sue Mr. E for the price.

(ii) **Suit for damages for non-acceptance (Section 56):** Mr. D may sue Mr. E for damages for non-acceptance if Mr. E wrongfully neglects or refuses to accept and pay for the goods. As regards measure of damages, Section 73 of the Indian Contract Act, 1872 applies.

(iii) **Suit for interest [Section 61]**: If there is no specific agreement between Mr. D and Mr. E as to interest on the price of the goods from the date on which payment becomes due, Mr. D may charge interest on the price when it becomes due from such day as he may notify to Mr. E.

3. **Right of stoppage of goods in transit:** The problem is based on Section 50 of the Sale of Goods Act, 1930 dealing with the right of stoppage of the goods in transit available to an unpaid seller. The section states that the right is exercisable by the seller only if the following conditions are fulfilled.

(i) The seller must be unpaid

(ii) He must have parted with the possession of goods

(iii) The goods must be in transit

(iv) The buyer must have become insolvent

(v) The right is subject to the provisions of the Act.

Applying the provisions to the given case, Ram being still unpaid, can stop the 100 bales of cloth sent by railway as these goods are still in transit. He may recover the price of other 100 bales sent by lorry by using his rights against the buyer.

4. As per the section 55 of the Sale of Goods Act, 1930 an unpaid seller has a right to institute a suit for price against the buyer personally. The said Section lays down that

(i) Where under a contract of sale the property in the goods has passed to buyer and the buyer wrongfully neglects or refuses to pay for the goods, the seller may sue him for the price of the goods [Section 55(1)].

(ii) Where under a contract of sale the price is payable on a certain day irrespective of delivery and the buyer wrongfully neglects or refuses to pay such price, the seller may sue him for the price. It makes no difference even if the property in the goods has not passed and the goods have not been appropriated to the contract [Section 55(2)].

This problem is based on above provisions. Hence, Suraj will succeed against Sohan for recovery of the remaining amount. Apart from this, Suraj is also entitled to:-

(1) Interest on the remaining amount

(2) Interest during the pendency of the suit.

(3) Costs of the proceedings.

5. Lien is the right of a person to retain possession of the goods belonging to another until claim of the person in possession is satisfied. The unpaid seller has also right of lien over the goods for the price of the goods sold.

Section 47(1) of the Sales of Goods Act, 1930 provides that the unpaid seller who is in the possession of the goods is entitled to exercise right of lien in the following cases:-

1. Where the goods have been sold without any stipulation as to credit

2. Where the goods have been sold on credit but the term of credit has expired

3. Where the buyer has become insolvent even though the period of credit has not yet expired.

In the given case, A has agreed to sell certain goods to B on a credit of 10 days. The period of 10 days has expired. B has neither paid the price of goods nor taken the possession of the goods. That means the goods are still physically in the possession of A, the seller. In the meantime B, the buyer has become insolvent. In this case, A is entitled to exercise the right of lien on the goods because the buyer has become insolvent and the term of credit has expired without any payment of price by the buyer.

6. The right of stoppage of goods in transit means the right of stopping the goods after the seller has parted with the goods. Thereafter the seller regains the possession of the goods.

This right can be exercised by an unpaid seller when he has lost his right of lien over the goods because the goods are delivered to a carrier for the purpose of taking the

goods to the buyer. This right is available to the unpaid seller only when the buyer has become insolvent. The conditions necessary for exercising this right are:-

1 The buyer has not paid the total price to the seller

2 The seller has delivered the goods to a carrier thereby losing his right of lien

3 The buyer has become insolvent

4 The goods have not reached the buyer, they are in the course of transit. (Section 50, 51 and 52)

In the given case A, who is an agent of the buyer, had obtained the goods from the railway authorities and loaded the goods on his truck. After this the railway authorities received a notice from the seller B to stop the goods as the buyer had become insolvent.

According to the Sale of Goods Act, 1930, the railway authorities cannot stop the goods because the goods are not in transit. A who has loaded the goods on his truck is the agent of the buyer. That means railway authorities have given the possession of the goods to the buyer. The transit comes to an end when the buyer or his agent takes the possession of the goods.

7. The right of lien and stoppage in transit are meant to protect the seller. These will not be affected even when the buyer has made a transaction of his own goods which were with the seller under lien. But under two exceptional cases these rights of the seller are affected:-

(i) When the buyer has made the transaction with the consent of the seller

(ii) When the buyer has made the transaction on the basis of documents of title such as bill of lading, railway receipt or a delivery order etc.

In the given case, J has sold the machine to K and K gave a cheque for the payment. But the cheque was dishonoured that means J, the seller is an unpaid seller. So, he is entitled to exercise the right of lien, but according to section 53(1) his right of lien is defeated because he has given the document of title to the buyer and the buyer has made a transaction of sale on the basis of this document. So, R who has purchased the machine from K can demand the delivery of the machine.

NOTES

CHAPTER 4

THE INDIAN PARTNERSHIP ACT, 1932

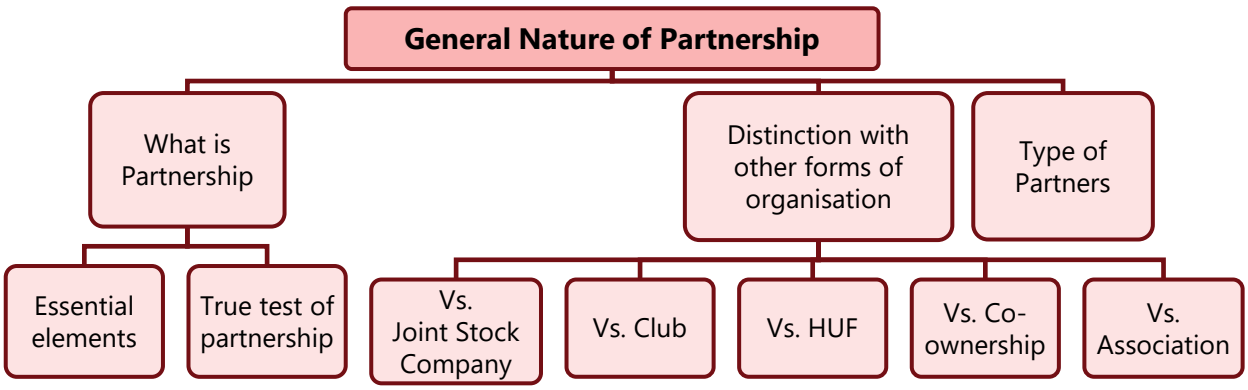
UNIT -1: GENERAL NATURE OF PARTNERSHIP

LEARNING OUTCOMES

After studying this unit, you would be able to understand-

- The concept of partnerships and be clear about its essentials.
- The 'principal - agent relationship' among the partners.
- Points of difference between partnership and other various forms of organization.
- Types of Partners

UNIT OVERVIEW



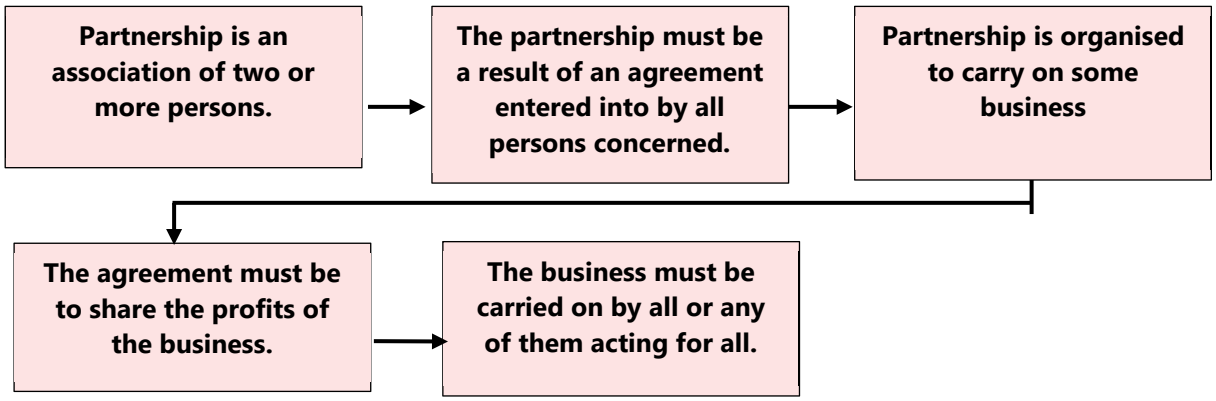
1.1 DEFINITION OF 'PARTNERSHIP', 'PARTNER', 'FIRM' AND 'FIRM NAME' (SECTION 4)

'Partnership' is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.

Persons who have entered into partnership with one another are called individually **'partners'** and collectively **'a firm'**, and the name under which their business is carried on is called the **'firm name'**.

1.2 ELEMENTS OF PARTNERSHIP

The definition of the partnership contains the following five elements which must co-exist before a partnership can come into existence.



We shall now discuss the aforestated elements one by one.

1. **ASSOCIATION OF TWO OR MORE PERSONS:** Partnership is an association of 2 or more persons. Again, only persons recognized by law can enter into an agreement of partnership. Therefore, a firm, since it is not a person recognized in the eyes of law cannot be a partner. Again, a minor cannot be a partner in a firm, but with the consent of all the partners, may be admitted to the benefits of partnership.

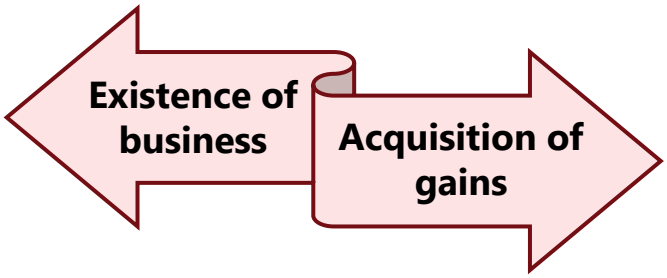
   The partnership Act is silent about the maximum number of partners but section 464 of the Companies Act, 2013 has now put a limit of 50 partners in any association/partnership firm.

2. **AGREEMENT:** It may be observed that partnership must be the result of an agreement between two or more persons. There must be an agreement entered into by all the

persons concerned. This element relates to voluntary contractual nature of partnership. Thus, the nature of the partnership is voluntary and contractual.

An agreement from which relationship of Partnership arises may be express. It may also be implied from the act done by partners and from a consistent course of conduct being followed, showing mutual understanding between them. It may be oral or in writing.

3. **BUSINESS:** In this context, we will consider two propositions. First, there must exist a business. For the purpose, the term 'business' includes every trade, occupation and profession. The existence of business is essential. Secondly, the motive of the business is the "acquisition of gains" which leads to the formation of partnership. Therefore, there can be no partnership where there is no intention to carry on the business and to share the profit thereof.



4. **AGREEMENT TO SHARE PROFITS:** The sharing of profits is an essential feature of partnership. There can be no partnership where only one of the partners is entitled to the whole of the profits of the business. Partners must agree to share the profits in any manner they choose.

But an agreement to share losses is not an essential element. It is open to one or more partners to agree to share all the losses. However, in the event of losses, unless agreed otherwise, these must be borne in the profit-sharing ratio.

Example 1: Co-owners who share amongst themselves the rent derived from a piece of land are not partners, because there does not exist any business.

Example 2: No charitable institution or club may be floated in partnership [A joint stock company may, however, be floated for non-economic purposes].

Example 3: X and Y buy certain bales of cotton which they agree to sell on their joint account and to share the profits equally. In these circumstances, X and Y are partners in respect of such cotton business.

5. **BUSINESS CARRIED ON BY ALL OR ANY OF THEM ACTING FOR ALL:** The business must be carried on by all the partners or by anyone or more of the partners acting for all. This is the cardinal principle of the partnership Law. In other words, there should be a binding contract of mutual agency between the partners.

An act of one partner in the course of the business of the firm is in fact an act of all partners. Each partner carrying on the business is the principal as well as the agent for all the other partners. He is an agent in so far as he can bind the other partners by his acts and he is a principal to the extent that he is bound by the act of other partners.

It may be noted that the true test of partnership is *mutual agency* rather than sharing of profits. If the element of mutual agency is absent, then there will be no partnership.

Example 4: A, B and C are partners in ABC Associates, a partnership firm. If A made certain purchases for the purpose of business from Mr. K, then Mr. K can recover the money from A, B or C as all partners are liable for any act done on behalf of firm.

In KD Kamath & Co.

The Supreme Court has held that the two essential conditions to be satisfied are that:

(1) there should be an agreement to share the profits as well as the losses of business; and

(2) the business must be carried on by all or any of them acting for all, within the meaning of the definition of 'partnership' under section 4.

The fact that the exclusive power and control, by agreement of the parties, is vested in one partner or the further circumstance that only one partner can operate the bank accounts or borrow on behalf of the firm are not destructive of the theory of partnership provided the two essential conditions, mentioned earlier, are satisfied.

Note:- The 'Partnership Agreement' is also known as 'Partnership Deed'.

1.3 TRUE TEST OF PARTNERSHIP

Mode of determining existence of partnership (Section 6): In determining whether a group of persons is or is not a firm, or whether a person is or not a partner in a firm, regard shall be had to the real relation between the parties, as shown by all relevant facts taken together.

For determining the existence of partnership, it must be proved.

1. There was an **agreement** between all the persons concerned;
2. The agreement was to **share the profits** of a business and
3. the business was **carried on by all or any of them** acting for all.

1. **Agreement:** Partnership is created by agreement and not by status **(Section 5)**. The relation of partnership arises from contract and not from status; and in particular, the members of a Hindu Undivided family carrying on a family business as such, or a Burmese Buddhist husband and wife carrying on business as such are not partners in such business.

2. **Sharing of Profit:** The sharing of profits or of gross returns arising from property by persons holding a joint or common interest in that property does not of itself make such persons partners.

   The receipt by a person of a share of the profits of a business, or of a payment contingent upon the earning of profits or varying with the profits earned by a business, does not of itself make him a partner with the persons carrying on the business; and in particular, the receipt of such share or payment-

   (a) by a lender of money to persons engaged or about to engage in any business,

   (b) by a servant or agent as remuneration,

   (c) by a widow or child of a deceased partner, as annuity, or

   (d) by a previous owner or part owner of the business, as consideration for the sale of the goodwill or share thereof, does not of itself make the receiver a partner with the persons carrying on the business.

   As discussed earlier, sharing of profit is an essential element to constitute a partnership. But, it is only a *prima facie* evidence and not conclusive evidence, in that regard. The sharing of profits or of gross returns accruing from property by persons holding joint or common interest in the property would not by itself make such persons partners. Although the right to participate in profits is a strong test of partnership, and there may be cases where, upon a simple participation in profits, there is a partnership, yet whether the relation does or does not exist must depend upon the whole contract between the parties.

   Where there is an express agreement between partners to share the profit of a business and the business is being carried on by all or any of them acting for all, there will be no difficulty in the light of provisions of Section 4, in determining the existence or otherwise of partnership.

But the task becomes difficult when either there is no specific agreement or the agreement is such as does not specifically speak of partnership. In such a case for testing the existence or otherwise of partnership relation, Section 6 has to be referred.

According to Section 6, regard must be had to the real relation between the parties as shown by all relevant facts taken together. The rule is easily stated and is clear but its application is difficult. Cumulative effect of all relevant facts such as written or verbal agreement, real intention and conduct of the parties, other surrounding circumstances etc., are to be considered while deciding the relationship between the parties and ascertaining the existence of partnership.

3. **Agency:** Existence of Mutual Agency which is the cardinal principle of partnership law, is very much helpful in reaching a conclusion in this regard. Each partner carrying on the business is the principal as well as an agent of other partners. So, the act of one partner done on behalf of firm, binds all the partners. If the elements of mutual agency relationship exist between the parties constituting a group formed with a view to earn profits by running a business, a partnership may be deemed to exist.

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Santiranjan Das Gupta Vs. Dasyran Murzamull (Supreme Court)

In *Santiranjan Das Gupta Vs. Dasyran Murzamull,* following factors weighed upon the Supreme Court to reach the conclusion that there is no partnership between the parties:

(a) Parties have not retained any record of terms and conditions of partnership.

(b) Partnership business has maintained no accounts of its own, which would be open to inspection by both parties.

(c) No account of the partnership was opened with any bank.

(d) No written intimation was conveyed to the Deputy Director of Procurement with respect to the newly created partnership.

1.4 PARTNERSHIP DISTINGUISHED FROM OTHER FORMS OF ORGANISATION

Partnership Vs. Joint Stock Company

Basis	Partnership	Joint Stock Company
Legal status	A firm is not legal entity i.e. it has no legal personality distinct from the personalities of its constituent members.	A company is a separate legal entity distinct from its members *(Salomon v. Salomon)*.
Agency	In a firm, every partner is an agent of the other partners as well as of the firm.	In a company, a member is not an agent of the other members or of the company, his actions do not bind either.
Distribution of profits	The profits of the firm must be distributed among the partners according to the terms of the partnership deed.	There is no such compulsion to distribute its profits among its members. Some portion of the profits, but generally not the entire profit, become distributable among the shareholders only when dividends are declared.
Extent of liability	In a partnership, the liability of the partners is unlimited. This means that each partner is liable for debts of a firm incurred in the course of the business of the firm and these debts can be recovered from his private property, if the joint estate is insufficient to meet them wholly.	In a company limited by shares, the liability of a shareholder is limited to the amount, if any, unpaid on his shares, but in the case of a guarantee company, the liability is limited to the amount for which he has agreed to be liable. However, there may be companies where the liability of members is unlimited.
Property	The firm's property is that which is the "joint estate" of all the partners as distinguished from the 'separate' estate of any of them and it does not belong to a body distinct in law from its members.	In a company, its property is separate from that of its members who can receive it back only in the form of dividends or refund of capital.
Transfer of shares	A share in a partnership cannot be transferred without the consent of all the partners.	In a company a shareholder may transfer his shares, subject to the provisions contained in its Articles.

		In the case of public limited companies whose shares are quoted on the stock exchange, the transfer is usually unrestricted.
Management	In the absence of an express agreement to the contrary, all the partners are entitled to participate in the management.	Members of a company are not entitled to take part in the management unless they are appointed as directors, in which case they may participate. Members, however, enjoy the right of attending general meeting and voting where they can decide certain questions such as election of directors, appointment of auditors, etc.
Registration	Registration is not compulsory in the case of partnership.	A company cannot come into existence unless it is registered under the Companies Act, 2013.
Winding up	A partnership firm can be dissolved at any time if all the partners agree.	A company, being a legal person is either wind up by the National Company Law Tribunal or its name is struck of by the Registrar of Companies.
Number of membership	According to section 464 of the Companies Act, 2013, the number of partners in any association shall not exceed 100. However, the Rule given under the Companies *(Miscellaneous) Rules, 2014* restrict the present limit to 50.	A private company may have as many as 200 members but not less than two and a public company may have any number of members but not less than seven. A private Company can also be formed by one person known as one person Company.
Duration of existence	Unless there is a contract to the contrary, death, retirement or insolvency of a partner results in the dissolution of the firm.	A company enjoys a perpetual succession.

Partnership Vs. Club

Basis of Difference	Partnership	Club
Definition	It is an association of persons formed for earning profits from a business carried on by all or any one of them acting for all.	A club is an association of persons formed with the object not of earning profit, but of promoting some beneficial purposes such as improvement of health or providing recreation for the members, etc.
Relationship	Persons forming a partnership are called partners and a partner is an agent for other partners.	Persons forming a club are called members. A member of a club is not the agent of other members.
Interest in the property	Partner has interest in the property of the firm.	A member of a club has no interest in the property of the club.
Dissolution	A change in the partners of the firm affect its existence.	A change in the membership of a club does not affect its existence.

Partnership vs. Hindu Undivided Family

Basis of difference	Partnership	Joint Hindu family
Mode of creation	Partnership is created necessarily by an agreement.	The right in the joint family is created by status means its creation by birth in the family.
Death of a member	Death of a partner ordinarily leads to the dissolution of partnership.	The death of a member in the Hindu undivided family does not give rise to dissolution of the family business.
Management	All the partners are equally entitled to take part in the partnership business.	The right of management of joint family business generally vests in the Karta, the governing male member or female member of the family.[1]

[1] **Joint Hindu Family:** The amendment in the Hindu Succession Act, 2005, entitled all adult members – Hindu males and females to become coparceners in a HUF. They now enjoy equal rights of

Authority to bind	Every partner can, by his act, bind the firm.	The Karta or the manager, has the authority to contract for the family business and the other members in the family.
Liability	In a partnership, the liability of a partner is unlimited.	In a Hindu undivided family, only the liability of the Karta is unlimited, and the other coparcener are liable only to the extent of their share in the profits of the family business.
Calling for accounts on closure	A partner can bring a suit against the firm for accounts, provided he also seeks the dissolution of the firm.	On the separation of the joint family, a member is not entitled to ask for account of the family business.
Governing Law	A partnership is governed by the Indian Partnership Act, 1932.	A Joint Hindu Family business is governed by the Hindu Law.
Minor's capacity	In a partnership, a minor cannot become a partner, though he can be admitted to the benefits of partnership, only with the consent of all the partners.	In Hindu undivided family business, a minor becomes a member of the ancestral business by the incidence of birth. He does not have to wait for attaining majority.
Continuity	A firm subject to a contract between the partners gets dissolved by death or insolvency of a partner.	A Joint Hindu family has the continuity till it is divided. The status of Joint Hindu family is not thereby affected by the death of a member.
Number of Members	In case of Partnership number of members should not exceed 50.	Members of HUF who carry on a business may be unlimited in number.
Share in the business	In a partnership, each partner has a defined share by virtue of an agreement between the partners.	In a HUF, no coparceners has a definite share. His interest is a fluctuating one. It is capable of being enlarged by deaths in the family diminished by births in the family.

inheritance due to this amendment. On 1st February 2016, Justice Najmi Waziri gave a landmark judgement which allowed the eldest female coparceners of an HUF to become its Karta.

Partnership Vs. Co-Ownership or joint ownership i.e. the relation which subsists between persons who own property jointly or in common.

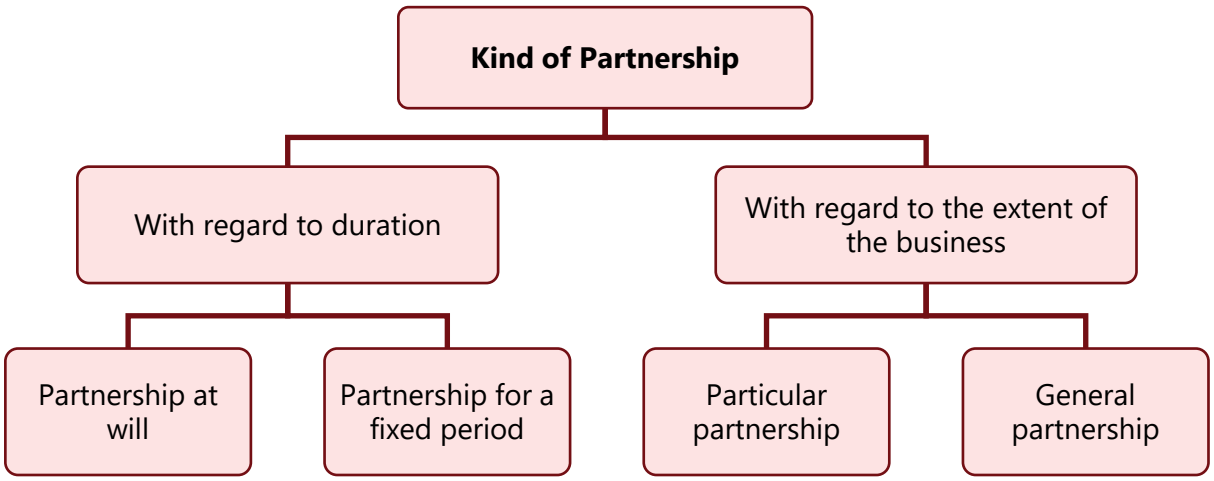
Basis of difference	Partnership	Co-ownership
Formation	Partnership always arises out of a contract, express or implied.	Co-ownership may arise either from agreement or by the operation of law, such as by inheritance.
Implied agency	A partner is the agent of the other partners.	A co-owner is not the agent of other co-owners.
Nature of interest	There is community of interest which means that profits and losses must have to be shared.	Co-ownership does not necessarily involve sharing of profits and losses.
Transfer of interest	A share in the partnership is transferred only by the consent of other partners.	A co - owner may transfer his interest or rights in the property without the consent of other co-owners.

Partnership vs. Association

Basis of difference	Partnership	Association
Meaning	Partnership means and involves setting up relation of agency between two or more persons who have entered into a business for gains, with the intention to share the profits of such a business.	Association evolves out of social cause and there is no necessarily motive to earn and share profits. The intention is not to enter in a business for gains.
Examples	Partnership to run a business and earn profit thereon.	Members of charitable society or religious association or an improvement scheme or building corporation or a mutual insurance society or a trade protection association.

1.5 KINDS OF PARTNERSHIPS

The following chart illustrates the various kinds of partnership:



The various kinds of partnership are discussed below:

1. **Partnership at will according to Section 7 of the Act, partnership at will is a partnership when:**

   1. no fixed period has been agreed upon for the duration of the partnership; and
   2. there is no provision made as to the determination of the partnership.

   These two conditions must be satisfied before a partnership can be regarded as a partnership at will. But, where there is an agreement between the partners either for the duration of the partnership or for the determination of the partnership, the partnership is not partnership at will.

   Where a partnership entered into for a fixed term is continued after the expiry of such term, it is to be treated as having become a partnership at will.

   A partnership at will may be dissolved by any partner by giving notice in writing to all the other partners of his intention to dissolve the same.

2. **Partnership for a fixed period:** Where a provision is made by a contract for the duration of the partnership, the partnership is called 'partnership for a fixed period'. It is a partnership created for a particular period of time. Such a partnership comes to an end on the expiry of the fixed period.

3. **Particular partnership:** A partnership may be organized for the prosecution of a single adventure as well as for the conduct of a continuous business. Where a person becomes a partner with another person in any particular adventure or undertaking the partnership is called 'particular partnership'.

   A partnership, constituted for a single adventure or undertaking is, subject to any agreement, dissolved by the completion of the adventure or undertaking.

4. **General partnership:** Where a partnership is constituted with respect to the business in general, it is called a general partnership. A general partnership is different from a particular partnership. In the case of a particular partnership, the liability of the partners extends only to that particular adventure or undertaking, but it is not so in the case of general partnership. General partnership is different from limited liability partnership.

Partnership Deed

Partnership is the result of an agreement. No particular formalities are required for an agreement of partnership. It may be in writing or formed verbally. But it is desirable to have the partnership agreement in writing to avoid future disputes. The document in writing containing the various terms and conditions as to the relationship of the partners to each other is called the 'partnership deed'. It should be drafted with care and be stamped according to the provisions of the Stamp Act, 1899. Where the partnership comprises immovable property, the instrument of partnership must be in writing, stamped and registered under the Registration Act.

Partnership deed may contain the following information:-

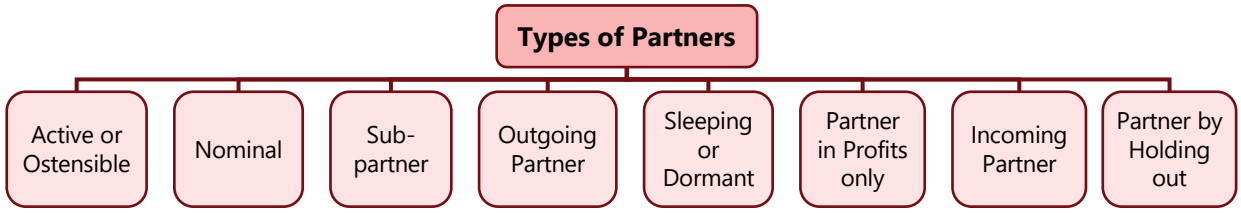
1. Name of the partnership firm.
2. Names of all the partners.
3. Nature and place of the business of the firm.
4. Date of commencement of partnership.
5. Duration of the partnership firm.
6. Capital contribution of each partner.
7. Profit Sharing ratio of the partners.
8. Admission and Retirement of a partner.
9. Rates of interest on Capital, Drawings and loans.
10. Provisions for settlement of accounts in the case of dissolution of the firm.
11. Provisions for Salaries or commissions, payable to the partners, if any.

12. Provisions for expulsion of a partner in case of gross breach of duty or fraud.

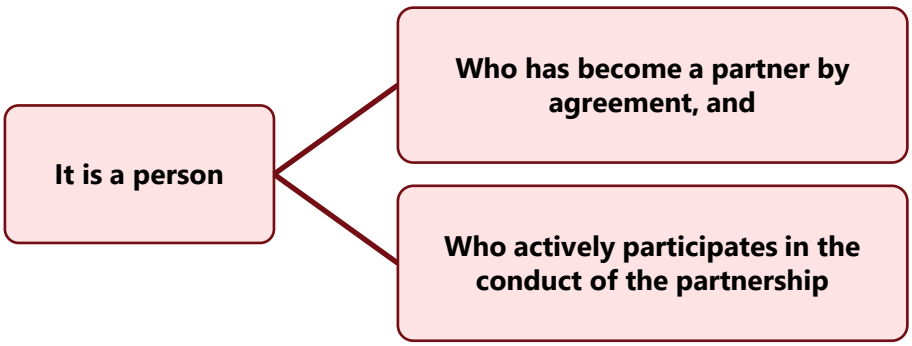
A partnership firm may add or delete any provision according to the needs of the firm.

1.6 TYPES OF PARTNERS

Based on the extent of liability, the different classes of partners are:

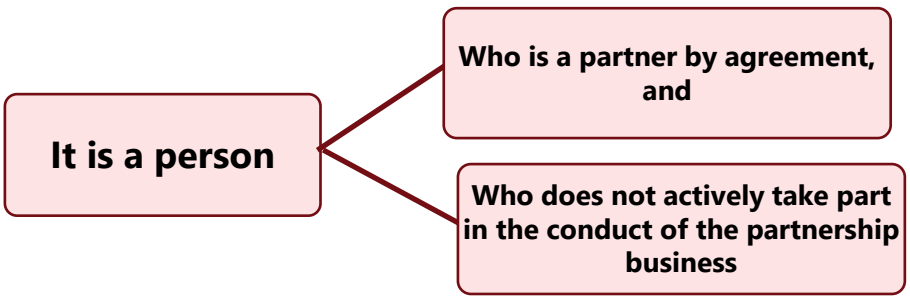


Active or Actual or Ostensible partner:



He acts as an agent of other partners for all acts done in the ordinary course of business. In the event of his retirement, he must give a public notice in order to absolve himself of liabilities for acts of other partners done after his retirement.

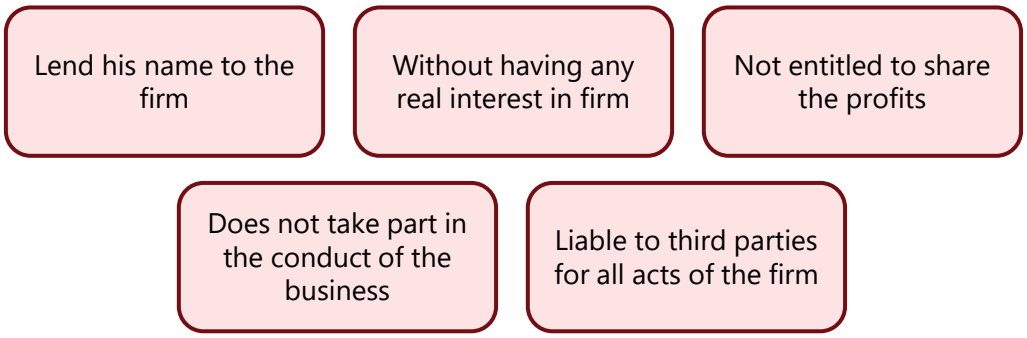
Sleeping or Dormant Partner:



They are called as 'sleeping' or 'dormant' partners. They share profits and losses and are liable to the third parties for all acts of the firm. They are, however not required to give public notice of their retirement from the firm.

Nominal Partner: A person who lends his name to the firm, without having any real interest in it, is called a nominal partner.

He is not entitled to share the profits of the firm. Neither he invests in the firm nor takes part in the conduct of the business. He is, however liable to third parties for all acts of the firm.



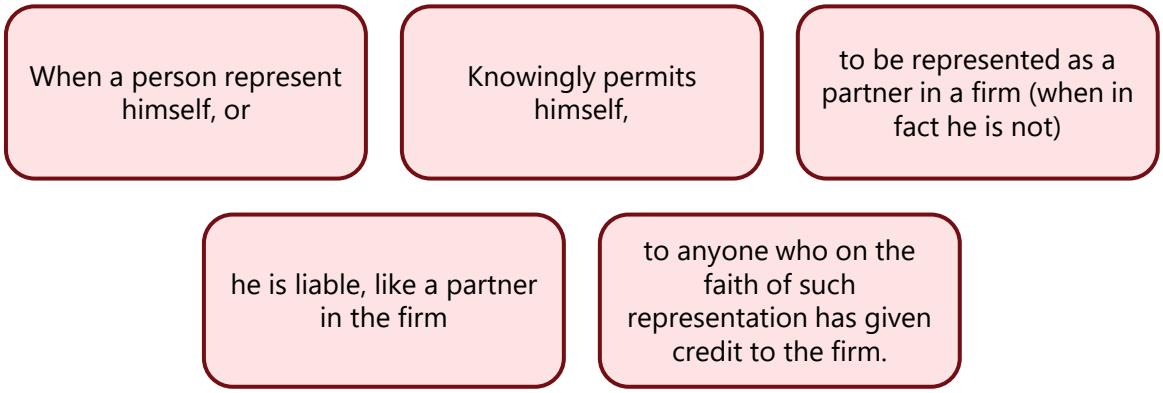
Partner in profits only: A partner who is entitled to share the profits only without being liable for the losses is known as the partner for profits only and also liable to the third parties for all acts of the profits only.

Incoming partners: A person who is admitted as a partner into an already existing firm with the consent of all the existing partners is called as "incoming partner". Such a partner is not liable for any act of the firm done before his admission as a partner.

Example 5: Mr. A joined as a partner on 10th September, 2021 in a firm MNQ Associates which was existing from 10th July, 2017. Mr. A will not be liable for any acts of the firm done before his date of joining i.e. 10th September, 2021

Outgoing partner: A partner who leaves a firm in which the rest of the partners continue to carry on business is called a retiring or outgoing partner. Such a partner remains liable to third parties for all acts of the firm until public notice is given of his retirement.

Partner by holding out (Section 28): Partnership by holding out is also known as partnership by estoppel. Where a man holds himself out as a partner, or allows others to do it, he is then stopped from denying the character he has assumed and upon the faith of which creditors may be presumed to have acted.



A person may himself, by his words or conduct have induced others to believe that he is a partner or he may have allowed others to represent him as a partner. The result in both the cases is identical.

Example 6: X and Y are partners in a partnership firm. X introduced A, a manager, as his partner to Z. A remained silent. Z, a trader believing A as partner supplied 100 T.V sets to the firm on credit. After expiry of credit period, Z did not get amount of T.V sets sold to the partnership firm. Z filed a suit against X and A for the recovery of price. Here, in the given case, A, the Manager is also liable for the price because he becomes a partner by holding out (Section 28, Indian Partnership Act, 1932).

It is only the person to whom the representation has been made and who has acted thereon that has right to enforce liability arising out of 'holding out'.

You must also note that for the purpose of fixing liability on a person who has, by representation, led another to act, it is not necessary to show that he was actuated by a fraudulent intention.

The rule given in Section 28 is also applicable to a former partner who has retired from the firm without giving proper public notice of his retirement. In such cases a person who, even subsequent to the retirement, give credit to the firm on the belief that he was a partner, will be entitled to hold him liable.

Example 7: A partnership firm consisting of P, Q, R and S. S retires from the firm without giving public notice and his name continues to be used on letterheads. Here, S is liable as a partner by holding out to creditors who have lent on the faith of his being a partner.

SUMMARY

It is not quite easy to define the term 'Partnership'. The definition given by Section 4 of the Act brings out very clearly the fundamental principle that each partner, when carrying on the business of the firm, is an agent as well as principal, and is probably the most business like definition of the term. The definition contains three elements which must be present before a group of persons can be held to be partners, namely; (a) agreement among all the partners; (b) agreement to share the profits of the business; (c) the business must be carried on by all or any of them, acting for all. These three elements may appear to overlap, but they are nevertheless distinct.

The element of agreement in partnership distinguishes it from various other relations which arise by operation of law and not from agreement, such as, joint-owners, Hindu Undivided Family, etc.

GENERAL NATURE OF PARTNERSHIP

Definition: Sec. 4

"The relationship between persons who have agreed to share the profits of a business carried on by all, or any of them acting for all."

Essentials of Partnership

1. An association of two or more persons;
2. An agreement between two or more persons;
3. Agreement to carry on some business;
4. Agreement to share profits of business;
5. Business must be carried on by all or any of them acting for all.

Test of Partnership: Sec. 6

A group of persons constitute a firm if the real relation between the parties as shown by all relevant facts taken together showing that all essential elements of partnership are present.

Kinds of Partnership Firms

With regard to duration

Partnership at will

- No provision is made for duration of partnership.
- Partnership may be dissolved by any partner by giving a notice to that effect to all the other partners.

Partnership for fixed period

- Partnership created for a particular period of time.
- Such partnership comes to an end on the expiry of the fixed period.**

With regard to Extent of Business

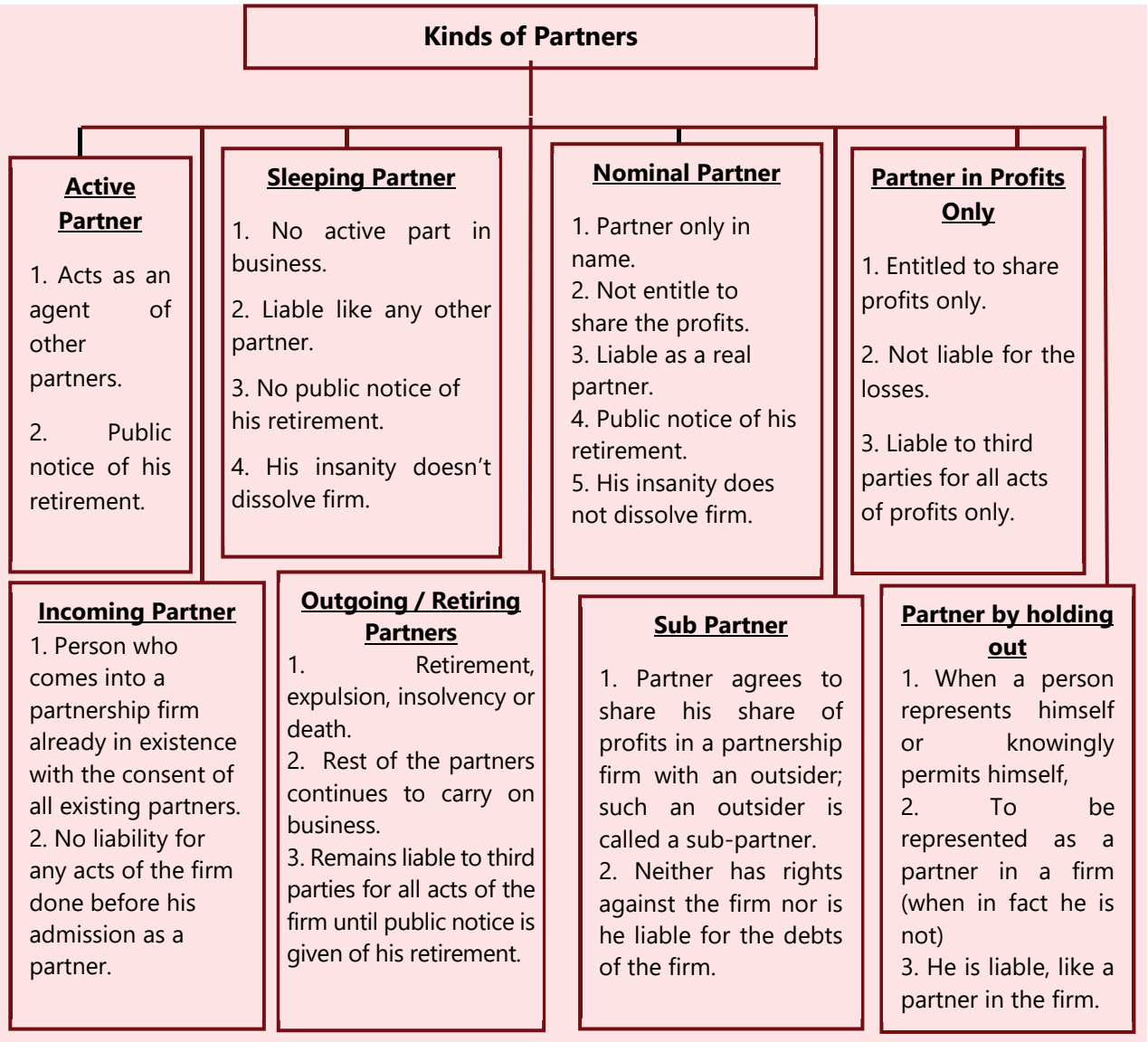
Particular Partnership

- Partnership is formed for a particular period or for a specific venture.
- Partnership is automatically dissolved at the expiry of the fixed term of on the completion of the venture.**

General Partnership

Partnership which is constituted with respect to business in general.

****Note:** *If the partners decide to continue then it becomes a 'partnership at will'.*



TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *The term 'Partnership' has been defined under ____ of the Partnership Act, 1932:*

   (a) Section 3

   (b) Section 4

   (c) Section 5

   (d) Section 6

2. *A partnership for which no period or duration is fixed under the Indian Partnership Act is known as:*

   (a) Unlimited partnership

   (b) Co-ownership

   (c) Particular partnership

   (d) Partnership at will

3. *The most important element in partnership is:*

   (a) Business

   (b) Sharing of profits

   (c) Agreement

   (d) Business to be carried on by all or any of them acting for all.

4. *A firm is the name of:*

   (a) The partners

   (b) The minors in the firm

   (c) The business under which the firm carries on business

   (d) The collective name under which it carries on business

5. *A partnership formed for the purpose of carrying on particular venture or undertaking is known as:*

   (a) Limited partnership

   (b) Special partnership

   (c) Joint venture

   (d) Particular partnership

6. *In the absence of agreement to the contrary all partners are:*

   (a) Not entitled to share profits

   (b) Entitled to share in capital ratio

   (c) Entitled to share in proportion to their ages

   (d) Entitled to share profits equally

7. *A partnership at will is one:*

   (a) Which does not have any deed

   (b) Which does not have any partner

(c) *Which does not provide for how long the business will continue*

(d) *Which cannot be dissolved.*

8. *What among the following is not an essential element of partnership:*

(a) *There must be an agreement entered into by all the persons concerned*

(b) *The agreement must be to share the profits of a business*

(c) *The business must start within six months from the date of agreement*

(d) *The business must be carried on by all or any one of them acting for all.*

9. *Partnership is a relationship, which arises from:*

(a) *Operation of law*

(b) *An agreement*

(c) *Status*

(d) *Almighty*

10. *Which is not a characteristics of partnership firms?*

(a) *Perpetual succession*

(b) *Unlimited liability of partners*

(c) *Mutual agency*

(d) *Sharing of profits of business*

11. *Select the odd one out of the available options for the entitlement of "Partners in profits only":*

(a) *He is entitled to share the profits only.*

(b) *He is liable for the losses of the firm.*

(c) *He is not liable for the losses of the firm.*

(d) *He is liable to the third parties for all acts of the profits only.*

12. *Mr. Pawan is nominal partner in the partnership firm so he:*

(a) *is not entitled to share the profits.*

(b) *is entitled to share the profits.*

(c) *can take part in the conduct of business.*

(d) *Is not liable to third parties for all acts of the firm.*

13. *When partnership entered into for a fixed term is continued after the expiry of such term, it is to be treated as having become a:*

(a) *Partnership for a fixed period.*

(b) *Particular partnership*

(c) *Partnership at will.*

(d) *General partnership.*

14. *Mr. Samarth retires from the partnership firm without giving public notice and his name continues to be used on letterhead of the firm. Mr. Samarth is _____ in the case of repayment of loan to creditors.*

(a) *liable as a partner.*

(b) *not liable as a partner.*

(c) *responsible.*

(d) *liable as a retiring partner.*

15. *The "dormant partner" of the firm is:*

(a) *not required to give notice of his retirement.*

(b) *required to give notice of his retirement*

(c) *not liable to the third parties for all act of the firm.*

(d) *does not share profits and losses.*

Descriptive Questions

1. *Mr. XU and Mr. YU are partners in a partnership firm. Mr. XU introduced MU (an employee) as his partner to ZU. MU remained silent. ZU, a trader believing MU as partner supplied 50 Laptops to the firm on credit. After expiry of credit period, ZU did not get amount of Laptop sold to the partnership firm. ZU filed a suit against XU and MU for the recovery of price. Does MU is liable for such purpose?*

2. *Ms. Lucy while drafting partnership deed taken care of few important points. What are those points? She want to know the list of information which must be part of partnership deed drafted by her. Also, give list of information to be included in partnership deed?*

ANSWERS/HINTS

Answers to MCQs

1.	**(b)**	2.	**(d)**	3.	**(d)**	4.	**(d)**	5.	**(d)**	6.	**(d)**
7.	**(c)**	8.	**(c)**	9.	**(b)**	10.	**(a)**	11.	**(b)**	12.	**(a)**
13.	**(c)**	14.	**(a)**	15.	**(a)**						

Answers to the Descriptive Questions

1. As per Section 28 of Indian Partnership Act, 1932, Partnership by holding out is also known as partnership by estoppel. Where a man holds himself out as a partner, or allows others to do it, he is then stopped from denying the character he has assumed and upon the faith of which creditors may be presumed to have acted. A person may himself, by his words or conduct have induced others to believe that he is a partner or he may have allowed others to represent him as a partner. The result in both the cases is identical.

In the given case, MU (the Manager) is also liable for the price because he becomes a partner by holding out as per Section 28 of Indian Partnership Act, 1932.

2. Ms. Lucy while drafting partnership deed must take care of following important points:

- No particular formalities are required for an agreement of partnership.
- Partnership deed may be in writing or formed verbally. The document in writing containing the various terms and conditions as to the relationship of the partners to each other is called the 'partnership deed'.
- Partnership deed should be drafted with care and be stamped according to the provisions of the Stamp Act, 1899.
- If partnership comprises immovable property, the instrument of partnership must be in writing, stamped and registered under the Registration Act.

List of information included in Partnership Deed while drafting Partnership Deed by Ms. Lucy:

- Name of the partnership firm.
- Names of all the partners.
- Nature and place of the business of the firm.
- Date of commencement of partnership.
- Duration of the partnership firm.
- Capital contribution of each partner.
- Profit Sharing ratio of the partners.
- Admission and Retirement of a partner.
- Rates of interest on Capital, Drawings and loans.
- Provisions for settlement of accounts in the case of dissolution of the firm.
- Provisions for Salaries or commissions, payable to the partners, if any.
- Provisions for expulsion of a partner in case of gross breach of duty or fraud.

Note: Ms. Lucy may add or delete any provision according to the needs of the partnership firm.

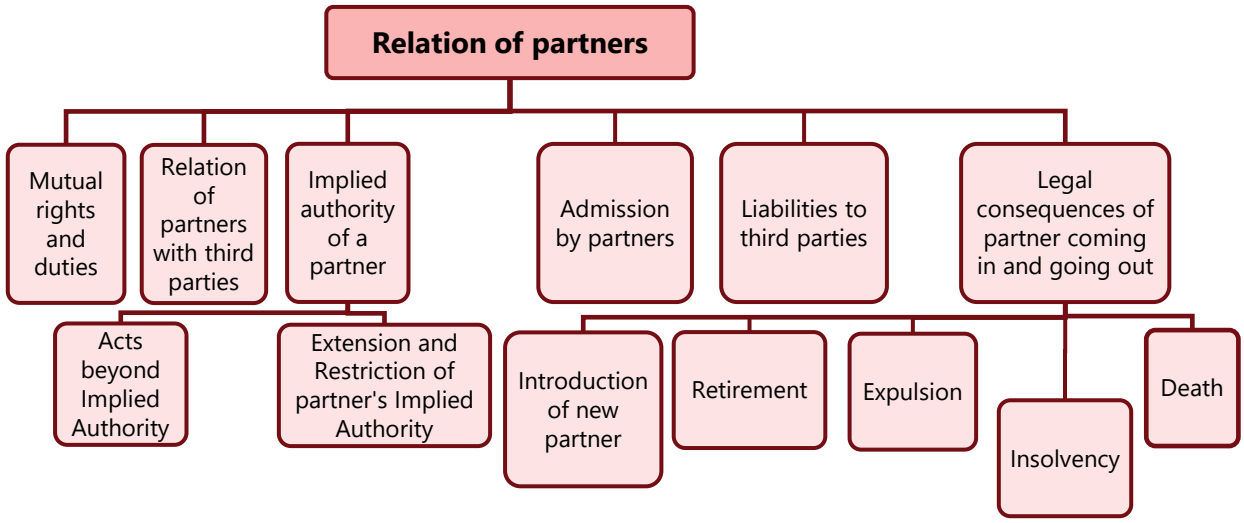
UNIT – 2: RELATIONS OF PARTNERS

LEARNING OUTCOMES

After studying this unit, you would be able to understand-

- The legal provisions regulating relation of partners' interest as well as relations with the third parties.
- The scope of implied authority of a partner to bind the partnership by his acts.
- About the various situations in which the constitution of a firm may change and its effect on the rights and duties of the partners.
- How the share in a partnership is transferred and what shall be the rights and obligations of such transferee.

UNIT OVERVIEW



2.1 RELATION OF PARTNERS TO ONE ANOTHER

The Partnership Act contains various provisions regulating the relationship between partners.

1. **GENERAL DUTIES OF PARTNERS (SECTION 9):** The partners should carry business of the firm to the greatest common advantages and later, they should render to any partner or his legal representatives full information of all things affecting the firm. A partner must observe the utmost good faith in his dealings with the other partners.

   All the partners are bound to render accounts to each other but where some of the accounts are kept by one of them, prima facie he would be the proper person to explain and give full information about them.

   Example 1: In a transaction between partners for the sale and purchase of a share in the business, if one of them is better acquainted with the accounts than the other, it is his duty to disclose all material facts.

2. **DUTY TO INDEMNIFY FOR LOSS CAUSED BY FRAUD (SECTION 10):** The partner, committing fraud in the conduct of the business of the firm, must make good the loss sustained by the firm by his misconduct and the amount so brought in the partnership should be divided between the partners.

   An act of a partner imputable to the firm or the principles of agency, which is a fraud on his co-partners, entitles the co-partners as between themselves, to throw the whole of the consequences upon him.

3. **DETERMINATION OF RIGHTS AND DUTIES OF PARTNERS BY CONTRACT BETWEEN THE PARTNERS (SECTION 11):**

   (1) Subject to the provisions of this Act, the mutual rights and duties of the partners of a firm may be determined by contract between the partners, and such contract may be express or may be implied by a course of dealing.

   Such contract may be varied by consent of all the partners, and such consent may be express or may be implied by a course of dealing.

   (2) **Agreements in restraint of trade-** Notwithstanding anything contained in section 27 of the Indian Contract Act, 1872, such contracts may provide that a partner shall not carry on any business other than that of the firm while he is a partner.

   Partnership is a relation eminently depending on the consent of the parties, not only for its existence, but for the terms of the agreement in all things consistent with its essential nature and purpose; and an agreement to become partners in the first

instance, or to vary the terms at any time, need not be manifested in any particular form.

4. **THE CONDUCT OF THE BUSINESS (SECTION 12):** Subject to contract between the partners-

(a) every partner has a right to take part in the conduct of the business;

(b) every partner is bound to attend diligently to his duties in the conduct of the business;

(c) any difference arising as to ordinary matters connected with the business may be decided by majority of the partners, and every partner shall have the right to express his opinion before the matter is decided, but no change may be made in the nature of the business without the consent of all partners; and

(d) every partner has a right to have access to and to inspect and copy any of the books of the firm.

(e) in the event of the death of a partner, his heirs or legal representatives or their duly authorised agents shall have a right of access to and to inspect the copy of any of the books of the firm.

(i) Right to take part in the conduct of the Business [Section 12(a)]: Every partner has the right to take part in the business of the firm. This is because partnership business is a business of the partners and their management powers are generally co-extensive.

Example 2: Now suppose this management power of the particular partner is interfered with and he has been wrongfully precluded from participating therein. Can the Court interfere in these circumstances? The answer is in the affirmative. The Court can, and will, by injunction, restrain other partners from doing so. It may be noted in this connection that a partner who has been wrongfully deprived of the right of participation in the management has also other remedies, e.g., a suit for dissolution, a suit for accounts without seeking dissolution, etc.

The above mentioned provisions of law will be applicable only if there is no contract to the contrary between the partners. It is quite common to find a term in partnership agreements, which gives only limited power of management to a partner or a term that the management of the partnership will remain with one or more of the partners to the exclusion of others. In such a case, the Court will normally be unwilling to interpose with the management with such partner

or partners, unless it is clearly made out that something was done illegally or in breach of the trust reposed in such partners.

(ii) **Right to be consulted [section 12(c)]:** Where any difference arises between the partners with regard to the business of the firm, it shall be determined by the views of the majority of them, and every partner shall have the right to express his opinion before the matter is decided. But no change in the nature of the business of the firm can be made without the consent of all the partners. This means that in routine matters, the opinion of the majority of the partners will prevail. Of course, the majority must act in good faith and every partner must be consulted as far as practicable.

It may be mentioned that the aforesaid majority rule will not apply where there is a change in the nature of the firm itself. In such a case, the unanimous consent of the partners is needed.

(iii) **Right of access to books [Section 12(d)]:** Every partner whether active or sleeping is entitled to have access to any of the books of the firm and to inspect and take out of copy thereof. The right must, however, be exercised *bona fide*.

(iv) **Right of legal heirs/ representatives/ their duly authorised agents [Section 12(e)]:** In the event of the death of a partner, his heirs or legal representatives or their duly authorised agents shall have a right of access to and to inspect and copy any of the books of the firm.

5. **MUTUAL RIGHTS AND LIABILITIES (SECTION 13):** Subject to contract between the partners-

(a) a partner is not entitled to receive remuneration for taking part in the conduct of the business;

(b) the partners are entitled to share equally in the profits earned, and shall contribute equally to the losses sustained by the firm;

(c) where a partner is entitled to interest on the capital subscribed by him such interest shall be payable only out of profits;

(d) a partner making, for the purposes of the business, any payment or advance beyond the amount of capital he has agreed to subscribe, is entitled to interest thereon at the rate of six percent per annum;

(e) the firm shall indemnify a partner in respect of payments made and liabilities incurred by him-

(i) in the ordinary and proper conduct of the business, and

(ii) in doing such act, in an emergency, for the purposes of protecting the firm from loss, as would be done by a person of ordinary prudence, in his own case, under similar circumstances;

(f) a partner shall indemnify the firm for any loss caused to it by his wilful neglect in the conduct of business of the firm.

(i) Right to remuneration [Section 13(a)]: No partner is entitled to receive any remuneration in addition to his share in the profits of the firm for taking part in the business of the firm. But this rule can always be varied by an express agreement, or by a course of dealings, in which event the partner will be entitled to remuneration. Thus, a partner can claim remuneration even in the absence of a contract, when such remuneration is payable under the continued usage of the firm. In other words, where it is customary to pay remuneration to a partner for conducting the business of the firm, he can claim it even in the absence of a contract for the payment of the same.

(ii) Right to share Profits [Section 13(b)]: Partners are entitled to share equally in the profits earned and so contribute equally to the losses sustained by the firm. The amount of a partner's share must be ascertained by enquiring whether there is any agreement in that behalf between the partners. If there is no agreement then you should make a presumption of equality and the burden of proving that the shares are unequal, will lie on the party alleging the same.

There is no connection between the proportion in which the partners shall share the profits and the proportion in which they have contributed towards the capital of the firm.

(iii) Interest on Capital [Section 13(c)]: The following elements must be there before a partner can be entitled to interest on moneys brought by him in the partnership business: (i) an express agreement to that effect, or practice of the particular partnership or (ii) any trade custom to that effect; or (iii) a statutory provision which entitles him to such interest.

(iv) Interest on advances [Section 13(d)]: Suppose a partner makes an advance to the firm in addition to the amount of capital to be contributed by him, in such a case, the partner is entitled to claim interest thereon @ 6% per annum. While interest on capital account ceases to run on dissolution, the interest on advances keep running even after dissolution and up to the date of payment.

(v) Right to be indemnified [Section 13(e)]: Every partner has the right to be indemnified by the firm in respect of payments made and liabilities incurred by him in the ordinary and proper conduct of the business of the firm as well as in

the performance of an act in an emergency for protecting the firm from any loss, if the payments, liability and act are such as a prudent man would make, incur or perform in his own case, under similar circumstances.

(vi) **Right to indemnify the firm [Section 13(f)]:** A partner must indemnify the firm for any loss caused to it by wilful neglect in the conduct of the business of the firm.

2.2 PARTNERSHIP PROPERTY (SECTION 14)

1. **THE PROPERTY OF THE FIRM (SECTION 14):** The expression 'property of the firm', also referred to as 'partnership property', 'partnership assets', 'joint stock', 'common stock' or 'joint estate', denotes all property, rights and interests to which the firm, that is, all partners collectively, may be entitled. The property which is deemed as belonging to the firm, in the absence of any agreement between the partners showing contrary intention, is comprised of the following items:

(i) all property, rights and interests which partners may have brought into the common stock as their contribution to the common business;

(ii) all the property, rights and interest acquired or purchased by or for the firm, or for the purposes and in the course of the business of the firm; and

(iii) Goodwill of the business.

The determination of the question whether a particular property is or is not 'property' of the firm ultimately depends on the real intention or agreement of the partners. Thus, the mere fact that the property of a partner is being used for the purposes of the firm shall not by itself make it partnership property, unless it is intended to be treated as such. Partners may, by an agreement at any time, convert the property of any partner or partners (and such conversion, if made in good faith, would be effectual between the partners and against the creditors of the firm) or the separate property of any partner into a partnership property.

Goodwill: Section 14 specifically lays down that the goodwill of a business is subject to a contract between the partners, to be regarded as 'property' of the 'firm'. But this Section does not define the term Goodwill.

'Goodwill' is a concept which is very easy to understand but difficult to define. Goodwill may be defined as the value of the reputation of a business house in respect of profits expected in future over and above the normal level of profits earned by undertaking belonging to the same class of business.

When a partnership firm is dissolved every partner has a right, in the absence of any agreement to the contrary, to have the goodwill of business sold for the benefit of all the partners.

Goodwill is a part of the property of the firm. It can be sold separately or along with the other properties of the firm. Any partner may upon the sale of the goodwill of a firm, make an agreement with the buyer that such partner will not carry on any business similar to that of the firm within a specified period or within specified local limits and notwithstanding anything contained in Section 27 of the Indian Contract Act, 1872. Such agreement shall be valid if the restrictions imposed are reasonable.

Property of a partner: Where the property is exclusively belonging to a person, it does not become a property of the partnership merely because it is used for the business of the partnership, such property will become property of the partnership if there is an agreement.

2. **APPLICATION OF THE PROPERTY OF THE FIRM (SECTION 15):** Section 15 provides that the property of the firm shall be held and used exclusively for the purpose of the firm. In partnership, there is a community of interest which all the partners take in the property of the firm. But that does not mean than during the subsistence of the partnership, a particular partner has any proprietary interest in the assets of the firm. Every partner of the firm has a right to get his share of profits till the firm subsists and he has also a right to see that all the assets of the partnership are applied to and used for the purpose of partnership business.

2.3 PERSONAL PROFIT EARNED BY PARTNERS (SECTION 16)

According to section 16, subject to contract between the partners,-

(a) If a partner derives any profit for himself from any transaction of the firm, or from the use of the property or business connection of the firm or the firm name, he shall account for that profit and pay it to the firm;

(b) If a partner carries on any business of the same nature as and competing with that of the firm, he shall account for and pay to the firm all profits made by him in that business.

Example 3: A, B, C & D established partnership business for refining sugar. A, who was himself a wholesale grocer, was entrusted with the work of selection and purchase of sugar. As a wholesale grocer, A was well aware of the variations in the sugar market and had the suitable sense of propriety as regards purchases of sugar. He had already in stock sugar purchased at

a low price which he sold to the firm when it was in need of some, without informing the partners that the sugar sold had belonged to him. It was held that A was bound to account to the firm for the profit so made by him. This rule, however, is subject to a contract between partners.

Example 4: A, B, C and D started a business in partnership for importing salt from foreign ports and selling it at Chittagong. A struck certain transactions in salt on his own account, which were found to be of the same nature as the business carried on by the partnership. It was held that A was liable to account to the firm for profits of the business so made by him. This rule is also subject to a contract between the partners.

2.4 RIGHTS AND DUTIES OF PARTNERS AFTER A CHANGE IN THE FIRM (SECTION 17)

Before going into rights and duties, we should first know how a change may take place in the constitution of the firm. It may occur in one of the four ways, namely,

- Where a new partner or partners come in
- Where some partner or partners go out, i.e., by death or retirement
- Where the partnership concerned carries on business other than the business for which it was originally formed
- Where the partnership business is carried out on after the expiry of the term fixed for the purpose.

According to section 17, subject to contract between the partners-

(a) **after a change in the firm:** Where a change occurs in the constitution of a firm, the mutual rights and duties of the partners in the reconstituted firm remain the same as they were immediately before the change, as far as may be;

(b) **after the expiry of the term of the firm:** Where a firm constituted for a fixed term continues to carry on business after the expiry of that term, the mutual rights and duties of the partners remain the same as they were before the expiry, so far as they may be consistent with the incidents of partnership at will; and

(c) **where additional undertakings are carried out:** where a firm constituted to carry out one or more adventures or undertakings carries out other adventures or undertakings are the same as those in respect of the original adventures or undertakings.

2.5 RELATION OF PARTNERS TO THIRD PARTIES

1. **PARTNER TO BE AN AGENT OF THE FIRM (SECTION 18):** You may recall that a partnership is the relationship between the partners who have agreed to share the profits of the business carried on by all or any of them acting for all (Section 4). This definition suggests that any of the partners can be the agent of the others.

   Section 18 clarifies this position by providing that, subject to the provisions of the Act, a partner is the agent of the firm for the purpose of the business of the firm. The partner indeed virtually embraces the character of both a principal and an agent. So as far as he acts for himself and in his own interest in the common concern of the partnership, he may properly be deemed a principal and so far as he acts for his partners, he may properly be deemed as an agent.

   The principal distinction between him and a mere agent is that he has a community of interest with other partners in the whole property and business and liabilities of partnership, whereas an agent as such has no interest in either.

   The rule that a partner is the agent of the firm for the purpose of the business of the firm cannot be applied to all transactions and dealings between the partners themselves. It is applicable only to the act done by partners for the purpose of the business of the firm.

2. **IMPLIED AUTHORITY OF PARTNER AS AGENT OF THE FIRM (SECTION 19):** Subject to the provisions of section 22, the act of a partner which is done to carry on, in the usual way, business of the kind carried on by the firm, binds the firm.

   The authority of a partner to bind the firm conferred by this section is called his "implied authority".

   (2) In the absence of any usage or custom of trade to the contrary, the implied authority of a partner does not empower him to-

   (a) Submit a dispute relating to the business of the firm to arbitration;

   (b) open a banking account on behalf of the firm in his own name;

   (c) compromise or relinquish any claim or portion of a claim by the firm;

   (d) withdraw a suit or proceedings filed on behalf of the firm;

   (e) admit any liability in a suit or proceedings against the firm;

(f) acquire immovable property on behalf of the firm;

(g) transfer immovable property belonging to the firm; and

(h) enter into partnership on behalf of the firm.

MODE OF DOING ACT TO BIND FIRM (SECTION 22): In order to bind a firm, an act or instrument done or executed by a partner or other person on behalf of the firm shall be done or executed in the firm name, or in any other manner expressing or implying an intention to bind the firm.

At the very outset, you should understand what is meant by "implied authority". You have just read that every partner is an agent of the firm for the purpose of the business thereof. Consequently, as between the partners and the outside world (whatever may be their private arrangements between themselves), each partner is agent of every other in every matter connected with the partnership business; his acts bind the firm.

Sections 19(1) and 22 deal with the implied authority of a partner. The impact of these Sections is that the act of a partner which is done to carry on, in the usual way, business of the kind carried on by the firm binds the firm, provided that the act is done in the firm name, or any manner expressing or implying an intention to bind the firm. Such an authority of a partner to bind the firm is called his implied authority. It is however subject to the following restrictions:

1. The act done must relate to the usual business of the firm, that is, the act done by the partner must be within the scope of his authority and related to the normal business of the firm.

2. The act is such as is done for normal conduct of business of the firm. The usual way of carrying on the business will depend on the nature and circumstances of each particular case [Section 19(1)].

3. The act to be done in the name of the firm or in any other manner expressing or implying an intention to bind the firm (Section 22).

   Thus, a partner has implied authority to bind the firm by all acts done by him in all matters connected with the partnership business and which are done in the usual way and are not in their nature beyond the scope of partnership. You must remember that an implied authority of a partner may differ in different kinds of business.

Example 5: X, a partner in a firm of solicitors, borrows money and executes a promissory note in the name of firm without authority. The other partners are not liable on the note, as it is not part of the ordinary business of a solicitor to draw, accept, or

endorse negotiable instruments; however, it may be usual for one partner of firm of bankers to draw, accept or endorse a bill of exchange on behalf of the firm.

If partnership be of a general commercial nature,

(i) he may pledge or sell the partnership property;

(ii) he may buy goods on account of the partnership;

(iii) he may borrow money, contract debts and pay debts on account of the partnership;

(iv) he may draw, make, sign, endorse, transfer, negotiate and procure to be discounted, Promissory notes, bills of exchange, cheques and other negotiable papers in the name and on account of the partnership.

Section 19(2) contains the acts which are beyond the implied authority of the partners.

3. EXTENSION AND RESTRICTION OF PARTNERS' IMPLIED AUTHORITY (SECTION 20):

The implied authority of a partner may be extended or restricted by contract between the partners. Under the following conditions, the restrictions imposed on the implied authority of a partner by agreement shall be effective against a third party:

1. The third party knows about the restrictions, and

2. The third party does not know that he is dealing with a partner in a firm.

Example 6: A, a partner, borrows from B ₹ 1,000 in the name of the firm but in excess of his authority, and utilizes the same in paying off the debts of the firm. Here, the fact that the firm has contracted debts suggests that it is a trading firm, and as such it is within the implied authority of A to borrow money for the business of the firm. This implied authority, as you have noticed, may be restricted by an agreement between him and other partners. Now if B, the lender, is unaware of this restriction imposed on A, the firm will be liable to repay the money to B. On the contrary, B's awareness as to this restriction will absolve the firm of its liability to repay the amount to B.

It may be noted that the above-mentioned extension or restriction is only possible with the consent of all the partners. Any one partner, or even a majority of the partners, cannot restrict or extend the implied authority.

4. PARTNER'S AUTHORITY IN AN EMERGENCY (SECTION 21)

According to section 21, a partner has authority, in an emergency, to do all such acts for the purpose of protecting the firm from loss as would be done by a person of ordinary prudence, in his own case, acting under similar circumstances, and such acts bind the firm.

2.6 EFFECT OF ADMISSIONS BY A PARTNER (SECTION 23)

Partners, as agents of each other can make binding admissions but only in relation to partnership transaction and in the ordinary course of business. An admission or representation by a partner will not however, bind the firm if his authority on the point is limited and the other party knows of the restriction. The section speaks of admissions and representations being evidenced against the firm. That is to say, they will affect the firm when tendered by third parties; they may not have the same effect in case of disputes between the partners themselves.

Example 7: X and Y are partners in a firm dealing in spare parts of different brands of motorcycle bikes. Z purchases a spare part for his Yamaha motorcycle after being told by X that the spare part is suitable for his motorcycle. Y is ignorant about this transaction. The spare part proves to be unsuitable for the motorcycle and it is damaged. X and Y both are responsible to Z for his loss.

2.7 EFFECT OF NOTICE TO ACTING PARTNER (SECTION 24)

The notice to a partner, who habitually acts in business of the firm, on matters relating to the affairs of the firm, operates as a notice to the firm except in the case of a fraud on the firm committed by or with the consent of that partner. Thus, the notice to one is equivalent to the notice to the rest of the partners of the firm, just as a notice to an agent is notice to his principal. This notice must be actual and not constructive. It must be received by a working partner and not by a sleeping partner. It must further relate to the firm's business. Only then it would constitute a notice to the firm.

Example 8: P, Q, and R are partners in a business for purchase and sale of second hand goods. R purchases a second hand car on behalf of the firm from S. In the course of dealings with S, he comes to know that the car is a stolen one and it actually belongs to X. P and Q are ignorant about it. All the partners are liable to X, the real owner.

The only exception would lie in the case of fraud, whether active or tacit.

Example 9: A, a partner who actively participates in the management of the business of the firm, bought for his firm, certain goods, while he knew of a particular defect in the goods. His knowledge as regards the defect, *ordinarily,* would be construed as the knowledge of the firm, though the other partners in fact were not aware of the defect. But because A had, in league with his seller, conspired to conceal the defect from the other partners, the rule would be inoperative and the other partners would be entitled to reject the goods, upon detection by them of the defect.

2.8 LIABILITY TO THIRD PARTIES (SECTION 25 TO 27)

The question of liability of partners to third parties may be considered under different heads. These are as follows:

1. **LIABILITY OF A PARTNER FOR ACTS OF THE FIRM (SECTION 25):** The partners are jointly and severally responsible to third parties for all acts which come under the scope of their express or implied authority. This is because that all the acts done within the scope of authority are the acts done towards the business of the firm.

   The expression 'act of firm' connotes any act or omission by all the partners or by any partner or agent of the firm, which gives rise to a right enforceable by or against the firm. Again, in order to bring a case under Section 25, it is necessary that the act of the firm, in respect of which liability is brought to be enforced against a party, must have been done while he was a partner.

   Example 10: Certain persons were found to have been partners in a firm when the acts constituting an infringement of a trademark by the firm took place, it was held that they were liable for damages arising out of the alleged infringement, it being immaterial that the damages arose after the dissolution of the firm.

2. **LIABILITY OF THE FIRM FOR WRONGFUL ACTS OF A PARTNER (SECTION 26):** The firm is liable to the same extent as the partner for any loss or injury caused to a third party by the wrongful acts of a partner, if they are done by the partner while acting:

   (a) in the ordinary course of the business of the firm

   (b) with the authority of the partners.

   If the act in question can be regarded as authorized and as falling within either of the categories mentioned in Section 26, the fact that the method employed by the partner in doing it was unauthorized or wrongful would not affect the question. Furthermore, all the partners in a firm are liable to a third party for loss or injury caused to him by the negligent act of a partner acting in the ordinary course of the business.

   Example 11: One of the two partners in coal mine acted as a manager was guilty of personal negligence in omitting to have the shaft of the mine properly fenced. As a result thereof, an injury was caused to a workman. The other partner was also held responsible for the same.

3. **LIABILITY OF FIRM FOR MISAPPLICATION BY PARTNERS (SECTION 27):**

   It may be observed that the workings of the two clauses of Section 27 is designed to bring out clearly an important point of distinction between the two categories of cases of misapplication of money by partners.

Clause (a) covers the case where a partner acts within his authority and due to his authority as partner, he receives money or property belonging to a third party and misapplies that money or property. For this provision to the attracted, it is not necessary that the money should have actually come into the custody of the firm.

On the other hand, the provision of clause (b) would be attracted when such money or property has come into the custody of the firm and it is misapplied by any of the partners.

The firm would be liable in both the cases.

If receipt of money by one partner is not within the scope of his apparent authority, his receipt cannot be regarded as a receipt by the firm and the other partners will not be liable, unless the money received comes into their possession or under their control.

Example 12: A, B, and C are partners of a place for car parking. P stands his car in the parking place but A sold out the car to a stranger. For this liability, the firm is liable for the acts of A.

2.9 RIGHTS OF TRANSFEREE OF A PARTNER'S INTEREST (SECTION 29)

A share in a partnership is transferable like any other property, but as the partnership relationship is based on mutual confidence, the assignee of a partner's interest by sale, mortgage or otherwise cannot enjoy the same rights and privileges as the original partner.

The rights of such a transferee are as follows:

(I) During the continuance of partnership, such transferee is not entitled:

(a) to interfere with the conduct of the business,

(b) to require accounts, or

(c) to inspect books of the firm.

He is only entitled to receive the share of the profits of the transferring partner and he is bound to accept the profits as agreed to by the partners, i.e., he cannot challenge the accounts.

(II) On the dissolution of the firm or on the retirement of the transferring partner, the transferee will be entitled, against the remaining partners:

(a) to receive the share of the assets of the firm to which the transferring partner was entitled, and

(b) for the purpose of ascertaining the share,

he is entitled to an account as from the date of the dissolution.

By virtue of Section 31, which we will discuss hereinafter, no person can be introduced as a partner in a firm without the consent of all the partners. A partner cannot by transferring his own interest, make anybody else a partner in his place, unless the other partners agree to accept that person as a partner. At the same time, a partner is not debarred from transferring his interest. A partner's interest in the partnership can be regarded as an existing interest and tangible property which can be assigned.

2.10 MINORS ADMITTED TO THE BENEFITS OF PARTNERSHIP (SECTION 30)

You have observed that a minor cannot be bound by a contract because a minor's contract is void and not merely voidable. Therefore, a minor cannot become a partner in a firm because partnership is founded on a contract. Though a minor cannot be a partner in a firm, he can nonetheless be admitted to the benefits of partnership under Section 30 of the Act. In other words, he can be validly given a share in the partnership profits. When this has been done with the consent of all the partners then the rights and liabilities of such a partner will be governed under Section 30 as follows:

(1) Rights:

(i) A minor partner has a right to his agreed share of the profits and of the firm.

(ii) He can have access to, inspect and copy the accounts of the firm.

(iii) He can sue the partners for accounts or for payment of his share but only when severing his connection with the firm, and not otherwise.

(iv) On attaining majority, he may within 6 months elect to become a partner or not to become a partner. If he elects to become a partner, then he is entitled to the share to which he was entitled as a minor. If he does not, then his share is not liable for any acts of the firm after the date of the public notice served to that effect.

(2) Liabilities:

(i) Before attaining majority:

(a) The liability of the minor is confined only to the extent of his share in the profits and the property of the firm.

(b) Minor has no personal liability for the debts of the firm incurred during his minority.

(c) Minor cannot be declared insolvent, but if the firm is declared insolvent his share in the firm vests in the Official Receiver/Assignee (which means minor can recover his share in the firm on proportionate basis from official receiver/assignee)

(ii) After attaining majority:

Within 6 months of his attaining majority or on his obtaining knowledge that he had been admitted to the benefits of partnership, whichever date is later, the minor partner has to decide whether he shall remain a partner or leave the firm.

Where he has elected not to become partner, he may give public notice that he has elected not to become partner and such notice shall determine his position with regard to the firm If he fails to give such notice he shall become a partner in the firm on the expiry of the said six months.

(a) When he becomes partner: If the minor becomes a partner on his own willingness or by his failure to give the public notice within specified time, his rights and liabilities as given in Section 30(7) are as follows:

(i) He becomes personally liable to third parties for all acts of the firm done since he was admitted to the benefits of partnership.

(ii) His share in the property and the profits of the firm remains the same to which he was entitled as a minor.

(b) When he elects not to become a partner:

(i) His rights and liabilities continue to be those of a minor up to the date of giving public notice.

(ii) His share shall not be liable for any acts of the firm done after the date of the notice.

(iii) He shall be entitled to sue the partners for his share of the property and profits. It may be noted that such minor shall give notice to the Registrar that he has or has not become a partner.

2.11 LEGAL CONSEQUENCES OF PARTNER COMING IN AND GOING OUT (SECTION 31 – 35)

Any change in the relation of partners will result in reconstitution of the partnership firm. Thus, on admission of a new partner or retirement of a partner or expulsion of the partner, or on insolvency of a partner etc. a firm will be reconstituted:

(i) INTRODUCTION OF A PARTNER (SECTION 31):

As we have studied earlier, subject to a contract between partners and to the provisions regarding minors in a firm, no new partners can be introduced into a firm without the consent of all the existing partners.

Rights and liabilities of new partner: The liabilities of the new partner ordinarily commence from the date when he is admitted as a partner, unless he agrees to be liable for obligations incurred by the firm prior to the date. The new firm, including the new partner who joins it, may agree to assume liability for the existing debts of the old firm, and creditors may agree to accept the new firm as their debtor and discharge the old partners. The creditor's consent is necessary in every case to make the transaction operative. Novation is the technical term in a contract for substituted liability, of course, not confined only to case of partnership.

But a mere agreement amongst partners cannot operate as Novation. Thus, an agreement between the partners and the incoming partner that he shall be liable for existing debts will not ipso facto give creditors of the firm any right against him.

In case of partnership of two partners: This section does not apply to a partnership of two partners which is automatically dissolved by the death of one of them.

(ii) RETIREMENT OF A PARTNER (SECTION 32):

(1) A partner may retire:

(a) with the consent of all the other partners;

(b) in accordance with an express agreement by the partners; or

(c) where the partnership is at will, by giving notice in writing to all the other partners of his intention to retire.

(2) A retiring partner may be discharged from any liability to any third party for acts of the firm done before his retirement by an agreement made by him with such third party and the partners of the reconstituted firm, and such agreement may be implied by a course of dealing between the third party and the reconstituted firm after he had knowledge of the retirement.

(3) Notwithstanding the retirement of a partner from a firm, he and the partners continue to be liable as partners to third parties for any act done by any of them which would have been an act of the firm if done before the retirement, until public notice is given of the retirement:

Provided that a retired partner is not liable to any third party who deals with the firm without knowing that he was a partner.

(4) Notices under sub-section (3) may be given by the retired partner or by any partner of the reconstituted firm.

In Vishnu Chandra Vs. Chandrika Prasad [Supreme Court]

The Supreme Court in *Vishnu Chandra Vs. Chandrika Prasad*, held that the expression 'if any partner wants to dissociate from the partnership business', in a clause of the partnership deed which was being construed, comprehends a situation where a partner wants to retire from the partnership. The expression clearly indicated that in the event of retirement, the partnership business will not come to an end.

Example 13: Mere retirement of a partner, who was the tenant of the premises in which the partnership business was carried out, would not result in assignment of the tenancy rights in favour of the remaining partners even though the retiring partner ceases to have any right, title or interest in the business as such.

(iii) EXPULSION OF A PARTNER (SECTION 33):

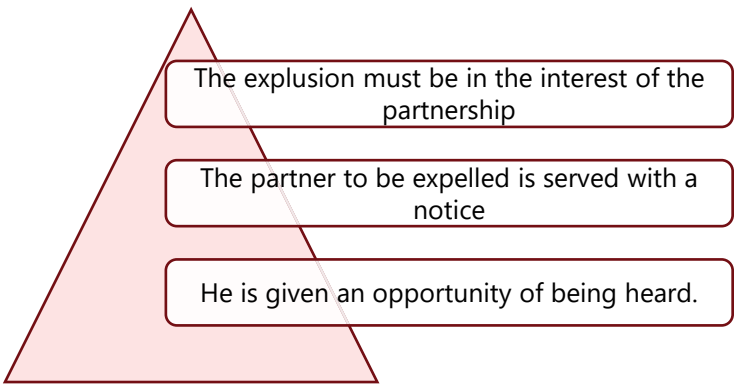
(i) the power of expulsion must have existed in a contract between the partners;

(ii) the power has been exercised by a majority of the partners; and

(iii) it has been exercised in good faith.

If all these conditions are not present, the expulsion is not deemed to be in bona fide interest of the business of the firm.

The test of good faith as required under Section 33(1) includes three things:



If a partner is otherwise expelled, the expulsion is null and void.

It may be noted that under the Act, the expulsion of partners does not necessarily result in dissolution of the firm. The invalid expulsion of a partner does not put an end to the partnership even if the partnership is at will and it will be deemed to continue as before.

Example 14: A, B and C are partners in a Partnership firm. They were carrying their business successfully for the past several years. Spouses of A and B fought in ladies club on their personal issue and A's wife was hurt badly. A got angry on the incident and he convinced C to expel B from their partnership firm. B was expelled from partnership without any notice from A and C. Considering the provisions of Indian Partnership Act, 1932 state whether they can expel a partner from the firm?

A partner may not be expelled from a firm by a majority of partners except in exercise, in good faith, of powers conferred by contract between the partners. It is, thus, essential that:

(i) the power of expulsion must have existed in a contract between the partners;

(ii) the power has been exercised by a majority of the partners; and

(iii) it has been exercised in good faith.

If all these conditions are not present, the expulsion is not deemed to be in bonafide interest of the business of the firm.

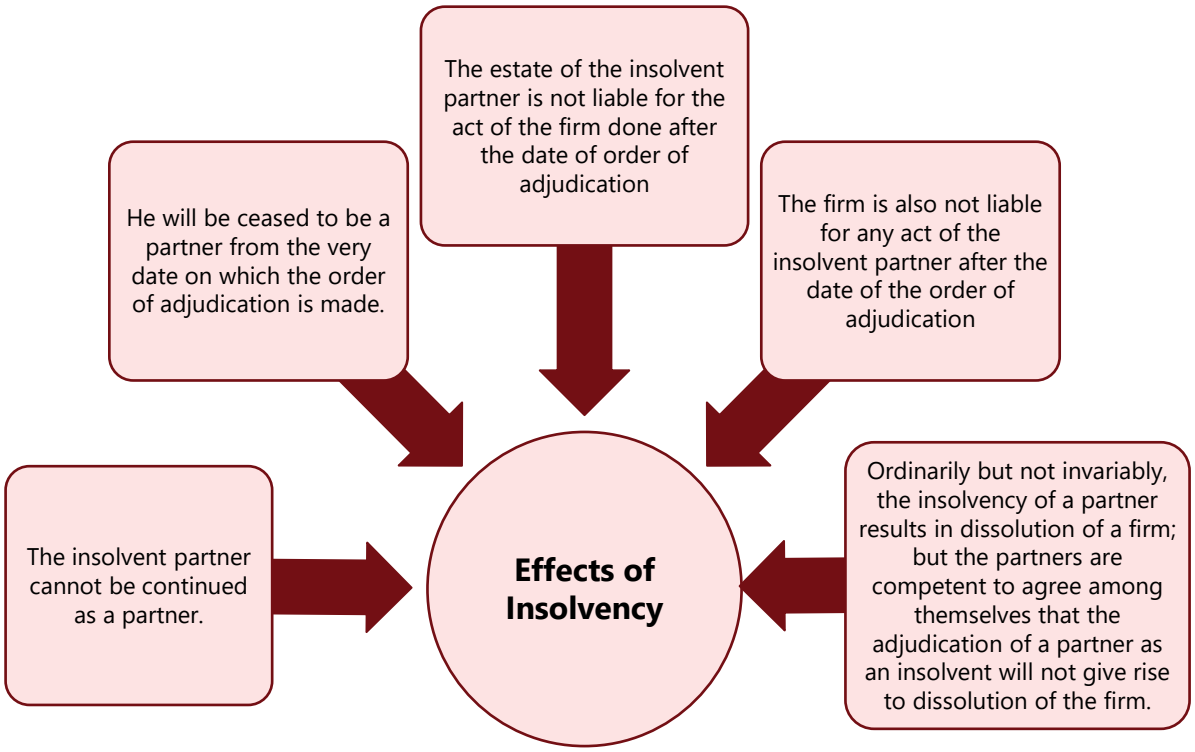
Thus, according to the test of good faith as required under Section 33(1), expulsion of Partner B is not valid.

In this context, you should also remember that provisions of Sections 32 (2), (3) and (4) which we have just discussed, will be equally applicable to an expelled partner as if he was a retired partner.

(iv) INSOLVENCY OF A PARTNER (SECTION 34):

(1) Where a partner in a firm is adjudicated as an insolvent he ceases to be a partner on the date on which the order of adjudication is made, whether or not the firm is hereby dissolved.

(2) Where under a contract between the partners the firm is not dissolved by the adjudication of a partner as an insolvent, the estate of a partner so adjudicated is not liable for any act of the firm and the firm is not liable for any act of the insolvent, done after the date on which the order of adjudication is made.



(v) LIABILITY OF ESTATE OF DECEASED PARTNER (SECTION 35):

Ordinarily, the effect of the death of a partner is the dissolution of the partnership, but the rule in regard to the dissolution of the partnership, by death of partner is subject to a contract between the parties and the partners are competent to agree that the death of one will not have the effect of dissolving the partnership as regards the surviving partners unless the firm consists of only two partners. In order that the estate of the deceased partner may be absolved from liability for the future obligations of the firm, it is not necessary to give any notice either to the public or the persons having dealings with the firm.

Example 15: X was a partner in a firm. The firm ordered goods in X's lifetime; but the delivery of the goods was made after X's death. In such a case, X's estate would not be liable for the debt; a creditor can have only a personal decree against the surviving partners and a decree against the partnership assets in the hands of those partners. A suit for goods sold and delivered would not lie against the representatives of the deceased partner. This is because there was no debt due in respect of the goods in X's lifetime.

2.12 RIGHTS OF OUTGOING PARTNER TO CARRY ON COMPETING BUSINESS (SECTION 36)

An outgoing partner may carry on business competing with that of the firm and he may advertise such business, but subject to contract to the contrary, he may not,-

(a) use the firm name,

(b) represent himself as carrying on the business of the firm or

(c) solicit the custom of persons who were dealing with the firm before he ceased to be a partner.

Agreement in restraint of trade- A partner may make an agreement with his partners that on ceasing to be a partner he will not carry on any business similar to that of the firm within a specified period or within specified local limits and, notwithstanding anything contained in section 27 of the Indian Contract Act, 1872, such agreement shall be valid if the restrictions imposed are reasonable.

2.13 RIGHT OF OUTGOING PARTNER IN CERTAIN CASES TO SHARE SUBSEQUENT PROFITS (SECTION 37)

According to section 37, Where any member of a firm has died or otherwise ceased to be partner, and the surviving or continuing partners carry on the business of the firm with the property of the firm without any final settlement of accounts as between them and the outgoing partner or his estate, then, in the absence of a contract to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm or to interest at the rate of six per cent per annum on the amount of his share in the property of the firm:

Provided that whereby contract between the partners, an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and that option is duly exercised, the estate of the deceased partner, or the outgoing partner or his estate, as the case may be, is not entitled to any further or other share of profits; but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section.

Example 16: A, B and C are partners in a manufacture of machinery. A is entitled to three-eighths of the partnership property and profits. A becomes bankrupt whereas B and C continue the business without paying out A's share of the partnership assets or settling accounts with his estate. A's estate is entitled to three-eighths of the profits made in the business, from the date of his bankruptcy until the final liquidation of the partnership affairs.

Example 17: A, B and C are partners. C retires after selling his share in the partnership firm. A and B fail to pay the value of the share to C as agreed to. The value of the share of C on the date of his retirement from the firm would be pure debt from the date on which he ceased to be a partner as per the agreement entered between the parties. C is entitled to recover the same with interest.

2.14 REVOCATION OF CONTINUING GUARANTEE BY CHANGE IN FIRM (SECTION 38)

According to section 38, a continuing guarantee given to a firm or to third party in respect of the transaction of a firm is, in the absence of an agreement to the contrary, revoked as to future transactions from the date of any change in the constitution of the firm.

SUMMARY

The mutual rights and duties of partners are regulated by the contract between them. Such contract need not always be expressed, it may be implied from the course of dealing between the partners (Section 11). Section 12 gives rules regulating the conduct of the business by the partners and Section 13 lay down rules of mutual rights and liabilities. Sections 14 to 17 also contain particular rules which become useful and important while determining the relations of partners to one - another. What is essential to note, however, is that all these rules are subject to contract between the parties.

As regards third parties, a partner is the agent of the firm for all purposes within the scope of the partnership concern. His rights, powers, duties and obligations are in many respects governed by the same rules and principles which apply to the agent. Generally, he may pledge or sell the partnership property; he may buy goods on account of the firm; he may borrow money, contract debt and pay debts on account of the firm; he may draw, make, sign, endorse, accept, transfer, negotiate and get discounted promissory notes, bills of exchange, cheques and other negotiable papers in the name and account of the firm. The implied authority of the partner to bind the firm is restricted to acts usually done in the business of the kind carried on by the firm. He is also empowered under the Act to do certain acts in an emergency so as to bind the firm. The firm, however, is bound only by those acts of a partner which were done by him in his capacity as a partner.

A partner may in some circumstances become liable on equitable grounds for obligations incurred by a co-partner in doing acts in excess of his authority, real or implied. He may also become liable for an unauthorized act of his co-partner on the ground of estoppel.

PARTNERS RIGHTS/DUTIES/LIABILITIES

Rights of a Partner

1. Take part in the conduct of business.
2. Express his opinion.
3. Access to and inspect and copy any of the books.
4. Share profits & property.
5. Interest on capital.
6. Interest on advance.
7. To be indemnified.
8. Not to be expelled unless majority partners agree and provision to that effect exists in agreement.
9. Resist the introduction of a new partner.
10. Right to retire.
11. Right of outgoing partner to carry on a competing business.
12. Right of outgoing partner to share subsequent profits.
13. Right to dissolve the firm.

Acts within implied authority of Partner

1. Purchase goods.
2. Sell the goods.
3. Settle accounts.
4. Receive payment of firm.
5. Engage servants for firm.
6. Engage a lawyer to defend an action brought against the firm.
7. Borrow money for firm's business.
8. Pledge the goods of the firm as security for the repayment of borrowings made for firm's business.
9. Draw, accept, and endorse bill of exchange and other negotiable instruments in the name of the firm.

Acts beyond implied authority of Partner

1. Submit a dispute to arbitration.
2. Opening a bank account.
3. Compromising or relinquishing any claim.
4. Withdrawal a suit or proceeding.
5. Admit any liability in a suit or proceeding.
6. Acquire immovable property.
7. Transfer immovable property.
8. Enter into partnership on behalf of the firm.

Note : The firm is not liable to third party for the above restricted acts of a partner whether or not the person dealing with the firm know about such restrictions.

Duties of a Partner

1. Carry on the business of the firm.
2. To be just and faithful to each other.
3. To render true accounts and full information.
4. To attend diligently to his duties without any remuneration.
5. Not to carry on any business other than that of the firm while he is a partner, if restrained by an agreement with other partners.
6. If a partner carries on any business competing with that of the firm, he shall account for and pay to the firm all profits made by him in that business.
7. To account for any secret profit, from the firm.
8. Not to assign his share.
9. To contribute equally to the losses of the firm.
10. To indemnify the firm for loss caused by his willful neglect or fraud.

MINOR AS A PARTNER: SEC. 30

♦ Cannot be partner but enter into partnership with consent of all partners for the benefits only. ♦ Agreement with or by a minor is void *ab-initio*. ♦ Right to receive his agreed share of property and of the profits of the firm. ♦ No personal liability.	♦ Right to have access, inspect and to take copies of the books of accounts of the firm. ♦ Not entitled to take part in the day to day affairs of the firm. ♦ Right to bring a suit against the partners for an account or payment of his share of property or profits of the firm.	♦ On attaining majority, he can decide, within 6 months, whether he would continue or not and give public notice of his decision. Otherwise, he will be liable for debts with retrospective effect. ♦ His share in the property and profits of the firm shall be liable if he chooses to be a partner ♦ His share of profits shall remain the same.

RECONSTITUTION OF FIRM

Introduction of a partner (Sec. 31)

Admission of a new partner, either-
- with the consent of all existing partners, or
- as per partnership deed.

The liability of a new partner from the date of joining unless otherwise agreed.

Liability for the acts of the old firm only if:
- the new firm assumes the liabilities of the old firm, and
- the creditors accept the new firm as their debtor.

Note: A minor who, on attaining majority decides to become a partner is liable for all acts of the firm done since he was admitted to benefits of partnership.

Retirement of a Partner (Sec. 32)

Retirement of the partner, either-
- with the consent of all existing partners, or
- as per partnership deed or
- where the partnership is at will, by giving notice in writing to all the other partners.

Liability of the retiring partner

A retiring partner continues to be liable as partner after the retirement until public notice is given of the retirement.

Discharge of retiring partner for acts of the firm done before his retirement

1. By an agreement b/w third party and remaining partners.
2. By an implied agreement to above effect. (E.g. Dealing between such third party and the reconstituted firm, after he (the third party) had the knowledge of the retirement.)

Expulsion of a partner (Sec. 33)

Three conditions:

(a) As per contract between the partners &

(b) Majority of the partners &

(c) In good faith.

Otherwise

Partner may claim re-instatement as a partner, **or**

may sue for the refund of his share of capital and profits in the firm.

Rights and Liabilities

Same as that of a retiring partner.

Insolvency of a partner (Sec. 34)

1. The insolvent partner ceases to be a partner on the date on which the order of adjudication is made.
2. The firm is dissolved unless otherwise specifically provided in deed.
3. The estate of the insolvent is not liable for the acts of the firm done after the date of the order of adjudication.
4. The firm is not liable for any act of the insolvent partner after the date of the order of adjudication.
5. No public notice is required on insolvency of partner.

Death of a Partner (Sec. 35)

1. The firm is dissolved unless otherwise specifically provided in deed.
2. The estate of the deceased partner is not liable for any act of the firm done after his death.
3. No public notice is required of the death of a partner.

General Notes

(a) Unless otherwise agreed by partners, a **continuing guarantee** given to third party by the firm is revoked as to the future transactions from the date of any change in the constitution of the firm. (Sec. 38)

(b) The rights and duties of the partners of the reconstituted firm shall be the same as they were before change of the firm. (Sec. 17)

Rights of outgoing partner

To carry on competing business *but* he may not-

(i) use the firm name;

(ii) represent himself as carrying on the business of firm, or

(iii) solicit the customers who were dealing with the firm before he ceased to be a partner. **(Sec. 36)**

If final settlement is pending, legal representatives of the deceased partner or the retiring partner are entitled to any of the following two options:

(a) Share of the profit earned after the death or retirement.

(b) Claim interest at the rate of 6 per cent per annum on the amount of his share in the property. **(Sec. 37)**

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *A partner can be expelled if:*
   - *(a) Such expulsion is in good faith*
   - *(b) The majority of the partner does not agree on such expulsion*
   - *(c) The expelled partner is given an opportunity to start a business competing with that of the firm*
   - *(d) Compensation is paid*
2. *Which of the following is not the right of partner i.e., which he cannot claim as a matter of right?*
   - *(a) Right to take part in business*
   - *(b) Right to have access to account books*
   - *(c) Right to share profits*
   - *(d) Right to receive remuneration.*
3. *Which of the following acts are not included in the implied authority of a partner?*
   - *(a) To buy or sell goods on accounts of partners.*
   - *(b) To borrow money for the purpose of firm.*
   - *(c) To enter into partnership on behalf of firm.*
   - *(d) To engage a lawyer to defend actions against firm.*
4. *The reconstitution of the firm takes place in case of*
   - *(a) Admission of a partner*
   - *(b) Retirement of a partner*
   - *(c) Expulsion or death of a partner*
   - *(d) All of the above*
5. *A new partner can be admitted in the firm with the consent of*
   - *(a) All the partners*
   - *(b) Simple majority of partners*

(c) *Special majority of partners*

(d) *New partner only.*

6. *A partner may be expelled from the firm on the fulfilment of the conditions that the expulsion power is exercised.*

(a) *As given by express contract*

(b) *By majority of partners*

(c) *In absolute good faith*

(d) *All of the above*

7. *A minor is:*

(a) *A partner of a firm*

(b) *Representative of the firm*

(c) *Entitled to carry on the business of the firm*

(d) *Entitled to the benefits of the firm*

8. *If a partner commits fraud in the conduct of the business of the firm:*

(a) *He shall indemnify the firm for any loss caused to it by his fraud*

(b) *He is not liable to the firm.*

(c) *He is liable to the partners*

(d) *He is liable to the third parties*

9. *Partners are bound to carry on the business of the firm-*

(a) *To the greatest common advantage*

(b) *For the welfare of the society*

(c) *For the advantage of the family members*

(d) *For earning personal profits*

10. *The liability of a minor partner is limited to the extent of:*

(a) *His share in the firm*

(b) *His personal assets*

(c) *His share in the firm as well as his personal assets*

(d) *He is not liable*

11. *The authority of a partner to bind the firm for his acts as contained in section 19 of the Partnership Act is known as:*

    (a) Express authority

    (b) Legal authority

    (c) Implied authority

    (d) Managerial authority

12. *Which are the matters that require unanimous consent of all the partners:*

    (a) Admission of a partner

    (b) Transfer by a partner of his interest in the firm

    (c) Fundamental change in the nature of the business

    (d) All of the above

13. *For admitting a minor into the benefits of the partnership, which of the following is required?*

    (a) Consent of the minor's guardian

    (b) Consent of the Registrar of firms

    (c) Consent of all the partners of the firm

    (d) All of the above

14. *The implied authority of a partner of the firm does empower him to:*

    (a) Open a bank account on behalf of the firm in his own name.

    (b) Enter into partnership on behalf of the firm.

    (c) Acquire immovable property on behalf of the firm.

    (d) Act expressing or implying an intention to bind the firm.

15. *In case of transfer of share in a partnership firm by one partner to any third party give such third party entitlement:*

    (a) to interfere with the conduct of the business.

    (b) to require accounts.

    (c) to receive the share of the profits of the transferring partner as agreed by the partners.

    (d) to receive the share of the profits of the transferring partner whether or not agreed by the partners.

Descriptive Questions

1. *State the modes by which a partner may transfer his interest in the firm in favour of another person under the Indian Partnership Act, 1932. What are the rights of such a transferee?*

2. *Whether a minor may be admitted in the business of a partnership firm? Explain the rights of a minor in the partnership firm.*

3. *M/s XYZ & Associates, a partnership firm with X, Y, Z as senior partners were engaged in the business of carpet manufacturing and exporting to foreign countries. On 25th August, 2018, they inducted Mr. G, an expert in the field of carpet manufacturing as their partner. On 10th January 2020, Mr. G was blamed for unauthorized activities and thus expelled from the partnership by united approval of rest of the partners.*

   (i) Examine whether action by the partners was justified or not?

   (ii) What should have the factors to be kept in mind prior expelling a partner from the firm by other partners according to the provisions of the Indian Partnership Act, 1932?

4. *A, B and C are partners in a firm. As per terms of the partnership deed, A is entitled to 20 percent of the partnership property and profits. A retires from the firm and dies after 15 days. B and C continue business of the firm without settling accounts. Explain the rights of A's legal representatives against the firm under the Indian Partnership Act, 1932?*

5. *Master X was introduced to the benefits of partnership of M/s ABC & Co. with the consent of all partners. After attaining majority, more than six months elapsed and he failed to give a public notice as to whether he elected to become or not to become a partner in the firm. Later on, Mr. L, a supplier of material to M/s ABC & Co., filed a suit against M/s ABC & Co. for recovery of the debt due.*

   In the light of the Indian Partnership Act, 1932, explain:

   (i) To what extent X will be liable if he failed to give public notice after attaining majority?

   (ii) Can Mr. L recover his debt from X?

6. *Mr. A (transferor) transfer his share in a partnership firm to Mr. B (transferee). Mr. B is not entitled for few rights and privileges as Mr. A (transferor) is entitled therefor. Discuss in brief the points for which Mr. B is not entitled during continuance of partnership?*

ANSWERS/HINTS

Answers to MCQs

1.	(a)	**2.**	(d)	**3.**	(c)	**4.**	(d)	**5.**	(a)	**6.**	(d)
7.	(d)	**8.**	(a)	**9.**	(a)	**10.**	(a)	**11.**	(c)	**12.**	(d)
13.	(c)	**14.**	(d)	**15.**	(c)						

Answers to the Descriptive Questions

1. Section 29 of the Indian Partnership Act, 1932 provides that a share in a partnership is transferable like any other property, but as the partnership relationship is based on mutual confidence, the assignee of a partner's interest by sale, mortgage or otherwise cannot enjoy the same rights and privileges as the original partner.

The rights of such a transferee are as follows:

(1) During the continuance of partnership, such transferee is not entitled

(a) to interfere with the conduct of the business,

(b) to require accounts, or

(c) to inspect books of the firm.

He is only entitled to receive the share of the profits of the transferring partner and he is bound to accept the profits as agreed to by the partners, i.e., he cannot challenge the accounts.

(2) On the dissolution of the firm or on the retirement of the transferring partner, the transferee will be entitled, against the remaining partners:

(a) to receive the share of the assets of the firm to which the transferring partner was entitled, and

(b) for the purpose of ascertaining the share,

he is entitled to an account as from the date of the dissolution.

By virtue of Section 31, no person can be introduced as a partner in a firm without the consent of all the partners. A partner cannot by transferring his own interest, make anybody else a partner in his place, unless the other partners agree to accept that person as a partner. At the same time, a partner is not debarred from transferring his interest. A partner's interest in the partnership

can be regarded as an existing interest and tangible property which can be assigned.

2. A minor cannot be bound by a contract because a minor's contract is void and not merely voidable. Therefore, a minor cannot become a partner in a firm because partnership is founded on a contract. Though a minor cannot be a partner in a firm, he can nonetheless be admitted to the benefits of partnership under Section 30 of the Act. In other words, he can be validly given a share in the partnership profits. When this has been done and it can be done with the consent of all the partners then the rights and liabilities of such a partner will be governed under Section 30 as follows:

Rights:

(i) A minor partner has a right to his agreed share of the profits and of the firm.

(ii) He can have access to, inspect and copy the accounts of the firm.

(iii) He can sue the partners for accounts or for payment of his share but only when severing his connection with the firm, and not otherwise.

(iv) On attaining majority he may within 6 months elect to become a partner or not to become a partner. If he elects to become a partner, then he is entitled to the share to which he was entitled as a minor. If he does not, then his share is not liable for any acts of the firm after the date of the public notice served to that effect.

3. Expulsion of a Partner (Section 33 of the Indian Partnership Act, 1932):

A partner may not be expelled from a firm by a majority of partners except in exercise, in good faith, of powers conferred by contract between the partners.

The test of good faith as required under Section 33(1) includes three things:

- The expulsion must be in the interest of the partnership.
- The partner to be expelled is served with a notice.
- He is given an opportunity of being heard.

If a partner is otherwise expelled, the expulsion is null and void.

(i) Action by the partners of M/s XYZ & Associates, a partnership firm to expel Mr. G from the partnership was justified as he was expelled by united approval of the partners exercised in good faith to protect the interest of the partnership against the unauthorized activities charged against Mr. G. A proper notice and opportunity of being heard has to be given to Mr. G.

(ii) The following are the factors to be kept in mind prior expelling a partner from the firm by other partners:

(a) the power of expulsion must have existed in a contract between the partners;

(b) the power has been exercised by a majority of the partners; and

(c) it has been exercised in good faith.

4. Section 37 of the Indian Partnership Act, 1932 provides that where a partner dies or otherwise ceases to be a partner and there is no final settlement of account between the legal representatives of the deceased partner or the firms with the property of the firm, then, in the absence of a contract to the contrary, the legal representatives of the deceased partner or the retired partner are entitled to claim either.

(1) Such shares of the profits earned after the death or retirement of the partner which is attributable to the use of his share in the property of the firm; or

(2) Interest at the rate of 6 per cent annum on the amount of his share in the property.

Based on the aforesaid provisions of Section 37 of the Indian Partnership Act, 1932, in the given problem, A's Legal representatives shall be entitled, at their option to:

(a) the 20% shares of profits (as per the partnership deed); or

(b) interest at the rate of 6 per cent per annum on the amount of A's share in the property.

5. As per the provisions of Section 30(5) of the Indian Partnership Act, 1932, at any time within six months of his attaining majority, or of his obtaining knowledge that he had been admitted to the benefits of partnership, whichever date is later, such person may give public notice that he has elected to become or that he has elected not to become a partner in the firm, and such notice shall determine his position as regards the firm.

However, if he fails to give such notice, he shall become a partner in the firm on the expiry of the said six months.

If the minor becomes a partner by his failure to give the public notice within specified time, his rights and liabilities as given in Section 30(7) are as follows:

(A) He becomes personally liable to third parties for all acts of the firm done since he was admitted to the benefits of partnership.

(B) His share in the property and the profits of the firm remains the same to which he was entitled as a minor.

(i) In the instant case, since, X has failed to give a public notice, he shall become a partner in the M/s ABC & Co. and becomes personally liable to Mr. L, a third party.

(ii) In the light of the provisions of Section 30(7) read with Section 30(5) of the Indian Partnership Act, 1932, since X has failed to give public notice that he has not elected to not to become a partner within six months, he will be deemed to be a partner after the period of the above six months and therefore, Mr. L can recover his debt from him also in the same way as he can recover from any other partner.

6. As per Section 29 of Indian Partnership Act, 1932, a transfer by a partner of his interest in the firm, either absolute or by mortgage, or by the creation by him of a charge on such interest, does not entitle the transferee, during the continuance of the firm, to interfere in the conduct of business, or to require accounts, or to inspect the books of the firm, but entitles the transferee only to receive the share of profits of the transferring partner, and the transferee shall accept the account of profits agreed to by the partners.

In the given case during the continuance of partnership, such transferee Mr. B is not entitled:

- to interfere with the conduct of the business.
- to require accounts.
- to inspect books of the firm.

However, Mr. B is only entitled to receive the share of the profits of the transferring partner and he is bound to accept the profits as agreed to by the partners, i.e. he cannot challenge the accounts.

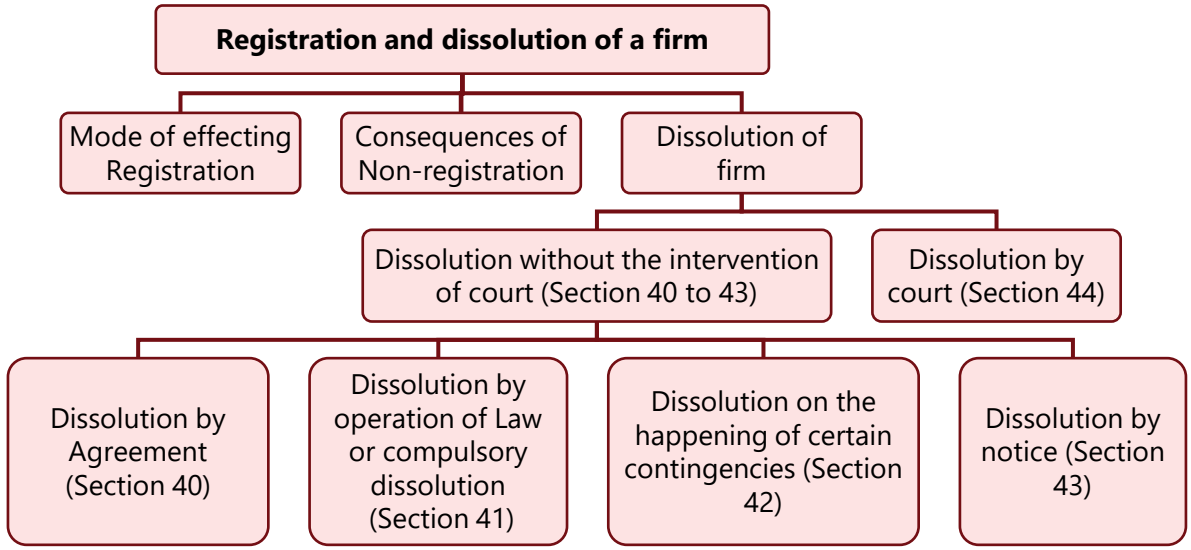
UNIT – 3: REGISTRATION AND DISSOLUTION OF A FIRM

LEARNING OUTCOMES

After studying this unit, you would be able to understand-

- About mode of getting a firm registered with the authorities.
- The effect of registration of a firm upon the rights of partners' inter-se and the rights of the third parties.
- The effect of non-registration on rights of partners and the third parties.
- The various circumstances when a firm is dissolved.
- The consequences and the effects of the dissolution upon rights and liabilities of various parties.

UNIT OVERVIEW



3.1 REGISTRATION OF FIRMS

APPLICATION FOR REGISTRATION (SECTION 58): (1) The registration of a firm may be effected at any time by sending by post or delivering to the Registrar of the area in which any place of business of the firm is situated or proposed to be situated, a statement in the prescribed form and accompanied by the prescribed fee, stating-

(a) The firm's name

(b) The place or principal place of business of the firm,

(c) The names of any other places where the firm carries on business,

(d) the date when each partner joined the firm,

(e) the names in full and permanent addresses of the partners, and

(f) the duration of the firm.

The statement shall be signed by all the partners, or by their agents specially authorised in this behalf.

(1) Each person signing the statement shall also verify it in the manner prescribed.

(2) A firm name shall not contain any of the following words, namely:-

Note: 'Crown', Emperor', 'Empress', 'Empire', 'Imperial', 'King', 'Queen', 'Royal', or words expressing or implying the sanction, approval or patronage of Government except when the State Government signifies its consent to the use of such words as part of the firm-name by order in writing.

REGISTRATION (SECTION 59): When the Registrar is satisfied that the provisions of Section 58 have been duly complied with, he shall record an entry of the statement in a Register called the Register of Firms and shall file the statement. Then he shall issue a certificate of Registration. However, registration is deemed to be completed as soon as an application in the prescribed form with the prescribed fee and necessary details concerning the particulars of partnership is delivered to the Registrar. The recording of an entry in the register of firms is a routine duty of Registrar.

Registration may also be effected even after a suit has been filed by the firm but in that case it is necessary to withdraw the suit first and get the firm registered and then file a fresh suit.

LATE REGISTRATION ON PAYMENT OF PENALTY (SECTION 59A-1): If the statement in respect of any firm is not sent or delivered to the Registrar within the time specified in sub-section (1A) of section 58, then the firm may be registered on payment, to the Registrar, of a penalty of one hundred rupees per year of delay or a part thereof.

3.2 CONSEQUENCES OF NON-REGISTRATION (SECTION 69)

Under the English Law, the registration of firms is compulsory. Therefore, there is a penalty for non-registration of firms. But the Indian Partnership Act does not make the registration of firms compulsory nor does it impose any penalty for non-registration. However, **under Section 69**, non-registration of partnership gives rise to a number of disabilities which we shall presently discuss. Although registration of firms is not compulsory, yet the consequences or disabilities of non-registration have a persuasive pressure for their registration. These disabilities briefly are as follows:

(i) **No suit in a civil court by firm or other co-partners against third party:** The firm or any other person on its behalf cannot bring an action against the third party for breach of contract entered into by the firm, unless the firm is registered and the persons suing are or have been shown in the register of firms as partners in the firm. In other words, a registered firm can only file a suit against a third party and the persons suing have been in the register of firms as partners in the firm.

(ii) **No relief to partners for set-off of claim:** If an action is brought against the firm by a third party, then neither the firm nor the partner can claim any set-off, if the suit be valued for more than ₹ 100 or pursue other proceedings to enforce the rights arising from any contract.

(iii) **Aggrieved partner cannot bring legal action against other partner or the firm:** A partner of an unregistered firm (or any other person on his behalf) is precluded from bringing legal action against the firm or any person alleged to be or to have been a partner in the firm. But, such a person may sue for dissolution of the firm or for accounts and realization of his share in the firm's property where the firm is dissolved.

(iv) **Third party can sue the firm:** In case of an unregistered firm, an action can be brought against the firm by a third party.

Exceptions: Non-registration of a firm does not, however effect the following rights:

1. The right of third parties to sue the firm or any partner.
2. The right of partners to sue for the dissolution of the firm or for the settlement of the accounts of a dissolved firm, or for realization of the property of a dissolved firm.
3. The power of an Official Assignees, Receiver of Court to release the property of the insolvent partner and to bring an action.
4. The right to sue or claim a set-off if the value of suit does not exceed ₹ 100 in value.

5. The right to suit and proceeding instituted by legal representatives or heirs of the deceased partner of a firm for accounts of the firm or to realise the property of the firm.

Example 1: A & Co. is registered as a partnership firm in 2017 with A, B and C partners. In 2018, A dies. In 2019, B and C sue X in the name and on behalf of A & Co. without fresh registration. Now the first question for our consideration is whether the suit is maintainable.

As regards the question whether in the case of a registered firm (whose business was carried on after its dissolution by death of one of the partners), a suit can be filed by the remaining partners in respect of any subsequent dealings or transactions without notifying to the Registrar of Firms, the changes in the constitution of the firm, it was decided that the remaining partners should sue in respect of such subsequent dealings or transactions even though the firm was not registered again after such dissolution and no notice of the partner was given to the Registrar.

The test applied in these cases was whether the plaintiff satisfied the only two requirements of Section 69 (2) of the Act namely,

(i) the suit must be instituted by or on behalf of the firm which had been registered;

(ii) the person suing had been shown as partner in the register of firms. In view of this position of law, the suit is in the case by B and C against X in the name and on behalf of A & Co. is maintainable.

Now, in the above example, what difference would it make, if in 2019 B and C had taken a new partner, D, and then filed a suit against X without fresh registration?

Where a new partner is introduced, the fact is to be notified to Registrar who shall make a record of the notice in the entry relating to the firm in the Register of firms. Therefore, the firm cannot sue as D's (new partner's) name has not been entered in the register of firms. It was pointed out that in the second requirement, the phrase "person suing" means persons in the sense of individuals whose names appear in the register as partners and who must be all partners in the firm at the date of the suit.

3.3 DISSOLUTION OF FIRM (SECTIONS 39 - 47)

According to Section 39 of the Indian Partnership Act, 1932, the dissolution of partnership between all partners of a firm is called the 'dissolution of the firm'.

Thus, the dissolution of firm means the discontinuation of the legal relation existing between all the partners of the firm. But when only one or more partners retires or becomes incapacitated from acting as a partner due to death, insolvency or insanity, the partnership, i.e. the relationship between such a partner and other is dissolved, but the rest may decide to

continue. In such cases, there is in practice, no dissolution of the firm. The particular partner goes out, but the remaining partners carry on the business of the firm, it is called dissolution of partnership. In the case of dissolution of the firm, on the other hand, the whole firm is dissolved. The partnership terminates as between each and every partner of the firm.

Dissolution of Firm Vs. Dissolution of Partnership

S. No.	Basis of Difference	Dissolution of Firm	Dissolution of Partnership
1.	**Continuation of business**	It involves discontinuation of business in partnership.	It does not affect continuation of business. It involves only reconstitution of the firm.
2.	**Winding up**	It involves winding up of the firm and requires realization of assets and settlement of liabilities.	It involves only reconstitution and requires only revaluation of assets and liabilities of the firm.
3.	**Order of court**	A firm may be dissolved by the order of the court.	Dissolution of partnership is not ordered by the court.
4.	**Scope**	It necessarily involves dissolution of partnership.	It may or may not involve dissolution of firm.
5.	**Final closure of books**	It involves final closure of books of the firm.	It does not involve final closure of the books of the firm.

Modes of Dissolution of a firm (Sections 40-44)

The dissolution of partnership firm may be in any of the following ways:

1. DISSOLUTION WITHOUT THE ORDER OF THE COURT OR VOLUNTARY DISSOLUTION:

It consists of following four types:

(i) Dissolution by Agreement (Section 40):

Section 40 gives right to the partners to dissolve the partnership by agreement with the consent of all the partners or in accordance with a contract between the partners. 'Contract between the partners' means a contract already made.

(ii) Compulsory dissolution (Section 41):

A firm is compulsorily dissolved

- by the adjudication of all the partners or of all the partners but one as insolvent; or

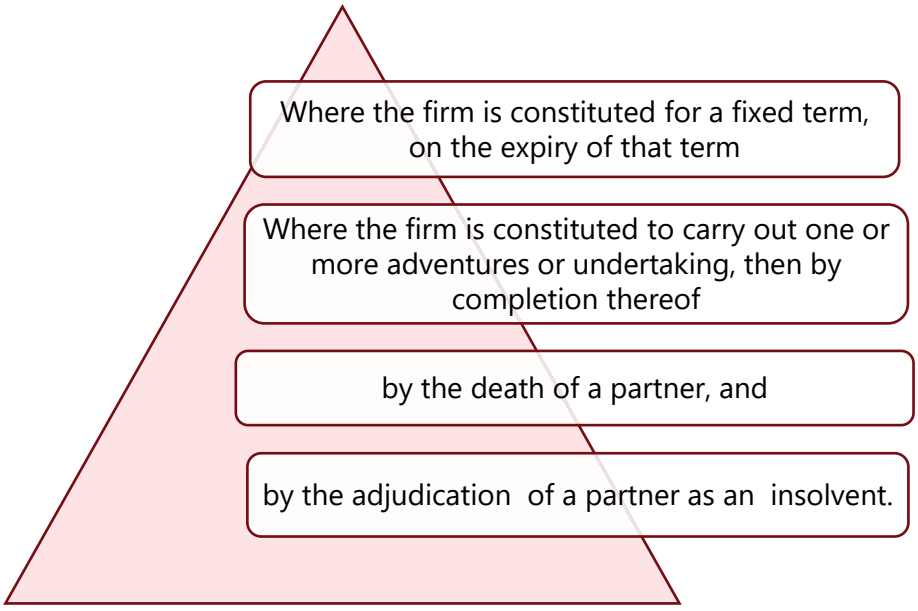
- by the happening of any event which makes it unlawful for the business of the firm to be carried on or for the partners to carry it on in partnership.

However, when more than one separate adventure or undertaking is carried on by the firm, the illegality of one or more shall not of itself cause the dissolution of the firm in respect of its lawful adventures and undertakings.

Example 2: A firm is carrying on the business of trading a particular chemical and a law is passed which bans on the trading of such a particular chemical. The business of the firm becomes unlawful and so the firm will have to be compulsorily dissolved.

(iii) Dissolution on the happening of certain contingencies (Section 42):

Subject to contract between the partners, a firm can be dissolved on the happening of any of the following contingencies-



(iv) Dissolution by notice of partnership at will (Section 43):

(1) Where the partnership is at will, the firm may be dissolved by any partner giving notice in writing to all the other partners of his intention to dissolve the firm.

(2) In case date is mentioned in the Notice: The firm is dissolved as from the date mentioned in the notice as the date of dissolution, or in case no date is so mentioned, as from the date of the communication of the notice.

(2) DISSOLUTION BY THE COURT (SECTION 44):

Court may, at the suit of the partner, dissolve a firm on any of the following ground:

(a) ***Insanity/unsound mind:*** Where a partner (not a sleeping partner) has become of unsound mind, the court may dissolve the firm on a suit of the other partners or by the next friend of the insane partner. Temporary sickness is no ground for dissolution of firm.

Example 3: A, B and C are partners in a firm. A has severe infection and got typhoid. Due to this, he was not able to conduct business for few weeks. This kind of illness cannot be treated as the ground for dissolution.

(b) ***Permanent incapacity:*** When a partner, other than the partner suing, has become in any way permanently incapable of performing his duties as partner, then the court may dissolve the firm. Such permanent incapacity may result from physical disability or illness etc.

(c) ***Misconduct:*** Where a partner, other than the partner suing, is guilty of conduct which is likely to affect prejudicially the carrying on of business, the court may order for dissolution of the firm, by giving regard to the nature of business. It is not necessary that misconduct must relate to the conduct of the business. The important point is the adverse effect of misconduct on the business. In each case nature of business will decide whether an act is misconduct or not.

(d) ***Persistent breach of agreement:*** Where a partner other than the partner suing, wilfully or persistently commits breach of agreements relating to the management of the affairs of the firm or the conduct of its business, or otherwise so conduct himself in matters relating to the business that it is not reasonably practicable for other partners to carry on the business in partnership with him, then the court may dissolve the firm at the instance of any of the partners. Following comes in to category of breach of contract:

- Embezzlement,
- Keeping erroneous accounts
- Holding more cash than allowed
- Refusal to show accounts despite repeated request etc.

Example 4: If one of the partners keeps erroneous accounts and omits to enter receipts or if there is continued quarrels between the partners or there is such a state of things that destroys the mutual confidence of partners, the court may order for dissolution of the firm.

(e) ***Transfer of interest:*** Where a partner other than the partner suing, has transferred the whole of his interest in the firm to a third party or has allowed his share to be charged or sold by the court, in the recovery of arrears of land revenue due by the partner, the court may dissolve the firm at the instance of any other partner.

(f) ***Continuous/Perpetual losses:*** Where the business of the firm cannot be carried on except at a loss in future also, the court may order for its dissolution.

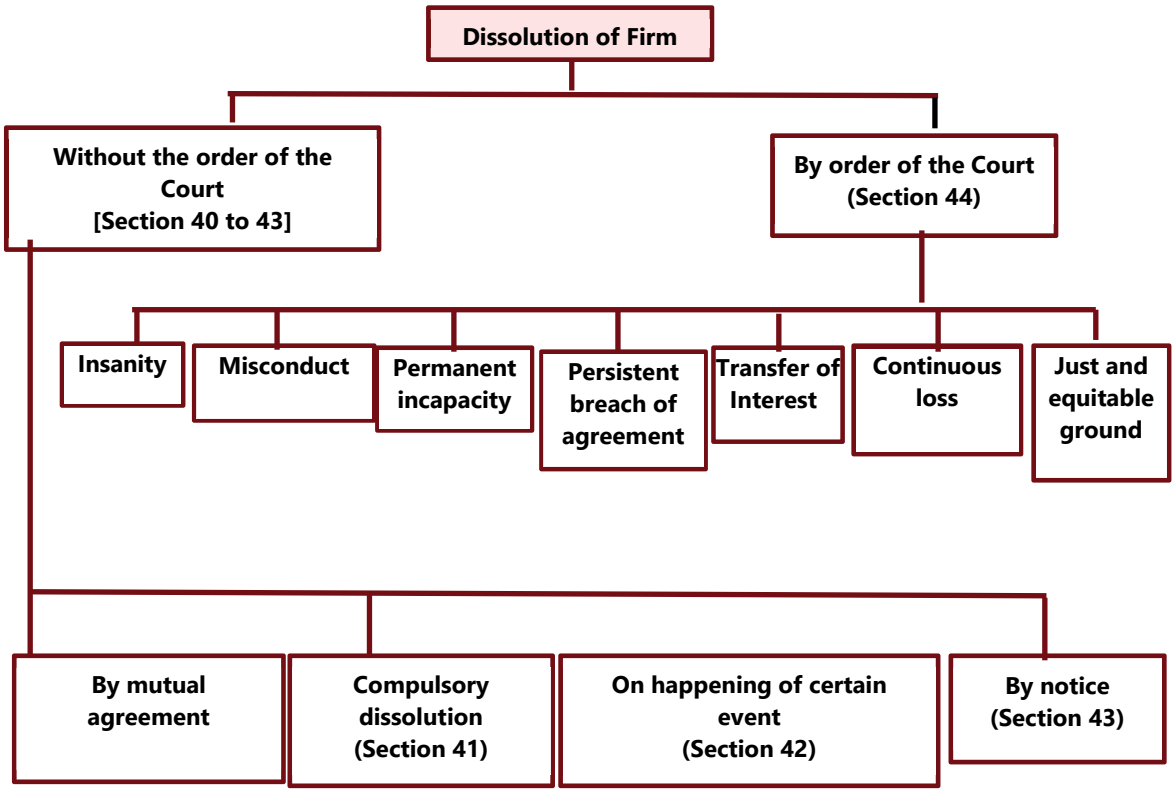
(g) ***Just and equitable grounds:*** Where the court considers any other ground to be just and equitable for the dissolution of the firm, it may dissolve a firm. The following are the cases for the just and equitable grounds-

(i) Deadlock in the management.

(ii) Where the partners are not in talking terms between them.

(iii) Loss of substratum.

(iv) Gambling by a partner on a stock exchange.



3.4 CONSEQUENCES OF DISSOLUTION (SECTIONS 45 - 55)

Consequent to the dissolution of a partnership firm, the partners have certain rights and liabilities, as are discussed:

(a) Liability for acts of partners done after dissolution (Section 45):

Section 45 has two fold objectives-

1. It seeks to protect third parties dealing with the firm who had no notice of prior dissolution and
2. It also seeks to protect partners of a dissolved firm from liability towards third parties.

Example 5: X and Y who carried on business in partnership for several years, executed on December 1, a deed dissolving the partnership from the date, but failed to give a public notice of the dissolution. On December 20, X borrowed in the firm's name a certain sum of money from R, who was ignorant of the dissolution. In such a case, Y also would be liable for the amount because no public notice was given.

However, there are exceptions to the rule stated in above example i.e. even where notice of dissolution has not been given, there will be no liability for subsequent acts in the case of:

(a) the estate of a deceased partner,

(b) an insolvent partner, or

(c) a dormant partner, i.e., a partner who was not known as a partner to the person dealing with the firm.

(b) Right of partners to have business wound up after dissolution (Section 46): On the dissolution of a firm every partner or his representative is entitled, as against all the other partners or their representative, to have the property of the firm applied in payment of the debts and liabilities of the firm, and to have the surplus distributed among the partners or their representatives according to their rights.

(c) Continuing authority of partners for purposes of winding up (Section 47): After the dissolution of a firm the authority of each partner to bind the firm, and the other mutual rights and obligations of the partners, continue notwithstanding the dissolution, so far as may be necessary to wind up the affairs of the firm and to complete transactions begun but unfinished at the time of the dissolution, but not otherwise:

Provided that the firm is in no case bound by the acts of a partner who has been adjudicated insolvent; but this proviso does not affect the liability of any person who has after the adjudication represented himself or knowingly permitted himself to be represented as a partner of the insolvent.

(d) **Mode of Settlement of partnership accounts (Section 48):** In settling the accounts of a firm after dissolution, the following rules shall, subject to agreement by the partners, be observed:-

(i) Losses, including deficiencies of capital, shall be paid first out of profits, next out of capital, and, lastly, if necessary, by the partners individually in the proportions in which they were entitled to share profits;

(ii) The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital, must be applied in the following manner and order:

(a) in paying the debts of the firm to third parties;

(b) in paying to each partner rateably what is due to him from capital;

(c) in paying to each partner rateably what is due to him on account of capital; and

(d) the residue, if any, shall be divided among the partners in the proportions in which they were entitled to share profits.

Example 6: X and Y were partners sharing profits and losses equally and X died. On taking partnership accounts, it transpired that he contributed ₹ 6,60,000 to the capital of the firm and Y only ₹40,000. The assets amounted to ₹ 2,00,000. In such situation, the deficiency (₹ 6,60,000 + ₹ 40,000 – ₹ 2,00,000 i.e. ₹ 5,00,000) would have to be shared equally by Y and X's estate.

If in the above example, the agreement provided that on dissolution the surplus assets would be divided between the partners according to their respective interests in the capital and on the dissolution of the firm a deficiency of capital was found, then the assets would be divided between the partners in proportion to their capital with the result that X's estate would be the main loser.

(e) **Payment of firm debts and of separate debts (Section 49):** Where there are joint debts due from the firm and also separate debts due from any partner:

(i) the property of the firm shall be applied in the first instance in payment of the debts of the firm, and if there is any surplus, then the share of each partner shall be applied to the payment of his separate debts or paid to him;

(ii) the separate property of any partner shall be applied first in the payment of his separate debts and surplus, if any, in the payment of debts of the firm.

SUMMARY

Registration of a firm is effected by the Registrar of Firms by recording in the Register of Firms an entry of the statement relating to registration furnished to him. The Act does not make registration of the firm compulsory, yet the effect of the rules relating to the consequences of non-registration is such as practically necessitates the registration of the firm at one time or other. Certain disabilities have been imposed on partners of an unregistered firm seeking to enforce certain claims in the Civil Courts. A firm which is not registered is not able to enforce its claim against third parties in the Civil Courts; and any partner who is not registered is not able to enforce his claim either against third parties or against the fellow partners. An unregistered partner may, however, sue for the dissolution of the firm or for accounts only if the firm is already dissolved.

Dissolution of a firm means the breaking up or extinction of the relationship which subsisted between all the partners of the firm under various circumstances contemplated by Act. A partnership can be dissolved only in accordance with the manner prescribed under the Act.

REGISTRATION OF FIRMS: SEC.58 & 59

Meaning: Getting registered with the Registrar of Firm.

Procedure: Application in prescribed form with prescribed fees.

Contents of Application Form:

- Name of the firm.
- Principal & other places of business of the firm.
- Date when each partner joined the firm.
- Names & addresses of the partners.
- The duration of the firm.

Note: *Registration of firm becomes effective from date of filing the form.*

Effects of Non-registration (Sec. 69)

1. No suit in a civil court by a partner against the firm or other co-partners.

2. No suit in a civil court by the firm against third parties

3. The firm or its partners cannot make a claim of set-off or other proceeding based upon a contract

Rights not affected by non-registration (Sec. 69)

1. Right of third parties to sue the firm or any partner.

2. Power of an Official Assignee or Receiver or the Court.

3. Right of the partners to sue for the dissolution of the firm or for the accounts of a dissolved firm or for the realization of the property of a dissolved firm.

4. Rights of the firm or partners of firm having no place of business in India.

5. Right to sue or claim a set-off if the value of the suit upto Rs. 100.

6. Rights of partners to sue for the criminal proceedings against the other partners of the firm and against the third parties.

DISSOLUTION : SEC. 39 – 44

Discontinuance of the jural relation between all the partners of the firm.

MODE OF DISSOLUTION

By Mutual Agreement (Sec. 40)

- With the consent of all the partners
- Or
- As per contract between the partners

By Operation of law (Sec. 41)

- All but one of the partners are adjudicated as insolvent.
- By the happening of an event which makes partnership unlawful.

By Happening of certain contingencies (Sec. 42)

Unless otherwise agreed,

- On the expiry of fixed term
- On completion of purpose
- On the death of a partner;
- On the insolvency of a partner.

By Notice of Dissolution (Sec. 43)

- Partnership at will.
- Notice once given cannot be withdrawn without consent of all partners.

By a Decree of the Court (Sec. 44)

- A partner becoming of unsound mind.
- Permanent incapacity of a partner.
- Misconduct of a partner affecting the business.
- Wilful and persistent breach of partnership agreement by a partner
- Transfer of whole interest or share by a partner.
- Improbability of business being carried on at loss.
- Just and Equitable.

Consequences of Dissolution

- Continuing liability until public notice.
- Rights to enforce winding up.
- Extent of continuing authority of the partners after dissolution.
- Settlement of partnership accounts.
- Personal profits earned after dissolution must be accounted.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *Registration of a firm is:*
   - *(a) Compulsory*
   - *(b) Optional*
   - *(c) Occasional*
   - *(d) None of the above*
2. *An unregistered firm cannot claim:*
   - *(a) Set on*
   - *(b) Set off*
   - *(c) Set on and set off*
   - *(d) None of the above*
3. *As per the accepted view, the registration of the firm is considered complete when*
   - *(a) Complete application for registration is filed with the Registrar.*
   - *(b) Registrar files the statement and makes entries in the Register of Firms.*
   - *(c) Registrar gives notice of registration to all partners.*
   - *(d) Court records the statement and certifies the entries in Register of Firms.*
4. *A partnership firm is compulsorily dissolved where*
   - *(a) All partners have become insolvent*
   - *(b) Firm's business has become unlawful*
   - *(c) The fixed term has expired*
   - *(d) In cases (a) and (b) only*
5. *On which of the following grounds, a partner may apply to the court for dissolution of the firm?*
   - *(a) Insanity of a partner*
   - *(b) Misconduct of a partner*
   - *(c) Perpetual losses in business*
   - *(d) All of the above*

6. *Which of the following do not constitute a ground for dissolution by Court?*

   (a) Misconduct by partner

   (b) Transfer of interest by partner

   (c) Just and equitable grounds

   (d) Insolvency of a partner

7. *Upon dissolution of firm, losses, including deficiencies of capital, shall be paid first-*

   (a) Out of Profits

   (b) Out of Capital

   (c) By the partners in their profit sharing ratio

   (d) By the partners equally

8. *Public notice in case of a firm is not required in case of:*

   (a) Admission of a partner

   (b) Retirement of a partner

   (c) Expulsion of a partner

   (d) Dissolution of the firm.

9. *Which of the following do not constitute ground for dissolution by Court?*

   (a) Insanity of the partner

   (b) Business carried on at a loss

   (c) Wilful misconduct of a partner

   (d) Expulsion of a partner

10. *Dissolution of partnership between all the partners of a firm is called-*

    (a) Dissolution of partnership

    (b) Dissolution of partners

    (c) Dissolution of the firm

    (d) Reconstitution of firm

11. *A partnership firm has to be registered with:*

    (a) Director of firms

    (b) Registrar of firms

(c) *Registrar of companies*

(d) *Competent Court*

12. *In settling the account after dissolution, the firm's assets shall be first applied in-*

(a) *Losses including deficiencies of capital.*

(b) *Payment of partner's loan.*

(c) *Payment of partner's goodwill share.*

(d) *Distribution to partners in their profit sharing ratio.*

13. *X, Y and Z are partners in a firm. Due to differences amongst the partners, there is deadlock in the management. X applies to the court for the dissolution of the firm. Will he succeed?*

(a) *Yes, on just and equitable ground*

(b) *No, because it is not a valid ground for dissolution*

(c) *No, it will require consent of all the partners*

(d) *Yes, if the Registrar of Firm agrees.*

14. *A firm is compulsorily dissolved on the:*

(a) *Death of a partner*

(b) *Adjudication of a partner as an insolvent*

(c) *Expiry of a fixed period for which the firm was constituted*

(d) *Business of the firm becoming illegal due to happening of an event.*

15. *The partnership deed does not include:*

(a) *The nature of the business of the firm.*

(b) *The duration of the firm.*

(c) *The date when each partner joined the firm.*

(d) *The date when each partner exit the firm.*

16. *Mr. A, partner of ABC Associates give notice in writing to all other partners i.e. Mr. B and Mr. C of his intention to dissolve the firm on 01.09.2020. Such notice was dated 30.08.2020. In the given case, the firm stands dissolved with effect from_____.*

(a) *30.08.2020.*

(b) *01.09.2020.*

(c) *Neither 30.08.2020 nor 01.09.2020 but as per the date mentioned in partnership deed as last date of existence of the firm.*

(d) *Either 30.08.2020 or 01.09.2020 as mutually agreed by all three partners.*

17. *A firm may be dissolved with the consent of all the partners or in accordance with a contract between the partners. Such dissolution is known as _____.*

(a) *Dissolution by contract.*

(b) *Dissolution by agreement.*

(c) *Dissolution by will.*

(d) *Dissolution of Partnership.*

18. *The statement for the purpose of registration under Section 58(1) of Indian Partnership Act, 1932 can be signed by:*

(a) *Any one partner of the Firm*

(b) *Legal heirs of all partners of the Firm*

(c) *All the partners or by their agents specially authorised in this behalf*

(d) *Agents of all partners of the Firm.*

Descriptive Questions

1. *What is the procedure of registration of a partnership firm under the Indian Partnership Act, 1932?*

2. *When does dissolution of a partnership firm take place under the provisions of the Indian Partnership Act, 1932? Explain.*

3. *"Indian Partnership Act does not make the registration of firms compulsory nor does it impose any penalty for non-registration." In light of the given statement, discuss the consequences of non-registration of the partnership firms In India?*

ANSWERS/HINTS

Answer to MCQs

1.	**(b)**	2.	**(b)**	3.	**(b)**	4.	**(d)**	5.	**(d)**	6.	**(d)**
7.	**(a)**	8.	**(a)**	9.	**(d)**	10.	**(c)**	11.	**(b)**	12.	**(a)**
13.	**(a)**	14.	**(d)**	15.	**(d)**	16.	**(b)**	17.	**(b)**	18.	**(c)**

Answer to Descriptive Questions

1. APPLICATION FOR REGISTRATION (SECTION 58):

(1) The registration of a firm may be effected at any time by sending by post or delivering to the Registrar of the area in which any place of business of the firm is situated or proposed to be situated, a statement in the prescribed form and accompanied by the prescribed fee, stating-

(a) The firm's name

(b) The place or principal place of business of the firm,

(c) The names of any other places where the firm carries on business,

(d) the date when each partner joined the firm,

(e) the names in full and permanent addresses of the partners, and

(f) the duration of the firm.

The statement shall be signed by all the partners, or by their agents specially authorised in this behalf.

(2) Each person signing the statement shall also verify it in the manner prescribed.

(3) A firm name shall not contain any of the following words, namely:-

'Crown', Emperor', 'Empress', 'Empire', 'Imperial', 'King', 'Queen', 'Royal', or words expressing or implying the sanction, approval or patronage of Government except when the State Government signifies its consent to the use of such words as part of the firm-name by order in writing.

2. Dissolution of Firm: The Dissolution of Firm means the discontinuation of the jural relation existing between all the partners of the Firm. But when only one of the partners retires or becomes in capacitated from acting as a partner due to death, insolvency or insanity, the partnership, i.e., the relationship between such a partner and other is dissolved, but the rest may decide to continue. In such cases, there is in practice, no dissolution of the firm. The particular partner goes out, but the remaining partners carry on the business of the Firm. In the case of dissolution of the firm, on the other hand, the whole firm is dissolved. The partnership terminates as between each and every partner of the firm.

Dissolution of a Firm may take place (Section 39 - 44)

(a) as a result of any agreement between all the partners (i.e., dissolution by agreement);

(b) by the adjudication of all the partners, or of all the partners but one, as insolvent (i.e., compulsory dissolution);

(c) by the business of the firm becoming unlawful (i.e., compulsory dissolution);

(d) subject to agreement between the parties, on the happening of certain contingencies, such as: (i) effluence of time; (ii) completion of the venture for which it was entered into; (iii) death of a partner; (iv) insolvency of a partner.

(e) by a partner giving notice of his intention to dissolve the firm, in case of partnership at will and the firm being dissolved as from the date mentioned in the notice, or if no date is mentioned, as from the date of the communication of the notice; and

(f) by intervention of court in case of: (i) a partner becoming the unsound mind; (ii) permanent incapacity of a partner to perform his duties as such; (iii) Misconduct of a partner affecting the business; (iv) wilful or persistent breach of agreement by a partner; (v) transfer or sale of the whole interest of a partner; (vi) improbability of the business being carried on save at a loss; (vii) the court being satisfied on other equitable grounds that the firm should be dissolved.

3. It is true to say that Indian Partnership Act, 1932 does not make the registration of firms compulsory nor does it impose any penalty for non-registration.

Following are consequences of Non-registration of Partnership Firms in India:

The Indian Partnership Act, 1932 does not make the registration of firms compulsory nor does it impose any penalty for non-registration. However, under Section 69, non-registration of partnership gives rise to a number of disabilities which we shall presently discuss. Although registration of firms is not compulsory, yet the consequences or disabilities of non-registration have a persuasive pressure for their registration. These disabilities briefly are as follows:

(i) **No suit in a civil court by firm or other co-partners against third party:** The firm or any other person on its behalf cannot bring an action against the third party for breach of contract entered into by the firm, unless the firm is registered and the persons suing are or have been shown in the register of firms as partners in the firm. In other words, a registered firm can only file a suit against a third party and the persons suing have been in the register of firms as partners in the firm

(ii) **No relief to partners for set-off of claim:** If an action is brought against the firm by a third party, then neither the firm nor the partner can claim any set-

off, if the suit be valued for more than ` 100 or pursue other proceedings to enforce the rights arising from any contract.

(iii) **Aggrieved partner cannot bring legal action against other partner or the firm:** A partner of an unregistered firm (or any other person on his behalf) is precluded from bringing legal action against the firm or any person alleged to be or to have been a partner in the firm. But, such a person may sue for dissolution of the firm or for accounts and realization of his share in the firm's property where the firm is dissolved.

(iv) **Third party can sue the firm:** In case of an unregistered firm, an action can be brought against the firm by a third party.

NOTES

CHAPTER 5

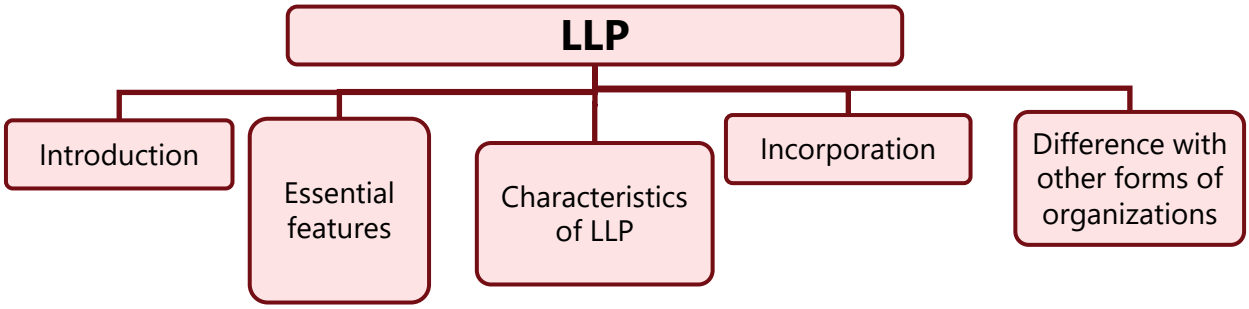
THE LIMITED LIABILITY PARTNERSHIP ACT, 2008

LEARNING OUTCOMES

After studying this chapter, you would be able to understand-

- The meaning of the term 'Limited Liability Partnership', its need, scope and advantages
- About Incorporation of LLP
- Differences between 'Limited Liability Partnership' and other forms of organisation

CHAPTER OVERVIEW



INTRODUCTION

The Ministry of Law and Justice on 9th January 2007 notified the Limited Liability Partnership Act, 2008.

The Parliament passed the Limited Liability Partnership Bill on 12th December, 2008 and the President of India has assented the Bill on 7th January, 2009 and called as the Limited Liability Partnership Act, 2008.

The LLP Act, 2008 is applicable to the whole of India.

This Act have been enacted to make provisions for the formation and regulation of Limited Liability Partnerships and for matters connected there with or incidental thereto.

The LLP Act, 2008 has 81 sections and 4 schedules.

The First Schedule deals with mutual rights and duties of partners, as well limited liability partnership and its partners where there is absence of a formal agreement with respect to them.

The Second Schedule deals with conversion of a firm into LLP.

The Third Schedule deals with conversion of a private company into LLP.

The Fourth Schedule deals with conversion of unlisted public company into LLP.

The Ministry of Corporate Affairs and the Registrar of Companies (ROC) are entrusted with the task of administrating the LLP Act, 2008. The Central Government has the authority to frame the Rules with regard to the LLP Act, 2008, and can amend them by notifications in the Official Gazette, from time to time.

It is also to be noted that the Indian Partnership Act, 1932 is not applicable to LLPs.

The Limited Liability Act, 2008 has been amended through the Limited Liability Partnership (Amendment) Act, 2021 dated 13th August, 2021.

Need of new form of Limited Liability Partnership

The lawmakers envisaged the need for bringing out a new legislation for creation of the Limited Liability Partnership to meet with the contemporary growth of the Indian economy. A need has been felt for a new corporate form that would provide an alternative to the traditional partnership with unlimited personal liability on the one hand and the statute-based governance structure of the limited liability company on the other hand. In order to enable professional expertise and entrepreneurial initiative and combine, organize and operate in flexible, innovative and efficient manner, the LLP Act, 2008 was enacted.

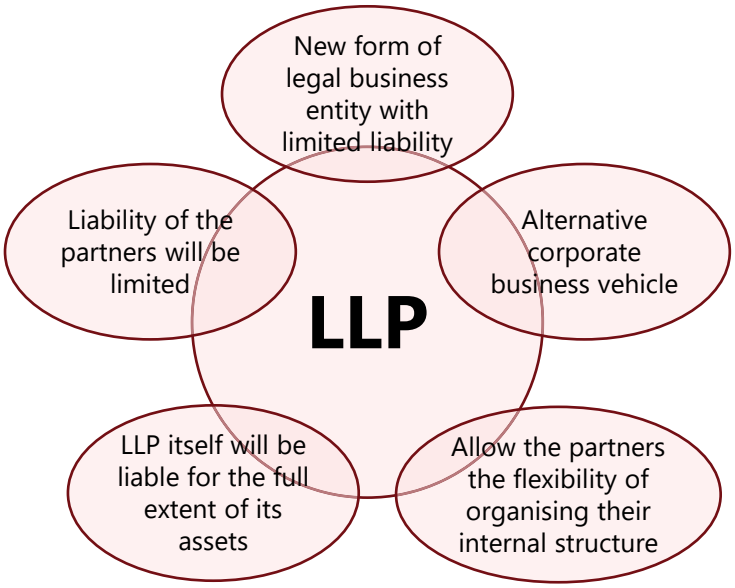
Thus, LLP as a form of business organization is an alternative corporate business vehicle. It provides the benefits of limited liability but allows its members the flexibility of organizing their internal structure as a partnership based on a mutually arrived agreement. The LLP form enables entrepreneurs, professionals and enterprises providing services of any kind or engaged in scientific and technical disciplines, to form commercially efficient vehicles suited to their requirements. Owing to flexibility in its structure and operation, the LLP is a suitable vehicle for small enterprises and for investment by venture capital.

1. LIMITED LIABILITY PARTNERSHIP- MEANING AND CONCEPT

Meaning: A LLP is a new form of legal business entity with limited liability. It is an alternative corporate business vehicle that not only gives the benefits of limited liability at low compliance cost but allows its partners the flexibility of organising their internal structure as a traditional partnership. The LLP is a separate legal entity and, while the LLP itself will be liable for the full extent of its assets, the liability of the partners will be limited.

LLP as a separate legal entity and business organisation is an alternative corporate business form that gives the benefits of limited liability of a company and the flexibility of a partnership.

Since LLP contains elements of both 'a corporate structure' as well as 'a partnership firm structure' LLP is called a hybrid between a company and a partnership.



Important Definitions

1. **Body Corporate [(Section 2(1)(d)]:** It means a company as defined in clause (20) of section 2 of the Companies Act, 2013 and includes

   (i) a limited liability partnership registered under this Act;

   (ii) a limited liability partnership incorporated outside India; and

   (iii) a company incorporated outside India,

   but does not include

   (i) a corporation sole;

   (ii) a co-operative society registered under any law for the time being in force; and

   (iii) any other body corporate (not being a company as defined in clause (20) of section 2 of the Companies Act, 2013 or a limited liability partnership as defined in this Act), which the Central Government may, by notification in the Official Gazette, specify in this behalf.

2. **Business [Section 2(1)(e)]:** "Business" includes every trade, profession, service and occupation except any activity which the Central Government may, by notification, exclude.

3. **Designated Partner [Section 2(1)(j)]:** "Designated partner" means any partner designated as such pursuant to section 7.

4. **Entity [Section 2(1)(k)]:** "Entity" means any body corporate and includes, for the purposes of sections 18, 46, 47, 48, 49, 50, 52 and 53, a firm setup under the Indian Partnership Act, 1932.

5. **Financial Year [Section 2(1)(l)]:** "Financial year", in relation to a LLP, means the period from the 1st day of April of a year to the 31st day of March of the following year.

   However, in the case of a LLP incorporated after the 30th day of September of a year, the financial year may end on the 31st day of March of the year next following that year.

   Example 1: If a LLP has been incorporated on 15th October, 2019, then its financial year may be from 15th October, 2019 to 31st March, 2021.

   The Income Tax department has prescribed uniform financial year from 1st April to 31st March of next year. In keeping with the Income tax law, the financial year for LLP should always be from 1st April to 31st March each year.

6. **Foreign LLP [section 2(1)(m)]:** It means a LLP formed, incorporated or registered outside India which establishes a place of business within India.

7. **Limited liability partnership [Section 2(1)(n)]:** Limited Liability Partnership means a partnership formed and registered under this Act.

8. **Limited Liability partnership agreement [Section 2(1)(o)]:** It means any written agreement between the partners of the LLP or between the LLP and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to that LLP.

9. **Partner [Section 2(1)(q)]:** Partner, in relation to a LLP, means any person who becomes a partner in the LLP in accordance with the LLP agreement.

10. **Small Limited Liability Partnership [Section 2(1)(ta)]:** It means a limited liability partnership—

    (i) the contribution of which, does not exceed twenty-five lakh rupees or such higher amount, not exceeding five crore rupees, as may be prescribed; and

    (ii) the turnover of which, as per the Statement of Accounts and Solvency for the immediately preceding financial year, does not exceed forty lakh rupees or such higher amount, not exceeding fifty crore rupees, as may be prescribed; or

    (iii) which meets such other requirements as may be prescribed, and fulfils such terms and conditions as may be prescribed.

Non-applicability of the Indian Partnership Act, 1932 (Section 4): Save as otherwise provided, the provisions of the Indian Partnership Act, 1932 shall not apply to a LLP.

Partners (Section 5): Any individual or body corporate may be a partner in a LLP. However, an individual shall not be capable of becoming a partner of a LLP, if—

(a) he has been found to be of unsound mind by a Court of competent jurisdiction and the finding is in force;

(b) he is an undischarged insolvent; or

(c) he has applied to be adjudicated as an insolvent and his application is pending.

Minimum number of partners (Section 6):

(i) Every LLP shall have at least two partners.

(ii) If at any time the number of partners of a LLP is reduced below two and the LLP carries on business for more than six months while the number is so reduced, the person, who is the only partner of the LLP during the time that it so carries on

business after those six months and has the knowledge of the fact that it is carrying on business with him alone, shall be liable personally for the obligations of the LLP incurred during that period.

Designated partners (Section 7):

(i) Every LLP shall have at least two designated partners who are individuals and at least one of them shall be a resident in India.

(ii) If in LLP, all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such LLP or nominees of such bodies corporate shall act as designated partners.

(iii) *Resident in India*: For the purposes of this section, the term resident in India means a person who has stayed in India for a period of not less than 120 days during the financial year.

Example 2: There is an LLP by the name Indian Helicopters LLP having 5 partners namely Mr. A (Non resident), Mr. B (Non Resident) Ms. C (resident), Ms. D (resident) and Ms. E (resident). In this case, at least 2 should be named as Designated Partner out of which 1 should be resident. Hence, if Mr. A and Mr. B are designated then it will not serve the purpose. One of the designated partners should be there out of Ms. C, Ms. D and Ms. E.

2. CHARACTERISTIC OF LLP

Body Corporate	Perpetual Succession	Separate legal entity	Mutual Agency
LLP Agreement	Artificial Legal person	Common Seal	Limited liability
Management of business	Minimum and maximum number of partners	Business for profit only	Investigation
Compromise or Arrangement	Conversion into LLP	E-filing of documents	Foreign LLPs

1. **LLP is a body corporate:** Section 2(1)(d) of the LLP Act, 2008 provides that a LLP is a body corporate formed and incorporated under this Act and is a legal entity separate from that of its partners and shall have perpetual succession. Therefore, any change in the partners of a LLP shall not affect the existence, rights or liabilities of the LLP.

   Section 3 of LLP Act provides that a LLP is a body corporate formed and incorporated under this Act and is a legal entity separate from that of its partners.

2. **Perpetual Succession:** The LLP can continue its existence irrespective of changes in partners. Death, insanity, retirement or insolvency of partners has no impact on the existence of LLP. It is capable of entering into contracts and holding property in its own name.

3. **Separate Legal Entity:** The LLP as a separate legal entity, is liable to the full extent of its assets but liability of the partners is limited to their agreed contribution in the LLP. In other words, creditors of LLP shall be the creditors of LLP alone.

4. **Mutual Agency:** No partner is liable on account of the independent or un-authorized actions of other partners, thus individual partners are shielded from joint liability created by another partner's wrongful business decisions or misconduct. In other words, all partners will be the agents of the LLP alone. No one partner can bind the other partner by his acts.

5. **LLP Agreement:** Mutual rights and duties of the partners within a LLP are governed by an agreement between the partners. The LLP Act, 2008 provides flexibility to partner to devise the agreement as per their choice. In the absence of any such agreement, the mutual rights and duties shall be governed by the provisions of the LLP Act, 2008.

6. **Artificial Legal Person:** A LLP is an artificial legal person because it is created by a legal process and is clothed with all rights of an individual. It can do everything which any natural person can do, except of course that, it cannot be sent to jail, cannot take an oath, cannot marry or get divorce nor can it practice a learned profession like CA or Medicine. A LLP is invisible, intangible, immortal (it can be dissolved by law alone) but not fictitious because it really exists.

7. **Common Seal:** A LLP being an artificial person can act through its partners and designated partners. LLP may have a common seal, if it decides to have one [Section 14(c)]. Thus, it is not mandatory for a LLP to have a common seal. It shall remain under the custody of some responsible official and it shall be affixed in the presence of at least 2 designated partners of the LLP.

8. **Limited Liability:** Every partner of a LLP is, for the purpose of the business of LLP, the agent of the LLP, but not of other partners. The liability of the partners will be limited to their agreed contribution in the LLP. Such contribution may be of tangible or intangible nature or both.

Example 3: The professionals like Engineering consultants, Legal Advisors and Accounting Professional are afraid of entering into business due to unlimited liability. Hence the LLP partnership Act provides an avenue for these professionals to Limited Liability Partnership firms which restricts their liability to the agreed amount. This has encouraged Professionals to form LLP.

9. **Management of Business:** The partners in the LLP are entitled to manage the business of LLP. But only the designated partners are responsible for legal compliances.

10. **Minimum and Maximum number of Partners:** Every LLP shall have least two partners and shall also have at least 2 individuals as designated partners, of whom at least one shall be resident in India. There is no maximum limit on the partners in LLP.

11. **Business for Profit Only:** The essential requirement for forming LLP is carrying on a lawful business with a view to earn profit. Thus, LLP cannot be formed for charitable or non-economic purpose.

12. **Investigation:** The Central Government shall have powers to investigate the affairs of an LLP by appointment of competence authority for the purpose.

13. **Compromise or Arrangement:** Any compromise or agreements including merger and amalgamation of LLPs shall be in accordance with the provisions of the LLP Act, 2008.

14. **Conversion into LLP:** A firm, private company or an unlisted public company would be allowed to be converted into LLP in accordance with the provisions of LLP Act, 2008.

15. **E-Filling of Documents:** Every form or application of document required to be filed or delivered under the act and rules made thereunder, shall be filed in computer readable electronic form on its website *www.mca.gov*.in and authenticated by a partner or designated partner of LLP by the use of electronic or digital signature.

16. **Foreign LLPs:** Section 2(1)(m) defines foreign limited liability partnership "as a limited liability partnership formed, incorporated, or registered outside India which established as place of business within India". Foreign LLP can become a partner in an Indian LLP.

Advantages of LLP form- LLP form is a form of business model which:

- is organized and operates on the basis of an agreement
- provides flexibility without imposing detailed legal and procedural requirements.
- Easy to form
- All partners enjoy limited liability
- Flexible capital structure
- Easy to dissolve

3. INCORPORATION OF LLP

Incorporation document (Section 11): The most important document needed for registration is the incorporation document.

(1) For a LLP to be incorporated:

(a) two or more persons associated for carrying on a lawful business with a view to profit shall subscribe their names to an incorporation document;

(b) the incorporation document shall be filed in such manner and with such fees, as may be prescribed with the Registrar of the State in which the registered office of the LLP is to be situated; and

(c) **Statement to be filed:**

- there shall be filed along with the incorporation document, a statement in the prescribed form,
- made by either an advocate, or a Company Secretary or a Chartered Accountant or a Cost Accountant, who is engaged in the formation of the LLP and
- by any one who subscribed his name to the incorporation document,
- that all the requirements of this Act and the rules made thereunder have been complied with,

- in respect of incorporation and matters precedent and incidental thereto.

(2) The incorporation document shall—

(a) be in a form as may be prescribed;

(b) state the name of the LLP;

(c) state the proposed business of the LLP;

(d) state the address of the registered office of the LLP;

(e) state the name and address of each of the persons who are to be partners of the LLP on incorporation;

(f) state the name and address of the persons who are to be designated partners of the LLP on incorporation;

(g) contain such other information concerning the proposed LLP as may be prescribed.

(3) If a person makes a statement as discussed above which he—

(a) knows to be false; or

(b) does not believe to be true, shall be punishable

- with imprisonment for a term which may extend to 2 years and
- with fine which shall not be less than ₹ 10,000 but which may extend to ₹ 5 Lakhs.

Incorporation by registration (Section 12):

(1) When the requirements imposed by clauses (b) and (c) of sub-section (1) of section 11 have been complied with, the Registrar shall retain the incorporation document and, unless the requirement imposed by clause (a) of that sub-section has not been complied with, he shall, within a period of 14 days—

(a) register the incorporation document; and

(b) give a certificate that the LLP is incorporated by the name specified therein.

(2) The Registrar may accept the statement delivered under clause (c) of sub-section (1) of section 11 as sufficient evidence that the requirement imposed by clause (a) of that sub-section has been complied with.

(3) The certificate issued under clause (b) of sub-section (1) shall be signed by the Registrar and authenticated by his official seal.

(4) The certificate shall be conclusive evidence that the LLP is incorporated by the name specified therein.

Registered office of LLP and change therein (Section 13):

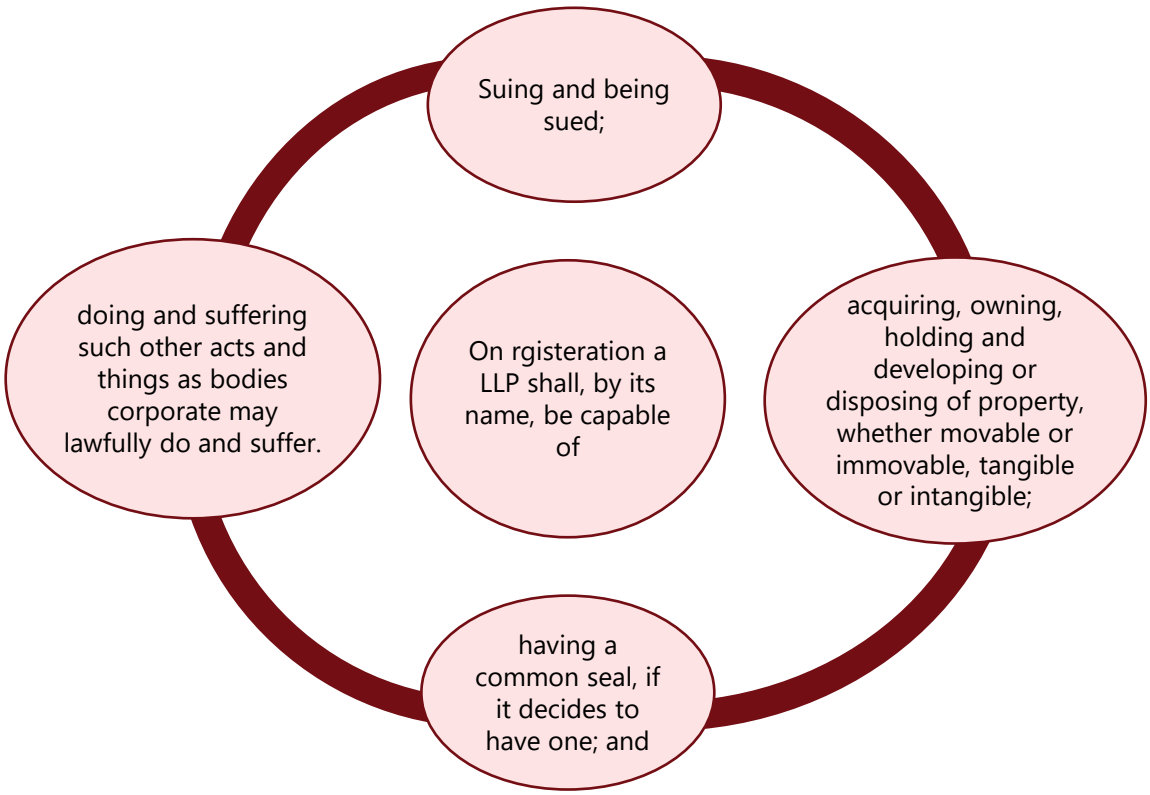
(1) Every LLP shall have a registered office to which all communications and notices may be addressed and where they shall be received.

(2) A document may be served on a LLP or a partner or designated partner thereof by sending it by post under a certificate of posting or by registered post or by any other manner, as may be prescribed, at the registered office and any other address specifically declared by the LLP for the purpose in such form and manner as may be prescribed.

(3) A LLP may change the place of its registered office and file the notice of such change with the Registrar in such form and manner and subject to such conditions as may be prescribed and any such change shall take effect only upon such filing.

(4) If the LLP contravenes any provisions of this section, the LLP and its every partner shall be liable to a penalty of ₹ 500 for each day during which the default continues, subject to a maximum of ₹ 50,000 for the LLP and its every partner.

Effect of registration (Section 14):



Name (Section 15):

(1) Every limited liability partnership shall have either the words "limited liability partnership" or the acronym "LLP" as the last words of its name.

(2) No LLP shall be registered by a name which, in the opinion of the Central Government is—

(a) undesirable; or

(b) identical or too nearly resembles to that of any other LLP or a company or a registered trade mark of any other person under the Trade Marks Act, 1999.

Reservation of name (Section 16):

(1) A person may apply in such form and manner and accompanied by such fee as may be prescribed to the Registrar for the reservation of a name set out in the application as—

(a) the name of a proposed LLP; or

(b) the name to which a LLP proposes to change its name.

(2) Upon receipt of an application under sub-section (1) and on payment of the prescribed fee, the Registrar may, if he is satisfied, subject to the rules prescribed by the Central Government in the matter, that the name to be reserved is not one which may be rejected on any ground referred to in sub-section (2) of section 15, reserve the name for a period of 3 months from the date of intimation by the Registrar.

Change of name of LLP (Section 17):

(1) Notwithstanding anything contained in sections 15 and 16, if through inadvertence or otherwise, a LLP, on its first registration or on its registration by a new body corporate, its registered name, is registered by a name which is identical with or too nearly resembles to —

(a) that of any other LLP or a company; or

(b) a registered trade mark of a proprietor under the Trade Marks Act, 1999, as is likely to be mistaken for it,

then on an application of such LLP or proprietor referred to in clauses (a) and (b) respectively or a company,

the Central Government may direct that such LLP to change its name or new name within a period of 3 months from the date of issue of such direction.

It is further provided that an application of the proprietor of the registered trade marks shall be maintainable within a period of 3 years from the date of incorporation or registration or change of name of the LLP under this Act.

(2) Where a LLP changes its name or obtains a new name under sub-section (1), it shall within a period of 15 days from the date of such change, give notice of the change to Registrar along with the order of the Central Government, who shall carry out necessary changes in the certificate of incorporation and within 30 days of such change in the certificate of incorporation, such LLP shall change its name in the LLP agreement.

(3) If the LLP is in default in complying with any direction given under sub-section (1), the Central Government shall allot a new name to the LLP in such manner as may be prescribed and the Registrar shall enter the new name in the register of LLP in place of the old name and issue a fresh certificate of incorporation with new name, which the LLP shall use thereafter.

Nothing contained in this sub-section shall prevent a LLP from subsequently changing its name in accordance with the provisions of section 16.

4. DIFFERENCES WITH OTHER FORMS OF ORGANISATION

Distinction between LLP and Partnership Firm: The points of distinction between a limited liability partnership and partnership firm are tabulated as follows:

	Basis	LLP	Partnership firm
1.	**Regulating Act**	The Limited Liability Partnership Act, 2008.	The Indian Partnership Act, 1932.
2.	**Body corporate**	It is a body corporate.	It is not a body corporate.
3.	**Separate legal entity**	It is a legal entity separate from its members.	It is a group of persons with no separate legal entity.
4.	**Creation**	It is created by a legal process called registration under the LLP Act, 2008.	It is created by an agreement between the partners.
5.	**Registration**	Registration is mandatory. LLP can sue and be sued in its own name.	Registration is voluntary. Only the registered partnership firm can sue the third parties.
6.	**Perpetual succession**	The death, insanity, retirement or insolvency of the partner(s)	The death, insanity, retirement or insolvency of the partner(s)

		does not affect its existence of LLP. Partners may join or leave but its existence continues forever.	may affect its existence. It has no perpetual succession.
7.	**Name**	Name of the LLP to contain the word limited liability partnership (LLP) as suffix.	No guidelines. The partners can have any name as per their choice.
8.	**Liability**	Liability of each partner is limited to the extent to agreed contribution except in case of willful fraud.	Liability of each partner is unlimited. It can be extended upto the personal assets of the partners.
9.	**Mutual agency**	Each partner can bind the LLP by his own acts but not the other partners.	Each partner can bind the firm as well as other partners by his own acts.
10.	**Designated partners**	At least two designated partners and atleast one of them shall be resident in India.	There is no provision for such partners under the Partnership Act, 1932.
11.	**Common seal**	It may have its common seal as its official signatures.	There is no such concept in partnership.
12.	**Legal compliances**	Only designated partners are responsible for all the compliances and penalties under this Act.	All partners are responsible for all the compliances and penalties under the Act.
13.	**Annual filing of documents**	LLP is required to file: (i) Annual statement of accounts (ii) Statement of solvency (iii) Annual return with the registration of LLP every year.	Partnership firm is not required to file any annual document with the registrar of firms.
14.	**Foreign partnership**	Foreign nationals can become a partner in a LLP.	Foreign nationals cannot become a partner in a partnership firm.
15.	**Minor as partner**	Minor cannot be admitted to the benefits of LLP.	Minor can be admitted to the benefits of the partnership with the prior consent of the existing partners.

Distinction between LLP and Limited Liability Company

	Basis	LLP	Limited Liability Company
1.	**Regulating Act**	The LLP Act, 2008.	The Companies Act, 2013.
2.	**Members/Partners**	The persons who contribute to LLP are known as partners of the LLP.	The persons who invest the money in the shares are known as members of the company.
3.	**Internal governance structure**	The internal governance structure of a LLP is governed by contract agreement between the partners.	The internal governance structure of a company is regulated by statute (i.e., Companies Act, 2013).
4.	**Name**	Name of the LLP to contain the word "Limited Liability partnership" or "LLP" as suffix.	Name of the public company to contain the word "limited" and Pvt. Co. to contain the word "Private limited" as suffix.
5.	**No. of members/partners**	Minimum – 2 partners Maximum – No such limit on the partners in the Act. The partners of the LLP can be individuals/or body corporate through the nominees.	**Private company:** Minimum – 2 members Maximum 200 members **Public company:** Minimum – 7 members Maximum – No such limit on the members. Members can be organizations, trusts, another business form or individuals.
6.	**Liability of members/partners**	Liability of a partners is limited to the extent of agreed contribution except in case of willful fraud.	Liability of a member is limited to the amount unpaid on the shares held by them.
7.	**Management**	The business of the company is managed by the partners including the designated partners authorized in the agreement.	The affairs of the company are managed by board of directors elected by the shareholders.
8.	**Minimum number of directors/designated partners**	Minimum 2 designated partners.	Pvt. Co. – 2 directors Public co. – 3 directors

SUMMARY

A LLP is a special type of partnership that can be used as business organizations owned by certain type of professionals such as Company Secretaries, Chartered Accountants, Cost Accountants, Lawyers, Engineers, Doctors, and Consultants etc., who are not allowed to use corporation form of entity to limit their liability. LLP is generally set up for carrying on a partnership consisting of partners carrying on practice in one or more eligible professions, etc.

Since India has witnessed considerable growth in services sector and the quality of our professionals have been acknowledged internationally. It was necessary that entrepreneurship knowledge and risk capital combine to provide a further momentum to our impressive economic growth. It is likely that in the years to come Indian professionals would be providing accountancy, legal and various other professional/technical services to a large number of entities across the globe. Such services would require multidisciplinary combinations that would offer a menu of solutions to international clients. In view of all this, the concept of LLP came into existence. LLP framework could be used for many enterprises, such as:-

- Persons providing services of any kind
- Enterprises in new knowledge and technology based fields where the corporate form is not suited.
- For professionals such as Chartered Accountants (CA), Cost and Management Accountants (CMA), Company Secretaries (CS) and Advocates, etc.
- Venture capital funds where risk capital combines with knowledge and expertise.
- Professionals and enterprises engaged in any scientific, technical or artistic discipline, for any activity relating to research production, design and provision of services.
- Small Sector Enterprises
- Producer Companies in Handloom, Handicrafts sector.

LLP has partners but no directors or shareholders. The major constituents of a LLP are its partners who are the ultimate owners.

The LLP Act, 2008

Applicability

From 31st March, 2009 (Extends whole of India)

Contents: 81 sections and 4 schedules

First Schedule- mutual rights & duties of partners,

Second Schedule - conversion of a firm into LLP,

Third Schedule - conversion of a Pvt. Co. into LLP,

Fourth Schedule- conversion of unlisted public company into LLP.

Non-Applicability

Non-Applicability of the Indian Partnership Act, 1932 to LLPs.

Meaning and Concept of LLP

1. New form of legal business entity with limited liability
2. Alternative corporate business vehicle
3. Allows the partners the flexibility of organising their internal structure
4. LLP itself will be liable for the full extent of its assets
5. Liability of the partners will be limited

Important Definitions

Body Corporate [Sec. 2(1)(d)]

A company & **includes** - LLP, foreign LLP, foreign company,

Not include – corporation sole; co-operative society & any other notified by CG.

Business [Sec. 2(1)(e)]

Includes: every trade, profession, service & occupation

Excludes: Any activity notified by CG.

Designated Partner [S 2(1)(j)]

Any partner designated as such pursuant to section 7.

Entity [Sec. 2(1)(k)]

Any body corporate & includes a partnership firm for specific purposes.

Foreign LLP [Sec. 2(1)(m)]

LLP formed, incorporated or registered outside India which establishes a place of business within India.

Financial Year [Sec. 2(1)(l)]:

1st April to 31st March.

If LLP incorporated after 30th September, F.Y. may end on 31st day of March of next following that year.

LLP agreement [Sec. 2(1)(o)]

Written agreement b/w partners of LLP or between the LLP and its partners.

PARTNERS

Who may be (Sec. 5) :
Any individual or body corporate may be a partner in a LLP. But not, person of unsound mind, undischarged insolvent; or who has applied to be adjudicated as an insolvent.

Minimum partners (Section 6)
1. Two partners.
2. If LLP carries on business for more than 6 months with only one partner, he shall be liable personally for the obligations of the LLP incurred during that period.

Important Concepts

Small LLP [S.2(ta)]

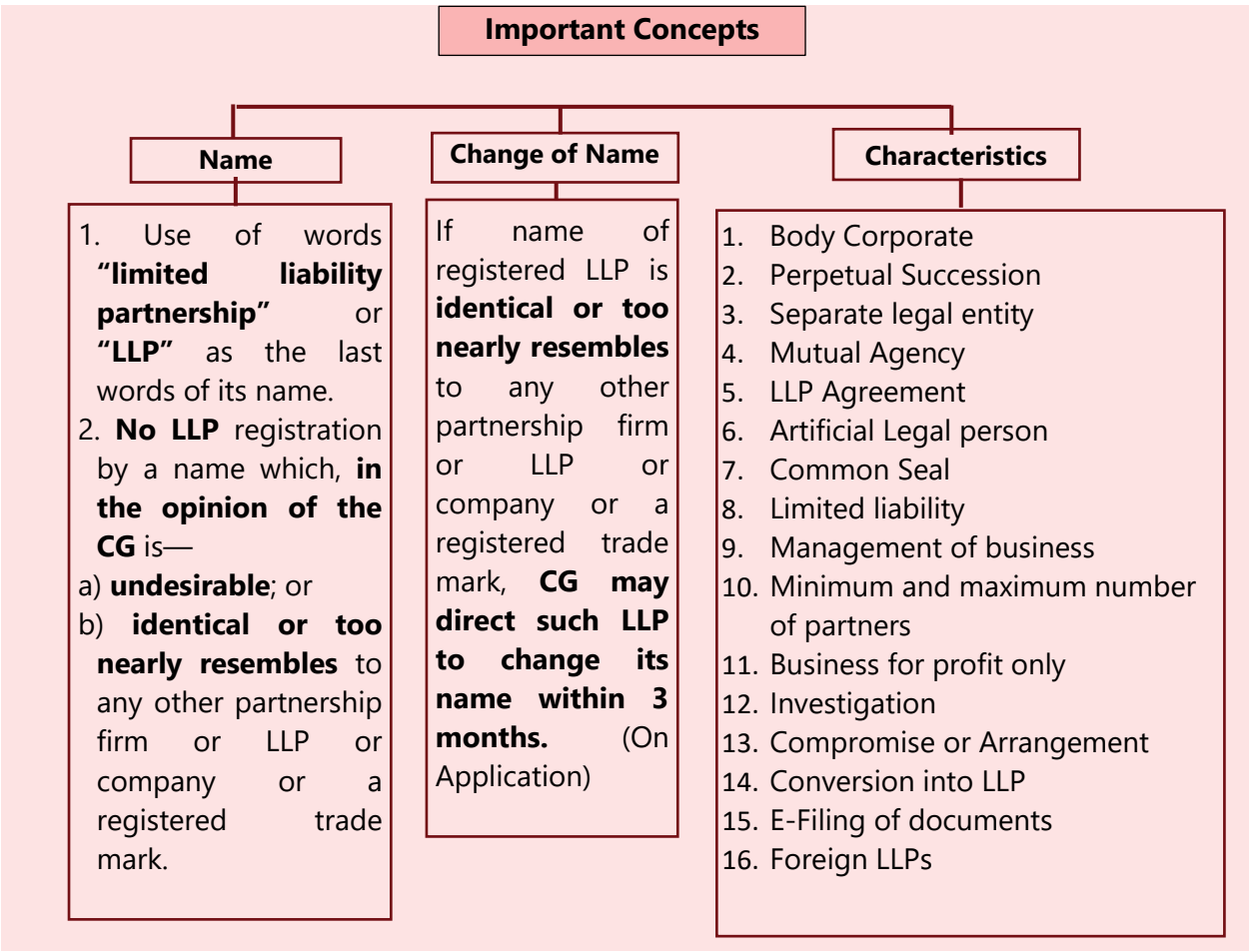
Contribution upto Rs.25L;
&
Turnover for immediately preceding F.Y. upto Rs.40 L
or
which fulfills prescribed terms and conditions.

Designated partners (S.7)

1. At least two designated partners who are individuals and at least one of them shall be a resident in India.
2. Resident in India: a person who has stayed in India for a period of not less than 120 days during the immediately preceding one year.

Incorporation of LLP

1. Subscription of Names by two or more persons,
2. Filing of Documents with ROC with prescribed fees.
3. Compliance Statement made by advocate/CS/CA/CWA & by any one of subscribers.
4. Documents containing - Name, Proposed business, Address of LLP; Name and address of each of to be partners & designated partners; Other prescribed information.
5. Issue of Incorporation Certificate by ROC within 14 days



TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *Ministry of Corporate Affairs enforced the LLP Act, with effect from-*

   (a) 31st March, 2008

   (b) 1st April 2008

   (c) 31st March, 2009

   (d) 1st April 2009

2. *Whether partnership law applies to the LLP-*

   (a) Yes

   (b) No

3. *State which of the statement is correct under the Limited Liability Partnership Act, 2008-*

   (a) All partners have unlimited liability

   (b) All partners have limited liability

4. *Which of the following cannot be converted into LLP?*

   (a) Partnership firm

   (b) Private company

   (c) Listed company

   (d) unlisted company

5. *The approved name of LLP shall be valid for a period of ___ from the date of approval:*

   (a) 1 Month

   (b) 2 Months

   (c) 3 months

   (d) 6 months

6. *Name of the Limited Liability Partnership shall be ended by:*

   (a) Limited

   (b) Limited Liability partnership or LLP

   (c) Private Limited

   (d) OPC

7. *Which one of the following statements about limited liability partnerships (LLPs) is incorrect?*

   (a) An LLP has a legal personality separate from that of its members.

   (b) The liability of each partner in an LLP is limited.

   (c) Members of an LLP are taxed as partners.

   (d) A listed company can convert to an LLP.

8. *For the purpose of LLP, Resident in India means:*

   (a) *Person who has stayed in India for a period of not less than 182 days during the current year.*

   (b) *Person who has stayed in India for a period of not less than 180 days during the immediately preceding one year.*

   (c) *Person who has stayed in India for a period of not less than 181 days during the immediately preceding one year.*

   (d) *Person who has stayed in India for a period of not less than 120 days during the financial year.*

Descriptive Questions

1. *Examine the concept of LLP.*
2. *Enumerate the various characteristics of the LLP.*
3. *What do you mean by Designated Partner? Whether it is mandatory to appoint Designated partner in a LLP?*
4. *What are the effects of registration of LLP?*
5. *"LLP is an alternative corporate business form that gives the benefits of limited liability of a company and the flexibility of a partnership". Explain.*
6. *Explain the essential elements to incorporate a Limited Liability Partnership under the LLP Act, 2008.*

ANSWERS/HINTS

Answers to MCQs

1	**(c)**	2	**(b)**	3	**(b)**	4	**(c)**	5	**(c)**	6	**(b)**
7	**(d)**	8	**(d)**								

Answer to the Descriptive Question

1. **Meaning –** A LLP is a new form of legal business entity with limited liability. It is an alternative corporate business vehicle that gives the benefits of limited liability but allows its partners the flexibility of organising their internal structure as a traditional

partnership. The LLP is a separate legal entity and, while the LLP itself will be liable for the full extent of its assets, the liability of the partners will be limited.

Concept of "limited liability partnership"

- The LLP can continue its existence irrespective of changes in partners. It is capable of entering into contracts and holding property in its own name.
- The LLP is a separate legal entity, is liable to the full extent of its assets but liability of the partners is limited to their agreed contribution in the LLP.
- Further, no partner is liable on account of the independent or un-authorized actions of other partners, thus individual partners are shielded from joint liability created by another partner's wrongful business decisions or misconduct.
- Mutual rights and duties of the partners within a LLP are governed by an agreement between the partners or between the partners and the LLP as the case may be. The LLP, however, is not relieved of the liability for its other obligations as a separate entity.
- LLP is an alternative corporate business form that gives the benefits of limited liability of a company and the flexibility of a partnership.

Since LLP contains elements of both 'a corporate structure' as well as 'a partnership firm structure' LLP is called a hybrid between a company and a partnership.

2. LLP registered with the Registrar under the LLP Act, 2008 has the following characteristics:

- Body Corporate
- Perpetual Succession
- Separate legal entity
- Mutual Agency
- LLP Agreement
- Artificial Legal person
- Common Seal
- Limited liability
- Management of business
- Minimum and maximum number of partners
- Business for profit only

- Investigation
- Compromise or Arrangement
- Conversion into LLP
- E-filing of documents
- Foreign

3. **Designated Partner [Section 2(j)]:** "Designated partner" means any partner designated as such pursuant to section 7.

According to section 7 of the LLP Act, 2008:

(i) Every LLP shall have at least two designated partners who are individuals and at least one of them shall be a resident in India.

(ii) If in LLP, all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such LLP or nominees of such bodies corporate shall act as designated partners.

(iii) *Resident in India*: For the purposes of this section, the term "resident in India" means a person who has stayed in India for a period of not less than 120 days during the financial year.

4. **Effect of registration (Section 14):**

On registration, a LLP shall, by its name, be capable of—

(a) suing and being sued;

(b) acquiring, owning, holding and developing or disposing of property, whether movable or immovable, tangible or intangible;

(c) having a common seal, if it decides to have one; and

(d) doing and suffering such other acts and things as bodies corporate may lawfully do and suffer.

5. **LLP is an alternative corporate business form that gives the benefits of limited liability of a company and the flexibility of a partnership**

Limited Liability: Every partner of a LLP is, for the purpose of the business of LLP, the agent of the LLP, but not of other partners. The liability of the partners will be limited to their agreed contribution in the LLP, while the LLP itself will be liable for the full extent of its assets.

Flexibility of a partnership: The LLP allows its members the flexibility of organizing their internal structure as a partnership based on a mutually arrived agreement. The LLP form enables entrepreneurs, professionals and enterprises providing services of any kind or engaged in scientific and technical disciplines, to form commercially efficient vehicles suited to their requirements. Owing to flexibility in its structure and operation, the LLP is a suitable vehicle for small enterprises and for investment by venture capital.

6. **Essential elements to incorporate Limited Liability Partnership (LLP) -** Under the LLP Act, 2008, the following elements are very essential to form a LLP in India:

(i) To complete and submit incorporation document in the form prescribed with the Registrar electronically;

(ii) To have at least two partners for incorporation of LLP [Individual or body corporate];

(iii) To have registered office in India to which all communications will be made and received;

(iv) To appoint minimum two individuals as designated partners who will be responsible for number of duties including doing of all acts, matters and things as are required to be done by the LLP. Atleast one of them should be resident in India.

(v) A person or nominee of body corporate intending to be appointed as designated partner of LLP should hold a Designated Partner Identification Number (DPIN) allotted by Ministry of Corporate Affairs.

(vi) To execute a partnership agreement between the partners inter se or between the LLP and its partners. In the absence of any agreement the provisions as set out in First Schedule of LLP Act, 2008 will be applied.

(vii) LLP Name.

NOTES

CHAPTER 6

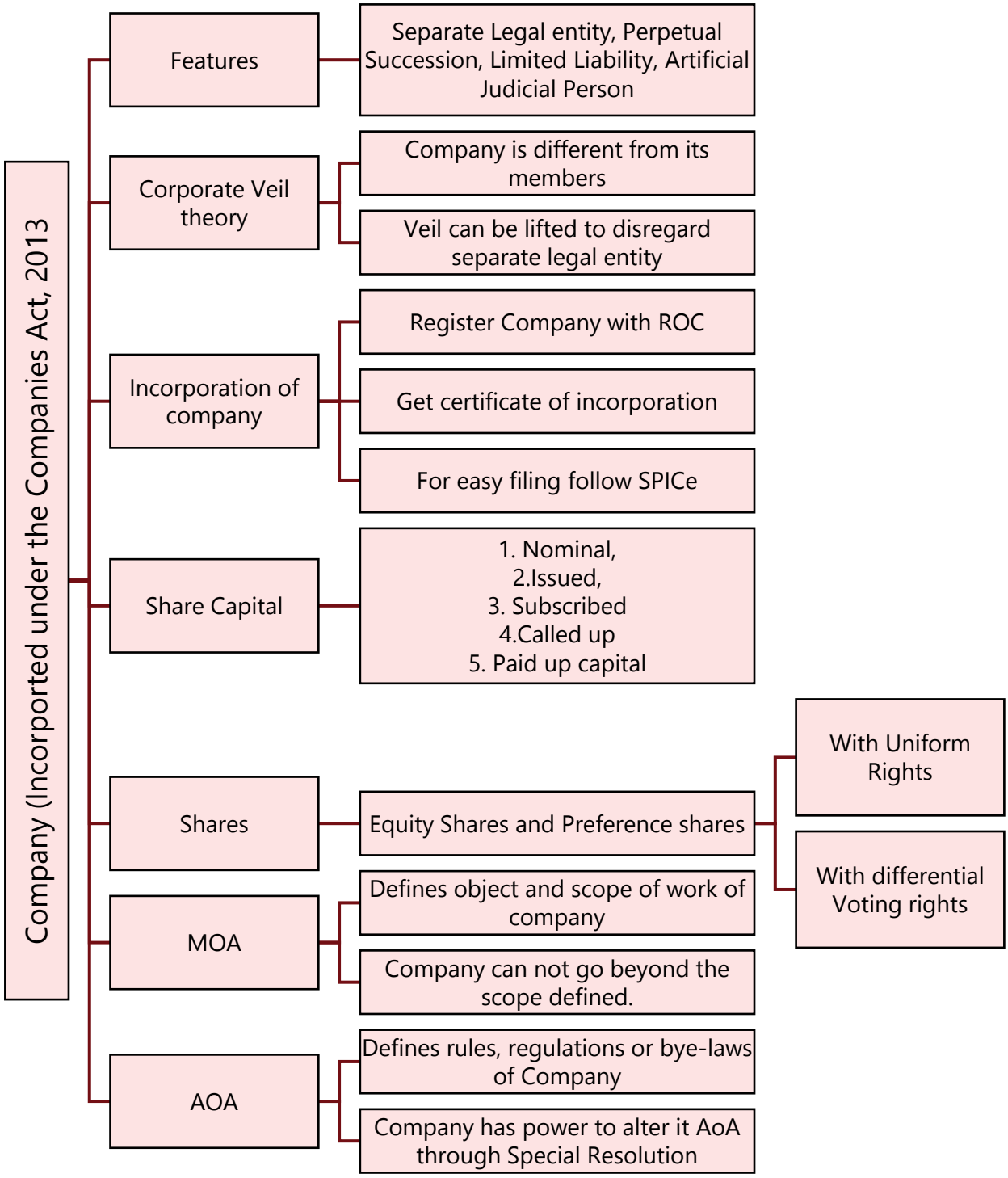
THE COMPANIES ACT, 2013

LEARNING OUTCOMES

After studying this chapter, you would be able to understand-

- Company form of Business Organisation and its features
- Corporate veil theory
- Classes of companies under the Companies Act
- Registration of companies
- Memorandum of Association and Articles of Association

CHAPTER OVERVIEW



INTRODUCTION

The Companies Act, 2013 was enacted to consolidate and amend the law relating to the companies. The Companies Act, 2013 was preceded by the Companies Act, 1956.

Due to changes in the national and international economic environment and to facilitate expansion and growth of our economy, the Central Government decided to replace the Companies Act, 1956 with a new legislation. The Companies Act, 2013 contains 470 sections and seven schedules. The entire Act has been divided into 29 chapters. A substantial part of this Act is in the form of Companies Rules. The Companies Act, 2013 aims to improve corporate governance, simplify regulations, strengthen the interests of minority investors and for the first time legislates the role of whistle-blowers and provisions relating to class action suit. Thus, this enactment seeks to make our corporate regulations more contemporary.

Applicability of the Companies Act, 2013:

The provisions of the Act shall apply to-

- Companies incorporated under this Act or under any previous company law.
- Insurance companies (except where the provisions of the said Act are inconsistent with the provisions of the Insurance Act, 1938 or the IRDA Act, 1999)
- Banking companies (except where the provisions of the said Act are inconsistent with the provisions of the Banking Regulation Act, 1949)
- Companies engaged in the generation or supply of electricity (except where the provisions of the above Act are inconsistent with the provisions of the Electricity Act, 2003)
- Any other company governed by any special Act for the time being in force.
- Such body corporate which are incorporated by any Act for time being in force, and as the Central Government may by notification specify in this behalf.

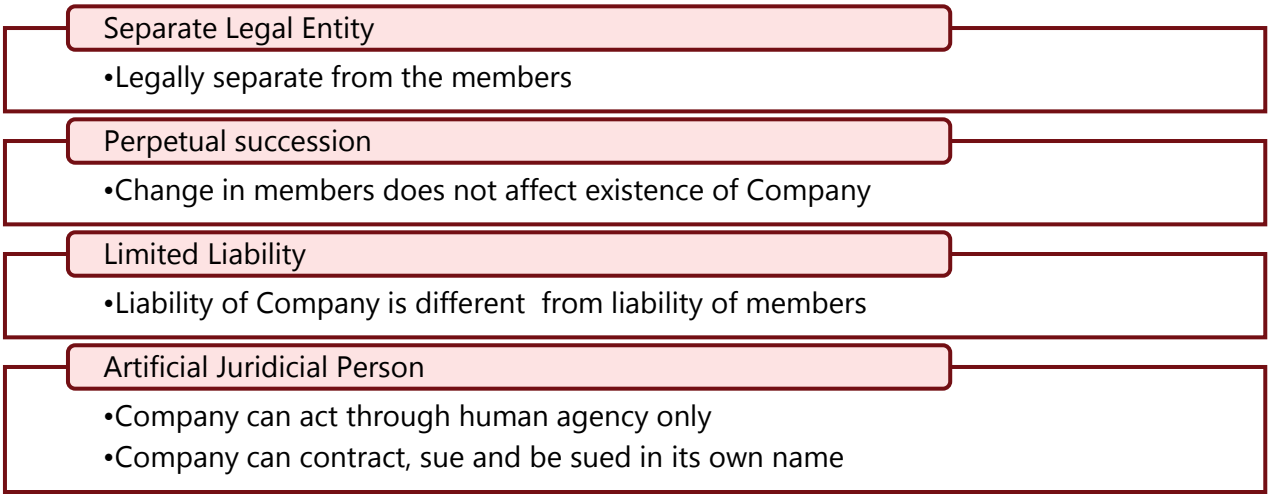
1. COMPANY: MEANING AND ITS FEATURES

Meaning: According to Chief Justice Marshall, "a corporation is an artificial being, invisible, intangible, existing only in contemplation of law. Being a mere creation of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as accidental to its very existence.

In the words of professor Haney, "A company is an incorporated association, which is an artificial person created by law, having a separate entity, with a perpetual succession and a common seal." This definition sums up the meaning as well as the features of a company succinctly.

However, the Act defines the term company a bit differently. Section 2(20) of the Companies Act, 2013 defines the term 'company'. "Company means a company incorporated under this Act or under any previous company law". As we shall progress under the chapter, the meaning of the term company will be understood by the students.

Features of a Company



We have seen the definition given to company from a layman's point of view and legal point of view. But the company form of organization has certain distinctive features that help us to understand the realms of a company. Following are the main features:

I. Separate Legal Entity: There are distinctive features between different forms of organisations and the most striking feature in the company form of organisation vis-à-vis the other forms of business organisations is that it acquires a unique character of being a *separate legal entity*. In other words, when a company is registered, it is clothed with a legal personality. It comes to have almost the same rights and powers as a human being. Its existence is distinct and separate from that of its members. A company can own property, have bank account, raise loans, incur liabilities and enter into contracts.

(a) It is at law, a person which is different from the subscribers to the memorandum of association. It's personality is distinct and separate from the personality of those who compose it.

(b) Even members can contract with company, acquire right against it or incur liability to it. For the debts of the company, only its creditors can sue it and not its members.

A company is capable of owning, enjoying and disposing of property in its own name. Although the capital and assets are contributed by the shareholders, the company becomes the owner of its capital and assets. The shareholders are not the private or joint owners of the company's property.

A member does not even have an insurable interest in the property of the company. The leading case on this point is of *Macaura Vs. Northern Assurance Co. Limited (1925):*

Fact of the case

Macaura (M) was the holder of nearly all (except one) shares of a timber company. He was also a major creditor of the company. M insured the company's timber in his own name. The timber was lost in a fire. M claimed insurance compensation. Held, the insurance company was not liable to him as no shareholder has any right to any item of property owned by the company, for he has no legal or equitable interest in them. Hence in this case, since the timber was insured in the company's name, M could not claim the compensation from insurance company.

II **Perpetual Succession:** Members may die or change, but the company goes on till it is wound up on the grounds specified by the Act. The shares of the company may change hands infinitely but that does not affect the existence of the company. Since a company is an artificial person created by law, law alone can bring an end to its life. Its existence is not affected by the death or insolvency of its members.

Example 1: Many companies in India are in existence for over 100 years. This is possible only due to the fact that the company has perpetual existence. There was a company which has 7 members and all of them died in an aircraft. Despite this the company still exists unlike partnership form of business.

III **Limited Liability:** The liability of a member depends upon the kind of company of which he is a member. We know that company is a separate legal entity which is distinct from its members.

(i) Thus, in the case of a *limited liability company*, the debts of the company in totality do not become the debts of the shareholders. The liability of the members of the company is limited to the extent of the nominal value of shares held by them. In no case can the shareholders be asked to pay anything more than the unpaid value of their shares.

(ii) In the case of a *company limited by guarantee,* the members are liable only to the extent of the amount guaranteed by them and that too only when the company goes into liquidation.

(iii) However, if it is an unlimited company, the liability of its members is unlimited as well.

IV Artificial Legal Person:

(1) A company is an artificial person as it is created by a process other than natural birth. It is legal or judicial as it is created by law. It is a person since it is clothed with all the rights of an individual.

(2) Further, the company being a separate legal entity can own property, have banking account, raise loans, incur liabilities and enter into contracts. Even members can contract with company, acquire right against it or incur liability to it. It can sue and be sued in its own name. It can do everything which any natural person can do except be sent to jail, take an oath, marry or practice a learned profession. Hence, it is a legal person in its own sense.

(3) As the company is an *artificial person*, it can act only through some human agency, viz., directors. The directors cannot control affairs of the company and act as its agency, but they are not the "agents" of the members of the company. The directors can either on their own or through the common seal (of the company) can authenticate its formal acts.

(4) Thus, a company is called an artificial legal person.

V Common Seal: A company being an artificial person is not bestowed with a body of a natural being. Therefore, it works through the agency of human beings. Common seal is the official signature of a company, which is affixed by the officers and employees of the company on its every document. The common seal is a seal used by a corporation as the symbol of its incorporation.

The Companies (Amendment) Act, 2015 has made the common seal optional by omitting the words "and a common seal" from Section 9 so as to provide an alternative mode of authorization for companies who opt not to have a common seal. Rational for this amendment is that common seal is seen as a relic of medieval times. Even in the U.K., common seal has been made optional since 2006. This amendment provides that the documents which need to be authenticated by a common seal will be required to be so done, only if the company opts to have a common seal. **In case a company does not have a common seal, the authorization shall be made by two directors or by a director and the Company Secretary, wherever the company has appointed a Company Secretary.**

2. CORPORATE VEIL THEORY

(i) Corporate Veil: Corporate Veil refers to a legal concept whereby the company is identified separately from the members of the company.

The term Corporate Veil refers to the concept that members of a company are shielded from liability connected to the company's actions. If the company incurs any debts or contravenes any laws, the corporate veil concept implies that members should not be liable for those errors. In other words, they enjoy corporate insulation.

Thus, the shareholders are protected from the acts of the company.

The ***Salomon Vs. Salomon and Co Ltd.*** laid down the foundation of the concept of corporate veil or independent corporate personality.

In *Salomon vs. Salomon & Co. Ltd.* the House of Lords laid down that a company is a person distinct and separate from its members. In this case one Salomon incorporated a company named "Salomon & Co. Ltd.", with seven subscribers consisting of himself, his wife, four sons and one daughter. This company took over the personal business assets of Salomon for £ 38,782 and in turn, Salomon took 20,000 shares of £ 1 each, debentures worth £ 10,000 of the company with charge on the company's assets and the balance in cash. His wife, daughter and four sons took up one £ 1 share each. Subsequently, the company went into liquidation due to general trade depression. The unsecured creditors to the tune of £ 7,000 contended that Salomon could not be treated as a secured creditor of the company, in respect of the debentures held by him, as he was the managing director of one-man company, which was not different from Salomon and the cloak of the company was a mere sham and fraud. **It was held by Lord Mac Naughten:**

"The Company is at law a different person altogether from the subscribers to the memorandum, and though it may be that after incorporation the business is precisely the same as it was before and the same persons are managers, and the same hands receive the profits, the company is not in law the agent of the subscribers or trustees for them. Nor are the subscribers, as members, liable, in any shape or form, except to the extent and in the manner provided by the Act."

Thus, this case clearly established that company has its own existence and as a result, a shareholder cannot be held liable for the acts of the company even though he holds virtually the entire share capital. The whole law of corporation is in fact based on this theory of separate corporate entity.

Now, the question may arise whether this Veil of Corporate Personality can even be lifted or pierced.

Before going into this question, one should first try to understand the meaning of the phrase "lifting the veil". It means looking behind the company as a legal person, i.e., disregarding the

corporate entity and paying regard, instead, to the realities behind the legal facade. Where the Courts ignore the company and concern themselves directly with the members or managers, the corporate veil may be said to have been lifted. Only in appropriate circumstances, the Courts are willing to lift the corporate veil and that too, when questions of control are involved rather than merely a question of ownership.

(ii) **Lifting of Corporate Veil:** The following are the cases where company law disregards the principle of corporate personality or the principle that the company is a legal entity distinct and separate from its shareholders or members:

(1) **To determine the character of the company i.e. to find out whether co-enemy or friend:** In the law relating to trading with the enemy where the test of control is adopted. The leading case in this point is ***Daimler Co. Ltd. vs. Continental Tyre & Rubber*** *Co.,* if the public interest is not likely to be in jeopardy, the Court may not be willing to crack the corporate shell. But it may rend the veil for ascertaining whether a company is an enemy company. It is true that, unlike a natural person, a company does not have mind or conscience; therefore, it cannot be a friend or foe. It may, however, be characterised as an enemy company, if its affairs are under the control of people of an enemy country. For this purpose, the Court may examine the character of the persons who are really at the helm of affairs of the company.

(2) **To protect revenue/tax:** In certain matters concerning the law of taxes, duties and stamps particularly where question of the controlling interest is in issue. ***[S. Berendsen Ltd. vs. Commissioner of Inland Revenue]***

(i) Where corporate entity is used to **evade or circumvent tax,** the Court can disregard the corporate entity ***[Juggilal vs. Commissioner of Income Tax AIR (SC)].***

(ii) In ***[Dinshaw Maneckjee Petit],*** it was held that the company was not a genuine company at all but merely the assessee himself disguised under the legal entity of a limited company. The assessee earned huge income by way of dividends and interest. So, he opened some companies and purchased their shares in exchange of his income by way of dividend and interest. This income was transferred back to assessee by way of loan. The Court decided that the private companies were a sham and the corporate veil was lifted to decide the real owner of the income.

(3) **To avoid a legal obligation:** Where it was found that the sole purpose for the formation of the company was to use it as a device to reduce the amount to be paid by way of bonus to workmen, the Supreme Court upheld the piercing of the veil to look at the real transaction ***(The Workmen Employed in Associated Rubber Industries Limited, Bhavnagar vs. The Associated Rubber Industries Ltd., Bhavnagar and another).***

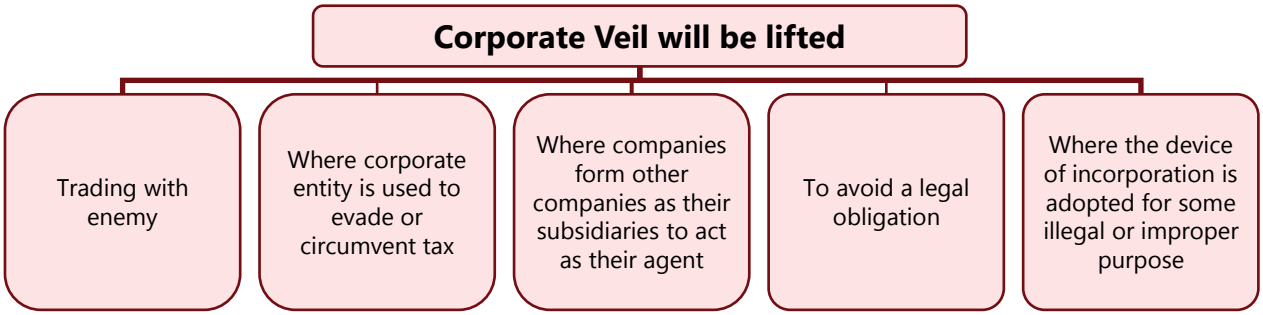
Workmen of Associated Rubber Industry Ltd., v. Associated Rubber Industry Ltd.: The facts of the case are that "A Limited" purchased shares of "B Limited" by investing a sum of ₹ 4,50,000. The dividend in respect of these shares was shown in the profit and loss account of the company, year after year. It was taken into account for the purpose of calculating the bonus payable to workmen of the company. Sometime in 1968, the company transferred the shares of B Limited, to C Limited a subsidiary, wholly owned by it. Thus, the dividend income did not find place in the Profit & Loss Account of A Ltd., with the result that the surplus available for the purpose for payment of bonus to the workmen got reduced.

Here a company created a subsidiary and transferred to it, its investment holdings in a bid to reduce its liability to pay bonus to its workers. Thus, the Supreme Court brushed aside the separate existence of the subsidiary company. The new company so formed had no assets of its own except those transferred to it by the principal company, with no business or income of its own except receiving dividends from shares transferred to it by the principal company and serving no purpose except to reduce the gross profit of the principal company so as to reduce the amount paid as bonus to workmen.

(4) **Formation of subsidiaries to act as agents:** A company may sometimes be regarded as an agent or trustee of its members, or of another company, and may therefore be deemed to have lost its individuality in favour of its principal. Here the principal will be held liable for the acts of that company.

In the case of ***Merchandise Transport Limited vs. British Transport Commission (1982)***, a transport company wanted to obtain licences for its vehicles but could not do so if applied in its own name. It, therefore, formed a subsidiary company, and the application for licence was made in the name of the subsidiary. The vehicles were to be transferred to the subsidiary company. Held, the parent and the subsidiary were one commercial unit and the application for licences was rejected.

(5) **Company formed for fraud/improper conduct or to defeat law:** Where the device of incorporation is adopted for some illegal or improper purpose, e.g., to defeat or circumvent law, to defraud creditors or to avoid legal obligations. ***[Gilford Motor Co. vs. Horne]***



3. CLASSES OF COMPANIES UNDER THE ACT

The growth of the economy and increase in the complexity of business operation in the corporate world has led to the emergence of different forms of corporate organizations. To regulate them, the Companies Act, 2013 has broadly classified the companies into various classes.

A company may be incorporated as a one-person company, private company or a public company, depending upon the number of members joining it. Again, it may either be an unlimited company, or may be limited by shares or by guarantee or by both. On the basis of control, companies can be classified as associate company, holding company and subsidiary company. Some other forms of classification of companies are foreign company, government company, small company, dormant company, nidhi company and company formed for charitable objects.

Companies may be classified into various classes on the following basis:

1. On the basis of liability:

(a) Company limited by shares: Section 2(22) of the Companies Act, 2013, defines that when the liability of the members of a company is limited by its memorandum of association to the amount (if any) unpaid on the shares held by them, it is known as a company limited by shares.

It thus implies that for meeting the debts of the company, the shareholder may be called upon to contribute only to the extent of the amount, which remains unpaid on his shareholdings. His separate property cannot be encompassed to meet the company's debt.

It may be worthwhile to know that though a shareholder is a co-owner of the company, he is not a co-owner of the company's assets. The ownership of the assets remains with the company, because of its nature as a legal person. The extent of the rights and duties of a shareholder as co-owner is measured by his shareholdings.

(b) Company limited by guarantee: Section 2(21) of the Companies Act, 2013 defines it as the company having the liability of its members limited by the memorandum to such amount as the members may respectively undertake by the memorandum to contribute to the assets of the company in the event of its being wound up.

Thus, the liability of the member of a guarantee company is limited upto a stipulated sum mentioned in the memorandum. Members cannot be called upon to contribute beyond that stipulated sum.

The **common features** between a 'guarantee company' and 'the company having share capital' are legal personality and limited liability. In the latter case, the member's liability is limited by the amount remaining unpaid on the share, which each member holds. Both of them have to state in their memorandum that the members' liability is limited.

However, the point of **distinction** between these two types of companies is that in the former case the members may be called upon to discharge their liability only after commencement of the winding up and only subject to certain conditions; but in the latter case, they may be called upon to do so at any time, either during the company's life-time or during its winding up.

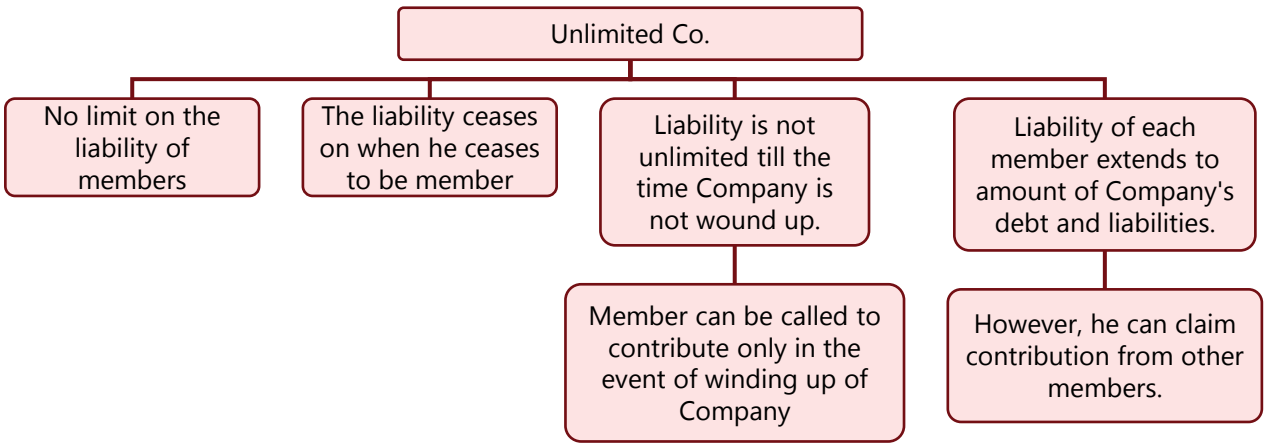
It is clear from the definition of the guarantee company that it does not raise its initial working funds from its members. Therefore, such a company may be useful only where no working funds are needed or where these funds can be held from other sources like endowment, fees, charges, donations, etc.

In ***Narendra Kumar Agarwal vs. Saroj Maloo,***

The Supreme Court has laid down that the right of a guarantee company to refuse to accept the transfer by a member of his interest in the company is on a different footing than that of a company limited by shares. The membership of a guarantee company may carry privileges much different from those of ordinary shareholders.

(c) **Unlimited company:** Section 2(92) of the Companies Act, 2013 defines unlimited company as a company not having any limit on the liability of its members. In such a company, the liability of a member ceases when he ceases to be a member.

The liability of each member extends to the whole amount of the company's debts and liabilities but he will be entitled to claim contribution from other members. In case the company has share capital, the Articles of Association must state the amount of share capital and the amount of each share. So long as the company is a going concern the liability on the shares is the only liability which can be enforced by the company. The creditors can institute proceedings for winding up of the company for their claims. The official liquidator may call the members for their contribution towards the liabilities and debts of the company, which can be unlimited.



2. On the basis of members:

(a) One person company: The Companies Act, 2013 introduced a new class of companies which can be incorporated by a single person.

Section 2(62) of the Companies Act, 2013 defines one person company (OPC) as a company which has only one person as a member.

One person company has been introduced to encourage entrepreneurship and corporatization of business. OPC differs from sole proprietary concern in an aspect that OPC is a separate legal entity with a limited liability of the member whereas in the case of sole proprietary, the liability of owner is not restricted and it extends to the owner's entire assets constituting of official and personal.

The procedural requirements of an OPC are simplified through exemptions provided under the Act in comparison to the other forms of companies.

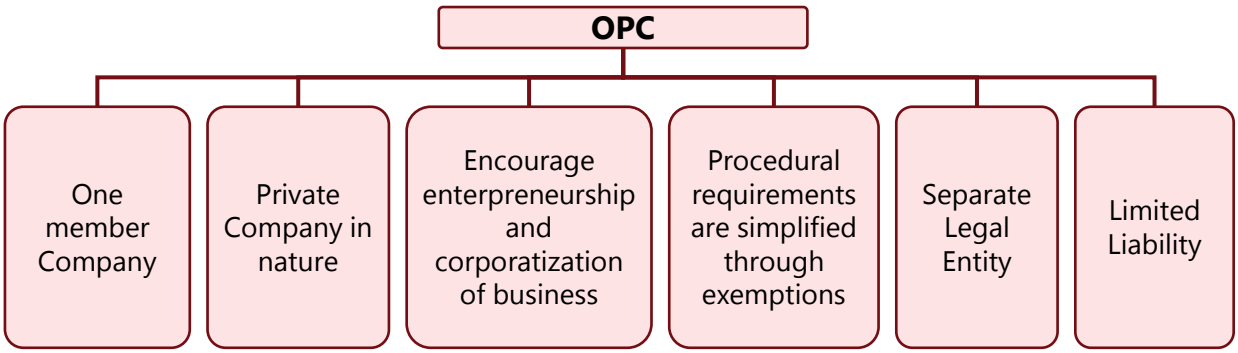
According to section 3(1)(c) of the Companies Act, 2013, **OPC is a private limited company** with the minimum paid up share capital as may be prescribed and having one member.

OPC (One Person Company) - significant points

- Only one person as member.
- Minimum paid up capital – no limit prescribed.
- The memorandum of OPC shall indicate the name of the other person, who shall, in the event of the subscriber's death or his incapacity to contract, become the member of the company.
- The other person whose name is given in the memorandum shall give his prior written consent in prescribed form and the same shall be filed with Registrar of companies at the time of incorporation of the company along with its e-memorandum and e-articles.
- Such other person may be given the right to withdraw his consent.
- The member of OPC may at any time change the name of such other person by giving notice to the company and the company shall intimate the same to the Registrar.
- Any such change in the name of the person shall not be deemed to be an alteration of the memorandum.
- Only a natural person who is an Indian citizen whether resident in India or otherwise and has stayed in India for a period of not less than 120 days during the immediately preceding financial year
  - shall be eligible to incorporate a OPC;
  - shall be a nominee for the sole member of a OPC.

- No person shall be eligible to incorporate more than one OPC or become nominee in more than one such company.
- No minor shall become member or nominee of the OPC or can hold share with beneficial interest.
- Such Company cannot be incorporated or converted into a company under section 8 of the Act. Though it may be converted to private or public companies in certain cases.
- Such Company cannot carry out Non-Banking Financial Investment activities including investment in securities of any body corporate.

Here the member can be the sole member and director.



(b) **Private Company [Section 2(68)]:** "Private company" means a company having a minimum paid-up share capital as may be prescribed, and which by its articles,—

(i) restricts the right to transfer its shares;

(ii) except in case of One Person Company, limits the number of its members to two hundred:

Provided that where two or more persons hold one or more shares in a company jointly, they shall, for the purposes of this clause, be treated as a single member:

Provided further that—

(A) persons who are in the employment of the company; and

(B) persons who, having been formerly in the employment of the company, were members of the company while in that employment and have continued to be members after the employment ceased,

shall not be included in the number of members; and

(iii) prohibits any invitation to the public to subscribe for any securities of the company;

Private company - significant points

- No minimum paid-up capital requirement.
- Minimum number of members – 2 (except if private company is an OPC, where it will be 1).
- Maximum number of members – 200, excluding present employee-cum-members and erstwhile employee-cum-members.
- Right to transfer shares restricted.
- Prohibition on invitation to subscribe to securities of the company.
- Small company is a private company.
- OPC can be formed only as a private company.

Small Company: Small company given under the Section 2(85) of the Companies Act, 2013 which means a company, other than a public company—

(i) **paid-up share capital** of which does not exceed fifty lakh rupees or such higher amount as may be prescribed which shall not be more than ten crore rupees; and

(ii) **turnover** of which as per profit and loss account for the immediately preceding financial year does not exceed two crore rupees or such higher amount as may be prescribed which shall not be more than one hundred crore rupees:

Exceptions: This clause shall not apply to:

(A) a holding company or a subsidiary company;

(B) a company registered under section 8; or

(C) a company or body corporate governed by any special Act.

For the purposes of sub-clause (i) and sub-clause (ii) of clause (85) of section 2 of the Act, paid up capital and turnover of the small company shall not exceed rupees four crores and rupees forty crores respectively. [Companies (Specification of definition details) Amendment Rules, 2022, w.e.f. 15th September, 2022]

Small Company –significant points

- A private company
- Paid up capital – not more than ₹ 50 lakhs

  Or

  Turnover – not more than ₹ 2 crores.
- Should not be – Section 8 company

  – Holding or a Subsidiary company

(c) Public company [Section 2(71)]: "Public company" means a company which—

(i) is not a private company; and

(ii) has a minimum paid-up share capital, as may be prescribed:

Provided that a company which is a subsidiary of a company, not being a private company, shall be deemed to be public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles;

Public company - significant points

- Is not a private company (Articles do not have the restricting clauses).
- Shares freely transferable.
- No minimum paid up capital requirement.
- Minimum number of members – 7.
- Maximum numbers of members – No limit.
- Subsidiary of a public company is deemed to be a public company.

According to section 3(1)(a), a company may be formed for any lawful purpose by seven or more persons, where the company to be formed is to be a public company.

3. On the basis of control:

(a) Holding and subsidiary companies: 'Holding and subsidiary' companies are relative terms.

A company is a holding company in relation to one or more other companies, means a company of which such companies are subsidiary companies. [Section 2(46)]

For the purposes of this clause, the expression "company" includes any body corporate.

Whereas section 2(87) defines "subsidiary company" in relation to any other company (that is to say the holding company), means a company in which the holding company—

(i) controls the composition of the Board of Directors; or

(ii) exercises or controls more than one-half of the total voting power either at its own or together with one or more of its subsidiary companies.

Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed.

For the purposes of this section —

(I) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (i) or sub-clause (ii) is of another subsidiary company of the holding company;

(II) the composition of a company's Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;

(III) the expression "company" includes any body corporate;

(IV) "layer" in relation to a holding company means its subsidiary or subsidiaries.

Example 2: A will be subsidiary of B, if B controls the composition of the Board of Directors of A, i.e., if B can, without the consent or approval of any other person, appoint or remove a majority of directors of A.

Example 3: A will be subsidiary of B, if B holds more than 50% of the share capital of A.

Example 4: B is a subsidiary of A and C is a subsidiary of B. In such a case, C will be the subsidiary of A. In the like manner, if D is a subsidiary of C, D will be subsidiary of B as well as of A and so on.

Status of private company, which is subsidiary to public company: In view of Section 2(71) of the Companies Act, 2013 a Private company, which is subsidiary of a public company shall be deemed to be public company for the purpose of this Act, even where such subsidiary company continues to be a private company in its articles.

(b) **Associate company [Section 2(6)]:** In relation to another company, means a company in which that other company has a significant influence, but which is not a subsidiary company of the company having such influence and includes a joint venture company.

Explanation. — For the purpose of this clause —

(a) the expression "significant influence" means control of at least twenty per cent of total voting power, or control of or participation in business decisions under an agreement;

(b) the expression "joint venture'' means a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

4. On the basis of access to capital:

(a) Listed company: As per the definition given in the section 2(52) of the Companies Act, 2013, it is a company which has any of its securities listed on any recognised stock exchange.

Provided that such class of companies, which have listed or intend to list such class of securities, as may be prescribed in consultation with the Securities and Exchange Board, shall not be considered as listed companies.

Whereas the word securities as per the section 2(81) of the Companies Act, 2013 has been assigned the same meaning as defined in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956.

Example 5: Scan Steel Rods Limited is a Public Limited Company whose shares are listed in the Stock Exchange, Kolkata. Hence Scan Steel Rods Limited is a Listed Company. The reason for calling it "Listed" is because the company and the Stock Exchange have signed a Listing Agreement for trading of shares in the capital market.

(b) Unlisted company means company other than listed company.

5. Other companies:

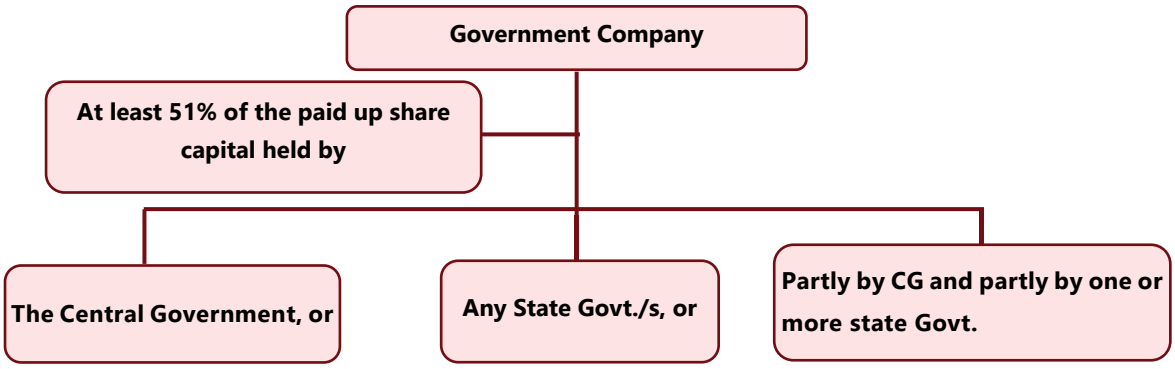
(a) Government company [Section 2(45)]: Government Company means any company in which not less than 51% of the paid-up share capital is held by-

(i) the Central Government, or

(ii) by any State Government or Governments, or

(iii) partly by the Central Government and partly by one or more State Governments, and the section includes a company which is a subsidiary company of such a Government company.

Explanation: For the purposes of this clause, the "paid up share capital" shall be construed as "total voting power", where shares with differential voting rights have been issued.



(b) Foreign Company [Section 2(42)]: It means any company or body corporate incorporated outside India which—

(i) has a place of business in India whether by itself or through an agent, physically or through electronic mode; and

(ii) conducts any business activity in India in any other manner.

(c) Formation of companies with charitable objects etc. (Section 8 company):

Section 8 of the Companies Act, 2013 deals with the formation of companies which are formed to

- promote the charitable objects of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of environment etc.
- Such company intends to apply its profit in
- promoting its objects and
- prohibiting the payment of any dividend to its members.

Examples of section 8 companies are FICCI, ASSOCHAM, National Sports Club of India, CII etc.

Power of Central government to issue the license–

(i) Section 8 allows the Central Government to register such person or association of persons as a company with limited liability without the addition of words 'Limited' or 'Private limited' to its name, by issuing licence on such conditions as it deems fit.

(ii) The registrar shall on application register such person or association of persons as a company under this section.

(iii) On registration the company shall enjoy same privileges and obligations as of a limited company.

Revocation of license: The Central Government may by order revoke the licence of the company where the company contravenes any of the requirements or the conditions of this sections subject to which a licence is issued or where the affairs of the company are conducted fraudulently, or violative of the objects of the company or prejudicial to public interest, and on revocation the Registrar shall put 'Limited' or 'Private Limited' against the company's name in the register. But before such revocation, the Central Government must give it a written notice of its intention to revoke the licence and opportunity to be heard in the matter.

Order of the Central Government: Where a licence is revoked then the Central Government may, in the public interest order that the company registered under this

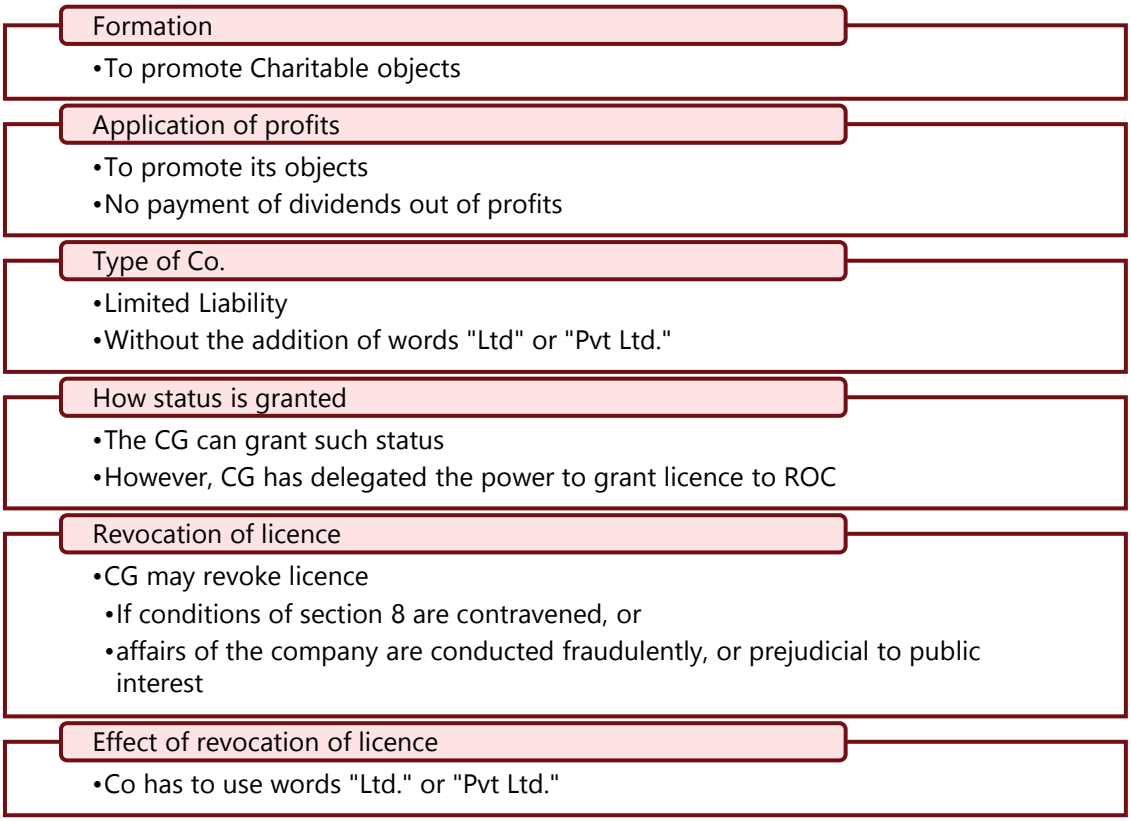
section should be amalgamated with another company registered under this section having similar objects, to form a single company with such constitution, properties, powers, rights, interest, authorities and privileges and with such liabilities, duties and obligations as may be specified in the order, or the company be wound up.

Penalty/punishment in contravention: If a company makes any default in complying with any of the requirements laid down in this section, the company shall, without prejudice to any other action under the provisions of this section, be punishable with fine which shall not be less than ten lakh rupees but which may extend to one crore rupees and the directors and every officer of the company who is in default shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to twenty-five lakh rupees.

Provided that when it is proved that the affairs of the company were conducted fraudulently, every officer in default shall be liable for action under section 447.

Section 8 Company- Significant points

- Formed for the promotion of commerce, art, science, religion, charity, protection of environment, sports, etc.
- Requirement of minimum share capital does not apply.
- Uses its profits for the promotion of the objective for which it is formed.
- Does not declare dividend to members.
- Operates under a special licence from Central Government.
- Need not use the word Ltd./ Pvt. Ltd. in its name and adopt a more suitable name such as club, chambers of commerce etc.
- Licence revoked if conditions contravened.
- On revocation, Central Government may direct it to
  - Converts its status and change its name
  - Wind – up
  - Amalgamate with another company having similar object.
- Can call its general meeting by giving a clear 14 days' notice instead of 21 days.
- Requirement of minimum number of directors, independent directors etc. does not apply.
- Need not constitute Nomination and Remuneration Committee and Shareholders Relationship Committee.
- A partnership firm can be a member of Section 8 company.



(d) **Dormant company (Section 455):** Where a company is formed and registered under this Act for a future project or to hold an asset or intellectual property and has no significant accounting transaction, such a company or an inactive company may make an application to the Registrar in such manner as may be prescribed for obtaining the status of a dormant company.

"Inactive company" means a company which has not been carrying on any business or operation, or has not made any significant accounting transaction during the last two financial years, or has not filed financial statements and annual returns during the last two financial years.

"Significant accounting transaction" means any transaction other than—

(i) payment of fees by a company to the Registrar;

(ii) payments made by it to fulfil the requirements of this Act or any other law;

(iii) allotment of shares to fulfil the requirements of this Act; and

(iv) payments for maintenance of its office and records.

(e) **Meaning of Nidhi Companies [Section 406(1) of the Companies Act, 2013]:** In this section, "Nidhi" or "Mutual Benefit Society" means a company which the Central

Government may, by notification in the Official Gazette, declare to be a Nidhi or Mutual Benefit Society, as the case may be. Nidhi Companies are created mainly for cultivating the habit of thrift and savings amongst its members.

(f) **Public Financial Institutions (PFI):** By virtue of Section 2(72) of the Companies Act, 2013, the following institutions are to be regarded as public financial institutions:

(i) the Life Insurance Corporation of India, established under the Life Insurance Corporation Act, 1956;

(ii) the Infrastructure Development Finance Company Limited,

(iii) specified company referred to in the Unit Trust of India (Transfer of Undertaking and Repeal) Act, 2002;

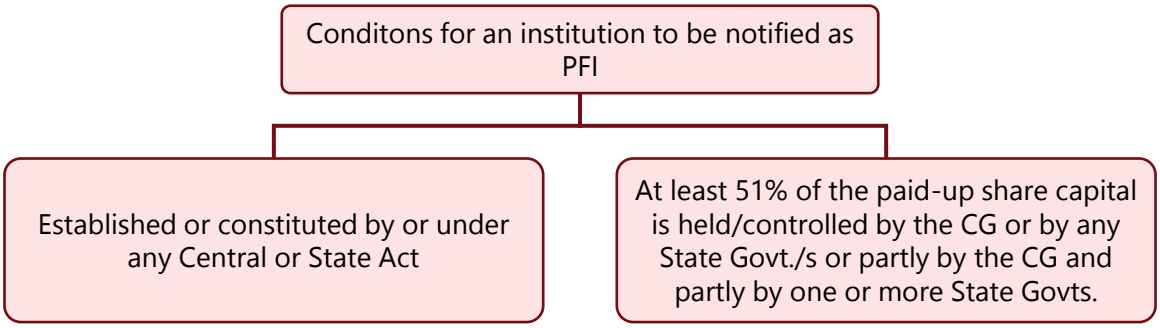
(iv) institutions notified by the Central Government under section 4A(2) of the Companies Act, 1956 so repealed under section 465 of this Act;

(v) such other institution as may be notified by the Central Government in consultation with the Reserve Bank of India:

Conditions for an institution to be notified as PFI: No institution shall be so notified unless—

(A) it has been established or constituted by or under any Central or State Act other than this Act or the previous Companies Law; or

(B) not less than fifty-one per cent of the paid-up share capital is held or controlled by the Central Government or by any State Government or Governments or partly by the Central Government and partly by one or more State Governments.



4. MODE OF REGISTRATION/INCORPORATION OF COMPANY

PROMOTERS: The Companies Act, 2013 defines the term "Promoter" under section 2(69) which means a person—

(a) who has been named as such in a prospectus or is identified by the company in the annual return referred to in section 92; or

(b) who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or

(c) in accordance with whose advice, directions, or instructions the Board of Directors of the company is accustomed to act.

In simple terms we can say,

✓ Persons who form the company are known as promoters.

✓ It is they who conceive the idea of forming the company.

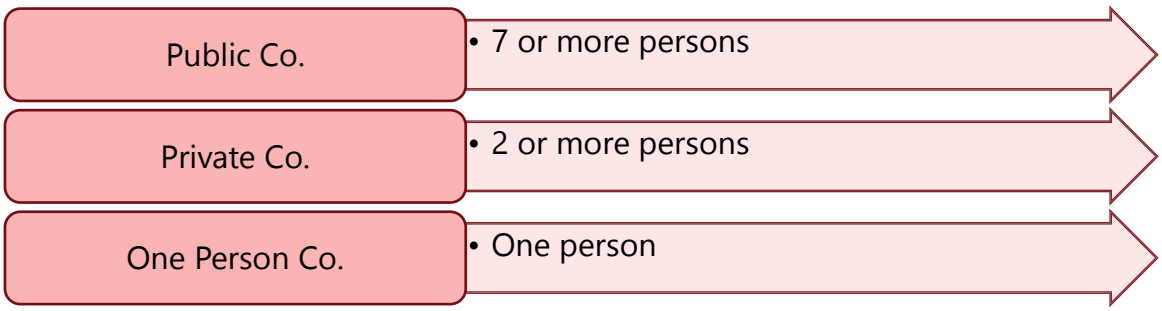
✓ They take all necessary steps for its registration.

✓ It should, however, be noted that persons acting only in a professional capacity e.g., the solicitor, banker, accountant etc. are not regarded as promoters.

FORMATION OF COMPANY: Section 3 of the Companies Act, 2013 deals with the basic requirement with respect to the constitution of the company.

In the case of a public company, any 7 or more persons can form a company for any lawful purpose by subscribing their names to memorandum and complying with the requirements of this Act in respect of registration.

In the same way, 2 or more persons can form a private company and one person can form one person company.



INCORPORATION OF COMPANY: Section 7 of the Companies Act, 2013 provides for the procedure to be followed for incorporation of a company.

(1) **Filing of the documents and information with the registrar:** For the registration of the company following documents and information are required to be filed with the registrar within whose jurisdiction the registered office of the company is proposed to be situated-

- the memorandum and articles of the company duly **signed by all the subscribers** to the memorandum.
- a **declaration by person who is engaged in the formation of the company** (an advocate, a chartered accountant, cost accountant or company secretary in practice), **and by a person named in the articles** (director, manager or secretary of the company), that all the requirements of this Act and the rules made thereunder in respect of registration and matters precedent or incidental thereto have been complied with.
- a **declaration from each of the subscribers to the memorandum and from persons named as the first directors, if any, in the articles stating** that-
  - he is not convicted of any offence in connection with the promotion, formation or management of any company, or
  - he has not been found guilty of any fraud or misfeasance or of any breach of duty to any company under this Act or any previous company law during the last five years,
  - and that all the documents filed with the Registrar for registration of the company contain information that is correct and complete and true to the best of his knowledge and belief;
- the **address for correspondence** till its registered office is established;
- the **particulars** (names, including surnames or family names, residential address, nationality) **of every subscriber** to the memorandum along with proof of identity, and in the case of a subscriber being a body corporate, such particulars as may be prescribed.
- the **particulars** (names, including surnames or family names, the Director Identification Number, residential address, nationality) **of the persons mentioned in the articles as the subscribers to the Memorandum** and such other particulars including proof of identity as may be prescribed; and
- the **particulars of the interests of the persons mentioned in the articles** as the first directors of the company in other firms or bodies corporate along with their consent to act as directors of the company in such form and manner as may be prescribed.

Particulars provided in this provision shall be of the individual subscriber and not of the professional engaged in the incorporation of the company *[The Companies (Incorporation) Rules, 2014]*.

(2) **Issue of certificate of incorporation on registration:** The Registrar on the basis of documents and information filed, shall register all the documents and information in the register and issue a certificate of incorporation in the prescribed form to the effect that the proposed company is incorporated under this Act.

(3) **Allotment of Corporate Identity Number (CIN):** On and from the date mentioned in the certificate of incorporation, the Registrar shall allot to the company a corporate identity number, which shall be a distinct identity for the company and which shall also be included in the certificate.

(4) **Maintenance of copies of all documents and information:** The company shall maintain and preserve at its registered office copies of all documents and information as originally filed, till its dissolution under this Act.

(5) **Furnishing of false or incorrect information or suppression of material fact at the time of incorporation (i.e. at the time of Incorporation):** If any person furnishes any false or incorrect particulars of any information or suppresses any material information, of which he is aware in any of the documents filed with the Registrar in relation to the registration of a company, he shall be liable for action for fraud under section 447.

(6) **Company already incorporated by furnishing any false or incorrect information or representation or by suppressing any material fact (i.e. post Incorporation):** Where, at any time after the incorporation of a company, it is proved that the company has been got incorporated by furnishing any false or incorrect information or representation or by suppressing any material fact or information in any of the documents or declaration filed or made for incorporating such company, or by any fraudulent action, the promoters, the persons named as the first directors of the company and the persons making declaration under this section shall each be liable for action for fraud under section 447.

(7) **Order of the Tribunal:** Where a company has been got incorporated by furnishing false or incorrect information or representation or by suppressing any material fact or information in any of the documents or declaration filed or made for incorporating such company or by any fraudulent action, the Tribunal may, on an application made to it, on being satisfied that the situation so warrants,—

(a) pass such orders, as it may think fit, for regulation of the management of the company including changes, if any, in its memorandum and articles, in public interest or in the interest of the company and its members and creditors; or

(b) direct that liability of the members shall be unlimited; or

(c) direct removal of the name of the company from the register of companies; or

(d) pass an order for the winding up of the company; or

(e) pass such other orders as it may deem fit:

Provided that before making any order,—

- the company shall be given a reasonable opportunity of being heard in the matter; and
- the Tribunal shall take into consideration the transactions entered into by the company, including the obligations, if any, contracted or payment of any liability.

Simplified Proforma for Incorporating Company Electronically (SPICe)

The Ministry of Corporate Affairs has taken various initiatives for ease of business. In a step towards easy setting up of business, MCA has simplified the process of filing of forms for incorporation of a company through Simplified Proforma for incorporating company electronically.

EFFECT OF REGISTRATION: Section 9 of the Companies Act, 2013 provides for the effect of registration of a company.

According to Section 9, from the date of incorporation (mentioned in the certificate of incorporation), the subscribers to the memorandum and all other persons, who may from time to time become members of the company, shall be a body corporate by the name contained in the memorandum. Such a registered company shall be capable of exercising all the functions of an incorporated company under this Act and having perpetual succession with power to acquire, hold and dispose of property, both movable and immovable, tangible and intangible, to contract and to sue and be sued, by the said name.

From the date of incorporation mentioned in the certificate, the company becomes a legal person separate from the incorporators; and there comes into existence a binding contract between the company and its members as evidenced by the Memorandum and Articles of Association ***[Hari Nagar Sugar Mills Ltd. vs. S.S. Jhunjhunwala].*** It has perpetual existence until it is dissolved by liquidation or struck out of the register. A shareholder who buys shares, does not buy any interest in the property of the company but in certain cases a writ petition will be maintainable by a company or its shareholders.

A legal personality emerges from the moment of registration of a company and from that moment the persons subscribing to the Memorandum of Association and other persons joining as members are regarded as a body corporate or a corporation in aggregate and the

legal person begins to function as an entity. A company on registration acquires a separate existence and the law recognises it as a legal person separate and distinct from its members ***[State Trading Corporation of India vs. Commercial Tax Officer].***

It may be noted that under the provisions of the Act, a company may purchase shares of another company and thus become a controlling company. However, merely because a company purchases all shares of another company it will not serve as a means of putting an end to the corporate character of another company and each company is a separate juristic entity ***[Spencer & Co. Ltd. Madras vs. CWT Madras].***

As has been stated above, the law recognizes such a company as a juristic person separate and distinct from its members. The mere fact that the entire share capital has been contributed by the Central Government and all its shares are held by the President of India and other officers of the Central Government does not make any difference in the position of registered company and it does not make a company an agent either of the President or the Central Government ***[Heavy Electrical Union vs. State of Bihar].***

EFFECT OF MEMORANDUM AND ARTICLES: As per Section 10 of the Companies Act, 2013, where the memorandum and articles when registered, shall bind the company and the members thereof to the same extent as if they respectively had been signed by the company and by each member, and an agreement to observe all the provisions of the memorandum and of the articles. All monies payable by any member to the company under the memorandum or articles shall be a debt due from him to the company.

5. CLASSIFICATION OF CAPITAL

The term Capital has a variety of meanings. It means one thing to economists; another to accountants and still another to businessmen and lawyers. In relation to a company limited by shares, the word capital means share-capital, i.e., the capital or figure in terms of so many rupees divided into shares of fixed amount. In other words, the contributions of persons to the common stock of the company form the capital of the company. The proportion of the capital to which each member is entitled, is his share. A share is not a sum of money; it is rather an interest measured by a sum of money and made up of various rights contained in the contract.

In the domain of Company Law, the term 'capital' is used in the following senses:

(a) **Nominal or authorised or registered capital:** This form of capital has been defined in section 2(8) of the Companies Act, 2013. "Authorised capital" or "Nominal capital" means such capital as is authorised by the memorandum of a company to be the maximum amount of share capital of the company. Thus, it is the sum stated in the memorandum as the capital of the company with which it is to be registered being the

maximum amount which it is authorised to raise by issuing shares, and upon which it pays the stamp duty. It is usually fixed at the amount, which, it is estimated, the company will need, including the working capital and reserve capital, if any.

(b) **Issued capital:** Section 2(50) of the Companies Act, 2013 defines "issued capital" which means such capital as the company issues from time to time for subscription. It is that part of authorised capital which is offered by the company for subscription and includes the shares allotted for consideration other than cash.

Schedule III to the Companies Act, 2013, makes it obligatory for a company to disclose its issued capital in the balance sheet.

(c) **Subscribed capital:** Section 2(86) of the Companies Act, 2013 defines "subscribed capital" as such part of the capital which is for the time being subscribed by the members of a company.

It is the nominal amount of shares taken up by the public. Where any notice, advertisement or other official communication or any business letter, bill head or letter paper of a company states the authorised capital, the subscribed and paid-up capital must also be stated in equally conspicuous characters. A default in this regard will make the company and every officer who is in default liable to pay penalty extending ₹ 10,000 and ₹ 5,000 respectively. [Section 60].

(d) **Called-up capital:** Section 2(15) of the Companies Act, 2013 defines "called-up capital" as such part of the capital, which has been called for payment. It is the total amount called up on the shares issued.

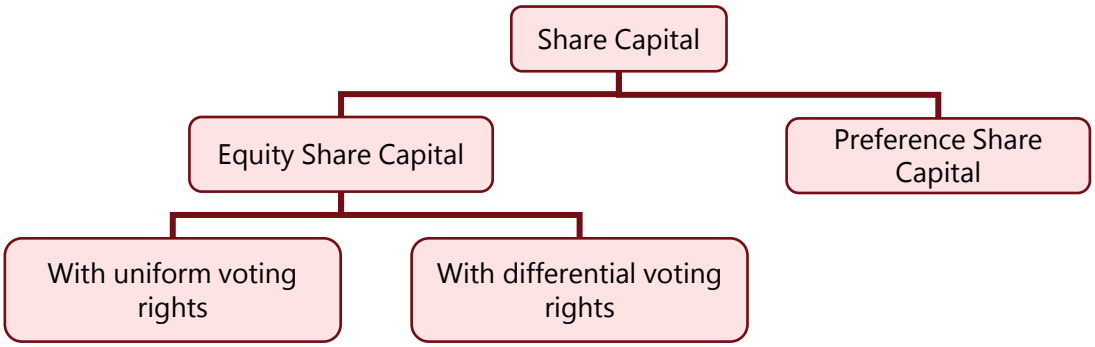
(e) **Paid-up capital** is the total amount paid or credited as paid up on shares issued. It is equal to called up capital less calls in arrears.

6. SHARES

(I) **Nature of shares:** Section 2(84) of the Companies Act, 2013 defines the term 'share' which means a share in the share capital of a company and includes stock. A share thus represents such proportion of the interest of the shareholders as the amount paid up thereon bears to the total capital payable to the company. It is a measure of the interest in the company's assets to which a person holding a share is entitled.

Share is an interest in the company: Farwell Justice, in ***Borland Trustees vs. Steel Bors. & Co. Ltd.*** observed that "a share is not a sum of money but is an interest measured by a sum of money and made up of various rights contained in the contract, including the right to a

sum of money of a more or less amount". You should note that the shareholders are not, in the eyes of law, part owners of the undertaking. The undertaking is somewhat different from the totality of the shareholders. The rights and obligations attaching to a share are those prescribed by the memorandum and the articles of a company. It must, however, be remembered that a shareholder has not only contractual rights against the company, but also certain other rights which accrue to him according to the provisions of the Companies Act.



Shares are a movable property: According to section 44 of the Companies Act, 2013, the shares or debentures or other interests of any member in a company shall be movable property transferable in the manner provided by the articles of the company.

Shares shall be numbered: Section 45 provides, every share in a company having a share capital, shall be distinguished by its distinctive number. This implies that every share shall be numbered.

However, this shall not apply to a share held by a person whose name is entered as holder of beneficial interest in such share in the records of a depository.

(II) Kinds of share capital:- Section 43 of the Companies Act, 2013 provides the kinds of share capital. According to the provision the share capital of a company limited by shares shall be of two kinds, namely:—

(i) Equity share capital —

(1) with voting rights; or

(2) with differential rights as to dividend, voting or otherwise in accordance with prescribed rules;

Example 6: It is to be noted that, Tata Motors in 2008 introduced equity shares with differential voting rights called 'A' equity shares in its rights issue. In the issue, every 10 'A' equity shares carried only one voting right but would get 5 percentage points more dividend than that declared on each of the ordinary shares. Since 'A' equity share did not carry the similar voting rights, it was being traded at discount to other common

shares having full voting. Other companies which have issued equity shares with differential voting rights (popularly called DVRs) are Future Retail, Jain Irrigation among others.

(ii) Preference share capital:

However, this Act shall not affect the rights of the preference shareholders who are entitled to participate in the proceeds of winding up before the commencement of this Act.

According to explanation to section 43:

1. **''Equity share capital'',** with reference to any company limited by shares, means all share capital which is not preference share capital;

2. **''Preference share capital'',** with reference to any company limited by shares, means that part of the issued share capital of the company which carries or would carry a preferential right with respect to—

   (a) **payment of dividend,** either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax; and

   (b) **repayment**, in the case of a winding up or repayment of capital, of the amount of the share capital paid-up or deemed to have been paid-up, whether or not, there is a preferential right to the payment of any fixed premium or premium on any fixed scale, specified in the memorandum or articles of the company;

Exception: In case of private company - Section 43 shall not apply where memorandum or articles of association of the private company so provides.

7. MEMORANDUM OF ASSOCIATION

The Memorandum of Association of company is in fact its charter; it defines its constitution and the scope of the powers of the company with which it has been established under the Act. It is the very foundation on which the whole edifice of the company is built.

Object of registering a memorandum of association:

- It contains the object for which the company is formed and therefore identifies the possible scope of its operations beyond which its actions cannot go.
- It enables shareholders, creditors and all those who deal with company to know what its powers are and what activities it can engage in.

A memorandum is a public document under Section 399 of the Companies Act, 2013. Consequently, every person entering into a contract with the company is presumed to have the knowledge of the conditions contained therein.

- The shareholders must know the purposes for which his money can be used by the company and what risks he is taking in making the investment.

A company cannot depart from the provisions contained in the memorandum however imperative may be the necessity for the departure. It cannot enter into a contract or engage in any trade or business, which is beyond the power confessed on it by the memorandum. If it does so, it would be ultra vires the company and void.

As per Section 4, Memorandum of a company shall be drawn up in such form as is given in Tables A, B, C, D and E in Schedule I of the Companies Act, 2013.

Table A is a form for memorandum of association of a company limited by shares.

Table B is a form for memorandum of association of a company limited by guarantee and not having a share capital.

Table C is a form for memorandum of association of a company limited by guarantee and having a share capital.

Table D is a form for memorandum of association of an unlimited company.

Table E is a form for memorandum of association of an unlimited company and having share capital.

The memorandum and articles of a company must be as closed to model forms, as possible, depending upon the circumstances.

Content of the memorandum: The memorandum of a company shall state—

(a) the name of the company **(Name Clause)** with the last word "Limited" in the case of a public limited company, or the last words "Private Limited" in the case of a private limited company. This clause is not applicable on the companies formed under section 8 of the Act.

The name including phrase 'Electoral Trust' may be allowed for Registration of companies to be formed under section 8 of the Act, in accordance with the Electoral Trusts Scheme, 2013 notified by the Central Board of Direct Taxes (CBDT). For the Companies under section 8 of the Act, the name shall include the words foundation, Forum, Association, Federation, Chambers, Confederation, council, Electoral trust and the like etc. *[The Companies (Incorporation) Rules, 2014].*

As per MCA notification dated 5th June, 2015, a Government company's name must end with the word "Limited". In the case of One Person Company, the words "One Person Company", should be included below its name.

(b) the State in which the registered office of the company **(Registered Office clause)** is to be situated;

(c) the objects for which the company is proposed to be incorporated and any matter considered necessary in furtherance thereof **(Object clause);**

If any company has changed its activities which are not reflected in its name, it shall change its name in line with its activities within a period of six months from the change of activities after complying with all the provisions as applicable to change of name.

(d) the liability of members of the company **(Liability clause)**, whether limited or unlimited, and also state,—

- **in the case of a company limited by shares,** that the liability of its members is limited to the amount unpaid, if any, on the shares held by them; and
- **in the case of a company limited by guarantee,** the amount up to which each member undertakes to contribute—
  - to the **assets of the company in the event of its being wound-up** while he is a member or within one year after he ceases to be a member for payment of the debts and liabilities of the company or of such debts and liabilities as may have been contracted before he ceases to be a member, as the case may be; and
  - to the costs, charges and expenses of winding-up and for adjustment of the rights of the contributories among themselves;

(e) the amount of authorized capital **(Capital Clause)** divided into share of fixed amounts and the number of shares with the subscribers to the memorandum have agreed to take, indicated opposite their names, which shall not be less than one share. A company not having share capital need not have this clause.

(f) the detail of the subscribers to be formed into a company. The Memorandum shall conclude with the **association clause.** Every subscriber to the Memorandum shall take atleast one share, and shall write against his name, the number of shares taken by him.

In the case of OPC, the name of the person who, in the event of death of the subscriber, shall become the member of the company.

The memorandum must be printed, divided into paragraphs, numbered consecutively, and signed by at least seven persons (two in the case of a private company and one in the case of

One Person Company) in the presence of at least one witness, who will attest the signatures. The particulars about the signatories to the memorandum as well as the witness, as to their address, description, occupation etc., must also be entered.

It is to be noted that a company being a legal person can through its agent, subscribe to the memorandum. However, a minor cannot be a signatory to the memorandum as he is not competent to contract. The guardian of a minor, who subscribes to the memorandum on his behalf, will be deemed to have subscribed in his personal capacity.

The above clauses of the Memorandum are called compulsory clauses, or "Conditions". In addition to these a memorandum may contain other provisions, for example rights attached to various classes of shares.

The Memorandum of Association of a company cannot contain anything contrary to the provisions of the Companies Act. If it does, the same shall be devoid of any legal effect. Similarly, all other documents of the company must comply with the provisions of the Memorandum.

8. DOCTRINE OF ULTRA VIRES

Doctrine of ultra vires: The meaning of the term ultra vires is simply "beyond (their) powers". The legal phrase "*ultra vires*" is applicable only to acts done in excess of the legal powers of the doers. This presupposes that the powers in their nature are limited.

It is a fundamental rule of Company Law that the objects of a company as stated in its memorandum can be departed from only to the extent permitted by the Act, thus far and no further. In consequence, any act done or a contract made by the company which travels beyond the powers not only of the directors but also of the company is wholly void and inoperative in law and is therefore not binding on the company. On this account, a company can be restrained from employing its fund for purposes other than those sanctioned by the memorandum. Likewise, it can be restrained from carrying on a trade different from the one it is authorised to carry on.

The impact of the doctrine of ultra vires is that a company can neither be sued on an ultra vires transaction, nor can it sue on it. Since the memorandum is a "public document", it is open to public inspection. Therefore, when one deals with a company one is deemed to know about the powers of the company. If in spite of this you enter into a transaction which is ultra vires the company, you cannot enforce it against the company.

Example 7: If you have supplied goods or performed service on such a contract or lent money, you cannot obtain payment or recover the money lent. But if the money advanced to the company has not been expended, the lender may stop the company from parting with it by

means of an injunction; this is because the company does not become the owner of the money, which is ultra vires the company. As the lender remains the owner, he can take back the property in specie. If the ultra vires loan has been utilised in meeting lawful debt of the company, then the lender steps into the shoes of the debtor paid off and consequently he would be entitled to recover his loan to that extent from the company.

An act which is ultra vires the company being void, cannot be ratified by the shareholders of the company. Sometimes, act which is ultra vires can be regularised by ratifying it subsequently. For instance, if the act is ultra vires the power of the directors, the shareholders can ratify it; if it is ultra vires the articles of the company, the company can alter the articles; if the act is within the power of the company but is done irregularly, shareholder can validate it.

The leading case through which this doctrine was enunciated is that of ***Ashbury Railway Carriage and Iron Company Limited v. Riche-(1875).***

The facts of the case are:

The main objects of a company were:

(a) To make, sell or lend on hire, railway carriages and wagons;

(b) To carry on the business of mechanical engineers and general contractors.

(c) To purchase, lease, sell and work mines.

(d) To purchase and sell as merchants or agents, coal, timber, metals etc.

The directors of the company entered into a contract with Riche, for financing the construction of a railway line in Belgium, and the company further ratified this act of the directors by passing a special resolution. The company however, repudiated the contract as being ultra-vires. And Riche brought an action for damages for breach of contract. His contention was that the contract was well within the meaning of the word general contractors and hence within its powers. Moreover, it had been ratified by a majority of shareholders. However, it was held by the Court that the contract was null and void. It said that the terms general contractors was associated with mechanical engineers, i.e. it had to be read in connection with the company's main business. If, the term general contractor's was not so interpreted, it would authorize the making of contracts of any kind and every description, for example, marine and fire insurance.

An ultra vires **contract can never be made binding on the company. It cannot become "Intravires" by reasons of estoppel, acquiescence, lapse of time, delay or ratification.**

The whole position regarding the doctrine of ultra vires can be summed up as:

(i) When an act is performed, which though legal in itself, is not authorized by the object clause of the memorandum, or by the statute, it is said to be ultravires the company, and hence null and void.

(ii) An act which is ultravires, the company cannot be ratified even by the unanimous consent of all the shareholders.

(iii) An act which is ultravires the directors, but intravires the company can be ratified by the members of the company through a resolution passed at a general meeting.

(iv) If an act is ultravires the Articles, it can be ratified by altering the Articles by a Special Resolution at a general meeting.

However, the disadvantages of this doctrine outweigh its main advantage, namely to provide protection to the shareholders and creditors. Although it may be useful to members in restraining the activities of the directors, **it is only a nuisance in so far as it prevents the company from changing its activities in a direction which is agreed by all.** Again, the purpose of doctrine of ultravires has been defeated as now the object clause can be easily altered, by passing just a special resolution of the shareholders.

9. ARTICLES OF ASSOCIATION

The articles of association of a company are its rules and regulations, which are framed to manage its internal affairs. Just as the memorandum contains the fundamental conditions upon which the company is allowed to be incorporated, so also the articles are the internal regulations of the company ***(Guiness vs. Land Corporation of Ireland).*** These general functions of the articles have been aptly summed up by Lord Cairns in ***Ashbury Carriage Co. vs. Riches*** as follows: "The articles play a part subsidiary to memorandum of association. They accept the memorandum as the charter of incorporation, and so accepting it the articles proceed to define the duties, the rights and powers of the governing body as between themselves and the company and the mode and form in which the business of the company is to be carried on, and the mode and form in which changes in the internal regulation of the company may from time to time be made."

The document containing the articles of association of a company (the Magna Carta) is a business document; hence it has to be construed strictly. It regulates domestic management of a company and creates certain rights and obligations between the members and the company ***[S.S. Rajkumar vs. Perfect Castings (P) Ltd.].***

The articles of association are in fact the bye-laws of the company according to which director and other officers are required to perform their functions as regards the management of the

company, its accounts and audit. It is important therefore that the auditor should study them and, while doing so he should note the provisions therein in respect of relevant matters.

Section 5 of the Companies Act, 2013 seeks to provide the contents and model of articles of association. The section lays the following law-

(1) **Contains regulations:** The articles of a company shall contain the regulations for management of the company.

(2) **Inclusion of matters:** The articles shall also contain such matters, as are prescribed under the rules. However, a company may also include such additional matters in its articles as may be considered necessary for its management.

(3) **Contain provisions for entrenchment:** The articles may contain provisions for entrenchment (to protect something) to the effect that specified provisions of the articles may be altered only if conditions or procedures as that are more restrictive than those applicable in the case of a special resolution, are met or complied with.

(4) **Manner of inclusion of the entrenchment provision:** The provisions for entrenchment shall only be made either on formation of a company, or by an amendment in the articles agreed to by all the members of the company in the case of a private company and by a special resolution in the case of a public company.

(5) **Notice to the registrar of the entrenchment provision:** Where the articles contain provisions for entrenchment, whether made on formation or by amendment, the company shall give notice to the Registrar of such provisions in such form and manner as may be prescribed.

(6) **Forms of articles:** The articles of a company shall be in respective forms specified in Tables, F, G, H, I and J in Schedule I as may be applicable to such company.

(7) **Model articles:** A company may adopt all or any of the regulations contained in the model articles applicable to such company.

(8) **Company registered after the commencement of this Act:** In case of any company, which is registered after the commencement of this Act, in so far as the registered articles of such company do not exclude or modify the regulations contained in the model articles applicable to such company, those regulations shall, so far as applicable, be the regulations of that company in the same manner and to the extent as if they were contained in the duly registered articles of the company.

The following are the key differences between the Memorandum of Association vs. Articles of Association:

1. **Objectives:** Memorandum of Association defines and delimits the objectives of the company whereas the Articles of association lays down the rules and regulations for

the internal management of the company. Articles determine how the objectives of the company are to be achieved.

2. **Relationship:** Memorandum defines the relationship of the company with the outside world and Articles define the relationship between the company and its members.

3. **Alteration:** Memorandum of association can be altered only under certain circumstances and in the manner provided for in the Act. In most cases permission of the Regional Director, or the Tribunal is required. The articles can be altered simply by passing a special resolution.

4. **Ultra Vires:** Acts done by the company beyond the scope of the memorandum are ultra-vires and void. These cannot be ratified even by the unanimous consent of all the shareholders. The acts ultra-vires the articles can be ratified by a special resolution of the shareholders, provided they are not beyond the provisions of the memorandum.

10. DOCTRINE OF INDOOR MANAGEMENT

Doctrine of Constructive Notice: Section 399 of the Companies Act, 2013 provides that any person can inspect by electronic means any document kept by the Registrar, or make a record of the same, or get a copy or extracts of any document, including certificate of incorporation of any company, on payment of prescribed fees.

The memorandum and articles of association of a company when registered with Registrar of Companies, become public documents, and they are available for inspection to any person, on the payment of a nominal fees. In other words, Section 399 confers the right of inspection to all. It is therefore, the duty of every person dealing with a company to inspect its documents and make sure that his contract is in conformity with their provisions but whether a person reads them or not, it will be presumed that he knows the contents of the documents. This kind of presumed/implied notice is called constructive notice.

By constructive notice is meant:

(i) Whether a person reads the documents or not, he is presumed to have knowledge of the contents of the documents. He is not only presumed to have read the documents but also understood them in their true perspective, and

(ii) Every person dealing with the company not only has the constructive notice of the memorandum and articles, but also of all the other related documents, such as Special Resolutions etc., which are required to be registered with the Registrar.

Thus, if a person enters into a contract which is beyond the powers of the company as defined in the memorandum, or outside the authority of directors as per memorandum or articles, he cannot acquire any rights under the contract against the company.

Doctrine of Indoor Management: The Doctrine of Indoor Management is the exception to the doctrine of constructive notice. The aforesaid doctrine of constructive notice ***does in no sense mean that outsiders are deemed to have notice of the internal affairs of the company.*** For instance, if an act is authorised by the articles or memorandum, an outsider is entitled to assume that all the detailed formalities for doing that act have been observed. This can be explained with the help of a landmark case ***The Royal British Bank vs. Turquand.*** This is the doctrine of indoor management popularly known as ***Turquand Rule.***

FACTS of the Royal British Bank vs. Turquand

Mr. Turquand was the official manager (liquidator) of the insolvent Cameron's Coalbrook Steam, Coal and Swansea and Loughor Railway Company. It was incorporated under the Joint Stock Companies Act, 1844. The company had given a bond for £ 2,000 to the Royal British Bank, which secured the company's drawings on its current account. The bond was under the company's seal, signed by two directors and the secretary. When the company was sued, it alleged that under its registered deed of settlement (the articles of association), directors only had power to borrow up to an amount authorized by a company resolution. A resolution had been passed but not specifying how much the directors could borrow.

Held, it was decided that the bond was valid, so the Royal British Bank could enforce the terms. He said the bank was deemed to be aware that the directors could borrow only up to the amount resolutions allowed. Articles of association were registered with Companies House, so there was constructive notice. But the bank could not be deemed to know which ordinary resolutions passed, because these were not registrable. The bond was valid because there was no requirement to look into the company's internal workings. This is the indoor management rule, that the company's indoor affairs are the company's problem.

Exceptions to the doctrine of Indoor Management: Thus, you will notice that the aforementioned rule of Indoor Management is important to persons dealing with a company through its directors or other persons. They are entitled to assume that the acts of the directors or other officers of the company are validly performed, if they are within the scope of their apparent authority. So long as an act is valid under the articles, if done in a particular manner, an outsider dealing with the company is entitled to assume that it has been done in the manner required.

The above-mentioned doctrine of Indoor Management or Turquand Rule has limitations of its own. That is to say, it is inapplicable to the following cases, namely:

(a) **Actual or constructive knowledge of irregularity:** The rule does not protect any person when the person dealing with the company has notice, whether actual or constructive, of the irregularity.

In ***Howard vs. Patent Ivory Manufacturing Co.*** where the directors could not defend the issue of debentures to themselves because they should have known that the extent to which they were lending money to the company required the assent of the general meeting which they had not obtained.

Likewise, in ***Morris v Kansseen***, a director could not defend an allotment of shares to him as he participated in the meeting, which made the allotment. His appointment as a director also fell through because none of the directors appointed him was validly in office.

(b) **Suspicion of Irregularity:** The doctrine in no way, rewards those who behave negligently. Where the person dealing with the company is put upon an inquiry, for example, where the transaction is unusual or not in the ordinary course of business, it is the duty of the outsider to make the necessary enquiry.

The protection of the "Turquand Rule" is also not available where the circumstances surrounding the contract are suspicious and therefore invite inquiry. Suspicion should arise, for example, from the fact that an officer is purporting to act in matter, which is apparently outside the scope of his authority. Where, for example, as in the case of ***Anand Bihari Lal vs. Dinshaw & Co.*** the plaintiff accepted a transfer of a company's property from its accountant, the transfer was held void. The plaintiff could not have supposed, in absence of a power of attorney that the accountant had authority to effect transfer of the company's property.

Similarly, in the case of ***Haughton & Co. v. Nothard, Lowe & Wills Ltd.*** where a person holding directorship in two companies agreed to apply the money of one company in payment of the debt to other, the court said that it was something so unusual "that the plaintiff were put upon inquiry to ascertain whether the persons making the contract had any authority in fact to make it." Any other rule would "place limited companies without any sufficient reasons for so doing, at the mercy of any servant or agent who should purport to contract on their behalf."

(c) **Forgery:** The doctrine of indoor management applies only to irregularities which might otherwise affect a transaction but it cannot apply to forgery which must be regarded as nullity.

Forgery may in circumstances exclude the **'Turquand Rule'.** The only clear illustration is found in the ***Ruben v Great Fingall Consolidated.*** In this case the plaintiff was the transferee of a share certificate issued under the seal of the defendant's company. The company's secretary, who had affixed the seal of the company and forged the signature of the two directors, issued the certificate.

The plaintiff contended that whether the signature were genuine or forged was apart of the internal management, and therefore, the company should be estopped from denying genuineness of the document. But it was held, that the rule has never been extended to cover such a complete forgery.

SUMMARY

Company

- An artificial person created under the Companies Act, 2013 with distinct characteristics of separate legal entity and perpetual succession.
- The capital of the company is divided into transferable shares and shareholders called as members because their name is entered into the Register of members.
- The member of the company generally has limited liability upto the extent of unpaid nominal value of shares held by him.

Corporate veil theory

- *Saloman vs. Saloman & Co. Ltd*. laid that company is a juristic person different and separate from its members.
- Under certain situations the courts may lift the corporate veil/ veil of incorporation and thus disregard the separate legal entity of the company. This is called lifting the corporate veil.

Incorporation of company

- A company is said to come into existence only after its registration and issue of Certificate of Incorporation.
- The company to be incorporated must be validly constituted and be an association for a lawful purpose. After all the formalities are compiled and the Registrar is satisfied, the company is registered under the Act.
- On registration the Registrar shall issue a Certificate of Incorporation to the company.
- To provide an integrated process of incorporation, the MCA has introduced SPICe for simplifying the filing of forms.

Effect of registration

- From the date of incorporation the company becomes a legal person by the name contained in the Memorandum and capable of exercising all the functions of an incorporated company.

- The issue of Certificate of Incorporation is considered as conclusive evidence as to compliance of all the legal formalities in respect of registration of company.

Capital

- **Nominal or authorized share capital:** Authorized by memorandum to be the maximum amount of share capital
- **Issued share capital:** That part of authorized capital which us offered by the company for subscription.
- **Subscribed share capital:** Such part of the capital which us for the time being subscribed by the members of a company.
- **Called up capital:** Such part of the capital that has been called for payment.
- **Paid up capital:** It is the total amount paid or credited as paid up on shares issued. Paid up capital= Called up capital – calls in arrears.

Share Capital

- **Equity share capital:** with reference to any company limited by shares, means all share capital which is not preference share capital.
- **Preference share capital:** with reference to any company limited by shares, means that part of the issued share capital of the company which carries or would carry a preferential right with respect to— payment of dividend and repayment.

Memorandum of Association

- It is known as charter of the company.
- It is fundamental document of a company containing the fundamental conditions upon which a company is to be incorporated.
- It lays object and scope of activities and limitations on the power of a company beyond which the company cannot go.
- Any act done or contracts made by a company which are beyond the express or implied scope of its memorandum, are said to be null and void. This is termed as doctrine of ultra vires.
- The conditions and the provisions of the memorandum can be altered to the extent and in the manner provided by the Act which allows alterations by special resolution and confirmation by Central Government/Registrar of Companies.

Article of Association

- Document containing rules, regulations or bye-laws of a company.
- It lays down the form in which the business of the company is to be carried on.

- It also lays down the powers of directors and officers of the company and thus forming the basis of a contract between the company and the members and between the members Inter se (among themselves).
- Every company have an absolute power to alter its Articles of Association by a special resolution subject to the provisions of the Act and conditions of the memorandum of the company.

Doctrine of Constructive Notice

- As memorandum and article is a public document so it is considered that every person dealing with the company is deemed to have notice of the contents of memorandum and articles of the company.
- It is presumed that person have not only read these documents but have also understood their proper meaning.

Doctrine of Indoor Management/ Turquand Rule

- This is an exception to doctrine of Constructive Notice.
- This protects the outsiders against the company, who acts in good faith.
- It says that person who deals with the company are not bound to enquire into the regularity of the internal procedure of the company. They assume that everything is done in accordance with the procedure laid down in the article of the company and thus not affecting adversely the rights of the dealing parties in any way by irregularity of the internal procedure.

COMPANIES ACT, 2013

Company – Definition, Characteristics & Corporate Veil

Section 2(20)

Company means a company incorporated under this Act or under any previous company law.

Chief Justice Marshall

A company is an artificial being, invisible, intangible and existing only in the contemplation of law.

Professor Haney

Company is an incorporated association, which is an artificial person created by law, having a separate entity, with a perpetual succession and a common seal.

Characteristics

1. Separate Legal Entity
2. Perpetual Succession
3. Limited Liability of members
4. Common Seal - official signature of co.
5. Artificial Legal Person

Corporate Veil

Means the company is identified separately from the members of the company.

Lifting Of Corporate Veil

Means ignoring legal entity of the company. Following are the circumstances-

a) Trading with Enemy
b) Protection of Revenue
c) To avoid a legal obligation
d) Formation of subsidiaries to act as agent
e)Prevention of Fraud or Improper Conduct

Classes of Company

On the basis of Liability
1. Co. Ltd. by shares
2. Co. limited by guarantee
3. Unlimited Co.

On the basis of No. of Members
1. OPC
2. Private Co.
3. Small Co.
4. Public Co.

On the basis of Control
1. Holding Co.
2. Subsidiary Co.
3. Associate Co.

On the basis of Access to Capital
1. Listed Co.
2. Unlisted Co.

Other Companies
1. Government Co.,
2. Foreign Co.
3. Charitable Co.,
4. Dormant Co.
5. Nidhi Co.
6. PFI

Mode of Registration / Incorporation of Company

Promoter [Sec. 2(69)]

a person—
(a) who has been named as such in a prospectus or annual return or
(b) who has control over the affairs of co., directly or indirectly or
(c) in accordance with whose advice, directions or instructions the BOD is accustomed to act.

Formation of Company

- Obtain DSC
- Obtain DIN
- Name availability for proposed co.
- Preparation of MOA and AOA
- Application for incorporation of co.
- Duty of ROC to scrutinise documents
- On satisfaction with documents filed, ROC will issue COI.

Formation of OPC

1. Only one person as member.
2. Minimum paid up capital – no limit prescribed.
3. MOA shall indicate the name of nominee
4. Prior written consent of nominee shall be filed with ROC.
5. Such nominee may withdraw his consent
6. Member of OPC may at any time change the name of nominee by giving notice to the company and the company to the ROC.
7. Such change shall not be deemed to be an alteration of the MOA.
8. Only a natural person who is an Indian citizen and resident in India (person who has stayed in India for a period of not less than 120 days during the immediately preceding financial year) can be a member or nominee.
9. One person can be a member or nominee of one OPC at any point of time.
10. No minor shall become member or nominee of the OPC or can hold share with beneficial interest.
11. OPC cannot be converted into a company u/s 8. But may be converted to private or public companies.
12. OPC cannot carry out Non-Banking Financial Investment activities.

Share & Share Capital Company

Classification

(a) Authorized capital- Capital authorized by MOA to be maximum capital of company.
(b) Issued capital: Capital issued for subscription;
(c) Subscribed capital- Capital subscribed by members of company
(d) Called up capital- Capital called for payment.
(e) Paid up share capital- Aggregate amount of money credited as paid on shares issued not including any other amount received in respect of such shares.

Shares [Section 2(84)]

Share- means a share in the share capital of a company and includes stock.
Numbering of shares- Every share in a company having a share capital shall be distinguished by its distinctive number.
Shares are a movable property transferable in the manner provided by the articles of the company.

Kinds of share capital

(i) Equity share capital —
(1) with voting rights; or
(2) with differential rights as to dividend, voting or otherwise in accordance with prescribed rules;
(ii) ''Preference share capital'', part of the issued share capital of the company which carries or would carry a preferential right with respect to—
(a) **payment of dividend,** either as a fixed amount or an amount calculated at a fixed rate, which may either be free of or subject to income-tax; and
(b) **repayment**, in the case of a winding up or repayment of capital, of the amount of the share capital paid-up or deemed to have been paid-up.

Memorandum of Association

MOA of a company as originally framed or as altered from time to time in pursuance of any previous company law or of this Act

Object of registering MOA

1. It contains objects of Co.
2. It shows co.'s powers.
3. Every person dealing with company is presumed to have knowledge of MOA.
4. Shareholders know for what his money is used

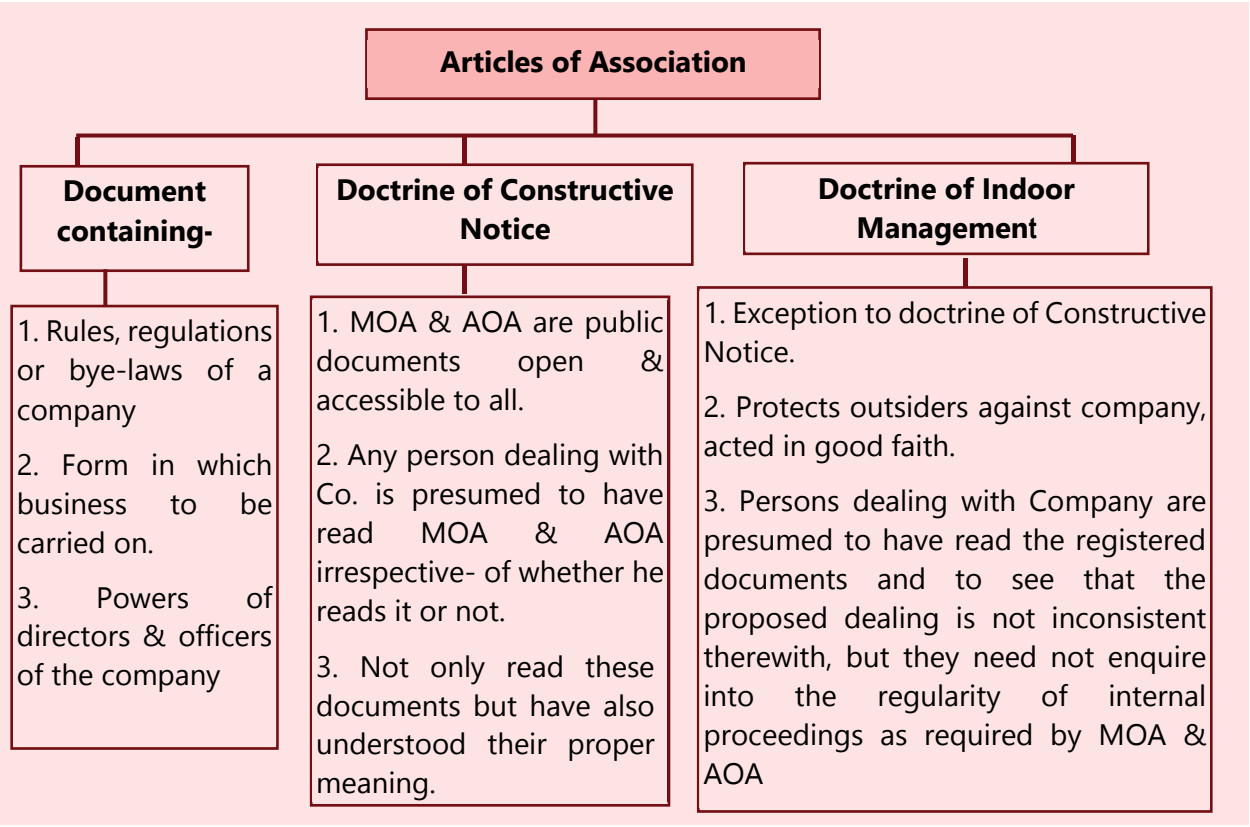
Contents of MOA

1. Name Clause
2. Registered Office Clause
3. Object Clause
4. Liability Clause
5. Capital Clause (Authorised Capital)
6. Nomination Clause (OPC)

Doctrine of Ultravires

Ultra means 'beyond' Vires means 'powers'

1. When an act beyond object clause of MOA is ultravires the company and null and void.
2. Ultravires act cannot be ratified even by unanimous consent of all the shareholders.
3. Act ultravires the directors, but Intravires Company, shareholders may ratify it.
4. Act ultravires the AOA, can be ratified by altering AOA.



TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *Maximum number of members under a private company as provided under the Companies Act, 2013.*

   (a) 50

   (b) 150

   (c) 200

   (d) No limit

2. *Document that regulates the management of internal affairs of a company are-*

   (a) Memorandum of Association

   (b) Prospectus

   (c) Articles of Association

   (d) Certificate of incorporation

3. *Under the Companies Act, 2013, "Significant influence" constitutes how much % of total share capital or of business decisions under an agreement?*

   (a) At least 2%

   (b) At least 2.5%

   (c) At least 10%

   (d) At least 20%

4. *A Private Company which is subsidiary of a Public Company is treated as-*

   (a) Public Company

   (b) Private Company

   (c) Holding Company

   (d) Dormant Company

5. *Which one of the following is not the content of the Memorandum of Association?*

   (a) Name clause

   (b) Registered office clause

   (c) Objects clause

   (d) Board of Directors clause.

6. *An Act is said to be ultra vires a company when it is beyond the powers.*

   (a) Of the Company

   (b) Of the Directors

   (c) Of the Directors but not the company

   (d) Conferred on the company by the Articles of Association.

7. *Turquand Rule is related to:*

   (a) Doctrine of ultra vires

   (b) Doctrine of constructive notice

   (c) Doctrine of indoor management

   (d) Doctrine of subrogation

8. *The minimum number of members in a private company and public company are*

   (a) Three and Seven respectively

   (b) Two and seven respectively

(c) Two and nine respectively

(d) None of the above

9. *Only a natural person who is an Indian citizen and who has stayed in India for a period of at least _____ days during the immediately preceding financial year shall be eligible to incorporate an OPC.*

(a) 180 days

(b) 181 days

(c) 120 days

(d) 183 days

10. *XYZ Limited is having 15% share capital held by X Limited and 50% held by Central Government and 10% held by State Government and 25% held by other people then that company will be _____ .*

(a) Government Company

(b) Private Company

(c) Public Company

(d) Dormant company

11. *The Doctrine of indoor management is a protection that is available to:*

(a) Shareholders

(b) Outsiders who deal with the company

(c) Board of Directors

(d) Creditors

12. *The doctrine which advocates the fact that company cannot act beyond the scope of its memorandum of association is:*

(a) Doctrine of constructive notice

(b) Doctrine of indoor management

(c) Doctrine of ultra vires

(d) Doctrine of intra vires

Descriptive Questions

1. *What is meant by a Guarantee Company? State the similarities and dissimilarities between a Guarantee Company and a Company having Share Capital.*

2. *Can a non-profit organization be registered as a company under the Companies Act, 2013? If so, what procedure does it have to adopt?*

3. *Briefly explain the doctrine of "ultravires" under the Companies Act, 2013. What are the consequences of ultravires acts of the company?*

4. *Explain clearly the doctrine of 'Indoor Management' as applicable in cases of companies registered under the Companies Act, 2013. Explain the circumstances in which an outsider dealing with the company cannot claim any relief on the ground of 'Indoor Management'.*

5. *A, an assessee, had large income in the form of dividend and interest. In order to reduce his tax liability, he formed four private limited company and transferred his investments to them in exchange of their shares. The income earned by the companies was taken back by him as pretended loan. Can A be regarded as separate from the private limited company he formed?*

6. *Sound Syndicate Ltd., a public company, its articles of association empowers the managing agents to borrow both short and long term loans on behalf of the company, Mr. Liddle, the director of the company, approached Easy Finance Ltd., a non banking finance company for a loan of ₹ 25,00,000 in name of the company.*

   The Lender agreed and provided the above said loan. Later on, Sound Syndicate Ltd. refused to repay the money borrowed on the pretext that no resolution authorizing such loan have been actually passed by the company and the lender should have enquired about the same prior providing such loan hence company not liable to pay such loan.

   Analyse the above situation in terms of the provisions of Doctrine of Indoor Management under the Companies Act, 2013 and examine whether the contention of Sound Syndicate Ltd. is correct or not?

7. *Naveen incorporated a "One Person Company" making his sister Navita as the nominee. Navita is leaving India permanently due to her marriage abroad. Due to this fact, she is withdrawing her consent of nomination in the said One Person Company. Taking into considerations the provisions of the Companies Act, 2013 answer the questions given below.*

   (a) If Navita is leaving India permanently, is it mandatory for her to withdraw her nomination in the said One Person Company?

(b) *If Navita maintained the status of Resident of India after her marriage, then can she continue her nomination in the said One Person Company?*

8. *Examine the following whether they are correct or incorrect along with reasons:*

(a) *A company being an artificial person cannot own property and cannot sue or be sued.*

(b) *A private limited company must have a minimum of two members, while a public limited company must have at least seven members.*

ANSWERS/HINTS

Answers to MCQs

1.	**(c)**	2.	**(c)**	3.	**(d)**	4.	**(a)**	5.	**(d)**	6.	**(a)**
7.	**(c)**	8.	**(b)**	9.	**(c)**	10.	**(a)**	11.	**(b)**	12.	**(c)**

Answer to Descriptive Questions

1. **Company limited by guarantee:** Section 2(21) of the Companies Act, 2013 defines it as the company having the liability of its members limited by the memorandum to such amount as the members may respectively undertake by the memorandum to contribute to the assets of the company in the event of its being wound up. Thus, the liability of the member of a guarantee company is limited upto a stipulated sum mentioned in the memorandum. Members cannot be called upon to contribute beyond that stipulated sum.

Similarities and dis-similarities between the Guarantee Company and the Company having share capital:

The common features between a 'guarantee company' and 'share company' are legal personality and limited liability. In the latter case, the member's liability is limited by the amount remaining unpaid on the share, which each member holds. Both of them have to state in their memorandum that the members' liability is limited.

However, the point of distinction between these two types of companies is that in the former case the members may be called upon to discharge their liability only after commencement of the winding up and only subject to certain conditions; but in the latter case, they may be called upon to do so at any time, either during the company's life-time or during its winding up.

2. Yes, a non-profit organization be registered as a company under the Companies Act, 2013 by following the provisions of section 8 of the Companies Act, 2013. Section 8 of the Companies Act, 2013 deals with the formation of companies which are formed to

- promote the charitable objects of commerce, art, science, sports, education, research, social welfare, religion, charity, protection of environment etc.
- Such company intends to apply its profit in
- promoting its objects and
- prohibiting the payment of any dividend to its members.

The Central Government has the power to issue license for registering a section 8 company.

(i) Section 8 allows the Central Government to register such person or association of persons as a company with limited liability without the addition of words 'Limited' or 'Private limited' to its name, by issuing licence on such conditions as it deems fit.

(ii) The registrar shall on application register such person or association of persons as a company under this section.

(iii) On registration the company shall enjoy same privileges and obligations as of a limited company.

3. **Doctrine of ultra vires:** The meaning of the term ultra vires is simply "beyond (their) powers". The legal phrase "ultra vires" is applicable only to acts done in excess of the legal powers of the doers. This presupposes that the powers are in their nature limited. To an ordinary citizen, the law permits whatever does the law not expressly forbid.

It is a fundamental rule of Company Law that the objects of a company as stated in its memorandum can be departed from only to the extent permitted by the Act - thus far and no further ***[Ashbury Railway Company Ltd. vs. Riche].*** In consequence, any act done or a contract made by the company which travels beyond the powers not only of the directors but also of the company is wholly void and inoperative in law and is therefore not binding on the company. On this account, a company can be restrained from employing its fund for purposes other than those sanctioned by the memorandum. Likewise, it can be restrained from carrying on a trade different from the one it is authorised to carry on.

The impact of the doctrine of ultra vires is that a company can neither be sued on an ultra vires transaction, nor can it sue on it. Since the memorandum is a "public document", it is open to public inspection. Therefore, when one deals with a company one is deemed to know about the powers of the company. If in spite of this you enter

into a transaction which is ultra vires the company, you cannot enforce it against the company. For example, if you have supplied goods or performed service on such a contract or lent money, you cannot obtain payment or recover the money lent. But if the money advanced to the company has not been expended, the lender may stop the company from parting with it by means of an injunction; this is because the company does not become the owner of the money, which is ultra vires the company. As the lender remains the owner, he can take back the property in specie. If the ultra vires loan has been utilised in meeting lawful debt of the company then the lender steps into the shoes of the debtor paid off and consequently he would be entitled to recover his loan to that extent from the company.

An act which is ultra vires the company being void, cannot be ratified by the shareholders of the company. Sometimes, act which is ultra vires can be regularised by ratifying it subsequently. For instance, if the act is ultra vires the power of the directors, the shareholders can ratify it; if it is ultra vires the articles of the company, the company can alter the articles; if the act is within the power of the company but is done irregularly, shareholder can validate it.

4. **Doctrine of Indoor Management (the Companies Act, 2013):** According to the "doctrine of indoor management" the outsiders, dealing with the company though are supposed to have satisfied themselves regarding the competence of the company to enter into the proposed contracts are also entitled to assume that as far as the internal compliance to procedures and regulations by the company is concerned, everything has been done properly. They are bound to examine the registered documents of the company and ensure that the proposed dealing is not inconsistent therewith, but they are not bound to do more. They are fully entitled to presume regularity and compliance by the company with the internal procedures as required by the Memorandum and the Articles. This doctrine is a limitation of the doctrine of "constructive notice" and popularly known as the rule laid down in the celebrated case of ***Royal British Bank v. Turquand***. Thus, the doctrine of indoor management aims to protect outsiders against the company.

The above mentioned doctrine of Indoor Management or Turquand Rule has limitations of its own. That is to say, it is inapplicable to the following cases, namely:

(a) Actual or constructive knowledge of irregularity: The rule does not protect any person when the person dealing with the company has notice, whether actual or constructive, of the irregularity.

In ***Howard vs. Patent Ivory Manufacturing Co.*** where the directors could not defend the issue of debentures to themselves because they should have known

that the extent to which they were lending money to the company required the assent of the general meeting which they had not obtained.

Likewise, in ***Morris v Kansseen***, a director could not defend an allotment of shares to him as he participated in the meeting, which made the allotment. His appointment as a director also fell through because none of the directors appointed him was validly in office.

(b) **Suspicion of Irregularity:** The doctrine in no way, rewards those who behave negligently. Where the person dealing with the company is put upon an inquiry, for example, where the transaction is unusual or not in the ordinary course of business, it is the duty of the outsider to make the necessary enquiry.

The protection of the "Turquand Rule" is also not available where the circumstances surrounding the contract are suspicious and therefore invite inquiry. Suspicion should arise, for example, from the fact that an officer is purporting to act in matter, which is apparently outside the scope of his authority. Where, for example, as in the case of ***Anand Bihari Lal vs. Dinshaw & Co.*** the plaintiff accepted a transfer of a company's property from its accountant, the transfer was held void. The plaintiff could not have supposed, in absence of a power of attorney that the accountant had authority to effect transfer of the company's property.

Similarly, in the case of ***Haughton & Co. v. Nothard, Lowe & Wills Ltd.*** where a person holding directorship in two companies agreed to apply the money of one company in payment of the debt to other, the court said that it was something so unusual "that the plaintiff were put upon inquiry to ascertain whether the persons making the contract had any authority in fact to make it." Any other rule would "place limited companies without any sufficient reasons for so doing, at the mercy of any servant or agent who should purport to contract on their behalf."

(c) **Forgery:** The doctrine of indoor management applies only to irregularities which might otherwise affect a transaction but it cannot apply to forgery which must be regarded as nullity.

Forgery may in circumstances exclude the 'Turquand Rule'. The only clear illustration is found in the ***Ruben v Great Fingall Consolidated.*** In this case the plaintiff was the transferee of a share certificate issued under the seal of the

defendant's company. The company's secretary, who had affixed the seal of the company and forged the signature of the two directors, issued the certificate.

The plaintiff contended that whether the signature were genuine or forged was apart of the internal management, and therefore, the company should be estopped from denying genuineness of the document. But it was held, that the rule has never been extended to cover such a complete forgery.

5. The House of Lords in *Salomon Vs Salomon & Co. Ltd.* laid down that a company is a person distinct and separate from its members, and therefore, has an independent separate legal existence from its members who have constituted the company. But under certain circumstances the separate entity of the company may be ignored by the courts. When that happens, the courts ignore the corporate entity of the company and look behind the corporate façade and hold the persons in control of the management of its affairs liable for the acts of the company. Where a company is incorporated and formed by certain persons only for the purpose of evading taxes, the courts have discretion to disregard the corporate entity and tax the income in the hands of the appropriate assesse.

In *Dinshaw Maneckjee Petit* case it was held that the company was not a genuine company at all but merely the assessee himself disguised that the legal entity of a limited company. The assessee earned huge income by way of dividends and interest. So, he opened some companies and purchased their shares in exchange of his income by way of dividend and interest. This income was transferred back to assessee by way of loan. The court decided that the private companies were a sham and the corporate veil was lifted to decide the real owner of the income.

In the instant case, the four private limited companies were formed by A, the assesse, purely and simply as a means of avoiding tax and the companies were nothing more than the façade of the assesse himself. Therefore, the whole idea of Mr. A was simply to split his income into four parts with a view to evade tax. No other business was done by the company.

Hence, A cannot be regarded as separate from the private limited companies he formed.

6. Doctrine of Indoor Management

According to this doctrine, persons dealing with the company need not inquire whether internal proceedings relating to the contract are followed correctly, once they are satisfied that the transaction is in accordance with the memorandum and articles of association.

Stakeholders need not enquire whether the necessary meeting was convened and held properly or whether necessary resolution was passed properly. They are entitled to take it for granted that the company had gone through all these proceedings in a regular manner.

The doctrine helps protect external members from the company and states that the people are entitled to presume that internal proceedings are as per documents submitted with the Registrar of Companies.

Thus,

1. What happens internal to a company is not a matter of public knowledge. An outsider can only presume the intentions of a company, but do not know the information he/she is not privy to.
2. If not for the doctrine, the company could escape creditors by denying the authority of officials to act on its behalf.

In the given question, Easy Finance Ltd. being external to the company, need not enquire whether the necessary resolution was passed properly. Even if the company claim that no resolution authorizing the loan was passed, the company is bound to pay the loan to Easy Finance Ltd.

7. **(A)** Yes, it is mandatory for Navita to withdraw her nomination in the said OPC as she is leaving India permanently as only a natural person who is an Indian citizen and resident in India shall be a nominee in OPC.

(B) Yes, Navita can continue her nomination in the said OPC, if she maintained the status of Resident of India after her marriage by staying in India for a period of not less than 120 days during the immediately preceding financial year.

8. **(a)** **A company being an artificial person cannot own property and cannot sue or be sued**

Incorrect: A company is an artificial person as it is created by a process other than natural birth. It is legal or judicial as it is created by law. It is a person since it is clothed with all the rights of an individual.

Further, the company being a separate legal entity can own property, have banking account, raise loans, incur liabilities and enter into contracts. Even members can contract with company, acquire right against it or incur liability to it. It can sue and be sued in its own name. It can do everything which any natural person can do except be sent to jail, take an oath, marry or practice a learned profession. Hence, it is a legal person in its own sense.

(b) A private limited company must have a minimum of two members, while a public limited company must have at least seven members.

Correct: Section 3 of the Companies Act, 2013 deals with the basic requirement with respect to the constitution of the company. In the case of a public company, any 7 or more persons can form a company for any lawful purpose by subscribing their names to memorandum and complying with the requirements of this Act in respect of registration. In exactly the same way, 2 or more persons can form a private company.

NOTES

CHAPTER 7

THE NEGOTIABLE INSTRUMENTS ACT, 1881

LEARNING OUTCOMES

After studying this chapter, you would be able to understand-

- The meaning, characteristics and elements of different kinds of negotiable instruments
- Classification and various ways of negotiation, Know about provisions related to Presentment of Instruments and Rules of Compensation

CHAPTER OVERVIEW

Chapter covers following headings

Notes, Bills & Cheques-Types, Classification and its characterstics	Modes of Negotiation	Presentment of Instruments	Rules of Compensation

INTRODUCTION

The law relating to negotiable instruments is the law of the commercial world which was enacted to facilitate the activities in trade and commerce making provision for giving sanctity to the instruments of credit which could be deemed to be convertible into money and easily passable from one person to another. In the absence of such instruments, the trade and commerce activities were likely to be adversely affected as it was not practicable for the trading community to carry with it the bulk of the currency in force. The source of Indian law relating to such instruments is admittedly the English Common Law.

The main objective of the Act is to legalise the system by which instruments contemplated by it could pass from hand to hand by negotiation like any other goods.

The Law in India relating to negotiable instruments is contained in the Negotiable Instruments Act, 1881. This is an Act to define and amend the law relating to promissory notes, bills of exchange and cheques. The Act applies to the whole of India, but nothing herein contained affects the Reserve Bank of India Act, 1934, (section 21 which provides the Bank to have the right to transact Government business in India), or affects any local usage relating to any instrument in an oriental language.

Provided that such usages may be excluded by any words in the body of the instrument, which indicate an intention that the legal relations of the parties thereto shall be governed by this Act; and it shall come into force on the first day of March, 1882.

The provisions of this Act are also applicable to Hundis, unless there is a local usage to the contrary. Other native instruments like Treasury Bills, Bearer Debentures, Railway Receipts, Delivery Orders, Bill of Lading etc. are also considered as negotiable instruments either by mercantile custom or under other enactments.

Recent developments: The Act was amended several times. Following are the significant amendments made in the Negotiable Instruments Act, 1881 (N.I. Act):

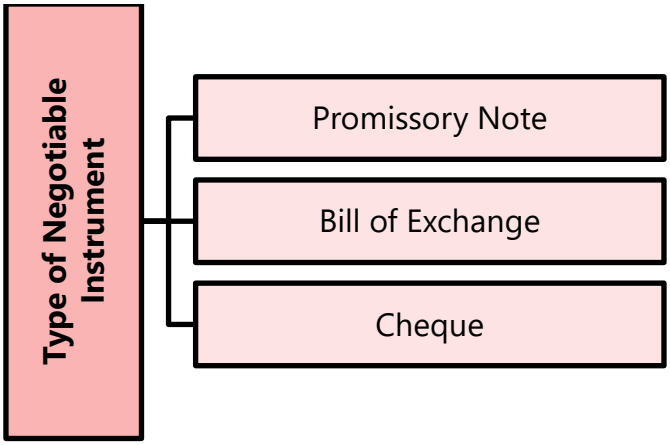
- The Negotiable Instruments (Amendment and Miscellaneous Provisions) Act, 2002;
- The Negotiable Instruments (Amendment) Act, 2015, and
- The Negotiable Instruments (Amendment) Act, 2018.

1. MEANING OF NEGOTIABLE INSTRUMENTS

Negotiable Instruments is an instrument (the word instrument means a document) which is freely transferable (by customs of trade) from one person to another by mere delivery or by indorsement and delivery. The property in such an instrument pass to a *bonafide* transferee for value.

The Act does not define the term 'Negotiable Instruments'. However, Section 13 of the Act provides for only **three kinds of negotiable instruments** namely **bills of exchange, promissory notes and cheques, payable either to order or bearer.**

It is to be noted that Hundies, Treasury Bills, Bearer Debentures, Railway Receipts, Delivery Orders, Bill of Lading etc. are also considered as negotiable instruments either by mercantile custom or usage.



(1) A negotiable instrument is payable to order when:

a. It is expressed to be so payable

b. When it is expressed to be payable to a specified person and does not contain words prohibiting its transfer. (i.e. it is transferrable by indorsement and delivery)

(2) A negotiable instrument is payable to bearer when:

a. When it is expressed to be so payable e.g. pay bearer

b. When the only or last indorsement (indorsement means signing of the instrument) on the instrument is an indorsement in blank i.e., the person who possesses it can demand payment. For example,. A cheque made payable to specified person and that cheque is endorsed by signing on the back of the cheque by that specified person.

Essential Characteristics of Negotiable Instruments

1. It is necessarily in writing.
2. It should be signed.
3. It is freely transferable from one person to another.
4. Holder's title is free from defects.
5. It can be transferred any number of times till its satisfaction.
6. Every negotiable instrument must contain an unconditional promise or order to pay money. The promise or order to pay must consist of money only.
7. The sum payable, the time of payment, the payee, must be certain.
8. The instrument should be delivered. Mere drawing of instrument does not create liability.

Characterstics							
written	signed	transferable	title free from defects	can be transferrred number of times	unconditional promise/order to pay	certainity of sum payable, time of payment and the payee	delivered

2. PROMISSORY NOTE

Meaning

According to section 4 of the NI Act, 1881, "A 'promissory note' is an instrument in writing (not being a bank-note or a currency-note) containing an unconditional undertaking signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument."

Specimen of Promissory note

₹ 10,000 Lucknow
April 10, 2022

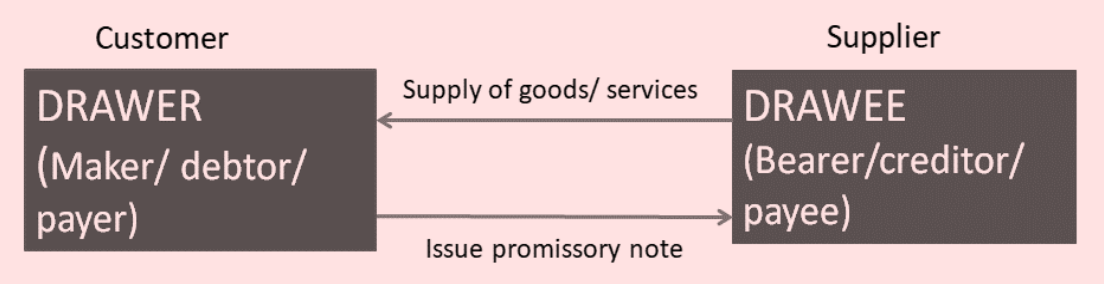
Three months after date, I promise to pay Shri Ramesh (Payee) or to his order the sum of Rupees Ten Thousand, for value received.

Stamp
Sd/-
Ram

To,
Shri Ramesh,
B-20, Green Park,
Mumbai.
(Maker)

Parties to promissory note

1. **Maker:** The person who makes the promise to pay is called the Maker. He is the debtor and must sign the instrument.
2. **Payee:** Payee is the person to whom the amount on the note is payable.



Essential Characteristics of a Promissory Note

a. In **writing**- An oral promise to pay is not sufficient.

b. There must be **an express promise to pay.** Mere acknowledgment of debt is insufficient.

Example 1: I acknowledge myself to be indebted to B in ₹ 1,000, to be paid on demand, for value received. (Valid promissory note as the promise to pay is definite)

Example 2: "Mr. B, I.O.U ₹ 1,000." – Invalid promissory note as there is no promise to pay. It is just an acknowledgement of debt.

c. The promise to pay should be **definite** and **unconditional**. Therefore, instruments payable on performance or non-performance of a particular act or on the happening or non-happening of an event, are not promissory notes. However, the promise to pay may be subject to a condition, which according to the ordinary experience of mankind, is bound to happen.

Example 3: I promise to pay B ₹ 500 seven days after my marriage with C. (the promissory note is invalid as marriage with C may or may not happen.)

Example 4: I promise to pay B ₹ 500 on D's death- as the death of D is certain, promise in unconditional. Thus, the promissory note is valid.

Example 5: I promise to pay B ₹ 500 on D's death, provided D leaves me enough to pay that sum. Invalid promissory note as promise is dependent on D's leaving behind money which is not certain.

d. A promissory note must be **signed by the maker** otherwise it is incomplete and ineffective.

e. Promise **to pay money only**.

Example 6: I promise to pay B ₹ 500 and to deliver to him my black horse on 1st January next. It is not a valid promissory note, as the promisor needs to deliver its black horse which is not money.

f. Promise to pay a **certain sum.**

Example 7: "I promise to pay B ₹ 500 and all other sums which shall be due to him."- Promissory note invalid as the amount payable is not certain.

But sometimes, the language of a promissory note is such that the amount payable can be easily ascertained. In such cases, the promissory note will be valid.

Example 8: "I promise to pay B ₹ 500 alongwith simple interest at the rate of 12% per annum.

g. The **maker and payee must be certain**, **definite and different persons**. A promissory note cannot be made payable to the bearer [Section 31 of the Bank of India Act, 1934 (RBI Act)]. Only the Reserve Bank or the Central Government can make or issue a promissory note 'payable to bearer'.

h. **Stamping:** A promissory note must be properly stamped in accordance with the provisions of the Indian Stamp Act and such stamp must be duly cancelled by maker's signatures or initials on such stamp or otherwise.

3. BILLS OF EXCHANGE

A "bill of exchange" is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.

Specimen of Bill of Exchange

Mr. A (Drawer)
48, MP Nagar, Bhopal (M.P.)
April 10, 2022

₹ 10,000/-

Four months after date, pay to Mr. B (Payee) a sum of Rupees Ten Thousand, for value received.

To,
Mr. C (Drawee)
576, Arera Colony, Bhopal (M.P.)

Signature
Mr. A

Parties to the bill of exchange

a. **Drawer:** The maker of a bill of exchange.

b. **Drawee**: The person directed by the drawer to pay is called the 'drawee'. He is the person on whom the bill is drawn. On acceptance of the bill, he is called an acceptor and is liable for the payment of the bill. His liability is primary and unconditional.

c. **Payee**: The person named in the instrument, to whom or to whose order the money is, by the instrument, directed to be paid.

Essential characteristics of bill of exchange

(a) It must be in writing.

(b) Must contain an express order to pay.

(c) The order to pay must be definite and unconditional.

(d) The drawer must sign the instrument.

(e) Drawer, drawee, and payee must be certain. All these three parties may not necessarily be three different persons. One can play the role of two. But there must be two distinct persons in any case. As per Section 31 of RBI Act, 1934, a bill of exchange cannot be made payable to bearer on demand.

Example 9: "On demand pay to the bearer the sum of rupees five hundred, for value received." It is invalid BOE.

However, a bill of exchange payable on demand, in which name of the payee is mentioned, is valid.

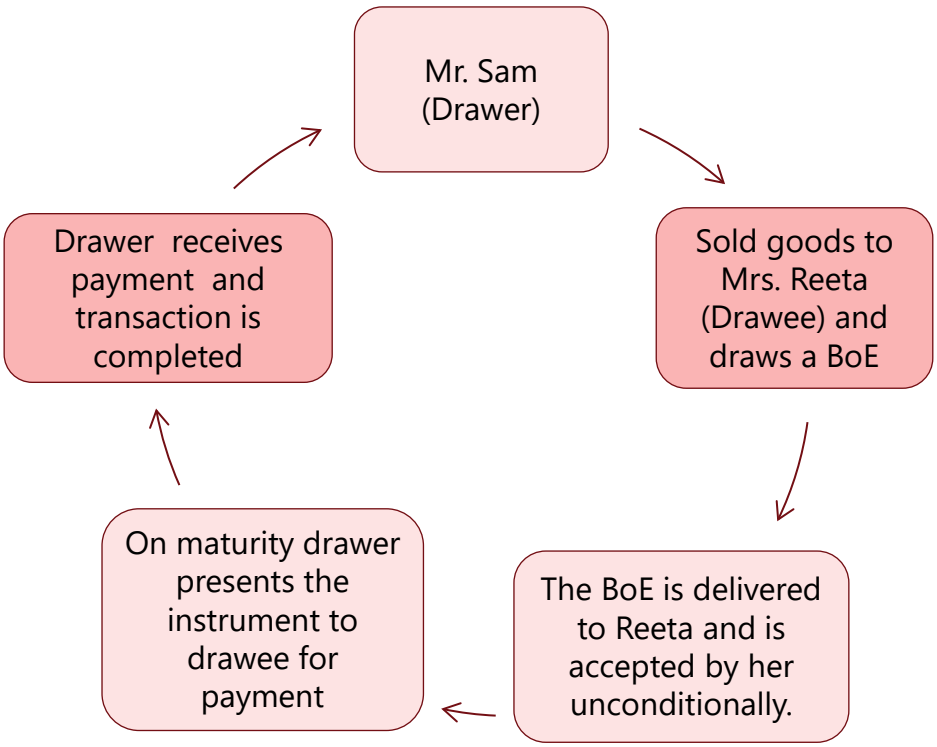
Example 10: "On demand pay to A or order the sum of rupees five hundred for value received." It is valid BOE.

(f) The sum must be certain.

(g) The order must be to pay money only.

(h) It must be stamped.

Process of bill of exchange



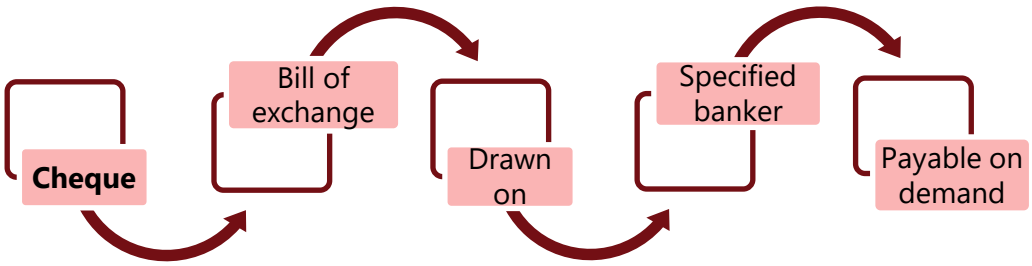
In above image, firstly the seller sold goods to the buyer/customer and then draws a bill of exchange on him. The Bill of exchange is delivered by the buyer who accepts it without any condition. On maturity of bill of exchange, the buyer will pay the amount due to the payee. (The payee may be the drawer himself or a third party.)

Difference between promissory note and bill of exchange

S.no	Basis	Promissory Note	Bill of Exchange
1.	**Definition**	"A Promissory Note" is an instrument in writing (not being a banknote or a currency-note) containing an unconditional undertaking signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument.	"A bill of exchange" is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument.
2.	**Nature of Instrument**	In a promissory note, there is a promise to pay money.	In a bill of exchange, there is an order for making payment.
3.	**Parties**	In a promissory note, there are only 2 parties namely: i. the maker and ii. the payee	In a bill of exchange, there are 3 parties which are as under: i. the drawer ii. the drawee iii. the payee
4.	**Acceptance**	A promissory note does not require any acceptance, as it is signed by the person who is liable to pay.	A bills of exchange needs acceptance from the drawee.
5.	**Payable to bearer**	A promissory note cannot be made payable to bearer.	On the other hand, a bill of exchange can be drawn payable to bearer. However, it cannot be payable to bearer on demand.

4. CHEQUE [SECTION 6]

A "cheque" is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form.



Payable on demand means- It should be payable whenever the holder chooses to present it to the drawee (the banker).

The expression "Banker" includes any person acting as a banker and any post office saving bank [Section 3]

Explanation I: For the purposes of this section, the expressions-

(a) **Cheque in the electronic form-**means a cheque drawn in electronic form by using any computer resource, and signed in a secure system with a digital signature (with/without biometric signature) and asymmetric crypto system or electronic signature, as the case may be;

Note- For the purposes of this section, the expressions "asymmetric crypto system", "computer resource", "digital signature", "electronic form" and "electronic signature" shall have the same meanings respectively assigned to them in the Information Technology Act, 2000.

(b) "a **truncated cheque**" means a cheque which is truncated during a clearing cycle, either by the clearing house or by the bank whether paying or receiving payment, immediately on generation of an electronic image for transmission, substituting the further physical movement of the cheque in writing.

Explanation II: For the purposes of this section, the expression "clearing house" means the clearing house managed by the Reserve Bank of India or a clearing house recognized as such by the Reserve Bank of India.

Explanation III: For the purposes of this section, the expressions "asymmetric crypto system", "computer resource", "digital signature", "electronic form" and "electronic signature" shall have the same meanings respectively assigned to them in the Information Technology Act, 2000.

A combined reading of sections 5 and 6 tells us that a bill of exchange is a negotiable instrument in writing containing an instruction to a third party to pay a stated sum of money at a designated future date or on demand. Whereas a cheque is also a bill of exchange but is drawn on a banker and payable on demand.

Specimen of Cheque

Date:.....

Pay .....

a sum of Rupees.....₹

A/C No. 12345678910

ABC Bank
622, Vijay Nagar, Indore (M. P.)

Signature

01212 1125864 000053 38

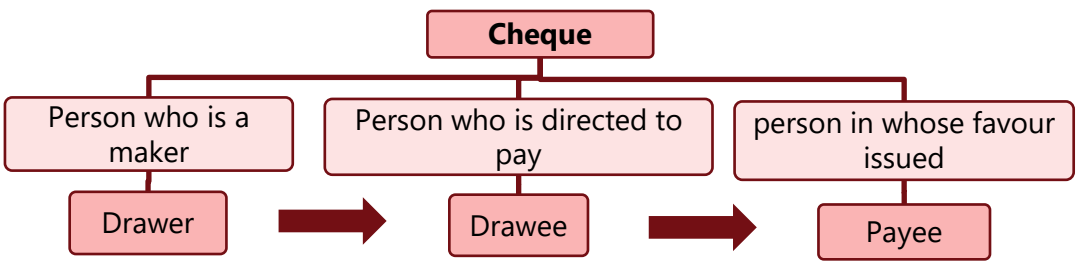
Parties to Cheque

1. **Drawer:** The person who draws a cheque i.e., makes the cheque (Debtor). His liability is primary and conditional.

2. **Drawee:** The specific bank on whom cheque is drawn. He makes the payment of the cheque. In case of cheque, drawee is always banker.

"drawee in case of need"— When in the bill or in any indorsement thereon, the name of any person is given in addition to the drawee to be resorted to in case of need such person is called a "drawee in case of need".

3. **Payee:** The person named in the instrument (i.e., the person in whose favour cheque is issued), to whom or to whose order the money is, by the instrument, directed to be paid, is called the payee. The payee may be the drawer himself or a third party.



Essential Characteristics of a cheque

According to the definition of cheque under section 6, a cheque is a species of bill of exchange. Thus, it should fulfil:

a. all the essential characteristics of a bill of exchange

b. Must be drawn on a specified banker.

c. It must be payable on demand.

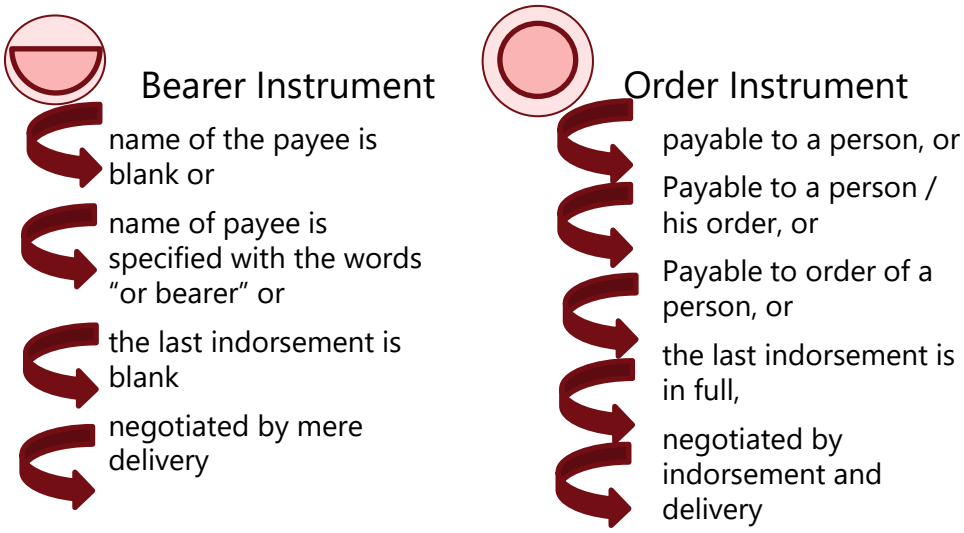
Note: These two additional features distinguish a cheque from bill. Thus, all cheques are bills while all bills are not cheques.

5. CLASSIFICATION OF NEGOTIABLE INSTRUMENTS

"Bearer instrument" and "order instrument" [Section 13]

Bearer Instrument: It is an instrument where the name of the payee is blank or where the name of payee is specified with the words "or bearer" or where the last indorsement is blank. Such instrument can be negotiated by mere delivery.

Order Instrument: It is an instrument which is payable to a person or Payable to a person or his order or Payable to order of a person or where the last indorsement is in full, such instrument can be negotiated by indorsement and delivery.



"Inland instrument" and "Foreign instrument" [Sections 11 & 12]

"Inland instrument": A promissory note, bill of exchange or cheque drawn or made in India and made payable in, or drawn upon any person resident in India shall be deemed to be an inland instrument.

Example 11: (i) A promissory note made in Kolkata and payable in Mumbai.

(ii) A bill drawn in Varanasi on a person resident in Jodhpur (although it is stated to be payable in Singapore)

(iii) A, a resident of Agra, drew (i.e., made) a bill of exchange in Agra on B, a merchant in New York. And B accepted the bill of exchange as payable in Delhi. It is an inland bill of exchange. In this case, the bill of exchange was drawn in India and also payable in India.

(iv) A, resident of Mumbai, drew a bill of exchange in Mumbai on B, a merchant in Mathura. And B accepted the bill of exchange as payable in London. It is also an inland bill of exchange. In this case, the bill of exchange was drawn in India on a person resident in India. It is immaterial that the amount is payable in London.

An inland instrument remains inland even if it has been endorsed in a foreign country.

(v) If the bills of exchange mentioned in above two examples, are endorsed in France, they will remain inland bills.

Place where Instrument is drawn and made payable	Residence of Person on whom Instrument is drawn	Nature of Instrument
P/N, BOE, C drawn/made in India	+ Payable in India OR	are Inland Instruments
	+ drawn upon a person resident in India.	

"Foreign instrument": A foreign instrument is one which is not an inland instrument.

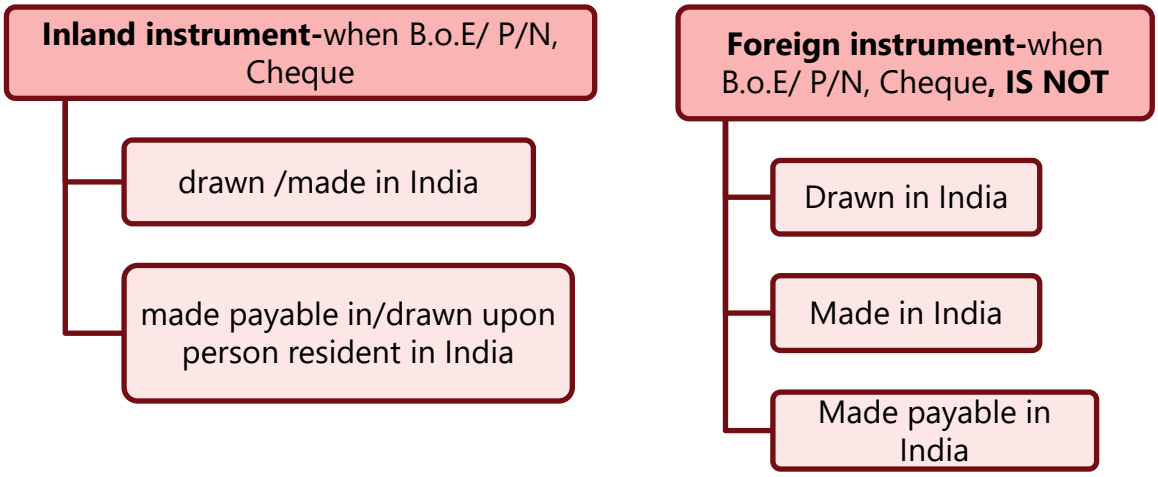
In other words, can be understood as follows:

Place where bill is drawn	Residence of Person on whom drawn and place where made payable	Nature of Instrument
P/N, BOE, C drawn/made outside India	on a person resident in or outside India + made payable in India	are foreign bills.
	on a person residing outside India + payable outside India.	
	on a person residing in India + payable outside India	

Liability of maker/ drawer of foreign bill

In the absence of a contract to the country, the liability of the maker or drawer of a foreign promissory note or bill of exchange or cheque is regulated in all essential matters by the law of the place where he made the instrument, and the respective liabilities of the acceptor and indorser by the law of the place where the instrument is made payable (Section 134).

Example 12: A bill of exchange is drawn by A in Berkley where the rate of interest is 15% and accepted by B payable in Washington where the rate of interest is 6%. The bill is indorsed in India and is dishonoured. An action on the bill is brought against B in India. He is liable to pay interest at the rate of 6% only. But if A is charged as drawer, he is liable to pay interest at 15%.



Inchoate and Ambiguous Instruments

Inchoate Instrument: It means an instrument that is incomplete in certain respects. The drawer/ maker/ acceptor/ indorser of a negotiable instrument may sign and deliver the instrument to another person in his capacity leaving the instrument, either wholly blank or having written on it the word incomplete. Such an instrument is called an inchoate instrument and this gives a power to its holder to make it complete by writing any amount either within limits specified therein or within the limits specified by the stamp's affixed on it. **The principle of this rule of an inchoate instrument is based on the principle of estoppel.**

Liability on drawing inchoate instrument: The person signing and delivering the inchoate instrument is liable both to a holder and holder in due course. However, there is a difference in their respective rights:

The holder of such an instrument cannot recover the amount in excess of the amount intended to be paid by the signor.

The holder in due course can, however, recover any amount on such instrument provided it is covered by the stamp affixed on the instrument.

Section 20 of the Act reads as "Where one person signs and delivers to another a paper stamped in accordance with the law relating to negotiable instruments then in force in India, and either wholly blank or having written thereon an incomplete negotiable instrument, he

thereby gives prima facie authority to the holder thereof to make or complete, as the case may be, upon it a negotiable instrument, for any amount specified therein and not exceeding the amount covered by the stamp. The person so signing shall be liable upon such instrument, in the capacity in which he signed the same, to any holder in due course for such amount. Provided that no person other than a holder in due course shall recover from the person delivering the instrument anything in excess of the amount intended by him to be paid thereunder".

Example 13: A person signed a blank acceptance on a bill of exchange and kept it in his drawer. The bill was stolen by X and he filled it up for ₹ 20,000 and negotiated it to an innocent person for value. It was held that the signer to the blank acceptance was not liable to the holder in due course because he never delivered the instrument intending it to be used as a negotiable instrument. Further, as a condition of liability, the signer as a maker, drawer, indorser or acceptor must deliver the instrument to another. In the absence of delivery, the signer is not liable. Furthermore, the paper so signed and delivered must be stamped in accordance with the law prevalent at the time of signing and on delivering otherwise the signer is not estopped from showing that the instrument was filled without his authority.

Ambiguous Instrument: Section 17 of the Act, reads as: "Where an instrument may be construed either as a promissory note or bill of exchange, the holder may at his election treat it as either, and the instrument shall be thenceforward treated accordingly."

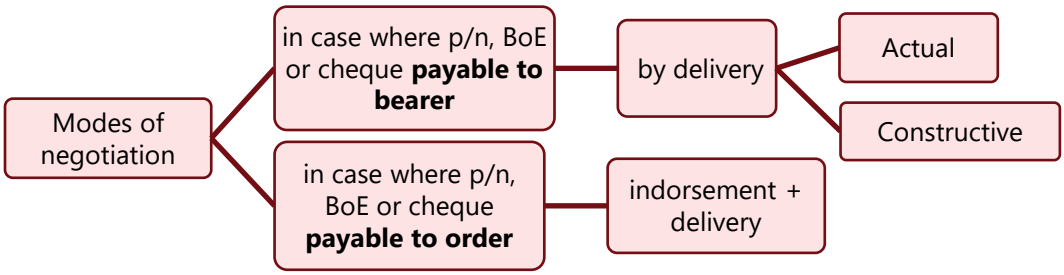
Thus, an instrument which is vague and cannot be clearly identified either as a bill of exchange, or as a promissory note, is an ambiguous instrument. In other words, such an instrument may be construed either as promissory note, or as a bill of exchange. Section 17 provides that the holder may, at his discretion, treat it as either and the instrument shall thereafter be treated accordingly. Thus, after exercising his option, the holder cannot change that it is the other kind of instrument.

6. NEGOTIATION (TRANSFER) OF NEGOTIABLE INSTRUMENTS

One of the essential characteristics of a negotiable instrument is that it is freely transferable from one person to another. The rights in a negotiable instrument can be transferred from one person to another by negotiation.

According to Section 14 of the N.I. Act, when a negotiable instrument is transferred to any person with a view to constitute the person holder thereof, the instrument is deemed to have been negotiated. Thus, there is a transfer of ownership of the instrument. Negotiable instruments may be negotiated either by delivery when these are payable to bearer or by indorsement and delivery when these are payable to order.

Modes of Negotiation



(i) A promissory note, bill of exchange or cheque payable to bearer is negotiable by the delivery thereof.

(ii) A promissory note, bill of exchange or cheque payable to order is negotiable by the holder by indorsement and delivery thereof.

Example 14: X drew a cheque for Rs. 50,000 payable to Y and delivered it to him. Y indorsed the cheque in favour of Z but kept it in his table drawer. Subsequently, Y died, and cheque was found by Z in Y's table drawer. In this case, Z does not become the holder of the cheque as the negotiation was not completed by delivery of the cheque to him.

Negotiation by delivery [Section 47]

Subject to the provisions of section 58 [Instrument obtained by unlawful means or for unlawful consideration], a promissory note, bill of exchange or cheque payable to bearer is negotiable by delivery thereof.

Exception: A promissory note, bill of exchange or cheque delivered on condition that it is not to take effect except in a certain event is not negotiable (except in the hands of a holder for value without notice of the condition) unless such event happens.

Example 15

(1) A, the holder of a negotiable instrument payable to bearer, delivers it to B's agent to keep for B. The instrument has been negotiated.

(2) A, the holder of a negotiable instrument payable to bearer, which is in the hands of A's banker, who is at the time the banker of B, directs the banker to transfer the instrument to B's credit in the banker's account with B. The banker does so, and accordingly now possesses the instrument as B's agent. The instrument has been negotiated, and B has become the holder of it.

Negotiation by indorsement [Section 48]

Subject to the provisions of section 58, a promissory note, bill of exchange or cheque **payable to order**, is negotiable by the holder by indorsement and delivery thereof.

Importance of Delivery in Negotiation [Section 46]

Delivery of an instrument is essential whether the instrument is payable to bearer or order for effecting the negotiation. The delivery must be voluntary, and the object of delivery should be to pass the property in the instrument to the person to whom it is delivered. The delivery can be, actual or constructive. Actual delivery takes place when the instrument changes hand physically. Constructive delivery takes place when the instrument is delivered to the agent, clerk or servant of the indorsee on his behalf or when the indorser, after indorsement, holds the instrument as an agent of the indorsee.

Section 46 also lays down that when an instrument is conditionally or for a special purpose only, the property in it does not pass to the transferee, even though it is indorsed to him, unless the instrument is negotiated to a holder in due course.

The contract on a negotiable instrument until delivery remains incomplete and revocable. The delivery is essential not only at the time of negotiation but also at the time of making or drawing of negotiable instrument. The rights in the instrument are not transferred to the indorsee unless after the indorsement the same has been delivered. If a person makes the indorsement of instrument but before the same could be delivered to the indorsee the indorser dies, the legal representatives of the deceased person cannot negotiate the same by mere delivery thereof. (Section 57)[1]

Delivery when effective between the parties

Negotiation of instruments between the parties	How delivery is to be made
As between parties standing in immediate relation →	Delivery to be effectual must be made by the party making, accepting, or endorsing the instrument, or by a person authorized by him in that behalf.

[1] According to section 57, the legal representative of a deceased person cannot negotiate by delivery only, a promissory note, bill of exchange or cheque payable to order and indorsed by the deceased but not delivered.
A legal representative is not an agent of the deceased. Therefore, a legal representative cannot complete the instrument if the instrument was executed by the deceased but could not be delivered because of his death.

As between such parties and any holder of the instrument other than a holder in due course	It may be shown that the instrument was delivered conditionally or for a special purpose only, and not for the purpose of transferring absolutely the property therein.

7. DISHONOUR OF CHEQUES FOR INSUFFICIENCY OF FUNDS IN THE ACCOUNTS [SECTION 138 TO 142]

DISHONOR OF CHEQUE FOR INSUFFICIENCY, ETC., OF FUNDS IN THE ACCOUNTS [SECTION 138]

Where any cheque drawn by a person on an account maintained by him with a banker—

- for payment of any amount of money
- to another person from that account
- for the discharge, in whole or in part, of any debt or other liability, [A cheque given as gift or donation, or as a security or in discharge of a mere moral obligation, or for an illegal consideration, would be outside the purview of this section]
- is returned by the bank unpaid,
- either because of the—
    - amount of money standing to the credit of that account is insufficient to honor the cheque, or
    - that it exceeds the amount arranged to be paid from that account by an agreement made with that bank,

such person shall be deemed to have committed an offence and shall, be punished with imprisonment for a term which may extend to two years, or with fine which may extend to twice the amount of the cheque, or with both.

When section 138 shall be not apply: unless the below given conditions are complied with—

(a) Cheque presented within validity period: The cheque has been presented to the bank within a period of three months from the date on which it is drawn or within the period of its validity, whichever is earlier.

(b) Demand for the payment through the notice: the payee or the holder in due course

of the cheque, as the case may be, makes a demand for the payment of the said amount of money by giving a notice, in writing, to the drawer of the cheque, within 30 days of the receipt of information by him from the bank regarding the return of the cheque as unpaid, and

(c) Failure of drawer to make payment: the drawer of such cheque fails to make the payment of the said amount of money to the payee or, as the case may be, to the holder in due course of the cheque, within fifteen days of the receipt of the said notice.

Explanation: For the purpose of this section, "debt or other liability" means a legally enforceable debt or other liability.

Therefore we may conclude that compliant can be filed after 45 days of dishonor of the cheque i.e., 30 days of notice period +15 days of the receipt of the said notice.

Example 16 X issued a post-dated cheque to Y on the account of discharge of its liability. Further, X instructed to the bank to stop the payment due to unavailability of the adequate amount in the account. Here, in this instance section 138 of the Act is attracted as when a cheque is dishonoured on account of stop payment instructions sent by the drawer to his banker in respect of a post- dated cheque irrespective of insufficiency of funds in the account. A post-dated cheque is deemed to have been drawn on the date it bears and the three months period for the purposes of section 138 is to be counted from that date. So, X will be liable for dishonour of cheque. Once a cheque is issued by the drawer, a presumption under section 139 must follow.

Penalty: According to Section 138 of the Act, the dishonour of cheque is a criminal offence and is punishable with imprisonment up to 2 years or fine up to twice the amount of cheque or both.

PRESUMPTION IN FAVOR OF HOLDER [SECTION 139]

When a cheque is dishonoured, it shall be presumed, unless the contrary is proved, that the holder of a cheque received the cheque of the nature referred to in section 138 for the discharge, in whole or in part, or any debt or other liability.

Presumption prescribed here is a "rebuttable presumption" as the provisions clearly provides that the person issuing the cheque is at liberty to prove to the contrary. The effect of this presumption is to place the evidential burden on the accused.

DEFENCE WHICH MAY NOT BE ALLOWED IN ANY PROSECUTION UNDER SECTION 138 [SECTION 140]

It shall not be a defence in a prosecution of an offence under section 138 that the drawer had no reason to believe when he issued the cheque that the cheque may be dishonoured on presentment for the reasons stated in that section.

8. PRESENTMENT OF INSTRUMENTS

Presentment for acceptance [Section 61]

A bill of exchange payable after sight must [if no time or place is specified therein for presentment] be presented to the drawee thereof for acceptance [if he can, after reasonable search, be found] by a person entitled to demand acceptance, within a reasonable time after it is drawn, and in business hours on a business day.

In default of such presentment, no party thereto is liable thereon to the person making such default. If the drawee cannot, after reasonable search, be found, the bill is dishonoured.

If the bill is directed to the drawee at a particular place, it must be presented at that place, and if at the due date for presentment he cannot, after reasonable search, be found there, the bill is dishonoured.

Where authorised by agreement or usage, a presentment through the post office by means of a registered letter is sufficient.

Presentment of promissory note for sight [Section 62]

A promissory note, payable at a certain period after sight, must be presented to the maker thereof for sight (if he can after reasonable search be found) by a person entitled to demand payment, within a reasonable time after it is made and in business hours on a business day.

In default of such presentment, no party thereto is liable thereon to the person making such default.

Drawee's time for deliberation [Section 63]

The holder must, if so required by the drawee of a bill of exchange presented to him for acceptance, allow the drawee 48 hours (exclusive of public holidays) to consider whether he will accept it.

Presentment for payment [Section 64]

Promissory notes, bill of exchange and cheques must be presented for payment to the maker, acceptor or drawee thereof respectively, by or on behalf of the holder as hereinafter provided.

In default of such presentment, the other parties thereto are not liable thereon to such holder.

Where authorised by agreement or usage, a presentment through the post office by means of a registered letter is sufficient.

Exception: Where a promissory note is payable on demand and is not payable at a specified place, no presentment is necessary in order to charge the maker thereof.

Notwithstanding anything contained in section 6, where an electronic image of a truncated cheque is presented for payment, the drawee bank is entitled to demand any further information regarding the truncated cheque from the bank holding the truncated cheque in case of any reasonable suspicion about the genuineness of the apparent tenor of instrument, and if the suspicion is that of any fraud, forgery, tampering or destruction of the instrument, it is entitled to further demand the presentment of the truncated cheque itself for verification:

Provided that the truncated cheque so demanded by the drawee bank shall be retained by it, if the payment is made accordingly.

Hours for presentment (Section 65)

Presentment for payment must be made during the usual hours of business, and, if at a banker's within banking hours.

Presentment for payment of instrument payable after date or sight (Section 66)

A promissory note or bill of exchange, made payable at a specified period after date or sight thereof, must be presented for payment at maturity.

Presentment for payment of promissory note payable by instalments (Section 67)

A promissory note payable by instalments must be presented for payment on the third day after the date fixed for payment of each instalment; and non-payment on such presentment has the same effect as non-payment of a note at maturity.

Presentment for payment of instrument payable at specified place and not elsewhere (Section 68)

A promissory note, bill of exchange or cheque made, drawn or accepted payable at a specified place and not elsewhere must, in order to charge any party thereto, be presented for payment at that place.

Instrument payable at specified place (Section 69)

A promissory note or bill of exchange made, drawn or accepted payable at a specified place must, in order to charge the maker or drawer thereof, be presented for payment at that place.

Presentment where no exclusive place specified (Section 70)

A promissory note or bill of exchange, not made payable as mentioned in sections 68 and 69, must be presented for payment at the place of business (if any) or at the usual residence, of the maker, drawee or acceptor thereof, as the case may be.

Presentment when maker, etc., has no known place of business or residence (Section 71)

If the maker, drawee or acceptor of a negotiable instrument has no known place of business or fixed residence, and no place is specified in the instrument for presentment for acceptance or payment, such presentment may be made to him in person wherever he can be found.

Presentment of cheque to charge drawer (Section 72)

Subject to the provisions of section 84, a cheque must, in order to charge the drawer, be presented at the bank upon which it is drawn before the relation between the drawer and his banker has been altered to the prejudice of the drawer.

Presentment of cheque to charge any other person (Section 73)

A cheque must, in order to charge any person except the drawer, be presented within a reasonable time after delivery thereof by such person.

Presentment of instrument payable on demand (Section 74)

Subject to the provisions of section 31, a negotiable instrument payable on demand must be presented for payment within a reasonable time after it is received by the holder.

Presentment by or to agent, representative of deceased, or assignee of insolvent (Section 75)

Presentment for acceptance or payment may be made to the duly authorised agent of the drawee, maker or acceptor, as the case may be, or, where the drawee, maker or acceptor has died, to his legal representative, or, where he has been declared an insolvent, to his assignee.

Excuse for delay in presentment for acceptance or payment (Section 75A)

Delay in presentment for acceptance or payment is excused if the delay is caused by circumstances beyond the control of the holder, and not imputable to his default, misconduct or negligence. When the cause of the delay ceases to operate, presentment must be made within a reasonable time.

When presentment unnecessary (Section 76)

No presentment for payment is necessary, and the instrument is dishonoured at the due date for presentment, in any of the following cases:

(a) (i) If the maker, drawee or acceptor intentionally prevents the presentment of the instrument, or

(ii) if the instrument being payable at his place of business, he closes such place on a business day during the usual business hours, or

(iii) if the instrument being payable at some other specified place, neither he nor any person authorised to pay it attends at such place during the usual business hours, or

(iv) if the instrument not being payable at any specified place, he cannot after due search be found;

(b) as against any party sought to be charged therewith, if he has engaged to pay notwithstanding non-presentment;

(c) as against any party if, after maturity, with knowledge that the instrument has not been presented—

- he makes a part payment on account of the amount due on the instrument,
- or promises to pay the amount due thereon in whole or in part,
- or otherwise waives his right to take advantage of any default in presentment for payment;

(d) as against the drawer, if the drawer could not suffer damage from the want of such presentment.

Liability of banker for negligently dealing with bill presented for payment (Section 77)

When a bill of exchange, accepted payable at a specified bank, has been duly presented there for payment and dishonoured, if the banker so negligently or improperly keeps, deals with or delivers back such bill as to cause loss to the holder, he must compensate the holder for such loss.

9. RULES OF COMPENSATION

Rules as to compensation (Section 117)

The compensation payable in case of dishonour of promissory note, bill of exchange or cheque, by any party liable to the holder or any endorsee, shall be determined by the following rules:

(a) the holder is entitled to the amount due upon the instrument, together with the expenses properly incurred in presenting, noting and protesting it;

(b) when the person charged resides at a place different from that at which the instrument was payable, the holder is entitled to receive such sum at the current rate of exchange between the two places;

(c) an endorser who, being liable, has paid the amount due on the same is entitled to the amount so paid with interest at 18% per annum from the date of payment until

tender or realisation thereof, together with all expenses caused by the dishonour and payment;

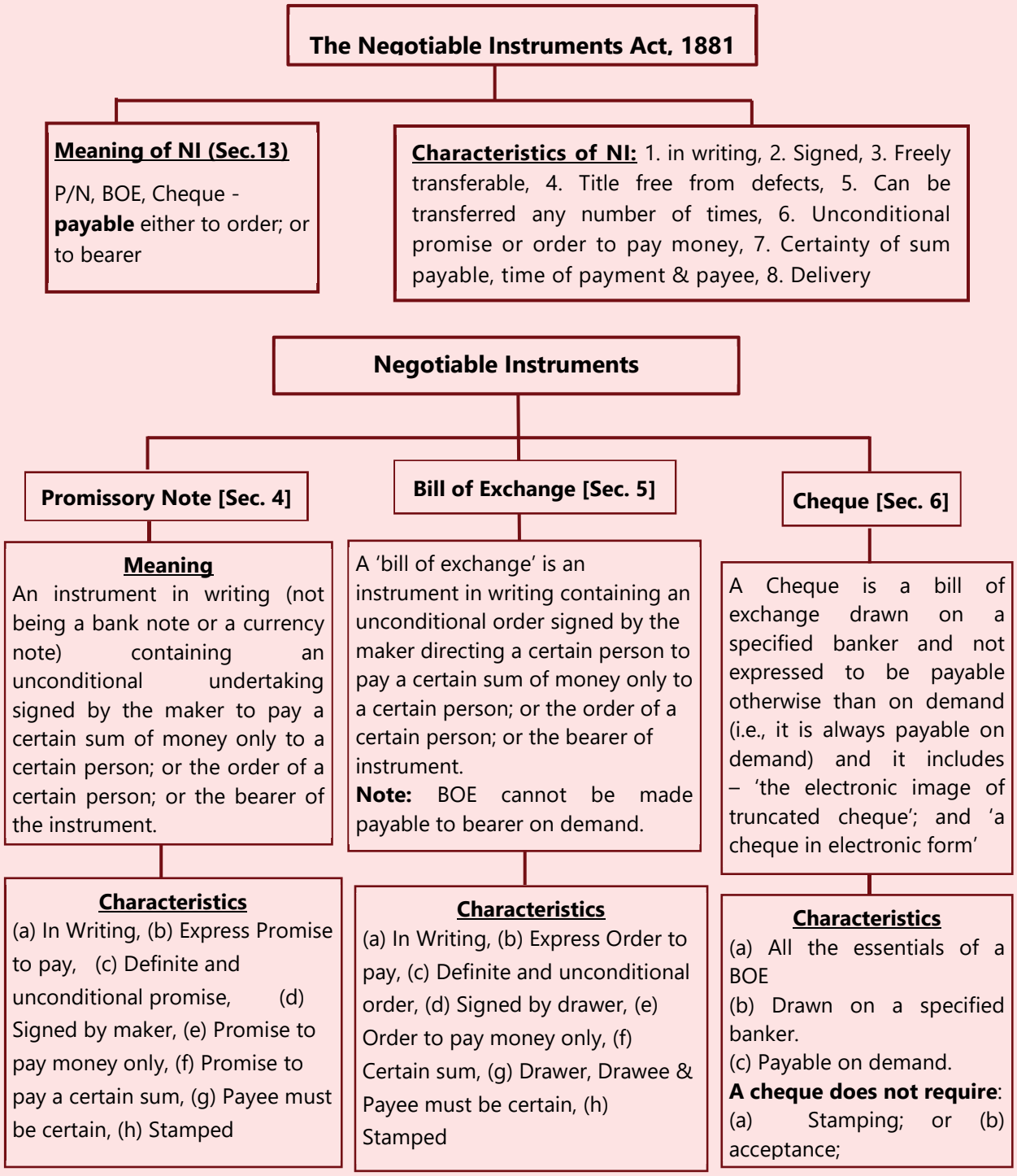
(d) when the person charged and such endorser reside at different places, the endorser is entitled to receive such sum at the current rate of exchange between the two places;

(e) the party entitled to compensation may draw a bill upon the party liable to compensate him, payable at sight or on demand, for the amount due to him, together with all expenses properly incurred by him. Such bill must be accompanied by the instrument dishonoured and the protest thereof (if any). If such bill is dishonoured, the party dishonouring the same is liable to make compensation thereof in the same manner as in the case of the original bill.

SUMMARY

- A promissory note is an unconditional undertaking, written and signed by the maker to pay a certain sum of money only to or to the order of a certain person. It does not include a bank note or currency note.
- A bill of exchange is an unconditional written order signed by the drawer, directing a certain person to pay a certain sum of money to the specified person or to his order or to the bearer of the bill.
- A cheque is a bill of exchange drawn on a specified banker and payable only on demand and it includes the electronic image of a truncated cheque and a cheque in the electronic form.
- A bearer instrument is one which is expressed to be payable to its bearer or which has last indorsement in blank.
- An instrument payable to order is the one which is expressed to be payable to a particular person.
- A negotiable instrument drawn or made in India and made payable in, or drawn upon any person resident in India shall be deemed to be inland instrument.
- Any instrument which is not an inland instrument is a foreign instrument.
- When the nature of an instrument is not clear, it is termed as ambiguous instrument. There such an instrument may be treated as either promissory or as a bill of exchange.
- Inchoate instrument is an instrument that is signed and duly stamped but otherwise wholly or partially blank.
- Negotiation means transfer of a negotiable instrument by one person to another in order to make the transferee the holder of the instrument.

- Negotiation may be made by delivery or by indorsement and delivery.
- A bank under certain conditions may refuse payment of cheque or is bound to dishonor cheque and when the cheque is dishonored for insufficiency of funds in the account of a customer, it is treated as offence.



Classification of Negotiable Instruments

Bearer Instrument	Order Instrument	Inland Instrument	Foreign Instrument	Inchoate Instrument	Ambiguous Instrument
Expressed to be payable to bearer or the last endorsement is in blank	Payable to a particular person or order and which does not restrict its further transfer.	Drawn in India + (Payable in India or Drawn on any person resident in India)	Which is not an Inland Instrument.	Incomplete Instrument in certain respects.	Which either be treated as P/N or BOE. (Once holder exercises his option, he is bound by it)

Presentment for acceptance (Only for BOE)

BOE payable after sight must	Must be presented within a reasonable time & in business hours on a business day. (**Note:** 48 hours, excluding public holidays, are given to drawee for acceptance)	
In default of such presentment	no party liable thereto	If Drawee not found after reasonable search, BOE is dishonored.
If BOE is directed to drawee at a particular place	must be presented at that place	

Presentment of Promissory Note for sight

P/N payable at a certain period after sight	Must be presented within a reasonable time & in business hours on a business day.
In default of such presentment	no party liable thereto

Rules regarding presentment for payment (P/N, BOE, CH)

To whom	Maker (P/N), Acceptor (BOE), Drawee (CH)
If default in presentment	no party liable thereto
Exception	If P/N is payable on demand and is not payable at a specified place, no presentment is necessary.
Time	During usual business hours
If instrument payable after date or sight	must be presented for payment at maturity
P/N payable by instalments	must be presented for payment on 3rd day after date fixed for payment of each instalment
instrument payable at specified place	Must be presented for payment at that place.
where no exclusive place specified	must be presented for payment at the place of business (if any) or at the usual residence
no known place of business or residence	presentment may be made to him in person wherever he can be found
Instrument payable on demand	Must be presented for payment within a reasonable time after it is received by the holder.
Note: Delay in presentment for acceptance or payment is excused if the delay is caused by circumstances beyond the control of the holder	

When Presentment Unnecessary

1. Maker, drawee or acceptor prevents the presentment,
2. Payable at business place & that's closed on business day during usual business hours,
3. Payable at specified place & liable party doesn't attend place,
4. Not payable at specified place & liable party not found after due search,
5. Liable party engaged to pay notwithstanding non-presentment,
6. Liable party makes part payment,
7. Liable party waives off his right to take advantage.
8. If drawer could not suffer damage from want of such presentment.

Rules as to Compensation (Sec.117)

In case of dishonour of NI, holder can claim:
1. Amount due on NI
2. Expenses incurred in presenting, noting & protesting.
3. Interest 18% p.a. from due date of payment to date of realisation.

Note: In case of foreign currency, current rate of exchange.

Dishonour of Cheques for Insufficiency of Funds in the Accounts [Section 138 to 142]

Debt - Cheque was issued to discharge a legally enforceable debt
Reason for dishonour - insufficiency of funds
Presentment of cheque - Within 3 months
Demand made from drawer - Within 30 days of dishonour
Default by drawer to pay - within 15 days of demand made

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *A negotiable instrument is an instrument which is freely transferable from one person to another by:*

   (a) Simple delivery

   (b) Indorsement and delivery

   (c) Indorsement

   (d) Registered post

2. *An instrument which is vague and cannot be clearly identified either as a bill of exchange, or as a promissory note, is called as:*

   (a) bearer instrument

   (b) Ambiguous instrument

   (c) Order instrument

   (d) Inland instrument

3. *As per Negotiable Instruments Act, 1881, Negotiable Instruments means:*

   (a) Promissory Note

   (b) Bills of Exchange

   (c) Cheque

   (d) All the above

4. *How many parties in Bills of exchange:*

   (a) 2

   (b) 3

   (c) 4

   (d) 5

5. *On which of the followings, even not defined in Negotiable Instruments Act 1881, provisions of Act are applicable:*

   (a) Hundies

   (b) Treasury Bills

   (c) Bearer Debentures

   (d) All of the above

6. *Which is not the essential characteristic of Bill of exchange:*

   (a) Must be in writing

   (b) Must contain an express promise to pay

   (c) Instrument must be signed

   (d) Must be stamped

7. *Which is not an Inland Instrument:*

   (a) P/N made in India + payable in India + drawn upon person resident in India

   (b) P/N made in India + payable in India + drawn upon person resident outside India

   (c) P/N made in India + payable outside India + drawn upon person resident in India

   (d) P/N made in India + payable outside India + drawn upon person resident outside India

8. *Negotiable Instrument which can be treated either P/N or BOE, is known as:*

   (a) Inland Instrument

   (b) Inchoate Instrument

   (c) Ambiguous Instrument

   (d) Foreign Instrument

9. *Order Instrument can be negotiated by:*

   (a) By delivery only

   (b) By endorsement only

   (c) By endorsement & delivery

   (d) None of above

10. *Where any cheque drawn by a person is dishonoured due to insufficiency of funds, such person shall be punished with:*

   (a) imprisonment for a term which may extend to two years,

   (b) with fine which may extend to twice the amount of the cheque,

   (c) imprisonment for a term which may extend to two years, or with fine which may extend to twice the amount of the cheque, or with both,

   (d) No punishment

Descriptive Questions

1. *M drew a cheque amounting to ₹ 2 lakh payable to N and subsequently delivered to him. After receipt of cheque N indorsed the same to C but kept it in his safe locker. After sometime, N died, and P found the cheque in N's safe locker. Does this amount to Indorsement under the Negotiable Instruments Act, 1881?*

2. *M owes money to N. Therefore, he makes a promissory note for the amount in favor of N, for safety of transmission he cuts the note in half and posts one half to N. He then changes his mind and calls upon N to return the half of the note which he had sent. N requires M to send the other half of the promissory note. Decide how rights of the parties are to be adjusted.*

3. *Bholenath drew a cheque in favour of Surendar. After having issued the cheque; Bholenath requested Surendar not to present the cheque for payment and gave a stop payment request to the bank in respect of the cheque issued to Surendar. Decide, under the provisions of the Negotiable Instruments Act, 1881 whether the said acts of Bholenath constitute an offence?*

4. *Rama executes a promissory note in the following form, 'I promise to pay a sum of ₹10,000 after three months'. Decide whether the promissory note is a valid promissory note.*

ANSWERS/HINTS

Answers to MCQs

1.	**(b)**	2.	**(b)**	3.	**(d)**	4.	**(b)**	5.	**(d)**	6.	**(b)**
7.	**(d)**	8.	**(c)**	9.	**(c)**	10.	**(c)**				

Answer to Descriptive Questions

1. No, P does not become the holder of the cheque as the negotiation was not completed by delivery of the cheque to him. (Section 48, the Negotiable Instruments Act, 1881)

2. The question arising in this problem is whether the making of promissory note is complete when one half of the note was delivered to N. Under Section 46 of the N.I. Act, 1881, the making of a Promissory Note (P/N) is completed by delivery, actual or constructive. Delivery refers to the whole of the instrument and not merely a part of it. Delivery of half instrument cannot be treated as constructive delivery of the whole. So, the claim of N to have the other half of the P/N sent to him is not maintainable.

M is justified in demanding the return of the first half sent by him. He can change his mind and refuse to send the other half of the P/N.

3. As per the facts stated in the question, Bholenath (drawer) after having issued the cheque, informs Surendar (drawee) not to present the cheque for payment and as well gave a stop payment request to the bank in respect of the cheque issued to Surendar.

Section 138 of the Negotiable Instruments Act, 1881, is a penal provision in the sense that once a cheque is drawn on an account maintained by the drawer with his banker for payment of any amount of money to another person out of that account for the discharge in whole or in part of any debt or liability, is informed by the bank unpaid either because of insufficiency of funds to honour the cheques or the amount exceeding the arrangement made with the bank, such a person shall be deemed to have committed an offence.

Once a cheque is issued by the drawer, a presumption under Section 139 of the Negotiable Instruments Act, 1881 follows and merely because the drawer issues a notice thereafter to the drawee or to the bank for stoppage of payment, it will not preclude an action under Section 138.

Also, Section 140 of the Negotiable Instruments Act, 1881, specifies absolute liability of the drawer of the cheque for commission of an offence under the section 138 of the Act. Section 140 states that it shall not be a defence in a prosecution for an offence under section 138 that the drawer had no reason to believe when he issued the cheque that the cheque may be dishonoured on presentment for the reasons stated in that section.

Accordingly, the act of Bholenath, i.e., his request of stop payment constitutes an offence under the provisions of the Negotiable Instruments Act, 1881.

4. The promissory note is an unconditional promise in writing. In the above question the amount is certain but the date and name of payee is missing, thus making it a bearer instrument. As per Reserve Bank of India Act, 1934, a promissory note cannot be made payable to bearer - whether on demand or after certain days. Hence, the instrument is illegal as per Reserve Bank of India Act, 1934 and cannot be legally enforced.

NOTES