BUSINESS LAW

M.B.A

First Year, Semester-II, Paper-I

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging ahead in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining 'A+' grade from the NAAC in the year 2024, Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over 221 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education in 2003-04 with the aim of taking higher education to the door step of all the sectors of the society. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even to housewives desirous of pursuing higher studies. Acharya Nagarjuna University has started offering B.Sc., B.A., B.B.A., and B.Com courses at the Degree level and M.A., M.Com., M.Sc., M.B.A., and L.L.M., courses at the PG level from the academic year 2003-2004 onwards.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers involved respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is my aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn be part of country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Academic Coordinators, Editors and Lesson-writers of the Centre who have helped in these endeavors.

Prof. K. Gangadhara Rao
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Acharya Nagarjuna University.

MBA
YEAR – I, SEMESTER – II
SYLLABUS
201EM24 – BUSINESS LAW

COURSE LEARNING OUTCOMES (CLOs) :
On successful completion of the course the learner will be able to:

l. Provide knowledge of general business law issues to the students
2. It aims at providing a rich source of contemporary knowledge, basic concepts, emerging ideas & techniques in the field of law
3. To Identify the fundamental legal principles behind contractual agreements
4. To understand the legal and fiscal structure of different forms of business organizations.

Unit-I: Indian Contract Act – 1872: Law of Contract, Essentials of Valid Contract, Classification of contracts, Offer & Acceptance, Consideration, Capacity to contract, Free consent, Breach of contracts and its Remedies.

Unit -II: Negotiable Instruments Act - l88l: Negotiable Instruments - Promissory Note, Bills of Exchange & Cheque, Differences, Essential elements, Parties to Negotiable Instruments, Dishonour & Discharge of a Negotiable Instrument.

Unit- III: Special Contracts - Indemnity and Guarantee, Bailment and Pledge, Contract of Agency

Unit-IV: Sale of Goods Act - 1930, Essentials of Sale Contract, Conditions & Warranties. Transfer of Property, Rights of an unpaid seller.

Unit-V: Companies Act, 2013: Definition of company - Characteristics - Classification of Companies Formation of Company -Memorandum and Articles of Association - prospectus - Company Meetings & Resolutions, Winding up.

Reference Books:

l. N.D. Kapoor, "Elements of Mercantile Law", 2007, Sultan
2. M.C. Kuchchal, Vivek Kuchchal, “Mercantile Law'”, 2013, 8th Ed, Vikas Publishing House Pvt. Ltd.,
3. Akhileshwar Pathak, "Legal Aspects of Business-,2007, 3rd Ed. Tata McGraw Hill.
4. S.S Gulshan, Business laws,20l0, Excel Books.
5. K.R. Bulchandani, "Business Law for Management", 2009, HPH.
6. S.R. Myneni, "lnternational Trade Law: International Business Law", 20l4, Allahabad Law Agency
7. PPS Gogna, "A Text Book of Company Law", 2006, S. Chand
8. Marianne moody Jennings, "The Legal, Ethical and Global Environment of Business",2009,
South western Cengage learning, New Delhi.

ACHARYA NAGARJUNA UNIVERSITY

MBA – Semester II

201EM24: BUSINESS LAW

Time: 3 Hours **Maximum Marks: 70**

SECTION – A : *(Short Answer Type Questions)*
Answer ANY FIVE questions
Each question carries 3 marks

(5 × 3 = 15 Marks)

Section A

1 a) Law of contract
b) Free consent
c) Bills of exchange
d) Discharge of negotiable instrument
e) Indemnity
f) Guarantee
g) Warranty
h)Unpaid seller
i) Winding up
j) Definition of company

Section B

SECTION – B : *(Essay Type / Analytical Questions)*
Answer the following questions
Each question carries 8 marks

(5 × 8 = 40 Marks)

2) a) What are the essentials of a valid contract?
Or
b) What is breach of contracts and explain its remedies?
3) a) Explain negotiable instrument act 1881 and parties to negotiable instruments?
Or
b) What is discharge of negotiable instrument?

4) a) What is bailment and pledge?
Or
b) Explain contract of agency?

5) a) Explain sale of goods act 1930 and essentials of sale contract?
Or
b) Explain the classification of companies and formation of company?

6) a) What is Memorandum of Association and explain its elements?
Or
b) Explain method of conducting company meetings and resolutions?

SECTION – C

(Case Study– Compulsory)

(1 × 15 = 15 Marks)

Case Study

Mr. S aged 58 years was employed in a Govt. Department. He was going to retire after two years. Mr. D made a proposal to Mr. S to apply for voluntary retirement from his post so that Mr. D can be appointed in his place; Mr. D offered a sum of Rs. 10 Lakhs as consideration to Mr. S in order to induce him to retire. Mr. S refused at first instance but when he evaluated the amount offered as consideration is just double of his cumulative remuneration to be received during the tenure of two years of employment, he agreed to receive the consideration and accepted the above agreement to receive money to retire from his office.

Questions:

1) Whether the above agreement is valid?
2) Explain with reference to provision of Indian Contract Act, 1872.

CONTENTS

LESSON-1
Indian Contract Act, 1872

NATURE OF CONTRACT

OBJECTIVES

After going through this unit, you will be able to:

- To understand the role of government in regulating the law of contract law in India
- To have adequate insights into the essentials and nature of the contract
- To understand the concept of offer, acceptance and rules of communication
- To know the capacity of persons to enter into a contract.
- To examine how contracts can be discharged and the remedies for breach

Structure:

OBJECTIVES:

- By the end of this lesson, students will be able to:
- Examine the statutory framework governing offer and acceptance under the Indian Contract Act, in the light of legal cases
- Analyze the distinctions between offer and invitation to treat, counteroffer and Cross offers and their legal validity
- Identify various approaches and modes of communication
- Understand the concepts of conditional acceptance, revocation and lapse of offer
- Critically examine the requirement of consideration for the formation of contract.

1.1 INTRODUCTION

The law of contract is that branch of law that determines the circumstances in *which promises made by the parties to a contract shall be legally binding on them.* Its rules define the remedies that are available in a court of law against a person who fails to perform his part of the contract and the conditions under which these remedies are available. It is the most important branch of business law. It affects all of us in one way or another.

The majority of commercial transactions depend on promises to be fulfilled at a later time, for example, purchasing goods on credit. The business world would be paralyzed if the rights and obligations created by these promises were not enforceable, whether these promises were made by businessmen or by others. The law of contracts deals with the enforcement of these promises. The Contract Act specifies the conditions under which rights or obligations established by the parties will be enforced, but it does not list the specific obligations that are legally enforceable.

The law of contract introduces definiteness in business transactions. Sir William Anson observes in this connection that the law of contract is intended to ensure that what a man has been led to expect shall come to pass, that what has been promised to him shall be performed. In simple words, it may be said that the purpose of the law of contract is to ensure the realization of the reasonable expectations of the parties who enter into a contract.

1.2 NATURE OF THE LAW OF CONTRACT

In one significant way, contract law varies from other fields of law. It does not lay down several rights and duties that the law enforces; it consists rather of limiting principles, subject to which the parties may create rights and duties for themselves that the law will uphold. The parties to a contract, in a sense, make the law for themselves. So long as they do not infringe on some legal prohibition, they can make rules they like in respect of the subject matter of their agreement, and the law will give effect to their decisions.

The law of contract is not the whole of the law of agreements nor the whole law of obligations.

1.2.1 Definition

A contract is an agreement made between two or more parties, which will be enforced.

Pollock's definition: ***'every agreement and promise enforceable at law is a contract.'***

According to ***Salmond, 'a contract is an agreement creating and defining obligations between parties.'***

Sec. 2 (h): "An agreement enforceable by law is a contract." Therefore, a contract has two important elements: one is the agreement, and the other is the obligation, which is enforceable by law**.**

Contract = Agreement + Enforceability

Section 2(e) defines an agreement as "every promise and every set of promises forming consideration for each other.

Section 2(b) defined a promise: "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." This, in other words, means that agreement is an accepted proposal. In order to form an agreement, there must be a proposal or offer by one party and its acceptance by the other.

Proposal or Offer

A proposal and its acceptance is the universally acknowledged process for the making of an agreement. The proposal is the starting point. Section 2(a) defines 'proposal' as follows:

When a 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.

Agreement = Offer + Acceptance

Promisor: A person who makes the promise is called the **'promisor' or 'offeror'** and the person to whom the proposal is made is known as the '**promisee' or 'offeree'**. In case an agreement is a set of promises, then a person becomes a promisor and promisee. Thus if there is an offer, acceptance, and *consensus ad idem* between parties, there is an agreement. However, this agreement does not become a contract unless there is a corresponding obligation, ie, enforceability

An agreement is the outcome of the consensus between the parties who enter into a contract. The expression "agreement" as defined in Sec. 2(e) is essentially and exclusively consensual in nature, ie, before there can be an agreement between two parties, there must be ***consensus ad idem.*** This means that the parties to the agreement must have agreed about the subject matter of the agreement in the same sense and at the same time. Unless there is ***consensus as idem***, there can be no contract.

Example: Arun, who owns two cars, one in blue and the other in black, is selling the blue car to Bala. Bala thinks he is purchasing a black car. There is no consensus ad idem, and consequently no contract.

In order to determine whether, in any given agreement, there is existence of consensus as idem, it is usual to employ the language of offer and acceptance. Thus if A says to B 'will you purchase my car for Rs.10,000?' and B says "yes" to it, there is *consensus ad idem* and an agreement comes into existence.

Obligation

An agreement, to become a contract, must give rise to a legal obligation or duty. The term 'obligation' or duty. The term 'obligation' is defined as a legal tie that imposes a definite act or acts. It may relate to social or legal matters. An agreement that rises to a social obligation is not a contract. It must give rise to a legal obligation in order to become a contract.

Example 1: P agrees to paint H's house for Rs.15,000. The agreement gives rise to an obligation on the part of P to paint and deliver the house to H and on the part of H to pay Rs.15,000 to P. This agreement is a contract.

Example 2: A invites his friend B to come for dinner at Hotel Taj. B accepted the invitation and reached Taj; A did not turn up. B cannot claim any compensation from A

"Agreement" is a very wide term. An agreement may be a social agreement or a legal agreement. If A invites B to a dinner and B accepts the invitation, it is a social agreement. A social agreement does not give rise to contractual obligations and is not enforceable in a court of law. It is only those agreements that are enforceable in a court of law that are contracts.

1.3 ESSENTIALS OF A VALID CONTRACT

It is the legal duty of a person to carry out what he has promised to do or not to do**. Section 10 defined essentials of “**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 not hereby expressly declared to be void.” Therefore, a person becomes legally bound to do what he has promised to do only if the following conditions are fulfilled.

1.1.3.1 Offer and acceptance: There must be two parties to an agreement, i.e., one party making the offer and the other party accepting it. The terms of the offer must be definite, and the acceptance of the offer must be absolute and unconditional. The acceptance must be in accordance with the mode prescribed and must be communicated to the offeror.

1.3.2 Intention to create a legal relationship: when the two parties entered into an agreement, their intention must be to create a legal relationship between them. If there is no such intention on the part of the parties, there is no contract between them. Agreements of a social or domestic nature do not contemplate legal relationships. As such, they are not contracts. **[case: Balfour Vs Balfour (1919) 2 KB 571]**

1.3.2.a Test of Contractual Intention: The test of contractual intention is objective, not subjective. What matters is not what the parties had in mind; it is what a reasonable person would think in such circumstances their intention to be.

In a case where three ladies, two of them being mother and daughter and the third a paying guest, together staying in a house, made entries in a crossword puzzle in the name of the mother, the expenses being met by one or the other without any rules. The entry was successful one week, and Mother refused to divide the prize. But the court held that she was bound to do so, for any reasonable man looking at their conduct would at once conclude that they must have intended to share the prize **[Case: Simpkins Vs Pays, (1995) 1 WLR 975 92)]**

1.3.2.b Business Matters: In commercial and business agreements, the presumption is usual that the parties intended to create legal relations. But this presumption is rebuttable, which means that it must be shown that the parties did not intend to be legally bound. Precisely, in every business matter, parties may intend to rely on each other’s good faith and honor and not on the courts. Thus for example, in [**Case: Rose and Frank Company vs. JR Crompton]**

1.3.3 Capacity of parties—Competency: The persons who are competent to enter into a contract can only create valid obligations. A minor, a lunatic, a drunkard, etc., suffers from flaw in capacity to contract and hence the contract made with them can’t be enforced against them.

1.3.4 Free Consent: Absence of consent does not create a legal obligation. For an agreement to become a contract, the parties to the agreement must give their consent to the agreement out of their own free will. It should not be induced by coercion, undue influence, fraud, misrepresentation, mistake, etc.

1.3.5 Lawful Consideration: An Agreement to be enforceable by law must be supported by consideration. Consideration means 'something in return.' The agreement is legally enforceable only when both parties give something and get something in return.

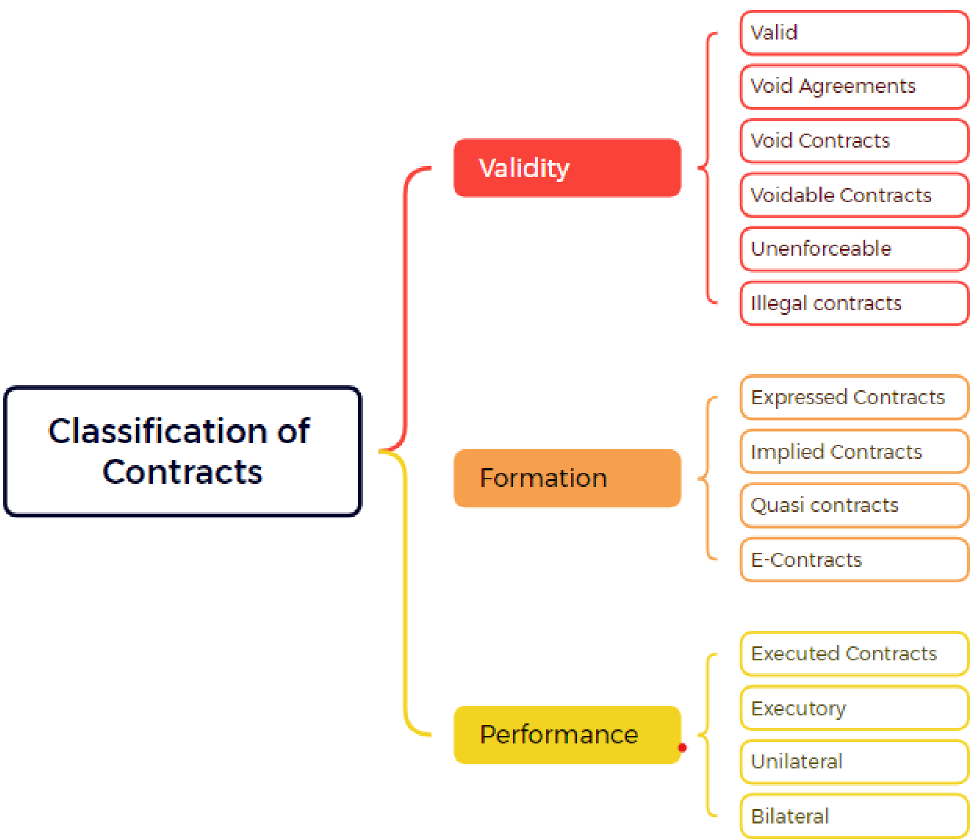
1.3.6Lawful object: The objective of the agreement must be lawful. In other words it means that the object is not (a) illegal,(b) immoral, or (c) opposed to public policy. If the agreement suffers from any legal flaw, it would not be enforceable by law

1.3.7Agreement not declared void: The agreement must not have been expressly declared void by any law in force in the country.

Example: Selling arms without a license is prohibited under the law

1.3.8 Certainty and possibility of performance: The agreement must be certain and not vague or indefinite. If it is vague and it is not possible to ascertain its meaning, it cannot be enforced.

1.4 CLASSIFICATION OF CONTRACTS



1.4.1 Classification of contracts based on Validity:

A contract is based on agreement. An agreement becomes a valid contract only when all the essential elements discussed above, according to **Section 10** satisfies. In such a case a contract is a ***valid contract.*** If one or more of the essential elements are missing, then the contract is either ***voidable, void, illegal or unenforceable*** according to circumstances.

Valid: Satisfies all the essential enforceability conditions under Section. 10 and can be enforced by either party at the court of law.

Voidable: Is defined under **Section 2(i) as** an agreement that 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**.** This occurs when the consent of the parties to a contract is not freely and genuinely given. Factors affecting free consent are coercion, undue influence, misrepresentation, or fraud. The party whose consent is not obtained freely has an option to rescind (avoid) the contract if he so desires, or elects to be bound by it. A voidable contract continues to be valid till it is voided by the party entitled to do so.

Example: X promises to sell his house to Y for Rs. 250,000. His consent was obtained by use of force. The contract is voidable at the option of X. Here X may avoid the contract or elect to be bound by it. So, the contract is voidable at the option of X.

(a) When a person promises to do something for another person for consideration but the other person prevents him from performing his promise the contract becomes voidable at his option. **(Section 53)**

    Example: A and B entered into a contract that B shall execute painting work for A for Rs. 15000. B is ready and willing to execute the work as per the terms of the contract, but A is not allowing him to enter his house, i.e., preventing 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 that he has incurred by its nonperformance (like the purchase of paints).

(b) When a party to a contract promises to perform an obligation within a specified time, any failure on his part to perform his obligation within the fixed time makes the contract voidable at the option of the promisee **(Section 55).**

What were the consequences of the recession of a voidable contract? When is a voidable contract rescinded?

As we see the conditions, now we shall explain the consequences. 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. If the party rescinding the contract has received any benefit under the contract from another party to such contract, he shall restore such benefit, so far as may be, to the person from whom it was received. It acts as security for performance. **(Section .64)**

The party who rightfully rescinds the contract is also entitled to compensation for any damage that he has sustained through the non-fulfillment of the contract **(section 65).**

Void Agreement and Void Contract:

Void Agreement: Section 2(g) defined void agreement as ‘an agreement not enforceable by law is said to be void’. A void agreement does not create any legal rights or obligations. It is considered as void ab initio- means void from the very beginning.

Example: contract with the minor

Void Contract: Section 2(j) defined ‘a contract which ceases to be enforceable by law becomes a void contract. When a contract is valid and binding between the parties when originally entered into, it becomes void due to some circumstances.

Example: A entered a contract with B to import raw materials from a foreign country. When war breaks out between the countries, the contract becomes void.

Illegal or unlawful contracts:

The term 'illegal' refers to something that violates the law. These contracts contradict statute law or public morals. They are void ab initio. Illegal contracts are invalidated not only between the individuals involved but also for collateral transactions.

Section 23: An agreement is unlawful if the consideration or object of which (1) is forbidden by law; (2) defeats the provisions of any law; (3) is fraudulent; (4) involves or implies injury to the person or property of another; and (5) the court regards it as immoral or opposed to public policy.

Example: A agrees to pay Rs. 1 Lakh to B if B kills C. This is an illegal agreement because its object is unlawful (forbidden by law)

Unenforceable Contract: An enforceable contract is one that cannot be enforced in a court of law due to some technical defects or absence in writing, where the remedy is barred by lapse of time.

1.4.2 Classification based on Formation

Contracts may be classified according to the mode of their formation

Expressed Contract:If the terms of the contract are expressly agreed upon between the parties either by the words spoken or written at the time of the formation of the contract, then the contract is said to be an express contract.

Implied contract: An implied contract is one that is inferred from the acts or conduct of the parties or course of dealings between them. It also results from the continuing course of conduct of the parties. Where the proposal or acceptance of any promise is made otherwise than in words, the promise is said to be implied (Section .9)

[Case: Upton Rural District Council Vs Powell (1942) All.E.R. 220]

Examples: (a) Gets into public bus

(b) obtains ticket from an automatic vending machine

(c) takes a cup of tea in a restaurant

Quasi Contract: Strictly speaking quasi contract is not a contract at all. A contract is intentionally entered into by parties . Aquasi contract on other hand , is created by law . It resembles a contract in that a legal obligation is imposed on a party who is requires to perform it. It is based on the equity principle ‘ a person shall not be allowed to enrich himself unjustly at the expense of another”

Example: T a Swiggy delivery boy, delivers pizza at R's house by mistake. R assumed the pizza was for him and ate it; now R is bound to pay for the pizza.

Classification of contracts based on performance

Executed Contracts: "Executed" means that which is done. Am executed contract is one in which both the parties performed their part of promises.

Example: A agrees to paint a picture for B for Rs.40000. When A painted the picture and B paid the price. Both fulfill their part of the contract.

Executory Contract: "Executory" means that which remains to be carried into effect. An executory contract is one in which both parties have yet to perform their obligations. In the above example, if A agreed to paint the picture and deliver it to B for next month and B has not yet paid the price, then the contract becomes executory.

Unilateral: A unilateral contract, or one-sided contract, is one in which only one party has to fulfill his obligation at the time of the formation of the contract; the other party already fulfilled his obligation at the time of the contract or before contract formation.

Example: A passenger allows a railway coolie to carry his luggage and keep it near his seat. A contact comes into existence as soon as the luggage is placed. Here the coolie has already performed his obligation. Now A has to fulfill his part of the contract, i.e., to pay reasonable charges to the coolie.

Bilateral Contract: A bilateral contract is one in which the obligations on the part of both the parties to the contract are yet to be performed at the time of formation of the contract.

Check your Progress 1

Q1. What is the object and nature of the law of contract?

Q2. Describe the essentials of valid contract. When does an agreement becomes void?

Q3 In commercial and business agreements, the presumption is, that the parties intended to create legal relations. 'Discuss'.

1.5 OFFER AND ACCEPTANCE

As said earlier, the first stage in creating a contract is to make an offer. Therefore, we will analyze what constitutes a valid offer.

Definition: 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 the other to such act or abstinence, he is said to make a proposal."

The following characteristics arise from the preceding definition of proposal: - It must be an expression of readiness to do or refrain from doing something; thus, it may involve a 'positive act' or an abstention' (refrain from doing).

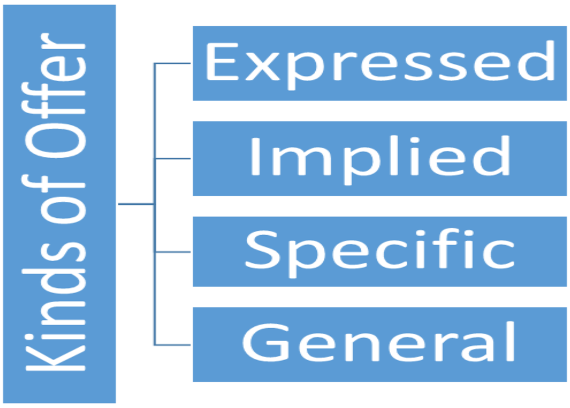
1. The offer must show an obvious intention on the part of the offeror to be bound by it. In other words, the **intention to create legal relationship.**

2. The offeror must make the offer with a view to obtaining the assent of the offeree to such act or abstinence

3. The offer must be definite

4. It must be communicated to the offeree.

1.5.1 Classification of offer



Earlier we discussed the expressed and implied contract and the same meaning is construed for the expressed and implied offer

Expressed/Implied: An offer, which is expressed by words, written or spoken, is called an express offer. An offer expressed by conduct is an ‘implied offer.’

Examples: Express Offer: 'A' offers to sell his car to 'B' for Rs.1,00,000. Implied Offer: When a transport company runs a bus on a particular route, it is an implied offer from the transport company to carry passengers for a certain fare.

A specific offer is one that is presented to a specific individual or group of individuals. Only that individual or that "specific group to whom it is made" may accept it. If it is accepted by any other person, there is no valid acceptance. The rule of law is clear that if you propose to make a contract with A, B cannot substitute himself/herself for A without your consent

For instance, "A" offered to purchase specific items from "B." The offer is made to a specific individual, "B." Consequently, a purchase from "X" rather than "B" will not result in a legally binding contract **[Case: Boulton v. Jones (1857) 2 H and N. 564].**

A general offer is one that is made to the world at large; any persons to whom the offer is made can accept it **[Case: Carlill v Carbolic Smoke Ball Co., (1893) 1Q B 256]**

Cross Offers: When two parties exchange identical offers in ignorance at the time of each other's offer, the offers are called cross offers. There is not a binding contract in such a case, as one's offer cannot be construed as acceptance by the other. **[Case:Tin v Hoffmann & Co. (1873) 29 LT,271]**

Counter Offer: When the offeree offers a qualified acceptance of the offer subject to modifications and variations in the terms of the original offer, he is said to have made a counteroffer. In that case the original offer gets cancelled**. [Case: Hyde v. Wrench (1840)]**

Standing, open or Continuing Offer : An offer, allowed to remain open for acceptance over a period of time, is known as a standing, open, or continuing offer. A tender for the supply of goods is a kind of standing offer.

1.5.2 Essentials of a valid Offer

1. **Offer must be such as in law is capable of being accepted and giving rise to legal relationship:** A social invitation, even if it is accepted, does not create legal relations because it is not so intended.
2. **Terms of offer must be definite, unambiguous, and certain and not loose and vague:** If the terms of an offer are vague or indefinite, its acceptance cannot create any contractual obligations

   Example: A says to B, 'I will sell my car.' A owns three different cars. The offer is not definite.

3. **An offer may be distinguished from:**
   - **(a) A declaration of intention and an announcement:** A declaration by a person that he intends to do something gives no right of action to another. Such a declaration only means that an offer will be made or invited in the future and not that an offer is made now.
   - **(b) An invitation to make an offer or do business (Invitation to treat)**

     A invites an offer from B. B makes the offer. A may or may not accept the offer. With the result, there may or may not be a contract. Goods 'displayed in a shop window are not offers for sale. They are only invitations to an offer for sale. They are only invitation to an offer to buy. The customer makes the offer to buy. The shopkeeper may or may not accept the offer. With the result, the shopkeeper is not bound to sell the goods.

     A flick knife was displayed in a shop-window. The Court held that it was not an offer for sale and hence was not an offence.**[Case: Fisher Vs Bell,]**

     Newspaper advertisements are not offers. But there is a well recognised exception to this general offer of reward to the public. Thus when A advertises in a newspaper that he would pay rs.100 to anyone who find and returns her lost dog, the offer is addressed to the first person who, by performing the required act with knowledge of the offer of reward creates an agreement

4. Offer must be communicated: An offer, to be complete, must be communicated to the person to whom it is made. Unless an offer communicated to the offeree by the offeror or by his duly authorized agent, there can be no acceptance of it. An acceptance of an offer in ignorance of the offer is no acceptance and does not confer any right on the acceptor.

G sent L to search for his missing nephew. Subsequently, G announced a reward for the finder. Meanwhile, L brought the nephew. L was not aware of the announcement when it was made. L claimed the reward. Held - L was not entitled for the reward. The Court observed as follows: A person who does an act in ignorance of an offer cannot say either that there was a consensus between himself and the offeror or that his act was done in relation to the offer. **[Case: Lalman v Gauri dutt (1913) 11 All.L.J,489]**

5. Offer must be made with a view to obtaining the assent: The offer to do or not to do something 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.

6. Offer should not contain a term the noncompliance of which may be assumed to amount to acceptance

Example: A writes to B, "I will sell my scooter for Rs.15000, and if you do not reply, I shall assume you have accepted the offer,." There is no contract if B does not reply.

7. A statement of price is not an offer: A mere statement of price is not construed as an offer to sell [Case: Harvey v. Facey (1893), A.C. 552]

1.6 ACCEPTANCE

1.6.1 DEFINITION: Sec. 2 (b) 'Acceptance' is an expression by the offeror of his willingness to be bound by the terms of the offer. **Section 2 (b) of the Act defines the term 'acceptance' as '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.

When the individual to whom the proposal is presented indicates his agreement to do or not do something, the proposal or offer is said to have been accepted.

An offer can only be accepted by the individual to whom it is made. Anyone who is aware of a general offer and complies with its terms may accept it.

Sir William P. Anson, in his English law of contracts, stated that "Acceptance is to an offer what a lighted match is to a train of gunpowder." It results in something that cannot be undone or recalled. Furthermore, an offer does not establish a relationship on its own. However, a contractual connection develops between the parties when an offer is accepted.

1.6.2 Legal rules for acceptance

The acceptance of an offer is the very essence of a contract. To be legally effective, it must satisfy the following conditions:

1. **It must be absolute and unqualified:** The acceptance needs to be complete and unconditional. It needs to match every clause in the offer. The acceptance would be void for even a small variance. Likewise, acceptance that is qualified or conditional is not acceptance at all. It will just be a counteroffer, which the offeror has the option to accept or reject.

   Example: M offered to sell a piece of land to N at $280. N accepted and enclosed $80 with a promise to pay the balance by monthly installments of $50. Held there was no contract between M and N, as the acceptance was not unqualified.

2. **It must be communicated to the offeror**: To conclude a contract between parties the acceptance must be communicated in some perceptible form. A mere resolve or mental determination on the part of the offeree to accept an offer, when there is no external manifestation of the intention to do so, is not sufficient. In order to result in a contract the acceptance must be a 'matter of fact'

Example: F offered to buy his nephew's horse for 30 pounds saying: "If I hear no more about it I shall consider horse is mine at 30 pounds". The nephew did not write to F at all, but he told his auctioneer who was selling his horses not to sell that particular horse because it had been sold to his uncle. The auctioner inadvertently sold the horse. Held, F had no right of action against the auctioneer as the horse has not sold to F, his offer of 30 pounds not having been accepted**[Case: Felthouse v Bindley(1862) 11 CB NS 869]**

3. **It must be according to the mode prescribed or the usual and reasonable mode:**Acceptance must follow the offeror's specified style or procedure. The offeror may request that the acceptance be in the specified mode within a reasonable period after receiving it. If he does not notify the offeree, he is considered to have accepted the acceptance. If no specific mode is specified, acceptance can occur by normal or reasonable means.
4. **It must be given within a reasonable time:** If the offeror specifies a time for acceptance, the offer must be accepted within that timeframe. If no time frame is specified, it must be accepted within a reasonable amount of time. **[Case:Ramsgate Victoria Hotel co.v. Montefiore(1886) LR 1Ex 109].**
5. **Acceptance cannot precede an offer:**There is no acceptance without an offer. Acceptors must be aware of the proposal when accepting it. Acceptance must always come after the offer.
6. **It must show an intention on the part of the acceptor to fulfill terms of the promise**. If no such intention is present the acceptance is not valid.
7. **It must be given by the parties to whom the offer is made**.
8. **It must be given before the offer lapses or before the offer is withdrawn:** The offer must be available at the time of acceptance. If an offer has expired or been revoked, accepting it again will not be effective.
9. **It cannot be implied from silence:**The acceptance of an offer cannot be implied from the silence of the offeree or his failure to answer unless the offeree has by his previous conduct indicated that his silence means that he accepts
10. **Acceptance subject to conduct:**Assent indicates acceptance through written or words spoken, or action. Acceptance occurs when a person performs an act intended by the proposer in exchange for a commitment. When a tradesman fulfills a customer's order by providing products, the customer's order is considered an offer, which is then accepted by the tradesman.This is a case of acceptance through actions. Section 8 states that accepting a proposal by fulfilling its requirements or accepting a reciprocal guarantee constitutes acceptance.

1.6.3 Communication and revocation of offer and acceptance:

When is communication complete? Section 4

Offer	Communication of the offer is complete when it comes to the knowledge of the person to whom it is made **Example**: X wants to sell his mobile to Y for Rs 25000. Communication of this offer comes to an end when Y receives the information by whatever mode.
Acceptance	Here two things: 1. As against the offerer/proposer: when it is put in a course of transmission to him to be out of the power of the acceptor 2. As against the offeree/ Acceptor: When it comes to the knowledge of the proposer

Offer	The offer may be revoked at any time before the communication of its acceptance is complete, as against the proposer but not afterwards. **Example**: A sends a letter offers to sell his car to B for Rs.2.5 lakhs. B sends his acceptance by post. A can revoke his offer at any time before or at the moment when B posts his acceptance but not afterwards
Acceptance	Acceptance can be revoked at any time before the communication of acceptor but not afterwards. **Example:** Ravi sends a letter to Chandu and offers to sell his laptop for Rs.30000. Chandu sends his acceptance via post. Chandu can revoke his acceptance at any time before or at the moment when he posts his letter of acceptance, but not afterwards.

When can revocation be made? Section 5

When is communication of revocation complete? Section 4

Offer	As against the offeror: when it is put into a course of transmission to the person to whom it is made **Example:** X proposes to Y by sending a letter. Y sends his acceptance by a letter. Later immediately Xsends a telegram revoking his offer. Revocation is completed against X when the telegram is dispatched.
Acceptance	As against the offeree When it comes to his knowledge. **Example:** Communication of revocation is complete only when Y receives the telegram. When Y revokes his acceptance it is complete when he dispatches the telegram

Check your Progress 1

Q1. Discuss briefly the law relating to communication of offer, acceptance, and revocation. When may an offer and acceptance be revoked?

Q2. “An acceptance to be effective must be communicated to the offeror”Are there any exceptions to this rule?

1.7 CONSIDERATION

In this section we discuss What is consideration? Why is it important to understand?

1.7.1 CONSIDERATION IS ONE OF THE ESSENTIAL ELEMENTS TO SUPPORT A CONTRACT.

Subject to certain exceptions, an agreement made without consideration is *nudum pactum (a nude contract)* and is ***void.*** Consideration is the technical term used in the sense of ‘***quid pro quo,’*** which means something in return.

The following are a few definitions of consideration:

In the words of Pollock, ‘consideration is the price for which the promise of the other is bought, and the promise thus given for value is enforceable”.

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 to abstain from doing, something, such act or abstinence or promise is called consideration for the promise.’

This definition can be broken into three parts for better understanding.

1. ***An act*** (doing of something , in this case consideration is in an affirmative form)

Example: A promises B to guarantee payment of price of the goods which B sell on credit to C.Herre selling of goods by B to C is consideration for A’s promise.

2. ***An abstinence or forbearance*** (abstaining or refraining from doing something. In this sense, consideration is in a negative form.)

Examples: A promises B not to file a suit against him if he pays him Rs.500. The abstinence of A is the consideration for B’s Payment.

3. **A return promise**

   Example: A agrees to sell his camera to B for Rs 10,000. Here, B’s promise to pay the sum of Rs. 10,000 is the consideration for A’s promise to sell the camera, which is the consideration for B’s promise to pay the sum of 10,000.

1.7.2 LEGAL RULES FOR CONSIDERATION

1. **It must move at the desire of the promisor:** An act constituting consideration must have been done at the desire of the promisor. If it is done at the instance of a third party or without the desire of the promisor, it will not be a good consideration.

   Example: B spents some money on the improvement of a market at the desire of the Collector of the district. In consideration of this D who was using the market promised to pay some money to B. Held the agreement was void being without consideration.[**Case:Dugra Prasad v Baldeo, (1880) 3 All.221**]

2. **It may move from the promisee or any other person:**Under English law consideration must move from the promisee. Under Indian law consideration may move from the promisee or any other person, even a stranger. But the stranger to consideration will be able to sue only if he is a party to the contract.

   Example: An old lady, by a deed of gift, made over certain property to her daughter D, under the direction that she should pay her aunt P (Sister of the old lady), certain sum of money for her annual maintenance.Later D refused to pay the amount on the plea that no consideration had moved from P to D. Held P was entitled to maintain suit as consideration had moved from the old lady, sister of P to the daughter D.**[Case: Chinnaya v Ramayya,(18820 4 Mad. 137]**

3. **It may be an act, abstinence or forbearance or a return promise: This has already been explained in the definition part.**
4. **It may be past present or future**.The words in the definitions of section2(d) are " … has done or abstained from doing (past) or does or abstains from doing(present), or promises to do or to abstain from doing (future) something…" this reflects that the consideration may be past, present or future.
5. **It must be real and not illusory:**Although consideration need not be adequate, it must be real, competent and of some value in the eyes of the law.
6. **It must be something which the promisor is not already bound to do**.
7. **It need not be adequate :**Adequate consideration is not required. It implies that there is no requirement for the promise made and the consideration received to be equal.
8. An agreement between two parties is called a contract. The agreement reached by two parties is unimportant to the courts. The parties are allowed to negotiate on their own terms. The courts are unable to represent the parties and negotiate on their behalf.But the aforementioned regulation only applies when the promisor freely agrees
9. **It must not be illegal, immoral aor opposed to public policy.**

1.7.3 STRANGER TO CONTRACT

The following are the exceptions to this general rule

1. **A Trust or Charge:**The individual who establishes a trust is referred to as the trust's author or founder. The trustees are the individuals designated or selected to manage the trust. Beneficiaries are the people for whom the trust is established. Despite not being a party to the trust deed, the beneficiary may file a lawsuit against the trustee in his own name.
2. **Family arrangements:**A family may have a division among its male members. An unmarried daughter's marriage expenses may be covered by a provision. Despite not being a party to the partition deed, the unmarried daughter may enforce this clause against the male members.
3. **Assignment of a contract:** The assignee of rights and benefits under a contract not involving perrsonall skill can enforce the contract subject to the equities between the original parties.
4. Contracts entered into through an agent
5. Covenants running with the land

1.7.4 A CONTRACT WITHOUT CONSIDERATION IS VOID —- EXCEPTIONS

"Nundum pactum non oritur actio" means an agreement made without consideration is void.There are a few exceptions to this rule, though. (Section 25) .

It should be an agreement between people who are close to each other.

Natural love and affection should have led to the agreement.

The contract needs to be recorded and in writing.

Compensation for voluntary services

Promise to pay a time -barred debt

Charatiable subscription

Even if there is no consideration, the agreement will still be enforceable if all three requirements are met.

Check your Progress 3

Q1 Define consideration. Why it is essential in a contract? What are the legal rules regarding consideration

Q2. ' A stranger to a contract cannot sue" Are there any exceptions to this rule?

Q3. A promises a subscription of Rs. 10,000 to the National Defence Fund. He does not pay. Is there any legal remedy against him?

Dr. V. Radhika

LESSON-2
CAPACITY OF PARTIES – FREE CONSENT

STRUCTURE:

OBJECTIVES:

- After going through this lesson, students will be able to
- Understand that the parties who enter into a contract must have capacity
- Analyze distinctions between Coercion, undue influence, misrepresentation, fraud, and mistake
- Evaluate the allocation of the burden of proof in cases involving undue influence and fraud and its implications for contractual fairness

2.1 INTRODUCTION

The parties who enter into a contract must have the capacity to do so. Capacity here means 'competency' of the parties to enter into a valid contract. We know **Section 10** defined an agreement as a contract if it is entered into between the parties who are competent to contract, and it is one of the essentials for a valid contract. Now, who are competent to contract? It is defined under **Section 11** of the Indian Contract Act, 1872.

Section 11 defines "every person is competent to enter into a contract—

(1) If he has attained the age of majority according to the law to which he is subject.

(2) Who is of sound mind, and

(3) Is not disqualified by any law for the time being in force."

2.2 MINORS

According to section 3 of the Indian Majority Act, 1875, a minor is a person who has not completed eighteen years of age. In the following two cases, he attains majority after twenty-one years of age:

(a) Where a guardian of a minor's person or property has been appointed under the Guardians and Wards Act, 1890, or
(b) Where the superintendence of a minor's property is assumed by a Court of Wards

The rules governing minors' agreements are based on two fundamental rules:

- The first rule is that the law protects minors against their own inexperience.
- Second, against the possible improper designs of those more experienced.

The intention behind this argument is that 'the law protects minors, preserves their rights and estates, excuses their laches, and assists them in their pleadings.' In other words, the judges are their counsellors, the jury their servants, and law is their guardian.

The second rule is that, in pursuing the above object, the law should not cause unnecessary hardship to persons who deal with minors.

2.2.1 MINOR'S AGREEMENTS:

1. **An agreement with or by a minor is void and inoperative ab initio.** A minor is not competent to contract. Hence an agreement with a minor is void ab initio. It is a, nullity

   Example: A minor obtained an advance of Rs. 8,000 and executed a mortgage for Rs. 20,000. The minor thereafter attempted to have the mortgage set aside on the grounds of minority. The mortgagee argued that the minor should return the advance he took since a contract with a minor is voidable.A contract with a minor is void ab-initio, the Privy Council ruled, rejecting the argument. Since the contract is null and void, the minor cannot be asked to return the advance he took. **[Case: Mohir Bibi v Dharmodas Ghose, (1903) 30 Cal. 539]**

2. **He can be a promisee or a beneficiary:** Incapacity of a minor to enter into a contract means incapacity to bind himself by a contract. There is nothing which debars him from becoming a beneficiary.
3. **His agreement cannot be ratified by him on attaining the age of majority:** Even after he has reached majority, he cannot ratify contracts he entered into while still a minor because they are completely void. A contract that is void ab-initio cannot be ratified since ratification takes effect retrospectively. Once a minor reaches majority, he cannot ratify the contract he signed while still a minor. The rationale is that ratification has a retroactive effect.
4. **If has received any benefit under the void agreement, he cannot be asked to compensate or pay for it.** Section 65, which provides for restitution in case of agreements discovered to be void does not apply to minors.
5. **He can always plead minority:** a minor's false claims are not legally binding. However, a minor cannot be barred from using minority as a defense if he enters into a contract by falsely claiming to be a major. It is not possible to use the estoppel rule against a minor.
6. **There can no specific performance of agreements entered into by him as they are void ab initio.**
7. **Minors cannot enter into a partnership contract, but they may be admitted to the benefits of an existing partnership with the consent of the other partners.**
8. **He cannot be adjusted insolvent. This is because he is incapable of contracting debts**
9. **He is liable for necessaries supplied or necessary services rendered to him or anyone whom he is legally bound to support**

10. **He can be an agent.** An agent is merely a connecting link between the principal and a third party. However, a minor binds the principal by his acts without incurring any personal liability**.**
11. **His parents/ guardian are not liable for the contracts entered into by him, even though the contract is for the supply of necessaries to a minor.** But minor is acting as an agent for the parents the parents shall be liable under the contract
12. **A minor is liable in tort (a civil wrong),** but where a tort arises out of contract a minor is not liable in tort as an indirect way of enforcing an invalid contract .

2.1.2 MINORS' LIABILITY FOR NECESSARIES

A minor is liable to pay out of his property for 'necessaries' supplied to him or to anyone whom he is legally bound to support (sec. 68). The claim is based on what are known as quasi-contracts rather than a contract. Furthermore, only the minor's property is responsible for fulfilling the obligations resulting from the contract. He is not personally liable. This exception was purposefully made by the law in order to protect them. This exception was purposefully made by the law in order to protect them.

2.2.3 PERSONS OF UNSOUND MIND

One of the essential conditions of competency of parties to a contract is that they should be of sound mind. According to **Sec. 12,** the following test for soundness of mind:

"A person is said to be of sound mind for the purpose of making a contract if, at the time when he makes it, he 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: 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.

Soundness of mind depends on two facts:

1. His capacity to understand the contents of business concerned, and
2. His ability to form a rational judgement as to its effect upon his interests.

If a person is incapable of both, he suffers from unsoundness of mind. Whether a party to a contract is of sound mind or not is a question of fact to be decided by the court. There is a presumption in favor of sanity. If a person relies on unsoundness of mind, he must prove it sufficiently to satisfy the court.

2.2.1 Nature of Contract with the persons of unsound mind

Lunatics

A lunatic can enter into a contract when he is of sound mind

Idiot

An agreement with an idiots like that of a minor is altogether void **[case: Inder Singh V Parmeshwardhari singh AIR 1957 Pat 491}**

Drunken or intoxicated persons

Their position is similar to that of lunatics. These persons, like a minor, are liable for necessaries supplied to them or their minor dependents.

2.3 OTHER PERSONS

1.Alien enemies

During the war the Indian citizen cannot enter into a contract with an alien enemy. Contracts made before the war was suspended

2. Foreign Sovereigns and accredited representatives of a foreign state.

They can enter into contracts and enforce these contracts in our Courts. But they cannot sued in our Courts without the prior sanction of the Central Government

3. Companies or Corporations:

A company is a legally established artificial person. It is a distinct legal entity. It may possess property in its own name. It is able to sign contracts. It is capable of suing and being sued. It does not, however, exist physically. Thus, it is unable to enter into specific contracts. The contractual capacity of a company is limited by a statute governing it. Its contractual capacity is regulated by its MOA. Additionally, it cannot enter into contracts that exceed its authority, which is constrained by the statute and the Memorandum of Association.

4. Insolvents: An insolvent person is incompetent to contract until he obtains a certificate of discharge**.**

5.Convicts: A convict is a person who has been found guilty and is punished. A felon cannot enter into a contract while they are incarcerated. However, the incapacity ends after the sentence expires.

Check your Progress 1

Q1. A minor fraudulently represented to a moneylender that he was of full age and executed a mortgage deed for Rs.25,000. Has the money lender any right of action against the minor for the money lent or for damages for fraudulent misrepresentation?

[Hint: No, Mohir Bibi vs. Dharmodas Ghouse]

Q2. A minor is supplied with life's necessaries by a grocer. He makes out a promissory note in favor of the grocer. Is the grocer entitled to claim payment under the promissory note (a) from minor personally, (b) against his estate

[Hint: (a) No, (b) Yes (Sec. 68)]

2.4 FREE CONSENT

What is free consent? Why does it matter?

It is essential to the creation of a contract that the parties are ad idem and that their consent is free and real. Sec. 10 also says that "all agreements are contracts if they are made by free consent of parties...

2.4.1 Meaning of Consent and Free consent

Consent, as defined in Sec. 13, means 'acquiescence or the act of assenting to an offer.' Two or more persons are said to consent when they agree upon the same thing in the same sense.

Free Consent: According to Section 14, consent is said to be free when it not caused by

1. Coercion, as defined in Section 15
2. Undue Influence, as defined in Section 16
3. Fraud, as defined in Section 17
4. Misrepresentation, as defined in Section 18
5. Mistake, as defined in Section 20, 21 and 22.

2.4.2 COERCION

An agreement the consent to which is caused by coercion is voidable at the option of the party whose consent was so caused. "Coercion" is defined in Section 15.

"Coercion" defined. — "Coercion" is the committing, or threatening to commit, any act forbidden by the Indian Penal Code (1860) (BNS), 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 agree.

Explanation. — It is immaterial whether the Indian Penal Code 1860 (BNS) is or is not in force in the place where the coercion is employed.

Techniques of causing coercion

Consent is said to be caused by coercion when it is obtained by pressure exerted by either of the following techniques:

(a) Committing or threatening to commit any offence under the Indian Penal Code (1860);

(b) Unlawful detention or the threat of detention of any property to the prejudice of any person.

Acts Prohibited by the Indian Penal Code (BNS): The first technique of coercion that is defined in Section 15 is the commission or threat to commit an act that is contrary to the penal law.

Example: Consent obtained at gunpoint would satisfy this definition

Detention of Property: The second technique of causing coercion, as defined under Section 15, is related to the unlawful detention or the threat of unlawful detention of property. Here, the threat to one's property is understood to be the pressure that vitiates the parties' free consent. **[Case: Astley v. Reynolds, (1731) 2 STR 915]**

2.4.3 UNDUEINFLUENCE

Section 16 of the Contract Act, 1872, stipulates that a contract is said to be induced by undue influence where the relations that subsist between the parties are such that one party is in a position to dominate the will of the other and uses that position to obtain an unfair advantage over the other

(a) Ability to dominate the will of others (Sec. 16(1))

(b) Relations involving domination (Sec. 16(2))

A person is deemed to be in a position to dominate the will of another

(1) Where has one held real or apparent authority over the other?

(2) Where he stands in a fiduciary relation to the other. (Fiduciary relation means a position of active confidence—where one person reposes confidence in another, which shall not be abused by the other).

Examples: parent and child, doctor and patient, lawyer and client, teacher and student, spiritual advisor and disciple.

(3) Where he makes a contract with a person whose mental capacity is temporarily or permanently affected by reason of (i) age, (ii) illness, (iii) mental distress, or (iv) Bodily distress The incapacity of parties may arise due to (1) status, (2) mental deficiency, or (3) unsoundness of mind.

Example: A parent can control his son's will because of his power over him. The husband can control the wife's will for the same reason.

Burden of Proof & Presumption of Undue Influence

First, it must be shown that the other party had the ability to dominate the will of the other. Second, it must be shown that this ability to exercise influence was actually used to induce the plaintiff's consent.

UNCONSCIONABLE BARGAINS: more frequently witnessed in moneylending transactions and gifts [**Case: Lakshmi Amma v. T. Narayana Bhatta, 1970 (3) SCC 159]** Inequality of bargaining power between the parties, such that one may cause economic duress. Exploitation of the needy has also been used as grounds to presume undue influence.

	Coercion (Sec. 15)	**Undue Influence (Sec. 16)**
Meaning	Using physical threat or force to person or property	Involves use of mental pressure
Consent/	Obtain the consent of the	Obtain an unfair advantage

Intention	party.	
Punishment	Under IPC	No criminal liability
Relationship Between the Parties	Stranger Relationship is immaterial.	Related One party dominates the other
Nature of Contract	Voidable at the option of the aggrieved party	Voidable or Court set aside
Benefit	Back	Back by the order of the court

2.4.4 MISREPRESENTATION

Meaning: A statement of fact that one party makes in the course of negotiations with a view to inducing the other party to enter into a contract is known as a representation. It must relate to some fact that is material to the contract. It may be expressed by words spoken or written or implied from the acts and conduct of the parties

A representation, when wrongly made, either innocently or intentionally, is a misrepresentation. The former is called **"misrepresentation,"** and the latter is **"fraud."**

Whether nondisclosure of a material fact comes from misrepresentation? YES

Sec. 18 defines "Misrepresentation." There is misrepresentation if—

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

Requirements of Misrepresentation:

1. It must be a representation of a material fact. Mere expression of opinion does not amount to misrepresentation, even if it turns out to be wrong

2. It must be made before the conclusion of the contract with a view to inducing the other party to enter into the contract.

3. It must be made with the intention that it should be acted upon by the person to whom it is addressed

4. It must actually have been acted upon and must have induced the contract

5. It must be made without any intention to deceive the other party

6. It must be wrong, but the person who made it honestly believed it to be true

7. It need not be made directly to the plaintiff. A wrong statement of facts made to a third person with the intention of communicating it to the plaintiff also amounts to misrepresentation

2.4.4.1 Consequences:

The aggrieved party, in case of misrepresentation by the other party—

(a) avoid or rescind the contract
(b) accept the contract but insist that he shall be placed in the position in which he would have been if the misrepresentation made had been true (Sec. 19)

2.4.5 FRAUD

Sec.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 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 who 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

Example: This is an example of a fraudulent proposition. A company's director released a prospectus that included information that, to the best of his knowledge, was untrue. The following is an example of active concealing. It was decided that a person who had purchased shares based on the prospectus could renounce the agreement on the grounds of fraud. After finding a seam of ore on A's property, B takes steps to hide the ore's existence from A, and A, in ignorance, accepts B's offer at a price that was undoubtedly undervalued.

A could choose to terminate the contract on the grounds of fraud. In a similar vein, purchasing things with the goal of not paying the full amount is fraudulent. Several acts have explicitly declared certain actions and inactions to be fraudulent. For instance, the seller of real estate must "disclose to the buyer any material defect in the property to be sold, and non-disclosure amounts to fraud" in accordance with Section 5 of the Transfer of Property Act. Any other deceptive act will likewise be considered fraud.

2.4.5.1 Essential elements of fraud

1. There must be representation or assertion, and it must be false

a false representation has been made (a) knowingly or (b) without belief in its truth or (c) recklessly, not caring whether it is true or false and maker intended the other party to act upon it or

there is a concealment of material fact or that there is a partial statement of a fact in such manner that the withholding of what is not stated makes that which is stated false **[Case: Derry v. Peek [1886-90] All ER 1 at 22]**

2. Active Concealment

Section 17(2). It is fraud where a person who knows or believes a fact to be true but actively conceals it from the other party with the intention to induce that person to enter into a contract.

Section 17(2) has to be read along with the explanation, which postulates that mere silence does not amount to fraud.

3. Where Silence Is Fraud

Silence may amount to fraud if:

i) there is a duty to disclose;

ii) silence is equivalent to speech;

iii) there is a change in circumstances;

v) half-truths.

A person who is under no duty to disclose may become guilty of fraud by suppression of facts if he voluntarily discloses a part of the facts and then stops halfway. In such a case, the statement is false in substance, and the willful suppression makes it fraudulent.

	Fraud (Sec. 17)	**Misrepresentation (Sec. 18)**
Meaning	Wrongful representation is made wilfully to deceive the party	Innocently without any intention to deceive the party
Knowledge of falsehood	The person making the wrong statement does not believe to be true	The person making wrong statement believes it to be true
Damages	Right to claim damages	Can't claim damages
Means of discovering truth	In case of fraud, the contract is voidable, even though the aggrieved party had a means of discovering the truth with ordinary diligence.	In case of misrepresentation the contract is not voidable if the aggrieved party had means to discovering the truth with ordinary diligence
Exceptions	Silence	

2.4.6 MISTAKE

These contracts, according to Salmond, are "error in Causa." There is no "consensus ad idem," or "error in consensus," when parties do not agree on the same item in the same sense due to a misunderstanding known as a "mistake."

The Indian Contract Act distinguishes between two kinds of errors: (1) Mistake of fact and (2) Mistake of law.

Mistake of law of land is NOT an excuse to set aside a contract. “Ignorantia Juris Non Excusat”: Ignorance of law is no excuse

Mistake of fact is divided into (1) bilateral and (2) unilateral

Bilateral Mistake: The contract is null and void if both parties are unaware of a fact that is crucial to the agreement.(sec.20)

Bilateral mistake may relate to:

a) Subject matter: a mistake of fact regarding the subject matter may relate to (i) existence, (ii) price, (iii) quantity, (iv) identity, (v) quality, and (vi) title of the subject matter.
b) Possibility of performance: Mistake of fact may also relate to (i) Physical or (ii) legal impossibility of performance.

In both the cases , the agreement is void

Example: (1) A consents to sell B a certain cargo item that is expected to go from England to Bombay. It turns out that the ship carrying the cargo had been abandoned and the contents had been lost prior to the day of the agreement. These facts were unknown to both parties. The contract is null and invalid.

(2) A consents to purchase a certain horse from B. As it happens, the horse was deceased when the deal was made. This fact was unknown to both parties. The contract is null and invalid.

Unilateral Mistake: This is a factual error committed by just one party. Just because one of the parties to a contract made a mistake about a fact does not render it voidable (Sec. 25). There are, however, two exceptions to this rule.

(i) Identity of the person contracted with. If A intends to enter into a contract with B, C cannot give himself any right in respect of the contract by accepting the offer. In such a case the contract is void

(ii) Nature of contract: where a person is made to enter into a contract through the inducement of another, but through no fault of his own, there is a mistake as to the nature of the contract, and the contract is void.

Check Your Progress:

Q1 When is a contract said to be induced by 'undue influence'? When is a party deemed to be in a position to dominate the will of another? What is the effect of the contract?

Q2: "A mere silence as to facts is not fraud", Discuss the statement.

Q3. Does a threat to commit suicide amount to coercion?

Q4 Explain and illustrate the effect of mistake of fact on contracts.

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LESSON-3

LEGALITY OF OBJECTS—CONTINGENT CONTRACT

STRUCTURE:

OBJECTIVES:

- After going through this lesson, students will be able to
- Understand the importance of the object of the contract
- Explain the effect of illegal, void and unlawful agreements
- Able to differentiate between wagering and contingent agreements and their validity

3.1 LEGALITY OF OBJECTS: A contract must not only be based upon mutual assent of competent parties but must also have a lawful object.

"Object" means purpose or design

Consideration means benefit or loss

Both the object and consideration of an agreement must be lawful; the agreement is void. As per Sec 23, the consideration object of an agreement is unlawful in the following circumstances:

1. If it is forbidden by law, or
2. If it is of such a nature that, if permitted, it would defeat the provisions of law, or
3. If it is fraudulent or
4. If it involves or implies injury to the person or property of another
5. If the court regards it as immoral or opposed to public policy.

1.Forbidden by Law: If the object or consideration of an agreement is the doing of an act forbidden by law, the agreement is void

- Violations of licences and permits **[Case: Nandalal Vs Thomas 171 IC 948]**
  Example: A sold liquor without a license to B. The sale is unlawful as the sale of liquor without a licence is forbidden by law.
- Assignment of copyright
- Stay order

Unlawful, not illegal **[Case: Tenet Homes and Resorts (P)Ltd Vs Ernakulum AIR 2001 Ker 279]**

2. Defeat any Law: If the object of the consideration of the agreement is such that not directly forbidden by law, it would defeat the provisions of any law, the agreement is void.

- Avoiding taxes**[Case: Naiper Vs National business Agency ltd (1951) 2 All.ER 263]**
- Undercutting statutory privileges

3. Fraudulent: An agreement made for a 'fraudulent' purpose is void. Where the parties agree to impose a fraud on a third person, their agreement is unlawful.

Example: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 is unlawful.

4. Injury to the person or property

- If it involves or implies injury to the person or property of another.
- Injury means wrong, harm, or damage. Person means one's body. Property includes both movable and immovable property[**Case: Ram Saroop Vs Bansi mandar(1915),42 cal 742]**

5. Immoral

- An agreement, the consideration or object of which is immoral.

Example: An agreement between a husband and wife for future separation is unlawful **[Case:Fender Vs John Mildway 1983 AC 1 HL]**

- Dealing with Sex Workers
- Illegal Cohabitation
- Dancing Girls **[Case:Gherulal Parakh v Mahadeodas]**

6. Public Policy: An Agreement is unlawful if the court regards it as opposed to public policy. The term "Public Policy" in its broadest sense means that sometimes the courts will, on consideration of public interest, refuse to enforce a contract. The following are some of the instances which related to public policy

- Trading with Enemy
- Trafficking in in Public
- Interference with the Administration of justice
- Marriage Contracts
- Unfair dealing

3.2 EFFECT OF ILLEGAL AND UNLAWFUL AGREEMENTS

Unlawful agreements: As has already been discussed, Section 23 of the Act lays down a plethora of circumstances wherein the object or consideration of an agreement is unlawful. An agreement hit by Section 23 is void ab initio and thereby in no circumstances enforceable.

Illegal agreements: Illegal agreements are those agreements that are:

- Void.
- Punishable by the criminal law of the country or by any special legislation/regulation.
- Such agreements are not enforced by a court of law, relying on the principle of **ex turpi causa**. It refers to cause of action arising from the transgression of positive laws of a country
- In other words, the courts will not entertain a cause of action based upon illegality. so unlawful agreements are void

  (1) ***Ex Turpi Causa Non Oritur Actio***. Out of an illegal act no cause of action arises
  (2) ***In Pari Delicto potiorest Conditio defendantis.*** In cases of equal guilt, the condition of the defendant is better.

  A void contract might not be unlawful. But an unlawful contract is null and void.It is possible to enforce a collateral agreement that is void. However, an illegal agreement's collateral is likewise tainted with illegality and cannot be enforced.

3.3 OTHER VOID AGREEMENTS

Section 26—An agreement in restraint of marriage of any person other than a minor is void.

Section 27—Every agreement by which anyone is restrained from exercising a lawful profession, trade, or business is to that extent void. However, a seller of goodwill of a business may agree with the buyer to refrain from carrying on a similar business. The restraint must be reasonable; the limits shall be specified. Further, under the Partnership Act, the partners may agree not to carry on business other than that of the firm.

Section 28—An agreement by which a party to a contract is restrained from enforcing his right under the contract through a court of law is void. However, parties may agree to refer their dispute to arbitration.

Section 29 – Agreements, the meaning of which is not certain or capable of being made certain, are void.

3.4 WAGERING AGREEMENT (Section 30)

An agreement between two persons under which money or money's worth is payable by one person to another on the happening or non-happening of a future uncertain event is called a wagering agreement.

Example: X promises to pay Rs. 1000 to Y if it rains on a particular day, and Y promises to pay Rs. 1000 to X if it does not.

A wagering agreement is a promise to give money or money's worth upon the determination of an uncertain event. - Sir William Anson.

Essential elements of wagering agreements

1. There must be a promise to pay money or money's worth
2. Performance of a promise must depend upon determination of an uncertain event. It might have already happened, but the parties are not aware of it.

3. Mutual chances of gains or loss.
4. Neither party to have control over the events
5. Neither party should have any other interest in the event.
6. One party is to win, and one party is to lose.

Effects of wagering agreements

The agreement is void.

No suit can be filed for any recovery of the amount won on any wager.

It is not illegal. Any agreement collateral to a wagering agreement is valid.

Exceptions: Horse Race, Crossword competitions

However, it is illegal in the states of Maharashtra and Gujarat

3.5 CONTINGENT CONTRACTS [Section 31 to 36]

A 'contingent contract' is a contract to do or not to do something. If some event, collateral to such contract does or does not happen

Definition: 'Contingent contract' in Section 31 of the Act makes it clear that this condition must be collateral to the contract.

Example: A promise to pay B Rs.1,00,000 if a certain ship does not return within a year.

Examples of contingent contracts include contracts of indemnity, contracts of guarantee, and contracts of insurance.

Essential features of a contingent contract

- It is a contract to do or not to do something
- Dependent on happening or non-happening of an event
- Such an event is a collateral event (i.e., it is collateral) to the contract, i.e., the event must not depend upon the mere will of a party.
- The event is uncertain

3.5.1 RULES REGARDING CONTINGENT CONTRACT

1. Happening of an event: It is a contingent contract whose fulfillment is contingent upon an event occurring. Only after the event occurs can the contract be enforced. The contract is void if the event is no longer a possibility.

2. Not happening of an event: Where the performance of a contract depends upon the non-happening of an event, naturally the parties have to wait till the happening of that event becomes impossible.

Example: A agrees to pay B a sum of money if a certain ship does not return. This ship is sunk. The contract can be enforced when the ship sinks.

3. Happening within a specified time: It is a contingent contract whose fulfillment depends upon an event occurring within a given time frame. The contract is null and void if the time has passed and the event has not occurred. Furthermore, the contract is void if the event becomes impossible before the specified period has passed.

4. NOT happening of an event within a specified time: This is a contingent contract whose fulfillment is contingent upon an event not occurring within a given time frame. Only if the time has passed and the event has not occurred, or if the event becomes impossible within the allotted time, can the contract be enforced.

5. Event linked with human conduct (section 34): The performance of this contingent contract is contingent upon an individual's actions at an undetermined time. When someone acts in a way that makes it impossible for him to do so within a specific time frame or in any other way than under additional circumstances, the contract is void.

Void: When such person does anything that makes the desired future conduct of such person impossible or dependent upon certain **[Case: Frost v. Knight (1872) LR 7 Exch 111]**

Example: A agrees to pay B a sum of money if B marries C. C marries D. The marriage of B to C is now impossible. The contract becomes void. It is possible that D may die and that C may afterwards marry B. Even then the contract becomes void because it is a further contingency.

6. Impossible Events (Section 36): This is a contingent contract; the fulfillment of this is contingent upon the occurrence of an impractical circumstance. The contract is null and void from the beginning, as an impossible event cannot occur. The participants to the agreement do not necessarily need to be aware of the event's impossibility when it is made.

	Wagering	Contingent
Meaning	Promise to give money or money’s worth with upon the determination of an uncertain event	To do or not to do something if some event occurs. Collateral to such contact does or does not happen
Nature of uncertain event	Contingent nature	Not be a wagering nature
Void/Valid	Void	Valid
Interest	No other interest in the subject matter of the agreement except for the loss of the wagering amount. A wagering agreement is essentially contingent in nature. Consists of reciprocal promises future events are the sole determine factor	Have real interest in the outcome of the uncertain gain A contingent not to be in wagering in nature. Not consisting of a reciprocal promise of a future event is fully collateral.

Check your progress:

1. Under what circumstances is the object or consideration of a contract deemed unlawful? Illustrate with examples.
2. "An agreement in restraint of trade is void." Examine this statement mentioning exceptions, any.
3. Distinguish between a wagering agreement and a contingent contract. Discuss the rules relating to the enforcement of contingent contracts.
4. A agrees to construct a swimming pool for B for Rs. 80,000. The payment is to be made by B only on the completion of the pool. Is it a contingent contract?

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LESSON-4
PERFORMANCE AND BREACH OF CONTRACT

STRUCTURE:

4.1 DISCHARGE BY PERFORMANCE

4.2 TENDER OF PERFORMANCE

4.3 WHO CAN DEMAND PERFORMANCE

4.4 WHO WILL PERFORM THE CONTRACT

4.5 ACCEPTANCE OF PROMISE FROM THE THIRD PARTY

4.6 JOINT PROMISES

4.7 TIME, PLACE AND MANNER OF PERFORMANCE

4.8 PERFORMANCE OF RECIPROCAL PROMISES

4.9 DISCHARGE BY CONTRACT

4.10 REMEDIES FOR BREACH OF PERFORMANCE

OBJECTIVES:

- After going through this lesson the students, will able to
- Understand the reasons for performance of contract
- Explain the manner in which contracts are discharged
- Able to realize the problems associated with breach of performance

Performance of contract takes place when the parties to the contract fulfil their obligations arising under the contract within the time and in the manner prescribed. Section 37 stipulates that parties to a contract must either perform or offer to perform their respective promises, unless such performance is dispensed with or excused.

4.1 DISCHARGE BY PERFORMANCE

When a contract is discharged by performance, it is said to have been discharged fully since the mutual rights and obligations of the parties are completely extinguished with no new legal ties arising from this mode of discharge. It is the principal and most usual mode of discharge and has been dealt with in Sections 31–67 of the Indian Contract Act, 1872.

- Performance occurs when the promisor fulfills the obligations he/she has undertaken under Section 37 of the Act. This performance must be exact‘ in the sense that the party must perform within the specified time and the agreed upon standard.
- This standard of obligation often varies according to the type of the contract.
- For example, contracts for the supply of goods have a strict standard. Whether the actual performance rendered satisfies the contractually prescribed standard is a mixed question of law and fact.

Contracts may be classified into two general categories with respect to performance:
(1) absolute contracts and
(2) contingent contracts.

In an absolute contract, the promisor binds himself/herself to perform without any condition external to the contract. However, there may be a condition internal to the contract, such as making the performance of one party conditional on the willingness to perform of the other party.
On the other hand, in a contingent contract, the condition precedent for performance is external to the contract

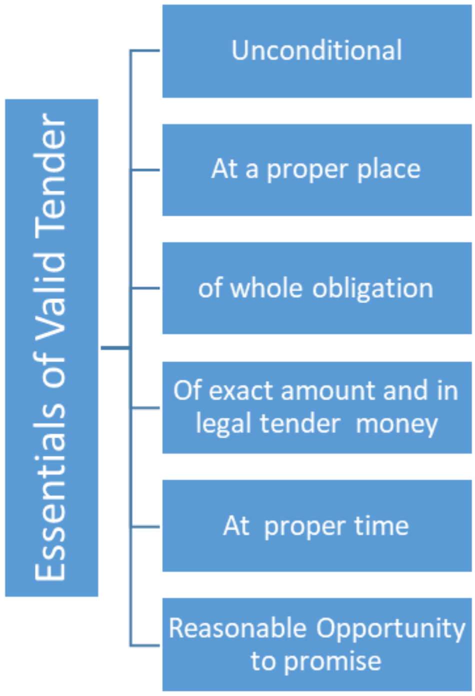
4.2 TENDER OF PERFORMANCE:

An attempted performance will also result in a discharge as it is the legitimate attempt on the part of the promisor to perform his/her contractual obligations unconditionally at the agreed upon time and place.

If the promisee unjustifiably does not accept the performance, this attempted performance or tender would amount to actual performance and, according to Section 38 of the Act, the contract is deemed to be discharged.

Any rights that would accrue to the promisor under the contract would not be prejudiced by such a discharge.

4.2.1 Essentials of a valid Tender



4.2.2 Type of a Tender
There are two types of tender(1) Tender of goods and services and,(2) Tender of money

Tender of goods and services
When a promisor offers to deliver goods or services to the promisee, it is said to be a tender of goods or services. If the promisee does not accept a valid tender, it has the following effects:
(i) The promisor is not responsible for nonperformance of the contract.
(ii) The promisor is discharged from his obligation under the contract. Therefore, he need not offer again.
(iii) He does not lose his right under the contract. Therefore, he can sue the promisor.

Tender of money
Tender of money is an offer to make payment. In case a valid tender of money is not accepted, it will have the following effects:
(i) The offeror is not discharged from his obligation to pay the amount.
(ii) The offeror is discharged from his liability for payment of interest from the date of the tender of money

Effect of Refusal: Effect of refusal of party to perform promise wholly (Sec 39)
Promisor – Refuse – Promise – wholly
The promisee can put an end to the contract, or he can continue the contract if he has given his consent either by words or by conduct in its continuance.

Result – claim damages. [compensation]
Liquidated Damages (Sec.74)

4.3 WHO CAN DEMAND PERFORMANCE?

1. **Promisee – a** stranger can't demand performance of the contract.
2. **Legal Representative—A** legal representative can demand exceptional performance.
   - contrary intention appears from the contract
   - contract is of a personal nature.
3. **Third party –** Exception to "stranger to a contract"

4.4 WHO WILL PERFORM THE CONTRACT?

Person by whom promise is to be performed: (Sec 40).
1. Promisor himself: include personal skill, taste, or artwork.
Example: 'A' promises to paint a picture for 'B,' as this promise involves the personal skill of 'A.' It must be performed by 'A.'.
2. Promisor or agent :- **[**does not involves personal skill] **[Case: Sohanlal Pachisia v. Bilasray Khemani, AIR 1954 Cal 179.]**
3. Legal Representative [does not involve personal skill and taste]

4.5 ACCEPTANCE OF PROMISE FROM THE THIRD PARTY [SEC.41]

If the promisor accepts performance of a contract by a third party, he can't afterwards enforce the performance against the promisor, although the promisor had neither authorized nor ratified the act of the third party. In other words, once the promisee accepts the performance from a third person, he cannot compel the promisor to perform the contract again.

4.6 JOINT PROMISES

There may also be joint promisors, and such a situation is governed by Sections 42 – 44 of the Act. Indian law is in slight variance with English law on this point. In India, all joint promisors are jointly and severally liable, whereas under English law, there is a difference between a 'joint promise' and a 'joint and several promise.'
It is primarily the promisee who may claim for enforcement of the contract, as the promise is for his/her benefit. As per S. 54, the promise may also be made for the benefit of more than one person jointly, and these joint promisees may together enforce the contract.

Example: A and B are joint promisors when they sign a promissory note. Two or more people are considered joint promisees when a promise is made to them. Such promises are governed by the following rules:

(1) The promise must be jointly fulfilled by all promisors: (2) The following actions may be required of any one of the joint promisors: (3) Contribution rights between joint promisors: (4) What happens if one joint promisor is released?
For instance, A, B, and C together agree to pay D Rs. 5,000. D has the right to demand that A, B, or C give him Rs. 5000.

4.7 TIME, PLACE, AND MANNER OF PERFORMANCE

1. No time is specified for performance [Sec 46] : Time of performance is not specified + promisor agreed to perform without, a demand from the promise the performance must be made within a reasonable time. Reasonable time – in each particular case—is a question of fact.

2. Time specified but hour not mentioned [Sec. 47]: Time of performance specified + promisor agreed to perform without application by the promisee. Performance must perform on the day fixed during the usual business hours and at the place at which the promise ought to be performed.

3. Where time is fixed and an application is to be made [Sec. 48]: Proper place and within the usual hour of business Promisee to apply for performance

4. Performance of promise where no place is specified and no application is to be made by the promisee [Sec. 49]: It is the duty of the promisor to apply to the promisee to appoint a reasonable place for the performance and perform it at such appointed place.

5. Performance in the manner or at the time prescribed or sanctioned by the promisee [Sec. 50]: In such prescribed manner and prescribed time

Example:—'A' desires 'B,' who owes him Rs 10,000, to send him a promissory note for Rs 10,000 by post. The debt is discharged as soon as 'B' puts into the post a letter containing the promissory note duly addressed to 'A.'.

4.8 PERFORMANCE BY RECIPROCAL PROMISES

"Promises that form the consideration or part of the consideration for each other are called reciprocal promises." **(Sec.2(f)).** The following are the conditions regarding reciprocal promises:

When promises must be fulfilled simultaneously

"When a contract includes reciprocal promises to be fulfilled simultaneously, the promisor is not required to fulfill his promise unless the promisee is prepared and willing to fulfill his reciprocal promise."

The order in which the nature of the transaction:
"Where the order in which reciprocal promises are to be performed 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." (Sec. 52)

"When the contract consists of reciprocal promises, such that one of them cannot be performed or that its performance cannot be claimed until the other has been performed, and the promisor of the aforementioned promise fails to perform it, such promisor cannot claim the performance of the reciprocal promise and must make compensation to the other party for any loss that such other party may sustain by the non-performance of the contract." These are referred to as dependent and mutual promises (Sec. 54).

"A contract becomes voidable at the option of the party so prevented when it contains reciprocal promises and one party prevents the other from carrying out his promise (Sec. 53).
“Where persons reciprocally promise, firstly, 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 contract, but the second is a void agreement.” (Sec. 57).

4.9 DISCHARGE OF A CONTRACT

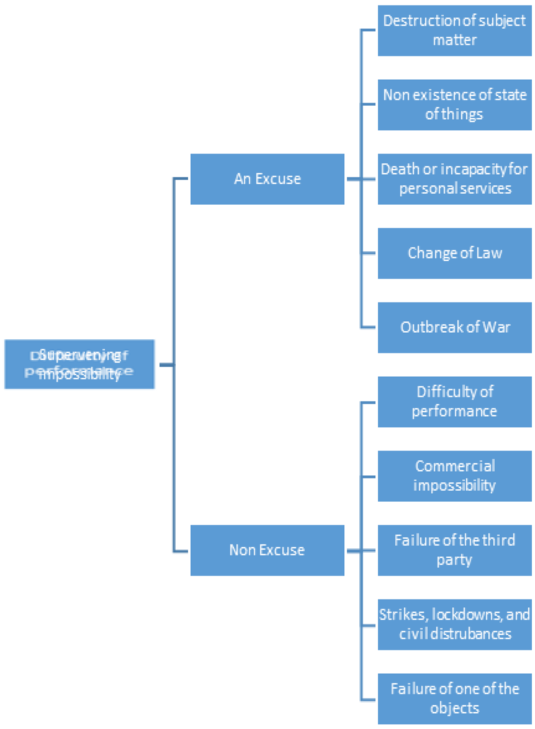
A contract is discharged, or terminated, when the rights and obligations created by it come to an end. A contract is terminated in the following ways:

1. **By Performance (Sec. 37):** A contract expires when both parties fulfill their portion of the bargain. There is nothing left to do.
2. **By Tender (Attempted Performance):** A promisor is released from his contractual duties in the event that his offer of performance is rejected. However, he retains his rights under the agreement, meaning that the promisee is not released from his responsibilities. We already discussed it in detail earlier.
3. **By Supervening Impossibility**:

   (a)At the time of contract: "An agreement to perform an act that is impossible on its own is null and void." For instance A and B decide to use magic to find gold. The contract is null and invalid.(Sec.56)

   (b)Subsequent Impossibility: A contract is void by subsequent or supervening impossibility if it is initially capable of performance but later becomes impossible due to a change in circumstances (section 56). This is known as the "Doctrine of Frustration" in English law. For instance, A and B agree to get married. B goes insane before the scheduled marriage date. The agreement is nullified.

Supervening impossibility may also arise in the following circumstances:



4. By Agreement or Mutual Consent:

Novation: Novation is the process of replacing an existing contract with a new one, either between the same parties or between different parties. The following conditions are satisfied:

(1) All the parties must consent to novation
(2) The novation must take place before the breach of the original contract.
(3) The new contract must be valid and enforceable

Alteration: A contract is said to be altered when one or more of its provisions are modified. In the event of modification, the contract's parties remain unchanged.

Example: X promises to sell and delivers 100 bales of cotton on 1 Oct., and Y promises to pay for the goods on 1 Nov. Afterwards X and Y mutually decide that the goods shall be delivered in five equal installments at its godown . Here original contract has been discharged and a new contract has come into effect

Rescission: A contract is said to be rescinded by mutual consent when both parties agree to terminate it without fulfilling their end of the bargain.

Example: X promises Y to sell and deliver 100 bales of cotton on 1 Oct. to his godown Y promises to pay for the goods on 1 Nov. X does not supply the goods. Y may rescind the contract.

Remission [Sec. 63]: Remission means accepting a lesser consideration than agreed in the contract. No consideration is necessary for remission. Remission takes place when a Promisee-

(a) dispense with (wholly or part) the performance of a promise made to him.
(b) Extends the time for performance due by the promisors
(c) Accept a lesser sum instead of sum due under the contract
(d) Accept any other consideration that agreed in the contract
A promise to paint a picture for B. B. afterwards for him to do so. A is no longer bound to perform the promise.

Waiver: Intentional relinquishment of a night under the contract.
Merger : conversion of an inferior right into a superior right is called a merger.

5. Discharge by operation

(a) **Death:** involving the personal skill or ability, knowledge of the deceased party one discharged automatically. In other contract the rights and liability passed to legal represent.
(b) **Insolvency**: when a person is declared insolvent. He is discharged from his liability up to the date of insolvency.
(c) **By unauthorized material alteration** – without the approval of other party – comes to an end – nature of contract substance or legal effect.
(d) **Merger:** When an inferior right accruing to a party in a contract mergers into a superior right accruing to the same party, then the contract conferring inferior right is discharged.

6. Discharge by lapse of time

Where a party fails to take action against the other party within the time prescribed under the Limitation Act, 1963. All his rights come to an end. Recover a debt – 3 Years recover an immovable property—12 years

Example: On 1 July 2021, X sold goods to Y for Rs 100,000, and Y had made no payment till August 2024. State the legal position on 1 Aug 2024
(a) If no credit period allowed
(b) If a 2-month credit period allowed

7.By Breach of Contract

Breach is the nonperformance of the promise by the promisor. It entitles the promisee to rescind the contract. It, therefore, operates as a mode of discharging a contract.

REMEDIES FOR BREACH OF CONTRACT

Where there is a right, there is a remedy.

A contract gives rise to correlative rights and obligations. A right accruing to a party under a contract would be of no value if there were no remedy to enforce that right in a law court in the event of its infringement or breach of contract. *A remedy is the means given by law for the enforcement of a right.*

When a contract is broken, the injured party (i.e., the party who is not in breach) has one or more of the following remedies:

1. Rescission of the contract
2. Suit for damages
3. Suit up on Quantum meruit
4. Suit for specific performance of the contract
5. Suit for injunction

Check your progress.

Q1. What are the rules of law relating to time and place of performance of a contract
Q2. Under what circumstances need a contract not be performed?
Q3. Discuss the effects of supervening impossibility on the performance of a contract

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LESSON-5
TYPES OF NEGOTIABLE INSTRUMENTS AND THEIR CLASSIFICATION

1. OBJECTIVE

In daily Indian commercial matters, it is often not practical to make payments in cash, in particular for large amounts or remote transactions. In such situations negotiable instruments play a key role by replacing the use of cash and facilitating the smooth transfer of funds from one person to another with a protected and legally accepted means to make easy banking transactions, commerce and trade. In India, the Negotiable Instruments Act, 1881 (NI Act) defines the nature, types, and classification of negotiable instruments to guarantee trust and uniformity in business transactions and provides a comprehensive legal framework for their liabilities, rights, remedies, transfer and usage.

The objective of this lesson is to discuss the concept of negotiable instruments, their essential ingredients, the main types accepted under the NI Act, and their classification according to Indian business law. A thorough understanding of the types and classification of negotiable instruments is essential for students, business professionals, and anyone involved in financial transactions in India.

2. THE CONCEPT OF NEGOTIABLE INSTRUMENT

According to legal scholar Thomas M. Cooley "a negotiable instrument is a written document that guarantees the payment of a certain sum of money either on demand or at a future date, and which is transferable from one person to another." It seems the word "negotiable" implies transferability, while "instrument" refers to a written legal document that is capable of transfer by delivery, or by endorsement along with delivery.

The NI Act does not define the term 'negotiable instruments.' However, Section 13 of the act provides negotiable instruments namely bills of exchange, promissory notes and cheques payable either to bearer or order. Thus, under Indian law, only these three instruments are expressly recognized as negotiable instruments by the act. However, courts have also recognized certain instruments as negotiable by custom or usage.

3. TYPES OF NEGOTIABLE INSTRUMENTS

According to Indian business law, there are three major types of negotiable instruments type which serves a distinct purpose in business transactions each governed by specific provisions. They are

1. Promissory notes
2. Bills of exchange
3. Cheques

5.1. PROMISSORY NOTE

In India, promissory notes are generally used in credit transactions where one party takes a loan of money and promises to repay it later. Section 4 of the act says that "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."

From the above definition the essential ingredients of promissory note are as follows:

1. The promissory note must be in writing
2. The promise to pay must be definite and unconditional.
3. The promissory note must be signed by the maker or promise.
4. The promise is to pay money only.
5. The amount payable must be certain or definite.
6. There is an involvement of two parties the maker and the payee.
7. The maker and the payee must be certain and different persons.

For instance X promises to pay Y or order Rs.5, 000 or he acknowledges himself to be indebted to Y in Rs.5, 000, to be paid on demand, for value received are promissory notes. Whereas X promise to pay Y Rs. 5000 and all other sums which shall be due to him is not a promissory note. The court in *Raghunath Prasad v. Harihar Prasad* held that an acknowledgment of debt without an express promise to pay does not constitute a promissory note.[1]

A promissory note must be stamped in accordance with the provisions of Indian Stamp Act, 1899 as prescribed in Schedule I. An unstamped or insufficiently stamped promissory note is inadmissible in evidence.

5.1.1 Bill of Exchange

Section 5 states that "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" The following are the traits derived from the aforesaid Section 5:

1. The bill of exchange must be in writing.
2. The order must be definite and unconditional.
3. It involves certain persons the drawer, the drawee, and the payee.
4. It must be signed by the drawer.
5. The order must be to pay only to certain person
6. The order must be to pay only certain sum
7. The order must be to pay money only.

An example of bill of exchange is "pay Rs. 20,000 to X or to anyone X authorizes, three months after the date of this bill." It indicates that Rs. 20,000 must be paid to X or someone chosen by X three months after the bill is written.

Bills of exchange are widely used in domestic and international trade transactions, particularly in credit sales. It must be stamped in accordance with the provisions of Indian Stamp Act, 1899. The Supreme Court *Hiralal v. Badkulal* recognized bills of exchange as instruments facilitating credit and trade.[2]

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1 AIR 1929 All 195

5.2. CHEQUE

Cheques are the frequently used negotiable instruments in daily banking transactions due to their ease and safety. Section 6 of the NI Act defines the cheque as: "A bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand." This definition clarifies the essential features of the cheque as follows:

1. It must be always drawn on a bank.
2. It is payable on demand.
3. All other traits are same as bills of exchange

Cheques are the most common negotiable instruments used in banking and everyday commercial transactions. A cheque is a special type of bill of exchange drawn on a bank and payable on demand.

5.2.1. Categories of Cheques

Cheques are classified into different categories like open, crossed, bearer and order to legalize their payment and transfer. Open cheques can be withdrawn directly at the bank counter, permitting immediate payment to the cheque holder. Crossed cheques are deposited merely into a bank account, avoiding direct cash withdrawal.[3] In case of cross cheques the Supreme Court stressed the banker's duty in handling crossed cheques.[4] Bearer cheques are payable to whoever presents them, allowing the transfer by handing them over. Order cheques are payable to a specific person or their order, requiring endorsement for transfer. Such classifications make certain transparency in transactions and assist in avoiding deceit in negotiable instruments.

5.2.2. Essential components of Negotiable Instruments

After analyzing Section 13 and Sections 4, 5, and 6 the following essential components must be present for an instrument to qualify as negotiable. They are:

1. Written document: A negotiable instrument must be in writing and it must be signed. The Act does not recognize the oral agreements as negotiable instruments.
2. Unconditional Promise or Order to Pay: The promise or order to pay must be unconditional. Any conditional payment makes negotiable character of the instrument non-negotiable
3. Payment of Money Only: The instrument must require payment of money and not goods, services, or any other consideration.
4. Certainty of Amount: The amount payable must be certain or able to made definite.
5. Payable to Order or Bearer: The instrument must be payable either to a specified person or to the bearer.
6. Transferability: Negotiable instruments are transferable so that ownership can pass from one person to another by delivery or by endorsement and delivery.

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[3] AIR 1953 SC 225

1. Right of Holder to Sue: A holder of the instrument has right to sue in their own name to recover the amount due.

The Allahabad High Court in *Bhagwati Prasad v. Nandlal* held that the negotiability of an instrument depends upon its transferability and the right of the holder to sue in his own name.[5]

5.2.3. Comparison of Promissory Note, Bills of Exchange and Cheque

Under the NI Act, a promissory note, bill of exchange, and cheque are the three main types of negotiable instruments defined under Sections 4, 5, and 6 respectively. A promissory note and a bill of exchange differ mainly in their nature and the parties involved. A promissory note involves two parties the maker and the payee, where the maker makes a written promise to pay a certain amount of money to the payee. The maker's liability is primary and absolute. A bill of exchange, on the other hand, involves three parties including the drawer, drawee, and payee and it contains an unconditional order directing the drawee to pay a particular sum. The drawer's liability is secondary and takes places only on the drawee's default. A cheque is a unique type of bill of exchange drawn on a banker and payable on demand. Unlike other bills, a cheque does not require acceptance by the drawee bank. Cheques are mainly used for banking transactions, while promissory notes and bills of exchange are commonly used in credit and commercial dealings.

5.2.4. Classification of Negotiable Instruments

Negotiable instruments under Indian business law can be classified on various bases. They are:

1. Statutory recognition
2. By Custom or Usage
3. Transferability
4. Time of payment
5. Inland instruments
6. Foreign instruments
7. Inchoate instruments
8. Ambiguous instruments
9. Purpose
10. Security
11. Crossing (in Case of Cheques)

5.3 BY STATUTE

Negotiable instruments can be classified on the basis of statute and by custom or usage. Promissory notes (Section 4), bills of exchange (Section 5) and cheques (Section 6) are acknowledged under the Negotiable Instruments Act, 1881. Hundis, bank drafts and pay orders are recognized through business customs and judicial decisions.

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[5] Section 123

[5] *Canara Bank v. Canara Sales Corporation*, AIR 1987 SC 1603

5.3.1 By Custom or Usage

Under the NI Act, some instruments attain negotiable nature by custom or usage in trade, though they do not firmly meet the requirements of legal conditions under Sections 4 to 6. However, these instruments are recognized because very old commercial practices allow them as generously transferable. Hundis are commonly used in India as credit instruments. In *Beni Madhav v. Raghunandan*, the court recognized hundis as negotiable instruments for commercial usage.[6] Similarly, bank drafts and pay orders facilitate payment to a specified person. Section 13 of the Act permits recognition of instruments made negotiable by custom, however, such usage is well established and acknowledged in commercial transactions, ensuring smooth business transactions.

5.3.2 Transferability

Negotiable instruments can be classified on the basis of transferability into bearer instruments and order instruments. A bearer instrument is one that is payable to the bearer and can be transferred by mere delivery, without any endorsement. Whoever holds the instrument is entitled to receive payment. It means it is an instrument where name of the payee is blank or where the name of the payee is specific with words "or bearer" could be negotiated by simple delivery.

In contrast, an order instrument is payable to a specified person or to their order and can be transferred only by endorsement followed by delivery. This distinction is important because it determines the method of transfer and the rights of the holder under the Negotiable Instruments Act, 1881.

5.4. TIME OF PAYMENT

Negotiable instruments are classified on the basis of time of payment into demand instruments and time instruments.

5.4.1. Demand Instruments

Section 19 defines a demand instrument as "a promissory note or bill of exchange, in which no time for payment is specified, and a cheque, are payable on demand." It means demand instrument is one that is payable on demand, implying that it is payable immediately when payment is asked for like cheques payable on demand as expressly provided under section 19, and promissory notes payable on demand.

5.4.2. Time Instruments

Time Instruments are those in which time for payment or maturity date is specified. It may be payable on a specified day (A promise B to pay Rs. 10,000 on 21 December 2025) or after a fixed period of time (If A promise B to pay Rs. 10, 000 after six months). Such instruments

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[6] AIR 1930 Pat 289.

ature according to the rules laid down in Sections 21[7] and 22,[8] which deal with instruments payable at sight, after sight,[9] or the occurrence of an event which is definite to happen.[10]

In *Sundaram v. Abdul Khader*, the court clarified the distinction between demand and time instruments. Distinguishing their enforceability, the court said that a demand instrument is payable on demand, whereas a time instrument is payable after a specified period.[11]

5.5. INLAND INSTRUMENTS

Section 11 of the Act defines an inland instrument. It is considered inland if it is drawn or made in India and is either payable in India, or drawn on upon any person who is resident in India. Accordingly, a promissory note, bill of exchange, or cheque will be an inland instrument when it fulfils these stipulations. The place of making, the place of payment, and the residence of the drawee are vital aspects. Inland instruments are administered exclusively by Indian law; therefore, the NI Act applies to their enforcement and interpretation.

5.6. FOREIGN INSTRUMENTS

A negotiable instrument which is not an inland instrument is called as foreign instrument, which is defined under Section 12 of the Act. It is generally a bill of exchange drawn outside India. Such a bill may be drawn on a person residing in India or outside India and may be payable either in India or outside India. A bill drawn outside India on a person living outside India can also be a foreign instrument, not considering the place of payment. The Act provides that the liability of the maker or drawer is governed by the law of the place where the instrument is made.[12] However, the liability of the acceptor and the endorser is governed by the law of the place where the instrument is made payable.[13]

5.7. INCHOATE INSTRUMENTS

An inchoate instrument is one that is incomplete in certain respects, for instance amount, date, or other material particulars. When the maker or drawer signs and delivers an instrument that is wholly blank or contains the word “incomplete,” he gives authority to the holder to complete it. The person who signs and delivers such an instrument is liable upon it to the holder as well as to a holder in due course, provided the instrument is completed within the authority given and in accordance with the Act.[14]

5.8. AMBIGUOUS INSTRUMENTS

An instrument is said to be ambiguous when it may be interpreted either as a promissory note or as a bill of exchange, due to vagueness in its terms. Such instruments cannot be clearly classified at first glance. The Act provides that in such cases, the holder has the option to treat

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7 Section 21 explains instruments payable at sight or after sight, meaning payment becomes due when presented or after presentation thereof.

8 Section 22 defines maturity, adding three days of grace to time instruments, except cheques and demand instruments under the Act.

9 E.g. A promises to pay B Rs. 1000 after sight.

10 For example, X promises to pay Y Rs. 5000after Z’s death.

11 AIR 1933 Mad 226.

12 Sections 134 and 135

13 Section 137

14 Section 20

the instrument as either a promissory note or a bill of exchange, subject to his choice.[15] Once the holder elects the nature of the instrument, it will be managed by the rules applicable to that type of negotiable instrument.

5.9. PURPOSE

Under the Act, negotiable instruments may be classified based on purpose into trade instruments and accommodation instruments. Trade instruments are used in legitimate business transactions for the sale of goods or services and include promissory notes, bills of exchange, and cheques which occur out of lawful consideration. On the contrary, accommodation instruments are issued without consideration to help another party in raising funds. [16]Even though such instruments not have consideration amid the original parties, the accommodation party stays liable to a holder for value, guarantying negotiability and creditworthiness.[17] The court in *Venkata Subba Rao v. Seshagiri Rao* held that accommodation bills are valid even without consideration.[18]

5.10. SECURITY

While the Act does not expressly define this classification, negotiable instruments can be categorized on the basis of security into secured and unsecured instruments. Secured instruments are those that are backed by collateral security, providing the holder additional protection in case of default. Unsecured instruments are not supported by any security and depend entirely on the personal liability of the parties involved. Instruments such as promissory notes, bills of exchange, and cheques are usually not secured, if not supported by a separate agreement under law.

5.11. Crossing (in Case of Cheques)

Broadly crossing can be categorized as general crossing, special crossing, restrictive crossing or account payee and non negotiable crossing. A cheque can be crossed by the drawer, the holder, or the collecting banker. The drawer can cross it either generally or specially, and can also make a restrictive crossing. The holder can cross an uncrossed cheque generally or specially. If the cheque is already crossed, the holder can add a restrictive crossing by writing “not negotiable” on it.[19]

5.11.1. General Crossing

Where a cheque is crossed generally it is a direction to the drawee banker to pay the amount of money on the crossed cheque to a banker, who presents such cheque for payment. A cheque is said to be crossed generally, if it bears face across the words “and Company” or any abbreviation thereof between the two parallel, transverse lines, with or without the words “not negotiable” or two parallel transverse lines simply.[20]

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15 Section 17
16 Section 59
17 Section 43
18 AIR 1925 Mad 1214.
19 Section 125
20 Section 123

5.11.2. Special Crossing

If the name of a bank is written across the front of a cheque, then the cheque is considered specially crossed. This means the cheque can be paid only through that bank, whether or not the words "not negotiable" are written on it.[21] Therefore, special crossing is a direction to the drawee banker to pay the amount of money on such cheque only to a particular banker whose name appears across the face of the cheque or between the two parallel transverse lines. If a cheque contains special crossing to more than one banker, then the paying banker shall refuse to make the payment of the same. If a cheque is specially crossed to more than one bank unless it's given to an agent for collection, the bank on which the cheque is drawn must not pay it[22].

5.11.3. Restrictive Crossing

A cheque which is crossed generally or specially can also be crossed again with restrictive crossing. The addition of the words **"**A/c Payee**"** and/or **"**Not Negotiable**"**, to a general crossing or special crossing will make the cheque restrictively crossed. The addition of the words "A/c payee" on a cheque is a direction to the collecting banker that the amount collected on the cheque should be credited to the account of the payee.

In this type of crossing, the bank collecting the cheque must pay the money only to the person whose name is written on the cheque. The banker will pay the cheque only after making sure that the person asking for the money is the right person to receive it.

5.11.4. Not Negotiable Crossing

If someone receives a cheque that is crossed (either generally or specially) and has the words "not negotiable" on it, that person can't have a better right to the cheque than the person who gave it to them. In other words, they can't pass on a stronger claim to someone else than what they themselves had.[23] Not negotiable crossing obliges writing of words "not negotiable" besides the two parallel lines and these words may be written inside or outside of these lines.

5.12 SUMMARY

Negotiable instruments form an integral and indispensable part of Indian business and financial transactions and play a significant role in facilitating trade and banking transactions. They are crucial for India, a developing economy because they provide a secure, transferable cashless transactions which are simplifying business operations, commercial certainty, easy transfer of credit, legally enforceable method of payment for protection of holders and growth of banking and trade.

The NI Act provides a comprehensive legal mechanism governing the use, transfer, and enforcement of promissory notes, bills of exchange, and cheques in India. These instruments serve different purposes but share common characteristics that define their negotiability. Negotiable instruments can be classified based on statutory recognition, transferability, time of payment, and purpose. This classification enhances legal clarity, practical understanding, and helps in determining their applicability in different financial and commercial situations.

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21 Section 124
22 Section 127
23 Section 130

5.13 TECHNICAL TERMS

Instrument
Instrument means a document in writing
Hundi

It is a traditional form of Bill of Exchange

5.14 SELF ASSESSMENT QUESTIONS

1. What is meant by negotiable instrument? Write a note on the essential features of the negotiable instrument?
2. What are the instruments recognized by Negotiable Instruments Act, 1881? What are the essential ingredients or characteristics of them?
3. What are the aspects based on classification of negotiable instruments and explain them?

5.15 SUGGESTED READINGS

1. Avtar Singh, “Banking and Negotiable Instruments,” (4th edition, EBC Explorer, 2018)
2. Bhashyam and Adiga, revised by Anand Sanjay M. Nuli and Saket Gogia, “The Negotiable Instruments Act,” (25th Edition, 2025)
3. Dutta , “Commentary on the Negotiable Instruments Act, 1881,” (2025)
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5. Negotiable Instruments Act: Bare Act with Section Notes —(Taxmann, 2025)
6. P. Krishna Kumar and S. Abdul Khader Kunju, “Khergamvala on The Negotiable Instruments Act,” (23rd edition, LexisNexis, 2021)
7. S.P. Tyagi, Commentary on the Negotiable Instruments, 1881, (4th Edition, 2025)

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LESSON-6
PARTIES TO NEGOTIABLE INSTRUMENTS AND ENDORSEMENT

6.1. OBJECTIVE

The objective of this lesson is to enable students to understand the effectiveness promissory notes, bills of exchange, and cheques under the Negotiable Instruments Act, 1881(NI Act) depends largely on the legal recognition of the parties to the instruments and the concept of endorsement. By the end of the lesson, students will be able to identify and distinguish between the various parties involved in negotiable instruments such as the maker, drawer, drawee, payee, endorser, and endorsee, and explain their respective rights, duties, and liabilities. The lesson also aims to develop a clear understanding of endorsement, its meaning, kinds, and legal effects, including how endorsement facilitates the transfer of negotiable instruments. Further, students will be able to apply statutory provisions to practical situations, analyze simple legal problems related to endorsement, and appreciate the role of negotiable instruments in commercial transactions and the smooth functioning of trade and banking in India.

6.2. PARTIES TO NEGOTIABLE INSTRUMENTS

The parties to a negotiable instrument vary depending on the nature of the instrument and their rights and liabilities also vary depending on the type of negotiable instrument. The NI Act defines, regulates and categorizes these parties and prescribes their obligations to ensure clarity and certainty in commercial dealings;

6.2.1. Parties to a Promissory Note

Section 4 of the NI Act defines promissory note as an instrument containing an unconditional promise by the maker to pay a certain sum of money to a certain person or to his order or to the bearer.

6.2.1.1 Maker

The maker is the person who makes or executes the promissory note and promises to pay the amount mentioned in the instrument. The maker is the primary and absolute debtor, and his liability is unconditional. The maker is the person who promises to pay the amount. He is primarily and absolutely liable.

6.2.1.2 Payee

The payee is the person to whom the payment is to be made and who may further negotiate the instrument.[1] The payee may also become the holder of the instrument and can endorse it further.

6.3. Parties to a Bill of Exchange

A bill of exchange is defined under Section 5 of the Act and drawer, drawee, acceptor and payee are the parties to bill of exchange.

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[1] Section 7

6.3.1. Drawer

The drawer is the person who draws the bill and orders the drawee to make payment. The drawer is secondarily liable and becomes liable upon dishonour of the bill.

6.3.2. Drawee

The drawee is the person on whom the bill is drawn and who is directed to pay the amount.[2] The drawee has no liability until acceptance.

6.3.3. Acceptor

When the drawee accepts the bill, he becomes the acceptor and assumes primary liability to pay the amount at maturity. Acceptance signifies assent to the order of the drawer and creates binding liability.[3]

6.3.4. Payee

The payee is the person to whom payment is to be made and may further endorse the bill. The payee may be the drawer himself or a third party.

6.4. Parties to a Cheque

A cheque, defined under Section 6, is a bill of exchange drawn on a specified banker and payable on demand.

6.4.1. Drawer
The drawer is the account holder who issues the cheque.

6.4.2. Drawee (Banker)

The drawee is the bank on which the cheque is drawn and which is directed to make payment. The bank must honour the cheque if funds are sufficient. The bank has duty of honouring and collecting cheques, especially crossed cheques.[4]

6.4.3. Payee

The payee is the person named in the cheque to whom payment has to be made.

6.5. Other Parties Common to Negotiable Instruments

Apart from the maker, drawer, and drawee, other parties include the holder, holder in due course, endorser, and endorsee. These parties help in transferring the negotiable instruments.

6.5.1. Holder
A holder is a person entitled in his own name to own the negotiable instrument and to receive or recover the amount due thereon.[5]

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2 Section 7

3 *Rajamannar Chettiar v. Kothandarama Pillai*, AIR 1921 Mad 197

4 *Canara Bank v. Canara Sales Corporation*, AIR 1987 SC 1603

6.5.2. Holder in Due Course

A holder in due course is a person who acquires the instrument for consideration, in good faith, and before maturity. Such a holder enjoys special privileges under the Act.[6]

6.5.3. Endorser and Endorsee

The endorser is the person who endorses the instrument, and the endorsee is the person in whose favour the endorsement is made. The endorser transfers the instrument; the endorsee receives rights under it. The endorsement followed by delivery completes negotiation.[7]

6.6. Endorsement

Endorsement is defined under Section 15 as the signing on the back or face of a negotiable instrument or signing on a slip of paper annexed to the negotiable instrument by the maker or holder for the purpose of negotiating it. For instance, A who is the holder of the instrument, writes on back there of: "Pay to B or order" and signs the instrument, then A is deemed to have endorsed the instrument to B. If A delivers the negotiable instrument to B, A ceases to be the holder and B becomes the holder.

Endorsement facilitates the transfer of ownership and rights in the instrument from one person to another. Endorsement is effective only when accompanied by delivery.[8]

6.6.1. Essentials of a Valid Endorsement

For an endorsement to be valid under the Act:
1. It must be made on the instrument or on a slip attached thereto.
2. No particular form of words is needed.
3. It must be in writing.
4. It must be signed by the endorser.
5. It must be completed by delivery of the instrument.
6. The endorsement must be through the holder of the instrument.

6.6.2. Types of Endorsement

6.6.2.1.. Blank or General Endorsement

A blank endorsement consists only of the signature of the endorser without specifying the name of the endorsee.[9] By virtue of Section 54 blank endorsement converts an order instrument into a bearer instrument. Court also confirmed that the instrument then becomes payable to bearer even though it was originally an order instrument.[10]

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5 Section 8
6 Section 9
7 *Official Assignee v. Mercantile Bank of India*, AIR 1931 Mad 351
8 *Shaw v. Delvalle*, (1839) 2 QB 108
9 Section 16
10 *Venkata Subba Rao v. Seshagiri Rao*, AIR 1925 Mad 1214

6.6.2.2. Special or Full Endorsement

In a special or full endorsement, the endorser specifies the person to whom or to whose order the instrument is payable. It implies that an endorsement made by a holder by signing his name and adding a direction to pay the amount to a specified person. It indicates that a special endorsement restricts payment to the named endorsee.[11]

6.6.2.3. Restrictive Endorsement

A restrictive endorsement restricts or excludes the further negotiability of the instrument or constitutes the endorsee as on to indorse to the negotiable instrument or to receive it content for the endorser or for some other specified person.[12] For example, pay Y on account of X. Restrictive endorsement limits the negotiability of the instrument.[13]

6.6.2.4. Partial Endorsement

This endorsement, which purports to transfer only part of the amount payable, is invalid under the Act.[14] For example, in case of bill of Rs. 10,000, "Pay Rs. 5,000 to B" Court commented that partial endorsement is invalid as it destroys the negotiable character.[15]

6.6.2.5. Conditional or Qualified Endorsement

Section 52 permits the endorser to insert by express words in the endorsement, excluding his own liability to the holder by making such liability or the right of the endorsee to receive the amount due thereon upon the happening of a specified event, although such event may never happen. It gives the impressions a conditional endorsement imposes a condition upon the endorsee, and payment is subject to the fulfillment of such condition. Courts also clarified that conditional endorsements are valid, but payment is subject to fulfillment of the condition.[16] **.** Conditional endorsements are of the following four categories:

(i). Sans Recourse Endorsement
In this type of endorsement, the endorser relieves himself from the liability to all subsequent endorsees by adding words such as "without recourse." In *Chandradhar Goswami v. Gauhati Bank Ltd.*, *t*he Supreme Court held that an endorser may exclude his liability by a sans recourse endorsement.[17]

(ii). Contingent Endorsement
An endorser may endorse a negotiable instrument in such a manner that the endorsement depends upon occurrence of a particular event, which may happen or may not happen. As a result, in such endorsements, the endorser shall be liable only on the happening of the event specified on the instrument. For instance, the endorser may endorse as "pay Mr. X or order on his marriage with Y."

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11 *Ramaswami v. Muthuswami*, AIR 1933 Mad 341
12 Section 50
13 *M.S. Anirudhan v. Thomco's Bank Ltd*, AIR 1963 SC 746
14 Section 56
15 *Sheo Narain v. Abdul Ghani*, AIR 1935 All 537
16 *Narayan v. Kannan*, AIR 1954 Mad 812
17 AIR 1967 SC 1058

(iii). Facultative Endorsement
In it, an endorser by express words abandons some rights or increases his liability under a negotiable instrument. For example an endorsement, "pay X or order-notice of dishonor waived"
is a facultative endorsement.

(iv). Sans Frais Endorsement
Where the endorser does not want to endorse or any subsequent holder of the negotiable instrument, to incur any expenses on his account upon the instrument, such an endorsement is called Sans Frais Endorsement.

6.7. LEGAL EFFECTS OF ENDORSEMENT

Under the Negotiable Instruments Act, 1881, endorsement has significant legal effects. Endorsement establishes direct legal connection between endorser and endorsee.[18] Endorsement operates to transfer ownership of the negotiable instrument to the endorsee, enabling lawful title.[19] The endorser incurs contractual liability, subject to due notice of dishonour.[20] Further, endorsement entitles the endorsee to sue in his own name without joining the endorser.[21] This lawful framework upholds the free and easy circulation of negotiable instruments. In *Balkishen Das v. Legge*, the court affirmed that endorsement effectively passes title, reinforcing commercial negotiability.

6.8. CANCELLATION OF ENDORSEMENT

If the holder of a negotiable instrument destroys or impairs the endorser's remedy against a prior party without the consent of the endorser then, the endorser is discharged from liability of instrument to the holder to the same extent as if it had been paid to maturity.[22]

For example A is the holder of a bill of exchange made payable to the order of B, which contains the following endorsements in blank: First endorsement, "B"; Second endorsement, "P"; Third endorsement "W"; Fourth endorsement "J". In this bill A puts in suit against J and strikes out, without J's consent, the endorsements by P and W. A is not entitled to recover anything from J.[23]

6.9 SUMMARY

The NI Act defines the various parties entailed in negotiable instruments such as promissory notes, bills of exchange, and cheques and clarifies their roles, rights, and liabilities, assisting to maintain transparency, reliability, and assurance in fiscal transactions, thereby facilitating trade and commerce.

In a promissory note, the maker, who promises to pay a certain sum of money, and the payee, who is entitled to receive the payment are two main parties. A bill of exchange involves three parties: the drawer, who gives the order to pay; the drawee, who is directed to make the

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18 *Kedar Nath v. State of West Bengal* , AIR 1953 SC 404
19 Sections 15 and 50
20 Section 35
21 Section 51
22 Section 40
23 This illustration is from Section 40 of the Negotiable Instruments Act 1881

payment; and the payee, who receives the money. In the case of a cheque, the drawer is the account holder, the drawee is the bank on which the cheque is drawn, and the payee is the person to whom payment is made.

Endorsement is a vital conception under the NI Act and is indispensable for maintaining the negotiability of instruments. It refers to the signing of a negotiable instrument by the holder for the purpose of transferring ownership to another person. Endorsements can be blank, special, restrictive, or conditional, depending on the intention of the parties. Through endorsement and delivery, negotiable instruments can be freely transferred, promoting smooth trade, credit flow, and commercial convenience. The collective study of parties to negotiable instruments and endorsement reflects the practical execution of negotiable instruments in Indian business law.

6.10 SELF ASSESSMENT QUESTIONS

1. Write a short note on different parties entitled to negotiate a negotiable instrument?
2. Define the term 'Endorsement'? What are the essential requisites of a valid endorsement?
3. Write briefly about various types of endorsement?
4. Explain different categories of conditional endorsement?

6.11 SUGGESTED READINGS

1. Avtar Singh, "Banking and Negotiable Instruments," (4th edition, EBC Explorer, 2018)
2. Bhashyam and Adiga, revised by Anand Sanjay M. Nuli and Saket Gogia, "The Negotiable Instruments Act," (25th Edition, 2025)
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6. P. Krishna Kumar and S. Abdul Khader Kunju, "Khergamvala on The Negotiable Instruments Act," (23rd edition, LexisNexis, 2021)
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LESSON-7
LIABILITIES OF PARTIES AND PRESENTATION OF NEGOTIABLE INSTRUMENTS

7.1. OBJECTIVE

The objective of this lesson is to provide students with a comprehensive understanding of the legal framework governing the liabilities of parties and the presentation of negotiable instruments under the Negotiable Instruments Act, 1881 (NI Act).

First, students will examine the nature and function of negotiable instruments and the statutory roles, rights, and obligations of the parties involved, including the maker, drawer, drawee, acceptor, endorser, and holder. Emphasis will be placed on understanding how liability of parties, describes the responsibilities of each party involved, and reduces disputes by fixing legal obligations in advance.

Second, the lesson will focus on the procedural requirements relating to the presentation of negotiable instruments for acceptance and payment. Students will study the legal provisions governing the time, place, and manner of presentation, and how proper presentation directly affects the fixation of liability and the availability of legal remedies in cases of default.

Finally, through legal analysis, students will develop the ability to apply legal principles to practical and commercial situations. By the end of the lesson, students will be prepared to identify rights, duties, and remedies under negotiable instruments law, enabling them to navigate business transactions with better legal conviction and self-confidence.

7.2. LIABILITY OF PARTIES TO NI ACT

The provisions relating to the liability of parties under the NI Act are important because they clearly describe the responsibilities of each party involved and also distinguish between primary and secondary liability. It protects the rights of holders, and also helps in the smooth circulation of negotiable instruments and reduces disputes by fixing legal obligations in advance.

7.2.1. Liability of Minor

The terms that deal with the liability/capacity of a minor regarding negotiable instruments are found in Section 26. A minor is not capable to enter into a contract; consequently any agreement made by a minor is void and cannot be ratified even after attaining majority. On the other hand, a minor may draw, endorse, deliver, and negotiate a negotiable instrument, and such acts will bind all other parties except the minor himself. This position may change if there is any law in force to the contrary.

7.2.2. Liability of Agent

Any person who is capable of incurring liability may join himself or be bound by a duly authorized agent acting in his name. When an agent acts within the scope of authority given by the principal, the principal is liable for the acts done by the agent in relation to a negotiable instrument.[1]

7.2.3. Liability of Agent Signing the Instrument

If an agent signs a negotiable instrument without clearly representing that he is signing as an agent, or without showing that he does not intend to incur personal liability, he will be held personally liable. The agent may also be sued by the holder for falsely representing that he had authority. However, this does not apply where the parties induced the agent to sign on the belief that the principal would be liable.[2]

7.2.4. LIABILITY OF LEGAL REPRESENTATIVE

A legal representative is personally liable for the negotiable instrument unless he expressly limits his liability to the extent of the assets received from the deceased. He is not considered an agent of the deceased, and therefore cannot complete or deliver an instrument that the deceased executed but could not deliver due to death.

7.2.5. Liability of Legal Representative Signing

When a legal representative signs his name to a promissory note, bill of exchange or cheque, he is personally liable with unlimited liability unless he expressly restricts his liability to the value of the assets inherited by him from the deceased.[3]

7.2.6. Liability of Drawer of Bill of Exchange or Cheque

Section 30 states that "the drawer of a bill of exchange or cheque is bound in case of dishonor by the drawee or acceptor thereof, to compensate the holder, provided due notice of dishonor has been given to, or received by, the drawer as hereinafter provided."

It is clear from the Section 30 that a bill of exchange or cheque is secondarily liable. The drawer of a bill of exchange or cheque is bound to compensate the holder in case of dishonor by the drawee or acceptor, provided due notice of dishonor is given. The Supreme Court also in *Hiralal v. Badkulal*, emphasized that the drawer's liability arises upon dishonour and proper notice.[4] The drawer guarantees payment to the holder in case the drawee fails to pay.

7.2.7. Liability of Drawee of Cheque

According to Section 31 "the drawee of a cheque having sufficient funds of the drawer in his hands properly applicable to the payment of such cheque must pay the cheque when duly required so to do, and, in default of such payment, must compensate the drawer for any loss or damage caused by such default."

Section 31 makes clear that the drawee of a cheque, usually a bank, is bound to honor the cheque if the drawer has sufficient funds. A banker is liable to compensate the drawer for the loss suffered if it wrongfully dishonours a cheque despite sufficient funds being available. In

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1 Section 27
2 Section 28
3 Section 29
4 AIR 1953 SC 225

Canara Bank v. Canara Sales Corporation, the Supreme Court held that a bank is liable for negligence in dealing with cheques, especially crossed cheques.[5] The bank's liability is only towards its customer and not towards the payee or holder, as there is no direct contractual or legal relationship between the bank and the payee.

7.2.8. Liability of Maker of Note, Acceptor of Bill, and Endorser

If there is no agreement stating otherwise, the maker of a promissory note must pay as written in the note, and the acceptor of a bill must pay the amount on or after its maturity or due date. In case of default, they must compensate parties who suffer loss.[6] Similarly, by virtue of Section 35 an endorser is liable to compensate the holder for loss caused due to dishonor, provided the instrument was endorsed and delivered before maturity and the endorser has not excluded or limited his liability. The endorser's liability is secondary and may be excluded by a *sans recourse* endorsement. The Supreme Court in *Chandradhar Goswami v. Gauhati Bank Ltd,* held that an endorser may exclude his liability by appropriate words, such as "without recourse."[7]

The maker of a promissory note and the acceptor of a bill of exchange are primarily liable to pay the amount. With regard to a cheque, the drawer is primarily liable until the cheque is dishonoured. Endorsers and the drawer of a bill are secondarily liable, meaning they become liable only after dishonour and upon giving due notice. The drawee of a bill is not liable until he accepts it. A holder in due course has the right to recover the amount from all prior parties.

7.2.9. Liability of Prior Parties to Holder in Due Course

Every prior party to a negotiable instrument is liable to a holder in due course until the instrument is duly satisfied.[8] Each prior party is considered a principal debtor in respect of subsequent parties, while the other parties act as sureties, making every party liable as a principal to those who follow.

7.3. PRESENTATION OF NEGOTIABLE INSTRUMENTS:

A negotiable instrument is presented under precise conditions, primarily for acceptance or for payment. In the case of a bill of exchange, both types of presentation may happen. Presentation for acceptance happens when the holder seeks the drawee's agreement to pay the bill on maturity, while presentation for payment occurs when the holder requests payment on the due date. In contrast, promissory notes and cheques involve presentation only for payment, as they already contain a promise to pay a particular sum and do not need acceptance. Therefore, the nature of the instrument determines the type of presentation required.

7.3.1. Presentation for Acceptance

It means showing the bill to the drawee at the right time and place so they can agree to pay it. Presentation for acceptance applies specifically to bills of exchange under Sections 61–62. If the bill specifies a time for presentation, it must be presented within that period; if no time is

5 AIR 1987 SC 1603
6 Section 32
7 AIR 1967 SC 1058
8 Section 36

mentioned, or presentation is not obligatory, it can be presented any time before maturity. Bills payable after sight must be presented within a reasonable time. The bill should be presented at the place mentioned in it, or at the drawee's business or residence if no place is specified. It is important to comply with statutory requirements regarding presentation.[9] Failure to make the required presentation can result in the discharge of the drawer and endorser, relieving them from liability, as the holder has not followed the proper procedure to obtain acceptance.

7.3.2. Presentation for Payment

Under Sections 64–66, negotiable instruments must be presented for payment:

1. On the due date
2. At the proper place
3. During business hours

This guarantees that the holder offers the maker or acceptor a fair opportunity to respect the instrument. If the instrument is not presented as needed, parties such as endorsers may be discharged from liability, even if the maker or acceptor remains responsible. It means that improper presentation discharges secondary parties.[10] Timely and proper presentation is indispensable to protect the rights of all parties involved.

7.4. ACCEPTANCE

On the basis of Sections 33 and 34, acceptance of a bill of exchange means the drawee agrees to pay it on the due date. Only the drawee, a drawee in case of necessity or an acceptor for honour can accept. If there are multiple drawees who are not partners, each can accept for themselves but not for others without permission.

7.4.1. Acceptance of a Bill: General and Qualified

An acceptance may be general or qualified. An acceptance is general where the drawee, at the time of accepting the bill, does not attach any conditions to it. Thus general acceptance is the correct method of acceptance. An acceptance is qualified where it is given subject to some conditions or qualifications. The NI Act does not provide a definition for "general acceptance," but it defines qualified acceptance.[11] By legal inference, any acceptance that is not "qualified" is considered a general acceptance.

According to this explanation of Section 86, an acceptance is qualified in the following cases:

1. Conditional: Payment is dependent on the occurrence of an event.
2. Partial: The drawee accepts to pay only a part of the sum ordered.
3. Local (Place): It undertakes payment only at a specific place and not elsewhere (when no place was specified, or it changes the specified place).
4. Time: It agrees to payment at a time different from when it is legally due.
5. Not signed by all: Where there are several drawees , and it is not signed by all of them.

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9 *Shri Ishar Alloy Steels Ltd. v. Jayaswals Neco Ltd*., (2001) 3 SCC 609

10 *Sundaram v. Abdul Khader*, (AIR 1933 Mad 226)

11 The explanation of Section 86 provides for how an acceptance "qualified."

The following are the effects of qualified acceptance:

1. The bill will be treated as dishonoured due to non-acceptance; or
2. If the holder takes a qualified acceptance, he does so at his own risk and discharges all the prior parties to the instrument.
3. Such bill can be negotiable subject to such qualified acceptance and discharge of prior parties.

7.4.2. Essential Features of Acceptance

1. Acceptance must be written:[12]
The drawee (the person who has to pay) must show their agreement in writing. Just signing the bill is enough to accept it. Saying "yes" or agreeing verbally does not count, except in special cases like hundis where local customs allow oral acceptance.
2. Acceptance must be signed:[13]
To accept a bill, the drawee can either just sign their name or write the word "accepted" and sign below it. Either way is legally enough to show acceptance.
3. Acceptance must be on the bill:[14]
The acceptance has to be written directly on the bill itself, either on the front or the back. Writing acceptance on a separate paper or a loose copy of the bill does not count.
4. Acceptance is complete only on delivery**:**[15]
The drawee becomes legally responsible only after they have given the accepted bill to the holder or have informed the holder that they accept it. Until then, the acceptance is not effective.
5. Acceptance in bills drawn in sets:[16]
If a bill is drawn in multiple copies (sets), signing on just one copy is enough to accept it.

However, if the drawee signs multiple copies, they may be held responsible for each signed copy separately.

7.5. RULES REGARDING PRESENTATION FOR PAYMENT

The rules regarding presentation for payment under the NI Act are important because they determine the proper time, place, and manner in which a negotiable instrument must be presented for payment. Proper presentation ensures the legality of the instrument and cares for the rights of the holder. Failure to present the instrument in the agreed time may discharge the drawer, maker, or endorsers from liability. As well, these rules facilitate in foiling misuse, fraud, and unnecessary disputes between parties.

A negotiable instrument payable on demand should be presented for payment within a reasonable time after it is received by the holder.[17]

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[12] Section 7
[13] Ibid
[14] Ibid
[15] Section 46
[16] Sections 132 and 133
[17] Section 74

7.5.1 Excuse for Delay in Presentation

A delay in presentment can be excused if the circumstances causing the delay are beyond the control of the holder and are not due to the holder's default, misconduct, or negligence.[18]

7.6. PRESENTATION FOR PAYMENT: PERSONS AND NECESSITY

Presentation for payment is a basic concept in negotiable instruments law, determining how and when payment may be lawfully demanded. It makes clear that who is entitled to present an instrument for payment, to whom such presentation must be made, and whether presentation is necessary in every case. These rules protect the rights of both holder and the party liable to pay, ensuring certainty in business deals. Understanding the persons involved in presentation and the conditions in which presentation may be exempted is critical for evaluating liability, enforcing payment, and maintaining the smooth functioning of financial and banking practices.

7.6.1. Presentation for Payment may be made to (to whom)

According to Section 75 of the NI Act presentation for acceptance or payment may be made to

1. The drawee or
2. All or some of the drawees as specified; or
3. Drawee in case of need; or
4. Acceptor for honour; or
5. Duly authorised agent of the drawee; or
6. Legal representative of the drawee; or
7. Official receiver/assignee if the drawee is insolvent.

7.6.2. Presentation for payment (by whom)

Presentation for payment must be made by a person who is legally entitled to demand payment of the instrument. Primarily, this right belongs to the holder of the instrument, who possesses it lawfully and is entitled to receive the amount due. In addition to the holder, presentation may also be made by any person acting on behalf of the holder, such as an authorized agent or representative.[19]Such presentation is legitimate provided the person acts with proper authority. This rule makes certain flexibility in commercial transactions while safeguarding the interests of the parties liable to make payment.

7.6.3. Presentation for payment - Not Necessary[20]

In the following cases, presentation for payment is not necessary: -

1. When the person responsible (maker, drawee or any other party) for payment intentionally stops the instrument from being presented.
2. The negotiable instrument is payable at a place and the presentation was made at such place during the standard business hours but the drawee was not present.
3. The place of payment is closed on the due date during the business hours. In such case it is assumed that the person liable to pay wants to avoid payment.

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[18] Section 75A

[19] Section 64

[20] Section 76

4. If the instrument is not payable at a specified place the drawee/maker cannot be found after due search.
5. There is a promise to pay even if the instrument is not presented.
6. Presentation for payment is avoided expressly or impliedly by the party payable on the instrument. The person who has to pay the instrument intentionally avoids its presentation, either openly or indirectly
7. The bill is dishonoured due to non-acceptance.
8. When the drawee is a fictitious person.
9. Where the drawer and the drawee are the same person.
10. Presentation becomes impossible

7.7. SUMMARY

NI Act establishes rules regarding the rights and obligations of different parties involved in negotiable instruments and presentation of these instruments such as promissory notes, bills of exchange, and cheques. A significant aspect of the NI Act is the liabilities of parties, which determines who is responsible for payment and under what circumstances. These liabilities vary depending on the position of the party, such as maker, drawer, acceptor, endorser, or holder. The NI Act also specifies special provisions for parties like minors, agents, and legal representatives. Understanding these liabilities is essential to ensure certainty, trust, and smooth functioning of commercial and financial transactions involving negotiable instruments.

Presentation of negotiable Instruments is a crucial concept under the NI Act that ensures the smooth operation of business transactions. Presentation refers to the act of submitting a negotiable instrument, such as a promissory note, bill of exchange, or cheque, to the proper party for payment or acceptance within the agreed time. The NI Act denotes who may present the instrument, where and how it should be presented, and the consequences of delay or improper presentation. Timely and proper presentation is essential to protect the rights of the holder, enforce payment, and hold liable parties responsible, thereby maintaining trust and efficiency in financial dealings.

7.8 TECHNICAL TERMS

Acceptor for Honour
When a bill of exchange is dishonoured due to non-acceptance by the drawee, the holder may permit another person to accept the bill for the honour of the drawer or any endorser. Such a person is known as an acceptor for honour. (Section 7)

Drawee in Case of Need
A “drawee in case of need” is essentially a backup person named in a bill of exchange given in addition to the drawee, to be referred in case of need. Legally, the bill is only considered dishonoured once both the original writer and this backup person have refused to settle it. (Section 115)

Holder
A holder is a person who has the legal right to possess a negotiable instrument in his own name and to receive the amount due on it. To be a holder, the person must be entitled to keep the instrument and recover the money in his own name. The payee, bearer, and endorsee are holders. (Section 8)

Holder in due course

'Holder in due course' means any person who, for consideration, became the possessor of the negotiable instrument if payable to bearer or the payee or endorsee thereof if payable to order, before the amount mentioned in it became payable and without sufficient cause to believe that any defect existed in the title of the person from whom he derived his title. (Sec. 9)

Maturity

The maturity of the negotiable instrument is the date at which it fall due.(Section 22)

7.9 SELF ASSESSMENT QUESTIONS

1. Discuss the liability of a drawer, drawee, and endorser under the Negotiable Instruments Act, 1881?
2. Explain the rules regarding presentation of payment?
3. Write a short note on cases, when presentation for payment is not necessary?

7.10 SUGGESTED READINGS

1. Avtar Singh, "Banking and Negotiable Instruments," (4th edition, EBC Explorer, 2018)
2. Bhashyam and Adiga, revised by Anand Sanjay M. Nuli and Saket Gogia, "The Negotiable Instruments Act," (25th Edition, 2025)
3. Dutta , "Commentary on the Negotiable Instruments Act, 1881," (2025)
4. Jitender Dabas, "Commentary on Negotiable Instruments Act, 1881," (2nd Edition, 2025)
5. Negotiable Instruments Act: Bare Act with Section Notes —(Taxmann, 2025)
6. P. Krishna Kumar and S. Abdul Khader Kunju, "Khergamvala on The Negotiable Instruments Act," (23rd edition, LexisNexis, 2021)
7. S.P. Tyagi, Commentary on the Negotiable Instruments, 1881, (4th Edition, 2025)

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LESSON-8
DISHONOUR AND MODES OF DISCHARGE OF NEGOTIABLE INSTRUMENTS

8.1. OBJECTIVE

The objective of this lesson is to enable students to understand the legal structure regulating the dishonour and discharge of negotiable instruments under the NI Act and ensuring their effective application in commercial practice. A thorough understanding of ingredients, presumptions, procedure supported by statutory provisions is essential to analyze the rights and liabilities arising out of dishonour and modes of discharge of negotiable instruments. In the course of this lesson, students will be able to explain the meaning and types of dishonour, including dishonour by non-acceptance and non-payment, and identify the circumstances under which a cheque is dishonoured. The objective of this lesson is to make students acquainted with the legal consequences of dishonour, mainly the conditions relating to cheque dishonour under Section 138. It also endeavours to provide knowledge of the various modes of discharge of negotiable instruments, such as payment in due course, cancellation, release and material alteration. By the end of the lesson, students should be able to make a distinction between dishonour and discharge, apply legal rules to develop a clear conceptual understanding essential for business law studies and examinations.

8.2. Dishonour of Negotiable Instruments

The term 'dishonour' refers to the refusal or failure to accept or pay a negotiable instrument when it is duly presented. A negotiable instrument may be dishonoured in two forms under the NI Act:

1. Dishonour by non-acceptance
2. Dishonour by non-payment

8.2.1. Dishonour by Non-Acceptance

Section 91 of the NI Act deals with the dishonour by non-acceptance. Dishonour occurs when the instrument is not accepted or paid in accordance with its tenor upon due presentation.[1] Refusal to accept a bill amounts to dishonour by non-acceptance and immediately gives the holder the right to proceed against prior parties.[2] Dishonour by non-acceptance occurs in the case of a bill of exchange in any of the following cases:

1. Presentment for acceptance is excused.
2. When the drawee gives a qualified acceptance and the holder does not accept.
3. If the drawee does not accept the bill within 48 hours of presentation.
4. Where drawee is incompetent to contract.
5. In a case where the drawee is a fictitious person.
6. When drawee cannot found with a reasonable reach.
7. If a bill is addressed to two or more drawees who are not partners, it must be accepted by all of them.

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1 *Bhagwati Prasad v. Nandlal*, AIR 1941 All 337
2 *Rajamannar Chettiar v. Kothandarama Pillai*, AIR 1921 Mad 197

If a “drawee in case of need” is mentioned in the bill, the bill is not deemed dishonoured unless it is also dishonoured by such drawee in case of need.

8.2.2. Dishonour by Non-Payment

Dishonour by non-payment occurs when a negotiable instrument is duly presented for payment and the maker, acceptor, or drawee fails to pay the amount.[3] It means a promissory note, bill of exchange, or cheque is dishonored by non-payment when the person responsible fails to pay it when payment is properly demanded. The Supreme Court observed that failure to pay on maturity constitutes dishonour and makes secondary parties liable upon notice.[4]

A bill may be dishonoured either by non-acceptance or by non-payment. A promissory note or a cheque can be dishonoured only by non-payment.

8.2.3. Notice of Dishonour

Under Sections 93–98, when a negotiable instrument is dishonoured, the holder must give notice of dishonour to all parties whom he seeks to make liable. The notice of dishonour is mandatory unless expressly waived.[5] Failure to give notice discharges secondary parties such as the drawer and endorsers.

8.2.3.1. Notice by Whom

The purpose of giving notice is to inform parties of dishonour and to enable them to protect their interests. The holder (or any person who is still responsible for it) must inform the other parties about the dishonor if the holder wants to claim money from them. Notice must be given to all persons who are separately responsible, and if some persons are jointly responsible, informing any one of them is enough. However, there is no need to give notice to the maker of a promissory note or the drawee or acceptor of a bill or cheque, because they are already aware of the dishonor.[6]

8.2.3.2. Notice to Whom

Notice of dishonour may be given to:[7]

1. All the parties liable.
2. The duly authorized agent.
3. Legal representatives in case of death.
4. Official assignee or receiver in case of insolvency.

8.2.3.4. Mode of Notice

If the holder does not know that a party has died or become insolvent, sending the notice to that person is considered sufficient. The notice can be given either orally or in writing and may be sent by post. There is no fixed format for the notice, but it must clearly state that the

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3 Section 92
4 *Hiralal v. Badkulal* AIR 1953 SC 225
5 *Hiten P. Dalal v. Bratindranath Banerjee,* 2001 6 SCC 16
6 Section 93
7 Section 94

instrument has been dishonored and that the concerned party will be held responsible for payment. The notice should be sent to the address mentioned on the instrument or to the person's place of business or home.[8]

If the holder of the instrument and the party are to be notified live in the same place, the notice must reach that party by the next day after the dishonour. If they live in different places, the notice must be sent by the next post or on the next day after the dishonour.[9]

If a person receives a notice that an instrument has been dishonored, and if that person wants to hold an earlier (prior) party responsible, he must inform that prior party about the dishonor within a reasonable time, unless the prior party has already received proper notice under Section 93 of the NI Act.[10] If a notice of dishonor is sent to a person who has died, but the sender does not know about their death, the notice is still considered valid.[11]

8.2.3.5. When Notice of Dishonour is Unnecessary

In a suit against the drawer on a dishonoured instrument, notice of dishonour is normally required. However, Section 98 of NI Act declares that in the following cases notice of dishonour is not necessary either for dishonour by non-Acceptance or for dishonour for non-payment:

1. When the right to notice is waived by the party entitled to it.
2. Where the drawer of the cheque himself has countermanded payment.
3. When the party charged could not suffer damages for want of notice.
4. When the party entitled to notice cannot be found after reasonable search.
5. When the party liable to give notice is unable to do so without fault of their own. For example in case of death, serious illness of the holder or agent, or accident.
6. When the promissory note is not negotiable.
7. When the drawer himself is the acceptor.
8. When the party entitled to notice, knowing the facts, unconditionally promises to pay the amount due on the instrument.

8.2.4. Dishonour of Cheques and Criminal Liability

Dishonour of cheques due to insufficiency of funds in drawer's bank attracts criminal liability under Section 138, then he is punishable with imprisonment up to two years or fine which may extend up to twice the amount of the cheque, or both.

Section 138 of NI Act was inserted by the Banking, Public Financial Institutions and Negotiable Instruments Laws (Amendment) Act, 1988 to enhance the credibility of cheques in business transactions. Prior to this amendment, the dishonour of cheques gave rise only to civil liability. Section 138 introduced criminal liability in cases where cheques are dishonoured due to insufficiency of funds or other specified reasons. The object of Section 138 is to ensure faith in banking operations, promote cheque-based transactions, and discourage dishonest drawers from issuing cheques without sufficient funds.

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8 Ibid
9 Section 106
10 Section 95
11 Section 97

8.2.4.1. Essential Ingredients of Section 138

Section 138 provides that where a cheque drawn by a person on an account maintained by him with a banker for the discharge of a legally enforceable debt or liability is returned unpaid due to insufficiency of funds or exceeding arrangement, such person shall be deemed to have committed an offence, subject to fulfillment of statutory conditions. For an offence under Section 138 to be established, the following ingredients must be proved:

1. **Drawing of cheque**
The accused must have drawn a cheque on an account maintained by him. Only the drawer of the cheque can be prosecuted under Section 138.[12]
2. **Cheque issued for legally enforceable debt or liability**
The cheque must be issued towards discharge of a legally enforceable debt or liability, wholly or in part. In *Rangappa v. Sri Mohan*,[13] the Supreme Court held that there is a presumption that the cheque was issued in discharge of a legally enforceable debt unless proved otherwise.
3. **Presentation of cheque within validity period**
The cheque must be presented to the bank within its period of validity (currently three months from the date of issuance, as per RBI guidelines). Presentation must be made to the drawee bank within the validity period is also confirmed by courts.[14]
4. **Dishonour of cheque**
The cheque must be returned unpaid due to insufficiency of funds, or exceeding arrangement with the bank. Dishonour due to "account closed" also falls under Section 138.[15]
5. **Statutory Notice by payee**
The payee must issue a written demand notice to the drawer within 30 days of receiving information about dishonour. The issuance of notice is a mandatory requirement.[16]
6. **Failure to pay within 15 days of notice**
The drawer must fail to make payment within 15 days of receipt of the notice. Therefore, if the drawer does not pay within 15 days, the offence is complete.[17]
7. **Filing of complaint within limitation**
The complaint must be filed within one month from the date when the cause of action arises. However delay may be condoned if sufficient cause is shown.[18]

8.2.5. Presumptions under the Act

Section 118(a) of NI Act presumes that every negotiable instrument was made for consideration. Section 139 presumes that the holder received the cheque, for repayment of debt or other liability either in whole or in part. Presumptions under Sections 118 and 139 are mandatory but rebuttable.[19] Accused can rebut presumption on the basis of preponderance of probabilities.[20]

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12 *Aparna A. Shah v. Sheth Developers*, (2013) 8 SCC 71
13 (2010) 11 SCC 441
14 For example, *Shri Ishar Alloy Steels Ltd. v. Jayaswals Neco Ltd*, (2001) 3 SCC 609
15 *NEPC Micon Ltd. v. Magma Leasing Ltd*., (1999) 4 SCC 253
16 K. *Bhaskaran v. Sankaran Vaidhyan Balan*, (1999) 7 SCC 510
17 *C.C. Alavi Haji v. Palapetty Muhammed*, (2007) 6 SCC 555
18 *Subodh S. Salaskar v. Jayprakash M. Shah*, (2008) 13 SCC 689
19 *Hiten P. Dalal v. Bratindranath Banerjee* (2001) 6 SCC 16
20 *Krishna Janardhan Bhat v. Dattatraya Hegde*, (2008) 4 SCC 54

The accused may rebut the statutory presumption of liability under Section 139 for dishonor of a cheque. Defenses include proving that there was no legally enforceable debt or liability, that the cheque was issued as a security, lack of consideration, material alteration of the cheque, or that the cheque was lost, stolen, or misused. Establishing any of these defenses can help the accused negate the presumption of guilt under Section 138 and Section 139 of the Act.

8.2.6. Rules for Compensation in Case of Dishonour of Negotiable Instruments:

Section 117 of the NI Act lays down the following rules:

1. Entitlement of Holder: The holder of a dishonoured promissory note, bill of exchange, or cheque is entitled to the amount due, along with expenses properly incurred in presenting, noting, and protesting the instrument.
2. Different Places of Residence: If the person liable resides at a different place than where the instrument is payable, the holder may claim the amount at the current rate of exchange between the two places.
3. Rights of Endorser**:** An endorser who pays the amount due is entitled to recover the sum paid, with 18% interest per annum from the date of payment until repayment, along with all expenses caused by the dishonour and payment.
4. Endorser in a Different Place**:** If the endorser and the person liable live in different places, the amount is recoverable at the current rate of exchange between those locations.
5. Recovery via Bill**:** The entitled party may draw a bill on the liable party for the amount and expenses, accompanied by the dishonoured instrument and protest. If this bill is dishonoured, the same compensation rules apply.

8.2.7. Duties of the Holder upon Dishonour

When a negotiable instrument is dishonoured, the holder has certain duties:

1. The holder must give notice of dishonour to the parties liable, as per Section 138 of the NI Act.
2. In the case of a promissory note or bill of exchange, the holder can get the instrument noted and protested by a notary to formally record the dishonor.[21]
3. After giving notice and (if necessary) noting and protesting, the holder can sue the party liable to recover the amount due.[22]

This ensures that the holder can legally enforce the instrument and that all liable parties are informed.

Noting means recording the fact of dishonour by a notary upon the instrument, or upon a paper attached thereto, or partly upon each, within a reasonable time after dishonour.

[21] Sections 97-104
[22] Sections 138-142

8.2.8. Noting and Protesting of Dishonoured Instruments

8.2.8.1. Noting

Noting means recording the fact of dishonour of an instrument by a notary, either on the instrument itself or on a separate paper, shortly after the dishonour. Before noting, the notary asks the maker or drawee to pay or accept the instrument in their presence, or asks for the reason for non-payment or non-acceptance. Then, the notary records the details on the instrument. The noting must include:[23]

1. The fact of dishonour
2. Date of dishonour
3. Reasons, if any, for dishonour
4. If dishonoured expressly, why the holder considers it dishonoured
5. The notary's charges

Even if an instrument is not noted, the holder's rights are not affected.

8.2.8.2. Protest

When an instrument is dishonoured due to non-acceptance or non-payment, the holder can have the dishonour noted and certified by a notary. This certificate is called a protest and it is a formal document issued by the notary that officially validates the dishonour of the instrument, and it is always based on the process of noting.[24]

8.2.8.3. Contents of a Protest

A protest must contain:[25]

1. A copy or literal transcript of the instrument
2. The name of the person for whom and against whom the instrument has been protested
3. The fact of dishonour and reasons for dishonour
4. The place and time of dishonour
5. The signature of the notary
6. In case of "acceptor for honour" or "payment for honour," the name of the person paying or accepting and the name of the person for whose honour it is accepted or paid

The letter of protest can also serve as notice of dishonour to be given to all parties liable on the instrument. A protest is beneficial because it is authentic evidence of dishonor and in a court of law, proof of protest allows the court to presume dishonour unless disproved.

8.3. Discharge of Negotiable Instruments

The discharge of a negotiable instrument can be understood in two ways: discharge of the instrument itself and discharge of one or more parties from liability. An instrument is said to be discharged when all rights arising from it come to an end and it is no longer negotiable. In

[23] Section 99
[24] Section 100
[25] Section 101

such a case, even a holder in due course cannot claim any rights under the instrument. However, when only one or more parties are discharged from liability, the instrument does not come to an end. It continues to be negotiable, and the remaining parties to the instrument are still liable to pay according to its terms.[26]

8.3.1. Various Modes of Discharge Negotiable Instruments

A negotiable instrument can be discharged in any of the following various modes:

1. By cancellation: when the holder intentionally cancels the name of the maker, acceptor, or endorser on the negotiable instrument.[27]
2. By release: when the holder releases or discharges him from liability against the party primarily liable.[28]
3. By payment: when payment is made in due course of the amount due, in the case of a bearer instrument or one endorsed in blank.[29]
4. By operation of law: When the instrument becomes time barred.
5. By negotiable back: If the party primarily liable on the negotiable instrument becomes the holder of the instrument.
6. Bill received by the acceptor after its due date: If a bill of exchange, after being transferred to others, comes back into the hands of the acceptor at or after maturity, then no legal action can be taken on that bill, and all rights under it come to an end.[30]

8.3.2. Cases where Parties are discharged from their Liability on the Negotiable instrument

A party may be discharged in any one of the following ways:

1. By cancellation of the name of a party

An instrument is discharged when the holder intentionally cancels the name of any party or the instrument itself. If the holder cancels the name of the maker, acceptor, or endorser of a negotiable instrument with the intention of freeing them from liability, that person is no longer responsible to the holder. Also, any parties who come after the cancelled person are discharged too, so the holder cannot claim the amount from them.[31] In *Sheo Narain v. Abdul Ghani,* the court held that cancellation by the holder releases the cancelled party from liability.[32]

2. By release of a party

When the holder releases any party to the instrument, all parties subsequent to the released party are also discharged.[33]

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26 Sections 82-90
27 Section 82
28 Ibid
29 Ibid
30 Section 90
31 Section 82 (a)
32 AIR 1935 All 537
33 Section 82 (b)

3. By allowing the drawee more than 48 hours to accept the Bill of Exchange
If the holder of a bill of exchange gives the drawee extra time (more than 48 hours, not counting public holidays) to decide whether to accept the bill, then all the previous parties who did not agree to this extra time are no longer responsible to the holder.[34]

4. By delay in presenting a cheque for payment
The drawer of a cheque is discharged from the extent of loss suffered by him if the cheque is not presented for payment within reasonable time of its issue and the drawer suffers the damage because of such delay. If the holder delays presenting a cheque and, during this time, the banker fails or becomes unable to pay, the drawer is discharged from liability. However, the holder can still claim the amount from the insolvent banker, becoming the banker's creditor instead of the drawer's.[35]

5. By qualified acceptance
If the holder accepts a bill with changes like a partial amount, different payment place or time, or missing signatures, then all previous parties who didn't agree to these changes are no longer liable to the holder or anyone claiming through him, unless they give their consent after notice.[36]

6. By operation of law
When a debtor is declared an insolvent he is discharged from his liability or by the expiry of limitation period. In *Union of India v. K. Venkata Rao*,[37] he court recognized discharge by operation of law through insolvency proceedings.

7. By the drawee banker making the payment in due course
The drawee banker is discharged from his liability by making the payment of a cheque in the due course.[38]

8. By material alternation without obtaining prior consent
If someone changes a negotiable instrument in any important way without the consent of the parties involved at the time, the instrument becomes invalid against those parties. The only exception is if the change is made to carry out what all the original parties actually intended.[39] Any material alteration without the consent of all parties renders the instrument void.[40] Alteration of amount, change of date and change of place of payment are examples.

9. By non presentation of a bill for acceptance
If the holder makes default in presentation, then no party to the instrument is liable to such holder.[41] Therefore, failure to present a bill for acceptance when required discharges the drawer and endorsers.

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34 Section 83
35 Section 84
36 Section 86
37 AIR 2016 SC 242
38 Section 85
39 Section 87
40 Loon Karan Sethia v. Ivan E. John, AIR 1977 SC 336)
41 Section 61

10. Failure to give notice of dishonor

All the parties to whom notice of dishonor not given are discharged from liability on such negotiable instrument.

8.3.3. Effect of Discharge

Once discharged then no party can be made liable; the instrument becomes unenforceable and rights of the holder are extinguished. However, discharge of one party does not always discharge all parties unless expressly provided.

8.4. SUMMARY

Dishonour and discharge of negotiable instruments are two crucial aspects of the law governing negotiable instruments under the NI Act. Dishonour of a negotiable instrument occurs when it is not accepted or paid on presentation. An instrument may be dishonoured by non-acceptance (in case of a bill of exchange) or by non-payment (in case of a promissory note, bill, or cheque). Dishonour of a cheque due to insufficiency of funds or other reasons attracts criminal liability under Section 138, provided statutory requirements such as notice and time limits are fulfilled. Section 138 stands as a unique example of criminal law being used to enforce financial discipline in commercial transactions.

On the other hand, modes of discharge of negotiable instruments refer to the ways of the lawful termination of the liability of parties comes to an end. Discharge may take place by payment in due course, cancellation and release of the debtor, allowing more time, material alteration, or insolvency of the debtor. An instrument is also discharged when the holder becomes the principal debtor. Thus, dishonour determines liability, while discharge signifies its lawful termination.

8..5 TECHNICAL TERMS

Material Alteration

An alteration is called material alteration if it alters the character of negotiable instrument; or the rights and liabilities of any of the parties to a negotiable instrument. For example changing the date, time or amount.

Presumption

A presumption is an inference drawn by law, which the court accepts as true until evidence is produced to rebut it.

8.6 SELF ASSESSMENT QUESTIONS

1. Explain negotiable instrument dishonoured due to non-acceptance and non-payment?
2. Write a short note on notice of dishonour under the NI Act, 1881?
3. What are the circumstances where notice of dishonor is not required?
4. State the conditions to establish an offence under Section 138 of NI Act, 1881?
5. What are the various modes of a negotiable instrument to get dishcharged?
6. When do the parties to negotiable instruments get discharged?

8..7 SUGGESTED READINGS

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2. Bhashyam and Adiga, revised by Anand Sanjay M. Nuli and Saket Gogia, "The Negotiable Instruments Act," (25th Edition, 2025)
3. Dutta , "Commentary on the Negotiable Instruments Act, 1881," (2025)
4. Jitender Dabas, "Commentary on Negotiable Instruments Act, 1881," (2nd Edition, 2025)
5. Negotiable Instruments Act: Bare Act with Section Notes —(Taxmann, 2025)
6. P. Krishna Kumar and S. Abdul Khader Kunju, "Khergamvala on The Negotiable Instruments Act," (23rd edition, LexisNexis, 2021)
7. S.P. Tyagi, Commentary on the Negotiable Instruments, 1881, (4th Edition, 2025)

Dr. Ravella Bhanu Krishna Kiran

LESSON-9
CONTRACT OF INDEMNITY AND GUARANTEE

Objective of the Lesson

- Meaning of Indemnity.
- Nature and Scope of Indemnity.
- Distinction between Indemnity and other Specific contracts.
- Indemnity under English and US Law.
- Meaning and scope of contract of Guarantee.
- Essential elements of a contract of Guarantee?
- Kinds of Guarantee and what are its modes of revocation.
- Rights of Surety and Surety's discharged and Extent of Surety's liability.

STRUCTURE OF THE LESSON

9.1 INTRODUCTION: LITERAL MEANING

Indemnity means Insurance or Security or Protection.
Principle: Indemnity is an obligation by a person (**indemnitor/indemnifier**) to provide compensation for a particular loss suffered by another person (**indemnitee/indemnity holder**). Indemnities form the basis of many insurance contracts; for example, a car owner may purchase different kinds of insurance as an indemnity for various kinds of loss arising from operation of the car, such as damage to the car itself, or medical expenses following an accident.

In an agency context, a principal may be obligated to indemnify their agent for liabilities incurred while carrying out responsibilities under the relationship. While the events giving rise to an indemnity may be specified by contract, the actions that must be taken to compensate the injured party are largely unpredictable, and the maximum compensation is often expressly limited.

In the old English law, Indemnity was defined as "a promise to save a person harmless from the consequences of an act. Such a promise can be express or implied from the circumstances of the case".

This view was illustrated in the case of **Adamson vs Jarvis 1872**. In this case, the plaintiff, an auctioneer, sold certain goods upon the instructions of a person. It turned out that the goods did not belong to the person and the true owner held the auctioneer liable for the goods. The auctioneer, in turn, sued the defendant for indemnity for the loss suffered by him by acting on his instructions. It was held that since the auctioneer acted on the instructions of the defendant, he was entitled to assume that if, what he did was wrongful, he would be indemnified by the defendant.

This gave a very broad scope to the meaning of Indemnity and it included promise of indemnity due to loss caused by any cause whatsoever. Thus, any type of insurance except life insurance was a contract of Indemnity. However, Indian contract Act 1872 makes the scope narrower by defining the contract of indemnity as follows.

9.2 DEFINITION UNDER INDIAN CONTRACT ACT 1872

Section 124: 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 a "contract of Indemnity".

Illustration: A contracts to indemnify B against the consequences of any proceedings which C may take against B in respect of a certain sum of Rs 200. This is a contract of indemnity.

9.3 ESSENTIAL ELEMENTS

The definition provides the following essential elements:

a) There must be a loss.
b) The loss must be caused either by the promisor or by any other person (in Indian context loss is to be caused by only by a human agency)
c) Indemnifier is liable only for the loss.
d) Thus, a contract is contingent in nature and is enforceable only when the loss occurs.

9.4 WHEN DOES THE COMMENCEMENT OF LIABILITY ARISES

In general, as per the definition given in section 124, it looks like an indemnity holder cannot hold the indemnifier liable until he has suffered an actual loss. This is a great disadvantage to the indemnity holder in cases where the loss is imminent and he is not in the position to bear the loss.

In the celebrated case of **Gajanan Moreshwar vs Moreshwar Madan, AIR 1942**, Bombay high court observed that the contract of indemnity held very little value if the indemnity holder could not enforce his indemnity until he actually paid the loss. If a suit was filed against him, he had to wait till the judgement and pay the damages upfront before suing the indemnifier. He may not be able to pay the judgement fees and could not sue the indemnifier. Thus, it was held that if his liability has become absolute, he was entitled to get the indemnifier to pay the amount.

9.5 RIGHTS OF INDEMNIFIER AND INDEMNITY HOLDER

9.5.1 Rights of Indemnifier:
After compensating the indemnity holder, indemnifier is entitled to all the ways and means by which the indemnifier might have protected himself from the loss.

9.5.2 Rights of the indemnity holder:
Section 125 defines the rights of an indemnity holder. These are as follows - The promisee (Indemnity holder) in a contract of indemnity, acting within the scope of his authority, is entitled to recover from the promisor (Indemnifier). These are:

A. Right of recovering Damages: All damages that he is compelled to pay in a suit in respect of any matter to which the promise of indemnity applies.

B. Right of recovering Costs: All costs that he is compelled to pay in any such suit if, in bringing or defending it, he did not contravene the orders of the promisor and has acted as it would have been prudent for him to act in the absence of the contract of indemnity, or if the promisor authorized him in bringing or defending the suit.

C. Right of recovering Sums: All sums which he may have paid under the terms of a compromise in any such suite, if the compromise was not contrary to the orders of the promisor and was one which would have been prudent for the promisee to make in the absence of the contract of indemnity, or if the promisor authorized him to compromise the suit.

Some of the important conditions which he ought to follow here are viz; that as per this section, the rights of the indemnity holder are not absolute or unfettered. He must act within the authority given to him by the promisor and must not contravene the orders of the promisor. Further, he must act with normal intelligence, caution, and care with which he would act if there were no contract of indemnity.

Therefore, at the same time, if he has followed all the conditions of the contract, he is entitled to the benefits.

This was held in the case of **United Commercial Bank vs Bank of India AIR 1981**. In this case, Supreme Court held that the courts should not grant injunctions restraining the performance of contractual obligations arising out of a letter of credit or bank guarantee if the terms of the conditions have been fulfilled. It held that such LoCs or bank guarantees impose on the banker an absolute obligation to pay.

In the case of **Mohit Kumar Saha vs New India Assurance Co, AIR 1997**, Calcutta HC held that the indemnifier must pay the full amount of the value of the vehicle lost to theft as given by the surveyor. Any settlement at lesser value is arbitrary and unfair and violates art. 14 of the constitution.

Some illustrations on contract of Indemnity under English Law are as follows:

Under section 4 of the Statute of Frauds (1677), a “guarantee” which means “an undertaking of secondary liability; to answer for another's default must be evidenced in writing. No such formal requirement exists in respect of indemnities which involves the assumption of primary liability; to pay irrespective of another's default, which are enforceable even if made orally. (Ref: Peel E: Treitel, The Law of Contract")

Under current English law, indemnities must be clearly and precisely worded in the contract in order to be enforceable. Under the Unfair Contract Terms Act 1977, Section 4, says that a consumer cannot be made to unreasonably indemnify another for their breach of contract or negligence.

Contract award:

In England and Wales an "indemnity" monetary award may form part of rescission (the revocation, cancellation, or repeal of a law, order, or agreement) during an action of ***restitutio in integrum*** (restoration of an injured party to the situation which would have prevailed had no injury been sustained; restoration to the original or pre-contractual position). The property and funds are exchanged, but indemnity may be granted for costs necessarily incurred to the innocent party pursuant to the contract. The leading case on this point is **Whittington vs Seale-Hayne**, in which a contaminated farm was sold. The contract made the buyers renovate the real estate and, the contamination incurred medical expenses for their manager, who had fallen ill. Once the contract was rescinded, the buyer could be indemnified for the cost of renovation as this was necessary to the contract, but not the medical expenses as the contract did not require them to hire a manager. Were the sellers at fault, damages would clearly be available.
The distinction between indemnity and damages is subtle which may be differentiated by considering the roots of the law of obligations.

Question arises how can money be paid where the defendant is not at fault?
The contract before rescission (the revocation, cancellation, or repeal of a law, order, or agreement) is voidable but not void, so, for a period of time, there is a legal contract. During that time, both parties have legal obligation. If the contract is to be void ab initio the obligations performed must also be compensated. Therefore, the costs of indemnity arise from the (transient and performed) obligations of the claimant rather than a breach of obligation by the defendant.

This distinction between indemnity and guarantee was discussed as early as the eighteenth century in **Birkmya vs Darnell**. In that case, concerned with a guarantee of payment for goods rather than payment of rent, the presiding judge explained that a guarantee effectively says **"Let him have the goods; if he does not pay you, I will."**

9.6 DISTINCTION BETWEEN CONTRACT OF INDEMNITY AND GUARANTEE

Contract of Indemnity (Section 124)	Contract of Guarantee (Section 126)
It is a bipartite agreement between the indemnifier and indemnity-holder.	It is a tripartite agreement between the Creditor, Principal Debtor, and Surety.
Liability of the indemnifier is contingent upon the loss.	Liability of the surety is not contingent upon any loss.
Liability of the indemnifier is primary to the contract.	Liability of the surety is co-extensive with that of the principal debtor although it remains in suspended animation until the principal debtor defaults. Thus, it is secondary to the contract and consequently

	if the principal debtor is not liable, the surety will also not be liable.
The undertaking in indemnity is original.	The undertaking in a guarantee is collateral to the original contract between the creditor and the principal debtor.
There is only one contract in a contract of indemnity between the indemnifier and the indemnity holder.	There are three contracts in a contract of guarantee an original contract between Creditor and Principal Debtor, a contract of guarantee between creditor and surety, and an implied contract of indemnity between the surety and the principal debtor.
The reason for a contract of indemnity is to make good on a loss if there is any.	The reason for a contract of guarantee is to enable a third person get credit.
Once the indemnifier fulfils his liability, he does not get any right over any third party. He can only sue the indemnity-holder in his own name.	Once the guarantor fulfils his liability by paying any debt to the creditor, he steps into the shoes of the creditor and gets all the rights that the creditor had over the principal debtor.

9.7 DISTINCTION FROM WARRANTIES

An indemnity is distinct from a warranty in that:
a) An indemnity guarantees compensation equal to the amount of loss subject to the indemnity, while a warranty only guarantees compensation for the reduction in value of the acquired asset due to the warranted fact being untrue (and the beneficiary must prove such diminution in value).
b) Warranties require the beneficiary to mitigate their losses, while indemnities do not.
c) Warranties do not cover problems known to the beneficiary at the time the warranty is given, while indemnities do.

- Anything done, or any promise made, for the benefit of the principal debtor, may be a sufficient consideration to the surety for giving the guarantee. The guarantor need not personally derive any benefit from the guarantee.
- The liability of the surety is co-extensive with that of the principal debtor, unless it is otherwise provided by the contract.
- The creditor can straightway proceed against the guarantor without first proceeding against the principal debtor.
- The liability of the surety can never be greater than that of the principal debtor. The surety can however may restrict his liability to part of the principal debtor's liability by contract.
- Surety's liability is distinct and separate.

CONTRACT OF GUARANTEE

Structure of The Lesson Contract of Guarantee

9.8 INTRODUCTION CONTRACT OF GUARANTEE

A Contract to perform the promise, or discharge the liability, of a third person in case of his default is called **Contract of Guarantee**. A guarantee may be either oral or written.

- The person who gives the guarantee is called the **Surety.**
- The person on whose default the guarantee is given is called the **Principal Debtor**.
- The person to whom the guarantee is given is called the **Creditor.**

9.9 MEANING AND DEFINITION OF CONTRACT OF GUARANTEE

A guarantee can be for many things. It can be assurance of a particular outcome or that something will be performed in a specified manner. A guarantee is a way of assuming responsibility for paying another’s debts or fulfilling another’s responsibilities. It can be a promise for the execution, completion, or existence of something. A guarantee can also be a promise or an assurance attesting to the quality or durability of a product or service.
The English law defines a ‘guarantee’ as a ‘promise to answer for the debt, default or miscarriage of another’.

Section 126 of the Indian Contract Act, 1872 says that a Contract of Guarantee is a contract to perform the promise or discharge the liability or a third person in case of his default.

Illustration:
If A gives an undertaking stating that if ` 200 are lent to C by B and C does not pay, A will pay back the money, it will be a contract of guarantee. Here, A is the surety, B is the principal debtor and C is the creditor.
Surety is the person gives the guarantee;

Principal Debtor is the one for whom the guarantee is given and the creditor is the person to whom the guarantee is given.

Contract Act uses the word ‘surety’ which is same as ‘guarantor’. Prima facie, the surety is not undertaking to perform should the principal debtor fail; the surety is undertaking to see that the principal debtor does perform his part of the bargain. A contract of guarantee pre-supposes a principal debt or an obligation that the principal debtor must discharge in favour of the creditor. Anything done, or any promise made, for the benefit of the principal debtor, is deemed sufficient consideration to the surety for giving the guarantee. It is sufficient inducement that the person for whom the surety has given guarantee has received a benefit or the creditor has suffered an inconvenience. While Section 2 (d) of the ICA, 1872 says that past consideration is good consideration, illustration (c) of Section 127 of the ICA, 1872 seems to negate this point. Those who favor the validity of past consideration state that law is not supposed to be guided by illustrations. But there have been conflicting judgments about whether past consideration is good consideration.

Illustration: 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. This deemed sufficient consideration for C's promise.

Illustration: A sells and delivers goods to B. C afterwards requests A to forbear to sue B for the debt for a year, and promises that, if he does so, C will pay for them in default of payment by B. A agrees to forbear as requested. This is a sufficient consideration for C's promise.

Illustration: A sells and delivers goods to B. C afterwards, without consideration, agrees to pay for them in default of B. The agreement is void. The most basic function of a contract of guarantee is to enable a person to get a job, a loan, or some goods as the case may be. In case, a person is desirous of buying a car on a hire- purchase agreement by making monthly payments over a period of time but the car dealer asks for guarantee. Then someone would have to assure him that he will make the monthly payments in case of default by the person who is buying the care. Such an undertaking results in a contract of surety ship or guarantee. Guarantee is security in form of a right of action against a third party called the surety or the guarantor.

9.10 ESSENTIALS OF CONTRACT OF GUARANTEE

9.10.1 Essentials of a valid contract: Since Contract of Guarantee if a species of a contract, the general principles governing contracts are applicable here. There must be free consent, a legal objective to the contract, etc. Though all the parties must be capable of entering into a contract, the principal debtor may be a party incompetent to contract, ie., a minor. This scenario is discussed later in this chapter.

9.10.2 A principal debt must pre-exist: A contact of guarantee seeks to secure payment of a debt; thus, it is necessary there is a recoverable debt. There cannot be a contract to guarantee a time barred debt.

9.10.3 Consideration received by the principal debtor is sufficient for the surety. Anything done, or any promise made for the benefit of the principal debtor can be taken as sufficient consideration to the surety for giving guarantee.

9.11 NATURE OF CONTRACT OF GUARANTEE

9.11.1 ***The contract of guarantee must be clear.*** A letter clearly stating the intention to guarantee a transaction will go on smoothly or one will behave appropriately conduct himself at work place will suffice. But a promise to pay extra attention or to take care of it does not constitute a guarantee.

9.11.2 ***In India, a contract of guarantee may be oral or written***. It may even be inferred from the course of conduct of the parties concerned. Under English Law, a guarantee is defined as a promise made by one person to another to be collaterally answerable for the debt, default, or miscarriage of the third persons and must be in writing.

9.11.3 ***There are three parties in a contract of guarantee;*** the creditor, the principal debtor, and the surety. In a contract of guarantee, there are two contracts; the Principal Contract between the principal debtor and the creditor as well as the Secondary Contract between the creditor and the surety. The contract of the surety is not contracting collateral to the contract of the principal debtor but is an independent contract. Liability of surety is secondary and arises when principal debtor fails to fulfil his commitments. Even an acknowledgement of debt by the principal debtor will bind the surety.

9.11.4 ***It is not essential that the Principal Contract must be in place/existence at the time of the Contract of Guarantee being made***. The original contract between the debtor and the creditor may be about to come into existence. Similarly, in certain situations, a surety may be called upon to pay though the principal debtor is not liable at all. For example, in cases where the principal debtor is a minor, the surety will be liable though the minor will not be personally liable.

9.11.5 ***A contract of guarantee is to be enforced according to the terms of the contract.*** A guarantee is a contract of *strictissima juris* that means 'liability of surety is limited by law'; a surety is offered protection by law and is treated as a favored debtor in the eyes of the law. A contract of guarantee is not a contract *uberrimae fidei* (requiring of utmost good faith). Still the suretyship relationship is one of trust and confidence and the validity of the contract depends upon the good faith of the creditor. However, it is not a part of the creditor's duty to inform the surety about all his previous dealings with the principal debtor. In **wythes vs labon chare 1858**, Lord Chelmsford held that the creditor is not bound to inform the matters affecting the credit of the debtor or any circumstances unconnected with the transaction in which he is about to engage which will render his position more hazardous. Since it is based on good faith, a contract of guarantee becomes invalid if the guarantee is obtained from the surety by misrepresentation or concealment as given in Sections 142 and 143 of the ICA, 1872.

Illustration: If a clerk in an office occasionally fails to account for some of the receipts for money collected, he may be asked for surety. In case the person who steps up to be a surety for the clerk in the office is not informed of the occasional lapses on part of the clerk which led to the requirement of a surety, any guarantee given by him is invalid as something of importance and directly affecting his decision to act as a surety was concealed from him.

Illustration: 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 ` 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.

9.11.6 But where the surety ship is about an advance to be made by a bank, the bank need not disclose past indebtedness to the surety unless it relates to the particular transaction.

Under **Section 126**, Indian Contract Act 1872, "A contract of guarantee is a contract to perform the promise, or to discharge the liabilities of a third person in case of his default. The person who gives the guarantee is called Surety, the person in respect of whose default the guarantee is given is called Principal Debtor, and the person to whom the guarantee is given is called Creditor. A Guarantee may be either oral or written."

Illustration: When A promises to a shopkeeper C that A will pay for the items being bought by B if B does not pay, this is a contract of guarantee. In this case, if B fails to pay, C can sue A to recover the balance.

In the case of **Birkmyr vs Darnell 1704**, where the court held that when two persons come to a shop, one person buys, and to give him credit, the other person promises, **"If he does not pay, I will"**, this type of a collateral undertaking to be liable for the default of another is called a contract of guarantee.
In the case of **Swan vs Bank of Scotland 1836**, it was held that a contract of guarantee is a tripartite agreement between the creditor, the principal debtor, and the surety:

9.11.7 Distinct promise of surety: There must be a distinct promise by the surety to be answerable for the liability of the Principal Debtor.

9.11.8 Liability must be legally enforceable: Only if the liability of the principal debtor is legally enforceable, the surety can be made liable. For example, a surety cannot be made liable for a debt barred by statute of limitation.

9.11.9 Consideration: As with any valid contract, the contract of guarantee also must have a consideration. The consideration in such contract is nothing but anything done or the promise to do something for the benefit of the principal debtor.

Section 127 clarifies this as follows: Consideration "Anything done or any promise made for the benefit of the principal debtor may be sufficient to Illustrations: the surety for giving the guarantee.".

Illustrations:

1. A agrees to sell to B certain goods if C guarantees the payment of the price of the goods. C promises to guarantee the payment in consideration of A's promise to deliver goods to B. This is a sufficient consideration for C's promise.
2. A sells and delivers goods to B. C, afterwards, requests A to forbear to sue B for a year and promises that if A does so, he will guarantee the payment if B does not pay. A forbears to sue B for one year. This is sufficient consideration for C's guarantee.
3. A sells and delivers goods to B. Later, C, without any consideration, promises to pay A if B fails to pay. The agreement is void for lack of consideration.

It is pertinent to note that there is no uniformity on the issue of past consideration. In the case of **Allahabad Bank vs S M Engineering Industries 1992**, Calcutta HC, the bank was not allowed to sue the surety in absence of any advance payment made after the date of guarantee. But in the case of **Union Bank of India vs A P Bhonsle 1991,** Maharashtra HC, past debts were also held to be recoverable under the wide language of this section. In general, if the principal debtor is benefitted because of the guarantee, it is sufficient consideration for the sustenance of the guarantee.

9.11.10 It should be without misrepresentation or concealment:
Section 142 specifies that a guarantee obtained by misrepresenting facts that are material to the agreement is invalid, and **section 143** specifies that a guarantee obtained by concealing a material fact is invalid as well.

Illustrations:

1. A appoints B for collecting bills. B fails to account for some of the bills. A asks B to get a guarantor for further employment. C guarantees B's conduct but C is not made aware of B previous mis-accounting by A. B, afterwards, defaults. C cannot be held liable.
2. A promises to sell Iron to B if C guarantees payment. C guarantees payment however; C is not made aware of the fact that A and B had contracted that B will pay 5 Rs higher that the market prices. B defaults. C cannot be held liable.

In the case of **London General Omnibus vs Holloway 1912**, a person was invited to guarantee an employee, who was previously dismissed for dishonesty by the same employer. This fact was not told to the surety. Later, the employee embezzled funds but the surety was not held liable.

9.12 CONTINUING GUARANTEE

As per **section 129**, a guarantee which extends to a series of transactions is called a continuing guarantee.

Illustrations

1. A, in consideration that B will employ C for the collection of rents of B's zamindari, promises B to be responsible to the amount of 5000/- for due collection and payment by C of those rents. This is a continuing guarantee.
2. A guarantees payment to B, a tea-dealer, for any tea that C may buy from him from time to time to the amount of Rs 100. Afterwards, B supplies C tea for Rs. 200/- and C fails to pay. A's guarantee is a continuing guarantee and so A is liable for Rs. 100/-.
3. A guarantees payment to B for 5 sacks of rice to be delivered by B to C over the period of one month. B delivers 5 sacks to C and C pays for it. Later, B delivers 4 more sacks but C fails to pay. A's guarantee is not a continuing guarantee and so he is not liable to pay for the 4 sacks.

Thus, a continuing guarantee is given to allow multiple transactions without having to create a new guarantee for each transaction.
In the case of **Nottingham Hide Co vs Bottrill 1873**, it was held that the facts, circumstances, and intention of each case must be investigated for determining if it is a case of continuing guarantee or not.

9.12.1. Revocation of Continuing Guarantee:

As per **section 130**, a continuing guarantee can be revoked at any time by the surety by notice to the creditor. 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.

Illustrations:

1. A promises to pay B for all groceries bought by C for a period of 12 months if C fails to pay. In the next three months, C buys 2000/- worth of groceries. After 3 months, A revokes the guarantee by giving a notice to B. C further purchases 1000 Rs of groceries. C fails to pay. A is not liable for 1000/- rs of purchase that was made after the notice but he is liable for 2000/- of purchase made before the notice.

This illustration is based on the old English case of **Oxford vs Davies**.
In the case of **Lloyd's vs Harper 1880**, it was held that employment of a servant is one transaction. The guarantee for a servant is thus not a continuing guarantee and cannot be revoked as long as the servant is in the same employment. However, in the case of **Wingfield vs De St Cron 1919**, it was held that a person who guaranteed the rent payment for his servant but revoked it after the servant left his employment was not liable for the rents after revocation.

2. A guarantees to B, to the amount of 10000 Rs, that C shall pay for the bills that B may draw upon him. B draws upon C and C accepts the bill. Now, A revokes the guarantee. C fails to pay the bill upon its maturity. A is liable for the amount up to 10000Rs.

As per **section 131**, the death of the surety acts as a revocation of a continuing guarantee with regards to future transactions, if there is no contract to the contrary.

It is important to note that there must not be any contract that keeps the guarantee alive even after the death. In the case of **Durga Priya vs Durga Pada AIR 1928**, Cal HC held that in each case the contract of guarantee between the parties must be investigated to determine whether the contract has been revoked due to the death of the surety or not. If there is a provision that says death does not cause the revocation then the contract of guarantee must be held to continue even after the death of the surety.

9.13 RIGHTS OF THE SURETY

A contract of guarantee being a contract, all rights that are available to the parties of a contract are available to a surety as well. The following are the rights specific to a contract of guarantee that are available to the surety.

9.13.1 Rights against principal debtor

9.13.1.1 Right of Subrogation: As per **section 140**, where a guaranteed debt has become due or default of the principal debtor to perform a 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 means that the surety steps into the shoes of the creditor. Whatever rights the creditor had, are now available to the surety after paying the debt.
In the case of **Lampleigh Iron Ore Co Ltd, Re 1927**, the court has laid down that the surety will be entitled, to every remedy which the creditor has against the principal debtor; to enforce every security and all means of payment; to stand in place of the creditor to have the securities transferred in his name, though there was no stipulation for that; and to avail himself of all those securities against the debtor. This right of surety stands not merely upon contract but also upon natural justice.

In the case of **Kadamba Sugar Industries Pvt Ltd vs Devru Ganapathi AIR 1993**, Kar HC held that surety is entitled to the benefits of the securities even if he is not aware of their existence.
In the case of Mamata Ghose vs United Industrial Bank AIR 1987, Cal HC held that under the right of subrogation, the surety may get certain rights even before payment. In this case, the principal debtor was disposing off his personal properties one after another lest the surety, after paying the debt, seize them. The surety sought for temporary injunction, which was granted.

9.13.1.2 Right to Indemnity: As per **section 145**, in every contract of guarantee there is an implied promise by the principal debtor to indemnify the surety; and the surety is entitled to recover from the the principal debtor whatever sum he has rightfully paid under the guarantee but no sums which he has paid wrong fully.

Illustrations:

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.

A guarantees to C, to the extent of 2000 Rs, payment of rice to be supplied by C to B. C supplies rice to a less amount than 2000/- but obtains from A, a payment of 2000/- for the rice. A cannot recover from B more than the price of the rice actually supplied. This right enables the surety to recover from the principal debtor any amount that he has paid rightfully. The concept of rightfully is illustrated in the case of **Chekkara Ponnamma vs A S Thammayya AIR 1983**. In this case, the principal debtor died after hire-purchasing four motor vehicles. The surety was sued and he paid over. The surety then sued the legal representatives of the principal debtor. The court required the surety to show how much amount was realized by selling the vehicles, which he could not show. Thus, it was held that the payment made by the surety was not proper.

9.13.2 Rights against creditor:

9.13.2.1 Right to securities: As per **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 about 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.

Illustrations:

C advances to B, his tenant, 2000/- on the guarantee of A. C also has a further security for 2000/- by a mortgage of B's furniture. C cancels the mortgage. B becomes insolvent and C sues A on his guarantee. A is discharged of his liability to the amount of the value of the furniture.

C, a creditor, whose advance to B is secured by a decree, also receives a guarantee from A. C afterwards takes B's goods in execution under the decree and then without the knowledge of A, withdraws the execution. A is discharged.

A as surety for B makes a bond jointly with B to C to secure a loan from C to B. Afterwards, C obtains from B a further security for the same debt. Subsequently, C gives up the further security. A is not discharged.

This section recognizes and incorporates the general rule of equity as expounded in the case of **Craythorne vs Swinburne 1807** that the surety is entitled to every remedy which the creditor has against the principal debtor including enforcement of every security. The expression "security" in section 141 means all rights which the creditor had against property at the date of the contract. This was held by the SC in the case of **State of MP vs Kaluram AIR 1967.** In this case, the state had sold a lot of felled trees for a fixed price in four equal instalments, the payment of which was guaranteed by the defendant. The contract further provided that if a default was made in the payment of an instalment, the State would get the right to prevent further removal of timber and the sell the timber for the realization of the price. The buyer defaulted but the State still did not stop him from removing further timber. The surety was then sued for the loss but he was not held liable. It is important to note that the right to securities arises only after the creditor is paid in full. If the surety has guaranteed only part of the debt, he cannot claim a proportional part of the securities after paying part of the debt. This was held in the case of **Goverdhan Das vs Bank of Bengal 1891**.

9.13.2.2 Right of set off: If the creditor sues the surety, the surety may have the benefit of the set off, if any, that the principal debtor had against the creditor. He is entitled to use the defences that the principal debtor has against the creditor. For example, if the creditor owes the principal debtor something, for which the principal debtor could have counter claimed, then the surety can also put up that counter claim.

9.13.3 Rights against co-sureties:

9.13.3.1 Effect of releasing a surety: As per **section 138**, Where there are co-sureties, a release by the creditor of one of them does not discharge the others; neither does it free the surety so released from his responsibility to the other sureties.

A creditor can release a co-surety at his will. However, as held in the case of **Sri Chand vs Jagdish Prashad 1966**, the released co-surety is still liable to the others for contribution upon default.

9.13.3.2 Right to contribution: As per **section 146**, where two or more persons are co-sureties for the same debt jointly or severally, with or without the knowledge of each other, under same or different contracts, in the absence of any contract to the contrary, they are liable to pay an equal share of the debt or any part of it that is unpaid by the principal debtor.

Illustrations:

a. A, B, and C are sureties to D for a sum of 3000Rs lent to E. E fails to pay. A, B, and C are liable to pay 1000Rs each.

b. A, B, and C are sureties to D for a sum of 1000Rs lent to E and there is a contract among A B and C that A and B will be liable for a quarter and C will be liable for half the amount upon E's default. E fails to pay. A and B are liable for 250Rs each and C is liable for 500Rs.

9.13.3.3 As per **section 147**, co-sureties who are bound in different sums are liable to pay equally as far as the limits of their respective obligations permit.

Illustrations:

1. A, B and C as sureties to D, enter into three several bonds, each in different penalty, namely A for 10000Rs, B for 20000 Rs, and C for 30000Rs with E. D makes a default on 30000Rs. All of them are liable for 10000Rs each.
2. A, B and C as sureties to D, enter into three several bonds, each in different penalty, namely A for 10000Rs, B for 20000 Rs, and C for 40000Rs with E. D makes a default on 40000Rs. A is liable for 10000Rs while B and C are liable for 15000Rs each.
3. A, B and C as sureties to D, enter into three several bonds, each in different penalty, namely A for 10000Rs, B for 20000 Rs, and C for 40000Rs with E. D makes a default on 70000Rs. A, B and C are liable for the full amount of their bonds.

9.14 DISCHARGE OF SURETY FROM LIABILITY

A surety is said to be discharged from liability when his liability comes to an end. Indian Contract Act 1872 specifies the following conditions in which a surety is discharged of his liability

9.14.1 Section 130: By a notice of revocation - discussed above.
9.14.2 Section 131: By death of surety - discussed above.
9.14.3 Section 133: By variance in terms of contract - A variance made without the consent of the surety in terms of the contract between the principal debtor and the creditor, discharges the surety as to the transactions after the variance.

Illustrations:

a) A becomes a surety to C for B's conduct as manager in C's bank. Afterwards, B and C contract without A's consent that B's salary shall be raised and that B shall be liable for 1/4th of the losses on overdrafts. B allows a customer to overdraft and the bank loses money. A is not liable for the loss.
b) A guarantees C against the misconduct of B in an office to which B is appointed by C. The conditions of employment are defined in an act of legislature. In a subsequent act, the nature of the office is materially altered. B misconducts. A discharged by the change from the future liability of his guarantee even though B's misconduct is on duty that is not affected by the act.
c) B appoints C as a salesperson on a fixed yearly salary upon A's guarantee on due account of sales by C. Later on, without A's consent, B and C contract that C will be paid on commission basis. A is not liable for C's misconduct after the change.
d) C promises to lends 5000Rs to B on 1st March. A guarantee the repayment. C gives the money to B on 1st January. A is discharged of his liability because of the variance in as much as C may decide to sue B before 1st march.

9.14.4 Section 134: By discharge of principal debtor - The surety is discharged by any contract between the creditor and the principal debtor by which the principal debtor is discharged; or by any action of the creditor the legal consequence of which is the discharge of the principal debtor.

Illustrations:

a) A gives a guarantee to C for goods to be delivered to B. Later, 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.
b) A contracts with B to grow indigo on A's land and deliver it to B at a fixed price. C guarantees A's performance. B diverts a stream of water that is necessary for A to grow indigo. This action of B causes A to be discharged of the liability. Consequently, C is discharged of his suretyship as well.
c) A contracts with B to build a house for B. B is to supply timber. C guarantees A's performance. B fails to supply timber. C is discharged of his liability.

If the principal debtor is released by a compromise with the creditor, the surety is discharged but if the principal debtor is discharged by the operation of insolvency laws, the surety is not discharged. This was held in the case of **Maharashtra SEB vs Official Liquidator 1982**.

9.14.5 Section 135: By composition, extension of time, or promise not to sue - A contract between the principal debtor and the creditor by which the creditor makes a composition with, or promises to give time to, or promises to not sue the principal debtor, discharges the surety unless the surety assents to such a contract.
9.14.6 It should be noted that as per **section 136**, if a contract is made by the creditor with a third person to give more time to the principal debtor, the surety is not discharged. However, in the case of **Wandoor Jupitor Chits vs K P Mathew AIR 1980**, it was held that the surety was not discharged when the period of limitation got extended due to acknowledgement of debt by the principal debtor.
9.14.7 Further, as per **section 137**, mere forbearance to sue or to not make use of any remedy that is available to the creditor against the principal debtor, does not automatically discharge the surety.

Illustration: B owes C a debt guaranteed by A. The debt becomes payable. However, C does not sue B for a year. This does not discharge A from his suretyship. It must be noted that forbearing to sue until the expiry of the period of limitation has the legal consequence of discharge of the principal debtor and thus as per section 134, will cause the surety to be discharged as well. If section 134 stood alone, this inference was correct. However, section 137 explicitly says that mere forbearance to sue does not discharge the surety. This contradiction was removed in the case of **Mahanth Singh vs U B Yi** by Privy Council. It held that failure to sue the principal debtor until recovery is banned by period of limitation does not discharge the surety.

9.14.8 Section **139**: By impairing surety's remedy - If the creditor does any act that is inconsistent with the rights of the surety or omits to do an act which his duty to surety requires him to do, and the eventual remedy of the surety himself against the principal debtor is thereby impaired, the surety is discharged.

Illustrations:

a) C contracts with B to build a ship the payment of which is to be made in instalments at various stages of completion. A guarantee's C's performance. B prepays last two instalments. A is discharged of his liability.
b) A appoints M as an apprentice upon getting a guarantee of M's fidelity by B. A also promises that he will at least once a month see M make up the cash. A fails to do this. M embezzles. B is discharged of his suretyship.
c) A lends money to B with C as surety. A also gets as a security the mortgage to B's furniture. B defaults and A sell his furniture. However, due to A's carelessness very small amount is received by sale of the furniture. C is discharged of the liability. **State of MP vs Kaluram** - Discussed above.

In the case of **State Bank of Saurashtra vs Chitranjan Ranganath Raja 1980**, the bank failed to properly take care of the contents of a go-down pledged to it against a loan and the contents were lost. The court held that the surety was not liable for the amount of the goods lost.

Creditor's duty is not only to take care of the security well but also to realize it proper value. Also, before disposing of the security, the surety must be informed on the account of natural justice so that he can have the option to take over the security by paying off the debt. In the case of **Hiranyaprava vs Orissa State Financial Corp AIR 1995**, it was held that if such a

notice of disposing off of the security is not given, the surety cannot be held liable for the shortfall.
However, when the goods are merely hypothecated and are in the custody of the debtor, and if their loss is not because of the creditor, the surety is not discharged of his liability.

9.15 EXTENT OF SURETY'S LIABILITY

As per **section 128**, the liability of a surety is co-extensive with that of the principal debtor, unless it is otherwise provided in the contract.

Illustration:
A guarantees the payment of a bill by B to C. The bill becomes due and B fails to pay. A is liable to C not only for the amount of the bill but also for the interest. This basically means that although the liability of the surety is co-extensive with that of the principal debtor, he may place a limit on it in the contract. Co-extensive implies the maximum extent possible. He is liable for the whole of the amount of the debt or the promises. However, when part of a debt was recovered by disposing off certain goods, the liability of the surety is also reduced by the same amount. This was held in the case of **Harigopal Agarwal vs State Bank of India AIR 1956.**

The surety can also place conditions on his guarantee. Section 144 says that where a person gives guarantee upon a contract that the creditor shall not act upon it until another person has joined it as co-surety, the guarantee is not valid if the co-surety does not join. In the case of **National Provincial Bank of England vs Brakenbury 1906**, the defendant signed a guarantee which was supposed to be signed by three other co-sureties. One of them did not sign and so the defendant was not held liable. Similarly, a surety may specify in the contract that his liability cannot exceed a certain amount.

However, where the liability is unconditional, the court cannot introduce any conditions. Thus, in the case of **Bank of Bihar Ltd. vs Damodar Prasad AIR 1969**, SC overruled trial court's and high court's order that the creditor must first exhaust all remedies against the principal debtor before suing the surety.

9.16 SUMMARY

Thus, in nutshell we have understood **Contract of Indemnity** as:

- “A Contract whereby 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 contract of indemnity.”
- The term is often used in business contracts and in insurance.
- Indemnity, in simple words, is protection against future loss.
- The term ‘Indemnity Agreement’ is often used in the US.
- Contract of Indemnities should all satisfy the conditions of a valid contract.
- All Contracts of Insurance are Contracts of Indemnity except life insurance.
- The indemnity holder can call upon the indemnifier to save him from loss even before the actual loss is incurred.

Thus, in nutshell we have understood **Contract of Guarantee** as:

- There are three parties in every Contract of Guarantee
- The liability arises right from the beginning. The surety becomes liable when the principle debtor commits default in meeting the liability.
- Surety has the right to sue the third party (Principle Debtor) directly. The Law puts him in the position of Creditor. Where as in Contracts of Indemnity, the Indemnifier cannot sue the third party in his name. He has to sue in the name of the Indemnity-holder or after obtaining the rights from him.

9.17 SUGGESTED READINGS

- Contracts-II including Sale of Goods, Partnership, Negotiable Instruments by Dr. S.K. Kapoor (Central Law Publications)
- Law of Contract and Specific Relief by Avtar Singh
- Suggested Readings:

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LESSON-10

CONTRACT OF BAILMENT AND PLEDGE

OBJECTIVE OF THE LESSON

- Meaning and definition.
- Essential ingredients of contract of bailment.
- Kind of Bailment.
- Rights of bailor and bailee
- Meaning and definition.
- Essential ingredients of contract of pledge.
- Rights and duties of the Pawnor and the Pawnee.
- Validity of the pledge made by a non-owner.

STRUCTURE OF THE LESSON

10.1 INTRODUCTION AND DEFINITION

10.2 NATURE AND SCOPE OF CONTRACT OF BAILMENT

10.3 ESSENTIAL CHARACTERISTICS OF BAILMENT

10.4 FINDER OF LOST GOODS

10.5 RIGHTS OF BAILOR

10.6 RIGHTS OF BAILEE

10.7 DUTIES AND LIABILITIES OF BAILOR

10.8 DUTIES AND RESPONSIBILITIES OF BAILEE

10.1 INTRODUCTION AND DEFINITION

Definition: In Contract, a **bailment** is the delivery of goods from 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 person delivering the goods is called the **Bailor**, and the person to whom the goods are delivered is the **Bailee**.

Principle: It is to be noted that if a person is already in possession of goods of other contracts to hold them as bailee, he thereby becomes the bailee and the owner of the goods as bailor, though the goods are not delivered by way of bailment.

There are many instances of bailment in our daily lives – when we give our clothes for laundry, when we use valet parking for our cars. We deliver our goods to another person or leave them in the power of another person for a purpose and expect to receive our goods back when the purpose has been achieved.

For example, a man visits a repair shop for getting his television set fixed. The television set is left at the shop where the repair man examines it and fixes the problem. Once fixed, the television set must be returned to its owner. There is a contract of bailment between the man and the repair-man.

Bailment is thus a process where the owner of certain goods places them in the temporary possession of another person. In its simple terms, bailment means that a person delivers his goods to another person or put them in another's possession for a specific purpose and there is an express or implied understanding between the two people that once the purpose has been achieved, the goods will be returned to the owner – the person who bailed them. Chapter IX (Section 148 – 181) of the Indian Contract Act, 1872 deals with the general rules relating to bailment. The Chapter is not exhaustive on the topic of bailment – there are various other Acts which deal with other types of bailments like the Carriers Act, 1865, the Railways Act, 1890, the Carriage of Goods by Sea Act, 1925.

10.2 NATURE AND SCOPE OF CONTRACT OF BAILMENT

10.2.1 The word 'bailment' is derived from the French word 'bailer' which means 'to deliver'. Etymologically, it means any kind of 'handing over'. In legal sense, it involves change of possession of goods from one person to another for some specific purpose.

10.2.2 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.

The person who owns and delivers the goods is called the '**bailor**'. The person to whom the goods are delivered is called the '**bailee**'.

Example: A man drops off his clothes for dry cleaning. He is the bailor and the purpose of bailment is to have the particular set of clothes cleaned. The dry cleaner is the bailee – he is the temporary custodian of the clothes and is responsible for keeping them safe and to return them to the bailor once they have been cleaned.

Explanation to Section 148 states that if a person already in possession of the goods of another person contracts to holds the goods as a bailee, he becomes the bailee even though the goods may not have been delivered to him by way of bailment in the first place.

For example, a seller of goods becomes a bailee if the goods continue to be in his possession after sale is complete. Here the original possession of goods was with the seller as the owner of the said goods and after the sale, his possession is converted into a contract of bailment.

Example: A has a motorcycle that he sells to B who leaves the motorcycle in the possession of A while he is out of town. Here, A becomes the bailee even though he was the owner originally.

10.2.3 Halsbury defines Bailment as 'delivery of personal chattels in trust on a contract, express or implied, that the trust shall be duly executed and chattels redelivered in either their original or altered form, as soon as the time of use, or condition on which they had been bailed has elapsed or been performed respectively'.

10.2.4 Justice Blackstone defines Bailment as ‘a delivery of goods in trust, upon contract, either expressed or implied, that the trust shall be faithfully executed on the part of the bailee’. Bailment can also be described as ‘the delivery of goods to another person for a particular use’.

10.2.5 Nature of Bailment

Bailment is a type of special contract and thus, all basic requirements of contract like consent of parties, competency, etc are applicable to any contract of Bailment. A bailment is usually created by an agreement between the bailor and bailee.

Section 148 specifically talks of bailment via a contract. But a valid bailment can also arise in absence of express contracts or from invalid or voidable contracts.
In bailment, neither the property nor the ownership of the goods involved is transferred at any point. Only the temporary possession of the bailed goods is transferred and the ownership of such goods remains with the bailor. The bailor can demand to have the property returned to him at any time.

10.2.6 What may be bailed

Only ‘goods’ can be bailed and thus, only movable goods can be the subject matter of bailment. Current money or legal tender cannot be bailed. Deposition of money in a bank is not bailment as money is not goods and the same money is not returned to the client. But the coins and notes that are no longer legal tender and are more or less just objects of curiosity, then they can be bailed.

10.3 ESSENTIAL CHARACTERISTICS OF BAILMENT

Section 148 of the Indian Contract Act, 1872 makes it very clear that there are three essential features of Bailment, namely:

1) Delivery of Possession
2) Delivery upon Contract
3) Delivery for a purpose and Return of Goods

10.3.1 Delivery of Possession: The delivery of possession of goods is essential for bailment. There must be transfer of possession of the bailed goods from bailor to bailee and the goods must be handed over to the bailee for whatever is the purpose of bailment. Here, possession means control over goods and an intention to exclude others from exercising similar control over the same goods. Thus, the bailee must have actual physical control of the property with the intent to possess it for a valid bailment.

As per **Section 149**, the delivery can also be made to the bailee by doing anything which has the effect of putting the bailed goods in the possession of the intended bailee or any person authorized by him for this purpose.

Thus, the delivery of possession can be actual or constructive. The delivery may either put the bailee in the actual physical possession of the goods or put the bailee in a position of power over such goods that may be possessed later. The essential of a bailment is the delivery of goods for a temporary purpose.

Mere custody of goods is not the same as delivery of possession. A guest who uses the goods of the host during a party is not a bailee. Similarly, it was held in **Reaves vs. Capper (1838)** that a servant in custody of certain goods by the nature of his job is not a bailee. Similarly, a servant holding his master's umbrella is not a bailee but is a custodian.

Similarly, hiring and storing goods in a bank locker by itself is not bailment thought there is delivery of goods to the bank premises. The goods are in no way entrusted to the bank. A bank cannot be presumed to know what goods are stored in any given locker at all the times. If a bank is given actual and exclusive possession of the property inside a locker by the person who hired the locker, only then can bailment under Section 148 can be presumed.

In **Atul Mehra vs. Bank of Maharashtra (2003),** it was held that mere hiring of a bank's locker and storing things in it would not constitute a bailment. But the position changes completely if the locker in the safe deposit vault of the bank can be operated even without the key of the customer.

Example: A hired a locker in a bank and kept some of his valuables in it. He was given one key to open the locker. But the bank manager of the particular branch had fraudulently filed the levers of the locks of the lockers. Thus, the lockers could be opened even without the key of the customers. A's valuables went missing. A's control over the valuables in that locker had gone because the locker could be operated even without A's key. The bank was liable for the loss of A's belongings from the locker as it became a bailee. This example is similar to the case of **National Bank of Lahore vs. Sohan Lal (1962)**

Thus, it is clear that the nature of possession is very important to determine whether a delivery is for bailment or not. If the owner continues to have control over the goods, there can be no bailment.

To create a bailment, the bailee must intend to possess and in some way physically possess or control the bailed goods or property. In a situation where a person keeps the goods in possession of another person but in fact, continues to have control over such goods, there is no delivery for the purpose of bailment.

The delivery of possession does not mean that the bailee now represents the bailor with respected to the bailed goods. The bailee only has certain power over the property of the bailor with his permission. The bailee has no power to make contracts on behalf of the bailor or make the bailor liable for his own acts with the goods bailed.

Example: If a person delivers his damaged car to a garage for repair under his insurance policy, the insurance company becomes a bailee and the garage a sub-bailee. If the car is stolen from the garage or destroyed by fire in the garage, both – the insurance company and the garage will be liable to the owner of the car, the bailor.

10.3.2 Delivery of possession, as required for bailment, can be made in two ways – Actual or Constructive.

a) **Actual Delivery:** Here, the bailor hands over the physical possession of the goods to the bailee.
b) Example: A's watch is broken. When he leaves his watch at the showroom for repair, he has given actual delivery of possession of goods to the showroom.

c) **Constructive Delivery:** Constructive delivery is an action that the law treats as the equivalent of actual delivery. It can be difficult to deliver intangible.

In constructive delivery, the physical possession of the goods may not be handed over. The possession of the goods may remain with the bailor with the consent or authorization of the bailee. In constructive delivery, an action on part of the bailor merely puts the bailee in position of power with respect to the bailed goods. The bailor gives the bailee the means of access to taking custody of it, without its actual delivery.
Example: A has rare coins in a locked safe-deposit box. Delivery of a safe deposit box is not possible. When he hands over the keys to the box to B, it is taken as constructive delivery for purpose of bailment.

Section 149 specifically deals with constructive delivery of goods. It states that anything done which has the effect of putting the goods in the possession of the intended bailee or any other person authorized to hold them on his behalf is to be treated as constructive delivery of the goods.
Constructive delivery is legal fiction – thus, a legal delivery is presumed even where the delivery of the actual goods has not taken place. Even the delivery of a railway receipt is taken as the equivalent of delivery of the goods.

In **Bank of Chittor vs. Narsimbulu (1966),** a person pledged cinema projector with the bank but the bank allowed him to keep the projector so as to keep the cinema hall functional. It was held that there was constructive delivery because action on part of the bailor had changed the legal character of the possession of the projector. Even though the actual and physical possession was with the person, the legal possession was with the bank, the bailee.

10.3.3 Delivery upon Contract: It is necessary that the goods are delivered to the bailee and returned to the bailor when the purpose is accomplished upon a contract. This means there should a contract between the two parties for such transaction of delivery and subsequent return. If there is no contract, there is no bailment. The contract giving rise to bailment can be express or implied.

Property deposited in a court under orders is not property delivered under a contract. Such delivery or transfer does not constitute bailment.

10.3.4 Exception to the delivery upon contract: A finder of goods is treated as a bailee even if there is no contract of Bailment or delivery of goods under a contract. A finder of the goods is a person who finds the goods belonging to some other person and keeps them under his protection till the actual owner of the goods is found. An involuntary contract of bailment arises and the finder automatically becomes bailee even in absence of bailment by the bailor – the owner of the lost goods. Since the person is in the position of the bailee, he has all the rights and duties of a bailee.

10.3.5 Under English Law, there can be bailment without a contract. If a person deposits or delivers the goods under stressful circumstance like fire flood, riots or if the person who is depositing the goods is incapable of appreciating the value of the action, it is still regarded as bailment despite the absence of a contract. Delivery of goods to another under a mistake of identity of the person is also treated as bailment without a contract as long as the bailor took reasonable care to ascertain the identity.

Present Position in India: The Law Commission of India in its 13th report suggested that bailment without contract should also be included in the Indian Contract Act, 1872 but no concrete steps have been taken as yet. Presently, the Indian Courts have taken the position that bailment can exist without a contract. In some of these cases, even the government has been held liable as a bailor despite the absence of a contract.
The case of **Lasalgoan Merchants Bank vs. Prabhudas Hathibhai** is one the first where the Courts started imposing the obligations of a bailee even without a contract. In State of Gujarat vs. Memom Mahomed, the Supreme Court of India accepted this view and stated that "…Bailment is dealt with by the Contract Act only in cases where it arises from a contract, but it is not correct to say that there cannot be bailment without an enforceable contract."

10.3.6 Delivery for a purpose and Return of Goods: There has to be a purpose for the bailment of goods and it is mandatory that once such purpose accomplishes, the goods have to be returned to the bailor or be disposed off per his instructions. Bailment cannot arise if the goods are not to be specially accounted for after completion of such task or purpose. This is a feature of bailment that distinguishes it from other relations like agency, etc. The third essential of bailment is twofold:

a) The delivery of goods must be for some specific task or performance. Delivery of goods in bailment is not permanent. There has to be a purpose for the bailment of goods and it is mandatory that once such purpose accomplishes, the goods have to be returned to the bailor or be disposed off per his instructions. A tailor is given a cloth for stitching a shirt, a watch repair shop is given a watch to mend it.
b) That the goods must be returned to the bailor or be taken care of as per the instructions of the bailor. If a person is not bound to return the goods to another, then the relationship between them is not of bailment. If there is an agreement to return the equivalent and not the same goods, it is not bailment. An agent who collects money on behalf of his principal is not a bailee because he is not liable to return the same money and coins.

Example: A tailor who receives a cloth for stitching is the bailee in this case. The tailor is supposed to return the finished garment to the customer, the bailor, once the garment has been stitched.
a) Return of goods in specie is also essential. The same goods that were bailed must be returned to the bailor in the same condition after the accomplishment of purpose as they were handed over to the bailee in the beginning. Any accruals to the goods must also be handed over. If an animal gives birth during the period of bailment, the bailee must return the animal with the offspring at the conclusion of the bailment.
The bailor can give other directions as to the disposal or return of the bailed goods. In case of such agreement or instructions, the bailee must immediately dispose the goods after completion of purpose as per the directions.

If the goods are not returned or dealt as per the directions of the bailor there is no bailment. For example, depositing money into bank by a customer does not give rise to a contract of bailment because the bank is not bound to return the same notes and coins to the customer. This same point was also made in the case of **Ichcha Dhanji vs.Natha (1888)**
In **Secy of State vs. Sheo Singh Rai (1880)**, a man delivered nine government promissory notes to the Treasury Officer at Meerut for cancellation and consolidation into a single note of Rupees 48,000 only. The notes were misappropriated by the servants of the Treasury Officer. The man sued the State to hold it responsible as a bailee. But the action failed as there can be no bailment without delivery of goods and a promise to the return the same. The government

was in no way bound to return the same notes or dispose the surrendered notes in accordance with the instructions of the man.

10.4 FINDER OF LOST GOODS

Finding is not keeping. A finder of lost goods is treated as the bailee of the goods found as such and is charged with the responsibilities of a bailee, besides the responsibility of exercising reasonable efforts in finding the real owner. However, he enjoys certain rights also. His rights are summed up hereunder:

a) Right to retain the goods
b) Right to Sell -the finder may sell it:

i. when the thing is in danger of perishing or of losing the greater part of its value;
ii. when the lawful charges of the finder in respect of the thing found, amount to 2/3rd of its value.

10.5 RIGHTS OF BAILOR

The Rights of Bailor under a contract of bailment are started as follows:

10.5.1 Rights of taking back the goods bailed: The bailor has right to take back the goods bailed as soon as the purpose of bailment is completed. If the bailee defaults in so returning, the bailor has right to receive compensation.

10.5.2 Right in case of unauthorized use of goods: The bailor is entitled to terminate the contract of bailment if the bailee makes the unauthorized use of the goods bailed.

10.5.3 Right to goods bailed before stated period: The bailor may get back his goods before the time stated in the contract of bailment with the consent of the bailee.

10.5.4 Right to Dissolution of contract: The bailor may dissolve the contract if the conditions of bailment are disobeyed by the bailee.

10.5.5 Right to Gratuitous goods: The bailor has right it terminate the contract of gratuitous bailment at any time even before the specified time, subject to the limitation that where such a termination of bailment causes loss in excess of benefit, the bailor must compensate the bailee.

10.5.6 Right in share of Profit: The bailor has share in the increase or profit gained from the goods bailed if there is provision in the contract.

10.6 RIGHTS OF BAILEE

10.6.1 Right to recover damages: A bailee has right to recover damages from the bailor if he suffers any loss due to defects of the goods bailed.

10.6.2 Right to receive compensation: A bailee is entitled to receive compensation from the bailor for any loss resulting from the defect in the bailor's title.

10.6.3 Right of Legal Action: A bailee may take necessary legal action against the person who wrongfully deprives him of the use of goods bailed or does them any injury (Sect. 180)

10.6.4 Right to recover Bailment Expenses: Bailee is entitled to be reimbursed for all legitimate expenses incurred for any purpose of bailment.

10.6.5 Right of Lien: Where the bailee has rendered any service for the purpose of bailment, he has right to retain such goods bailed until he receives due remuneration for his services in absence of contract to the contrary. (Sect. 170)

10.6.6 Right of Indemnity: The bailee has right to receive the amount of indemnity from bailor for any loss which he 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. (Sect. 164)

10.7 DUTIES AND LIABILITIES OF BAILOR

10.7.1 To disclose Facts: The important duty of the bailor is to disclose the faults in the goods bailed in so for as they are known to him; and if he fails to do that, he will be liable to pay such damages to the bailee as may have resulted directly from the faults. (Sect. 150)
Illustration: X hires a carriage of Y. The carriage is unsafe, though Y is not aware of it, and X is injured. Y is responsible to X for the injury.
10.7.2 Payment of Extraordinary Expenses: Section 158 provides that all the necessary expenses incurred by the bailee in connection with the bailment, must be paid by the bailor.
10.7.3 To Indemnity Bailee: The bailor is bound to pay the bailee for any loss which the bailee may sustain by reason that the bailor was not entitled to make the bailment. (Sect. 164)
10.7.4 Warning to the Bailee: When the things are in danger i.e. explosive goods, the bailor must give extraordinary warning to the bailee.

10.8 DUTIES AND RESPONSIBILITIES OF BAILEE

10.8.1 To take care of goods bailed: The bailee is bound to take as much care of the goods entrusted to him as a man of ordinary prudence. (Sect. 151)
10.8.2 To avoid the inconsistent act: A contract of bailment is voidable at the option of the bailor, if the bailee does any act about the goods bailed, inconsistent with the conditions of the bailment (Sect. 153)
10.8.3 The authorize use of goods: If the bailee makes any unauthorized use of the goods bailed, he is liable to make compensation to the bailor for any damage arising to the goods from or during such use of them. (Sect. 154)
10.8.4 Not to mix bailor's goods: The bailee is bound to keep the goods of the bailor separate from his own where the mixture without the consent of the bailor is inseparable, the bailor is entitled to be compensated by the bailee for the loss of the goods. (Sect. 155, 156, 157)
10.8.5 To return the goods: It is the duty of the bailee to return, or deliver the goods bailed according to the bailor's directions. (Sect. 160)
10.8.6 Responsibility in case of default: If the goods are not returned, delivered, or tendered due to default of the bailee, he is responsible to the bailor for any loss of the goods from that time. (Sect. 161)
10.8.7 To return any profit from the goods: 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. (Sect. 163)
10.8.8 Not to set up adverse title: The bailee has no right to deny the bailor's title or set up against the bailor his own title or the right of a third party.

PLEDGE

STRUCTURE OF THE LESSON

10.9 MEANING AND DEFINITION

"Pledge", "pawnor" and "pawnee" defined [Section 172] as 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".
Pledge is a variety or specie of bailment.

It is bailment of goods as security for payment of debt or performance of a promise. The person who pledges [or bails] is known as pledgor or also as pawnor, the bailee is known as pledgee or also as pawnee. In pledge, there is no change in ownership of the property.
Under exceptional circumstances, the pledgee has a right to sell the property pledged. Section 172 to 182 of the Indian Contract Act, 1872 deal specifically with the bailment of pledge.
Example: A lends money to B against the security of jewellery deposited by B with him i.e. A. This bailment of jewellery is a pledge as security for lending the money. B is a pawnor and A is a pawnee.

10.10 ESSENTIALS 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:

10.10.1 There shall be a bailment for security against payment or performance of the promise,
10.10.2 The subject matter of pledge is goods,
10.10.3 Goods pledged for shall be in existence,
10.10.4 There shall be the delivery of goods from pledger to pledgee.

10.11 PAWNEE'S RIGHTS

Rights of Pawnee can be classified as under the following headings:

10.11.1 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: 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.

10.11.2 Right to retention of subsequent debts [Section 174]: The Pawnee shall not, in the absence of a contract to that effect, retain the goods pledged for any debt or promise other than the debt or promise for which they are pledged; but such contract in the absence of anything to the contrary, shall be presumed regarding subsequent advances made by the Pawnee.

10.11.3 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.

10.11.4 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 may bring a suit against the pawnor upon the debt or promise, and retain the goods pledged as a collateral security; or 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.

10.12 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.

10.13 Rights of Pawnor

As the bailor of goods pawnor has all the rights of the bailor:

10.13.1**Enforcement of Pawnee's duties**

10.13.2 **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.

10.14 DUTIES OF 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. 24 Department of Commerce, Gargi College
d) If loss occurs to the pawnee due to defect in pawnors 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.

10.15 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.

10.15.1Pledge by mercantile agent [Section 178]: Where a mercantile agent is, with the consent of the owner, in possession of goods or the documents of title to goods, any pledge made by him, when acting in the ordinary course of business of a mercantile agent, shall be as valid as if he were expressly authorised by the owner of the goods to make the same; provided that the pawnee acts in good faith and has not at the time of the pledge notice that the Pawnor has no authority to pledge.

10.15.2Pledge 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, 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.

10.15.3 Pledge where pawnor has only a limited interest [Section 179]: Where a person pledges goods in which he has only a limited interest, the pledge is valid to the extent of that interest. 25 Department of Commerce, Gargi College.

10.15.4 Pledge by a co-owner in possession: Where the goods are owned by many persons 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.

10.15.5 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. For example, 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 B, and acted in good faith. This is valid pledge

SUMMARY

Thus, in nutshell we have understood **Contract of Bailment** as:

- Bailment is the delivery of goods from one person to another for a specific purpose, upon a contract that the goods shall be returned or disposed of according to directions once the purpose is accomplished.
- The person delivering the goods is the **Bailor**, and the person to whom the goods are delivered is the **Bailee**.
- Bailment involves a change of possession but not a transfer of ownership. Only movable "goods" can be bailed; current money or legal tender cannot be bailed unless they are specific coins/notes treated as objects of curiosity.
- There must be a transfer of control. This can be **Actual** (physical handover) or **Constructive** (doing something that puts the goods in the bailee's power, e.g., handing over keys). Mere custody (like a servant holding an umbrella) is not bailment.
- Generally, bailment arises from a contract (express or implied). However, exceptions exist, such as a **Finder of Lost Goods**, who is treated as a bailee by law even without a formal contract.
- The goods are delivered for a specific task or time. Once accomplished, the *same* goods (in specie) or their altered form must be returned.
- A person who finds goods belonging to another has the responsibility to take care of them and find the owner. They have the right to retain the goods until compensated and the right to sell them if the goods are perishing or if lawful charges amount to two-thirds of the value.
- **Bailor:** Must disclose known faults in the goods and pay necessary expenses. They have the right to terminate the bailment if the bailee uses the goods unauthorizedly.
- **Bailee:** Must take reasonable care of the goods (as a man of ordinary prudence), keep them separate from their own goods, and return them on time. They have a right of lien (to retain goods) until paid for services rendered
- **Suggested Readings**
- Contracts-II including Sale of Goods, Partnership, Negotiable Instruments by Dr. S.K. Kapoor (Central Law Publications)
- Law of Contract and Specific Relief by Avtar Singh

Summary

Thus, in nutshell we have understood **Contract of Pledge** as:

- "Pledge" is the bailment of goods as security for the payment of a debt or the performance of a promise. It is a specific variety or species of bailment.
- The person who pledges the goods (the bailor) is called the **Pawnor**, and the person to whom the goods are delivered (the bailee) is called the **Pawnee**.
- While possession is transferred to the pawnee, there is no change in the ownership of the property. All essential elements of a valid bailment apply to a pledge.
- The pawnee can retain the goods not only for the debt but also for interest and necessary preservation expenses; If the pawnor defaults, the pawnee may sell the goods after giving reasonable notice to the pawnor. If the sale proceeds are less than the debt, the pawnor is liable for the balance; if more, the surplus must be returned; The pawnee is entitled to receive extraordinary expenses incurred for preserving the goods but cannot retain the goods specifically for these expenses.
- The pawnor has the statutory right to redeem the pledged goods at any time before the actual sale, provided they pay the debt and any expenses arising from the default; The

pawnor has the rights of a bailor, including the enforcement of the pawnee's duties (e.g., duty to take reasonable care of the goods).

- Ordinarily, only the owner can pledge goods, but the law recognizes exceptions to facilitate trade. Valid pledges can be made by non-owners if they act in good faith and are in possession of the goods, such as:
    - Mercantile agents acting in the ordinary course of business.
    - Persons holding goods under a voidable contract that has not yet been rescinded.
    - Co-owners in possession with the consent of other owners.
    - Sellers or buyers left in possession of goods after/before sale.

SUGGESTED READINGS

- Contracts-II including Sale of Goods, Partnership, Negotiable Instruments by Dr. S.K. Kapoor (Central Law Publications)
- Law of Contract and Specific Relief by Avtar Singh

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LESSON-11
LAW OF AGENCY

OBJECTIVES:

After going through this lesson, students will be able to:

- Examine the legal relationship between agent and principal in commercial contracts
- Assess the rights and liabilities of principals, agents, and third parties in cases of breach, fraud, or excess of authority
- Understand actual, apparent, and implied authority, when authority is delegated, and evaluate their implications for third-party rights and liabilities
- Explain various agents, sub-agents, and undisclosed principals in complex commercial arrangements

STRUCTURE :

11.1 WHO IS AN AGENT ?

The complexities of modern business are such that it is not possible for any person to transact all his business by himself. He cannot personally attend to all matters in which it is necessary for him to be brought into legal relations with other people. Due to necessity, he has to depend on the services of other persons in order to run his day-to-day business affairs. Such other persons are called *agents*.

A person who has capacity to contract may enter into a contract with another

(i) either by himself or

(ii) (ii) through another person. When he adopts the latter course, he is said to be acting through an ‘agent.’

11.2 ESSENTIALS OF THE RELATIONSHIP OF AGENCY: There are two essentials of the relationship of agency.

1. Agreement between the principal and the agent

Agency depends on agreement but not necessarily on contract. As between the principal and third persons, any person may become an agent [Sec. 184]

No consideration is necessary to create an agency [Sec. 185]: The fact that the principal has agreed to be represented by the agent is sufficient ‘detriment’ to the principal to support the agency.

2. Intention of the agent to act on behalf of the principal

Whether a person does intend to act on behalf of another is a question of fact. Where a person does intend to act on behalf of another, agency may arise although the contract between the parties provides that there is no such relationship.

11.3 RULES OF AGENCY

1. Whatever a person can do personally, he can do with his agent. There are few exceptions, like marriage and public office

2. Qui *facit per altum facit per se* (he who does an act through another does it by himself)

11.4 TEST OF AGENCY

The test for determining whether a person is or is not an agent is this: Does that person have the capacity to bind the principal and make him answerable to the third party by bringing him into legal relations with the third person and thus establish a privity of contract between that person and the principal? If yes he is an agent; otherwise, not. Another important issue is that if a person is in the habit of advising another in business dealings, he does not become the agent of the other.

11.5 AGENT AND SERVANT

An agent does not act under the direct supervision and control of their employer, but a servant does. "A principal has the authority to dictate what the agent must do, but a master also has the authority to specify how it should be carried out." As a result, an agent is frequently referred to as a "superior servant." A servant does not establish relationships between his master and third parties, whereas an agent binds the principal with a third party.

11.6 CREATION OF AGENCY

The relationship of agent and principal may arise by the following ways:

1. By Expressed agreement
2. By Implied Agreement
3. By Ratification or
4. By Operation of law

1. By Expressed agreement: "An agent's authority can be expressed or implied." (Section 186) "When authority is conveyed through spoken or written words, it is said to be expressed." (Sec. 187).

2. By Implied Agreement: Implied agency arises from the conduct, situation, or relationship of parties. It may be inferred from the circumstances of the case, and things spoken or written or the ordinary course of dealing may be accounted as circumstances of the case

Example: A and P are brothers. A lives in Delhi, while P lives in Meerut. A, with the knowledge of P, leases P's land in Delhi. He realizes the rent and remits it to P. A is the agent of P, though not expressly appointed as such.

Agency by estoppel : "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: A starts manufacturing plastic products. A, B, and C are sitting together. B in the presence of A tells C that A has appointed him

Agency by necessity: In certain urgent circumstances the law confers an authority on a person to act as an agent for the benefit of another , there being no opportunity of communicating with that other . Such agency is called an 'agency of necessity.' It arises in the following cases:

(i) An agent exceeding his authority in an emergency (Sec. 189)
(ii) A person entrusted with another's property
(iii) Husband and Wife

3. Agency by Ratification: A person may act on behalf of another without his knowledge or consent.A may act as P's agent though he has no prior authority from P. In such case P may subsequently either accept to act of A or reject it. If he accepts the act of A, done without his consent he is said to have ratified that act and it places parties exactly in the same position in which they would have been if A had P's authority at the time he made the contract. Likewise, when an agent exceeds the authority bestowed upon him by the principal, the principal may ratify the unauthorized act.

Example: A insures P's goods without his authority. If P ratifies A's act the policy wii be as valid as if A had been authorised to insure the goods **[Case: Williams v North China Insurance Co. (1876) 1 CPD 757]**

Requisites for valid ratification:

1. The agent must purport to act as agent for a principal who is in contemplation and is identifiable at the time of contract
2. The principal mus tbe in existence at the time of contract
3. The principal must have contractual capacity both at the time of contract and at the time of ratification
4. Ratification must be with full knowledge of facts
5. Ratification must be done within a reasonable time of the act purported to be ratified.
6. The act to be ratified must be lawful and not void or illegal or vires.
7. The whole transaction can be ratified
8. Ratification must be communicated to the party who sought

4. Agency by operation of law:\Sometimes an agency arises by operation of law. When a company is formed its promoters are its agents by operation of law. A partner is an agent of the firm for the purpose of business of the firm, and 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. In all these cases agency is implied by operation of law.

11.7 KINDS OF AGENTS

1. Auctioneer: He is an agent to sell property at a public auction. He is primarily an agent for the sellers. He becomes the agent of the buyer also when the property is knocked down.
2. Factor: An agent to whom items are consigned for sale is known as a factor. He possesses the products and acts as an agent. The products may be sold under his own name. He may accept the price, provide the buyer credit, and release the buyer.
3. Broker: A broker is an agent employed to negotiate a contract between his principal and a third person.
4. Del Credre Agent: A Del Credre agent is employed for sale. He is responsible to the principal for payment of price by the buyer. He is entitled for extra remuneration for this purpose. Consideration is not necessary to CREATE an agency. The authority of an agent may be expressed or implied.

HUSBAND AND WIFE The liability of a husband for a wife's debt depends on the principles of agency. This is a case of implied authority.
Here two circumstances may arise: (1) Husband and wife living together: Now an implied agency to buy necessaries is presumed
(2) Husband and wife living separately: Now, the implied agency is only assumed when she lives apart from her spouse in situations that justify it. Furthermore, maintenance should not have been given to the wife.

11.8 TERMINATION OF AGENCY

The contract of agency would come to an end in any of the following circumstances:

- By Revocation by the principal
- Renunciation by the Agent
- Completion of business
- Death or Insanity
- Insolvency of the principal
- Expiration of Time
- Destruction of the subject matter
- Dissolution of a company
- Principal or agent becoming alien enemy

11.9 AGENT'S DUTY TOWARDS PRINCIPAL

An agent is required to carry out the principal's business in accordance with the principal's instructions. If not, he will reimburse the principal for any losses. He will account for any profit that is made.

An agent must manage the firm with the same level of expertise that people in similar businesses typically possess. He must use the skill he possesses and act with reasonable diligence. He must compensate his principal for the direct effects of his own carelessness, incompetence, or misbehavior. But he won't be responsible for any distant or indirect effects.

On demand, an agent is required to provide accurate accounts to his principal. If he is having trouble, he will try to get guidance from his principal. The principal may revoke the transaction if the agent conducts business on his own account without the principal's approval and without providing the principal with relevant information that he has learned.
Any advantage that results from an agent dealing on his own account without the principal's knowledge can be claimed from the principal. An agent can keep money for advances and expenses incurred while conducting business, as well as any income for operating as an agent, from any business earnings.

Payment for the performance of an act is only required upon completion. An agent may keep money received for products sold even if the entire consignment was not sold or the transaction was incomplete. This is subject to a special agreement to the contrary.

An agent who is found to have committed misconduct is not entitled to any remuneration for that portion of the transaction in question. An agent has the right to detain commodities, papers, and other property (movable or immovable) received from the principal until the sum owed to him for commission, expenses, and services in relation to the same has been paid or accounted for. A contract may limit the right of lien.

11.10 PRINCIPAL'S DUTIES TOWARDS AGENT

1. To indemnify that agent against the consequences of all lawful acts
2. To indemnify the agent against the consequences of acts done in good faith
3. To indemnify agent for injury caused by principal's neglect
4. To pay the agent the commission or other remuneration agreed

11.11 RIGHTS OF THE PRINCIPAL

1. He can carry out the varied duties of an agent.
2. He may seek compensation for any breach of duty by the agent.
3. The agent's remuneration may be forfeited if they commit wrongdoing in the agency business.
4. The principal is entitled to any additional profits made by the agent through their agency. This includes any illicit gratification that may occur.
5. The principal is entitled to receive all payments if the transactions carried out by the agent on behalf of the principal were void or illegal.

11.12 DELEGATION OF AUTHORITY

The general rule is that an agent cannot delegate his authority to another. It means he cannot appoint a sub-agent
Sub-agent: A 'sub-agent' is a person employed by and acting under the control of the original agent in the business of the agency (Sec. 191). A sub agent therefore, is the agent of the original agent. The relation of the sub- agent to the original agent is as between themselves that of agent and principal

Substituted agent : Asubstituted agent is a person who is named by the agent holding an express or implied authority from the principal to act for the principal. He is the agent of the principal though he is named at the request of the principal, by the agent (Sec.194)

Exceptions:
Delegating authority to a sub-agent is appropriate in the following situations:
(1) Nature of Agency
(2) Custom of Trade: When an agent appoints a sub-agent as is customary.
(3) Ministerial activities: These are activities that require no discretion, personal or professional expertise.
(4) Express Delegation: When the principal directly authorizes delegation.
(5) Implied Permission: When a principal acts or behaves in a way that implies delegation of authority, it might be assumed that they have permitted it. (6) In emergencies, agents might delegate authority to sub-agents.

11.13 POSITION OF PRINCIPAL AND AGENT IN RELATION TO THIRD PARTIES

"In the absence of any contract to that effect, an agent cannot personally enforce contract entered into by him on behalf of his principal nor is he personally bound by them…'
The act of an agent is the act of the principal, therefore if an agent enters into a contract with a third party, the legal consequences are the same as if the contract had been entered into by the principal himself with the third party.
When an agent exceeds their power, they may be able to differentiate what falls inside their authority from what falls outside of it.
(1) The part done within his authority is simply binding between him and his principal.
(2) The components cannot be separated. The principal is not required to recognize the full transaction.

Undisclosed Principal: The agent is bound by the contract. He may be sued on it, and he has the right to sue the third party. The principal too has the right to intervene and assert his position as an undisclosed party to the contract.

Check Your Progress:
Q1: State the effect of death, insanity and insolvency of the principal or agent on a contract of agency.
Q2: What are the various ways in which the relation of agency arises?
Q3 Explain the effect of a contract made by an agent with a third party- Where the agent discloses the existence but not the name of the principal.

REFERENCES:

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3.Pollock and Mulla, Indian Contracts Act, 1872 (8th Edn.)
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Dr. V. RADHIKA

LESSON-12
SALE OF GOODS ACT, 1930

CONTRACT OF SALE OF GOODS

Objective of the Lesson: It is intended to state the definition of contract of sale goods and its essentials. In every day life a person may be entering into a few or many contracts of sale of goods. There has been the need of knowing the importance of contract of sale of goods.

STRUCTURE OF THE LESSON:

12.1 CONTRACT OF SALE OF GOODS

Property means anything of marketable value. Properties are of two types – 1) Movable Property and 2) Immovable Property. Movable property is the property that can be moved. Movable property is also known as goods. Section 2 (7) of Sale of goods Act, 1930 (hereinafter referred to as the 'Act') defined goods as "every kind of movable property … and includes stock and shares, growing crops, grass and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale. Under the definition, 'goods' does not include actionable claims and money. Immovable property is the property that cannot be moved.

Every property owner shall have four important rights: 1. Right to ownership 2. Right to possession 3. Right to use and enjoyment of property and 4. Right of alienation i.e., transfer. The matters relating to transfer of immovable property are dealt under Transfer of Property Act, 1882. The matters relating to transfer of goods are dealt under Sale of Goods Act, 1930 (hereinafter referred to as 'Act'). The goods may be sold under a contract of sale or under an agreement to sell.

12.2 DEFINITION

For sale and purchase of goods there must be two parties - a) the buyer and b) the seller. Section 2 (1) defined buyer as a person who buys or agrees to buy goods. Seller is the absolute owner of goods who has transferable right on goods. The agreement between the buyer and seller to sell or buy goods is the contract of sale of goods.

Agreement enforceable by law is known as a contract. In general English agreement and contract may be synonyms. But, in Law agreement and contract are two different things. When a party made an offer to the other and when such other party accepted, it is said that an agreement is entered into. When such agreement is between two competent persons, for a valuable consideration and when both parties gave their offer and acceptance with a free mind and when the parties have intention to create legal obligation, the agreement becomes a contract.

According to Section 4 of the Act 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.

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, the contract is called Agreement to sell.

12.3 ESSENTIALS OF CONTRACT OF SALE OF GOODS

The following are the essentials of a valid contract of sale of goods –

1) Offer
2) Acceptance
3) Writing or no writing
4) Money consideration or Price
5) Goods
6) Free consent
7) Transfer of ownership in goods
8) Intention to create legal obligation.

12.3.1 Offer: The first step in entering into any contract is making an offer. Either the seller or the buyer has to make an offer. The person that made the offer is known as 'Offeror' and the person to whom the offer is made is known as 'offeree' or 'acceptor'. According to Section 2 (a) of 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 ascent of that other to such act or abstinence, he is said to make an offer.

Offer is the foundation to the contract of sale of goods. The offer must be clear, specific and certain. Offer is to be communicated to the other side. Communication of offer may be made either by spoken words or by written words. The offer is complete when the offer reaches the other party. Offer is to be made with an intention of obtaining the acceptance of the other party. Acceptance is to be given by such other party when the offer is still in force. The offer may be revoked by the offeror at any point of time before it is accepted by the other side.

12.3.2 Acceptance: The person to whom the offer is made has to give acceptance in order to enter into the contract of sale of goods. The person that gave acceptance is known as 'acceptor'. According to Section 2 (b) of Indian Contract Act when the person to whom the offer is made signifies his assent thereto the offer is said to be accepted. Offer when accepted becomes an agreement.

An offer is to be accepted. But, generally no offer as such will be accepted by the acceptor. Between seller and the buyer negotiations may take place. During the negotiations both the seller and the buyer agree upon a renewed offer. Such renewed offer is to be accepted. When such an offer is accepted an agreement is entered into.

The acceptance of offer is to be communicated to the offeror. Communication of acceptance may be made by words spoken or written. Acceptance is complete when such acceptance reached the offeror. The acceptance also like offer may be revoked. The acceptor may revoke the acceptance before the acceptance reached the offeror. When the communication of acceptance is complete the contract of sale of goods is entered into between the seller and buyer.

In a contract of sale of goods, the seller and buyer shall be two different persons. A person cannot buy his own goods. But, still a partner can purchase goods of a Firm of which he is a partner. In a court auction a person can purchase his goods which are auctioned.

12.3.3. Writing or no writing: A contract of sale of goods may be in writing or even oral. Sale of Goods Act has not insisted on writing. Section 5 (2) of the Act states that a contract of sale may be made in writing or by word of mouth or partly in writing and partly by word of mouth or may be implied from the conduct of parties.

Proof of oral contract of sale of goods may be difficult. Contract in writing may be easier to prove. When contract is in writing, oral evidence of certain provisions of contract of sale of goods may be made. For example, in a written contract of sale of goods, the quantum of goods sold and purchased is not mentioned. In such a case oral evidence of the quantum of goods may be made.

When the contract of sale of goods is in writing no payment of stamp duty and registration are necessary, unlike in case if contract of sale of immovable property. Signatures of seller and buyer give validity to the contract. Signature are not compulsorily attestable.

12.3.4 Money Consideration or Price:

One of the essentials of a valid contract is consideration which means the thing of value that is given in return for a promise. To a contract of sale of goods, the consideration is the price agreed upon by the seller and the buyer for the sale of goods. Fixing or determining the price to the goods is mandatory. If no price is agreed upon the transaction may be a gift or barter and when some other goods good is transferred it may be called ‘exchange’. The price may be determined in various ways. The parties in the contract itself may fix the price. Otherwise the parties may take the market price on the day of delivery or on some other day as the price for the goods. If no price is agreed upon the buyer has to pay to the seller the reasonable price. According to Section 9(2) what is a reasonable price is a question of fact to be determined on various circumstances. The price may be paid in instalments. If the agreed price is not paid the seller may withhold the goods either in part or in whole. The seller has the right to stop the goods in transit. The price may be paid on delivery of goods.

The seller who is not paid the price has to file a Suit for Price in the court. The buyer may withhold the payment of price in-part or in whole on the ground of breach of the contract of sale of goods. The buyer who has paid the price may refuse to receive the good in-part or in toto on the ground of breach of contract and may sue for the repayment of the price paid.

12.3.5 Goods: The subject matter of contract of sale of goods is goods. According to Section 5 of the Act a contract of sale is made by an offer to buy or sell goods for a price. Section 2 (7) of Sale of goods Act, 1930 defined goods as “every kind of movable property other than actionable claim 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 before sale or under the contract of sale”.

Actionable claim is not goods. According to Section 3 of Transfer of Property Act, 1882 “Actionable claim” means a claim to any debt, other than a debt secured by mortgage of immoveable property or by hypothecation or pledge of moveable property, or to any beneficial interest in moveable property not in the possession, either actual or constructive, of the claimant, which the Civil Courts recognise as affording grounds for relief, whether such debt or beneficial interest be existent, accuring, conditional or contingent.

Stock and shares of a company are goods which can be sold and purchase. Purchase and sale of shares is regulated both under Sale of Goods Act and the Companies Act. Growing crop when agreed to be cut before the sale is a goods. Water, electricity and gas are also goods. Particularly electricity which is intangible property is considered movable property and held to be goods which can be sold and purchased. Power purchase agreements are important contracts under Sale of Goods Act. Electric signals are also goods. Incomplete film is held to be a goods and can be sold and purchased under the Act.

Goods further are of different kinds. Goods may be existing goods or future goods. Contract of sale of goods may be entered into both on existing goods and future goods. According to Section 2 (6) future goods means goods to be manufacture or produced or acquired by the seller after making of the contract of sale. According to Section 6(1) of the Act the goods which form the subject of a contract of sale may be either existing goods, owned or possessed by the seller, or future goods. The contract for sale of future goods may be a contingent contract whose performance depends upon a future uncertain event which may or may not happen. Section 6(3) states that where by a contract of sale the seller purports to effect a present sale of future goods, the contract operates as an agreement to sell the goods.

Goods may be perishable goods. Perishable goods are un-preservable goods. The life time of goods may be less. Goods may be perish before making of contract ot after agreement. Section 7 states that 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 as no longer to answer to their description in the contract. According to 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 as no longer to answer to their description in the agreement before the risk passes to the buyer, the agreement is thereby avoided.

12.3.6 Free Consent: For a valid contract of sale of goods the consent given by seller and buyer shall be free. According to Section 14 of Indian Contract Act consent is said to be free when it is not caused by (1) coercion, or (2) undue influence, or (3) fraud, or (4) misrepresentation, or (5) mistake. When the consent of seller or buyer is obtained by coercion, undue influence, fraud or misrepresentation the contract becomes a voidable contract. Voidable contract is one which can be avoided by a party who was so coerced, unduly influenced, defrauded or misrepresented. When the consent was obtained by mistake of either party, the contract of sale of goods generally becomes void. Mistake may be of different types. The mistake may be of quality, quantity, price etc.

When consent is free the contract of sale of goods becomes a valid contract.

12.3.7 Intention to create legal obligation: At the time of entering into the contract of sale of goods both the seller and buyer must have intention to create legal obligation. Both must have intended to create legal rights and obligations mutually. If the parties wanted to create only social or moral obligations no contract of sale of goods is constituted.

12.3.8 Transfer of ownership in goods: One of the important rights of the owner on the goods is right to ownership. When a valid contract of sale of goods is entered into between the seller and buyer, in ownership in the goods is transferred form seller to buyer. Section 4 (3) of the

Act states that 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, the contract is called an agreement to sell. Under Section 4 (4) 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.

Generally, ownership in the goods transfers when a valid contract of sale of goods is entered into. No other formalities need to be fulfilled. But, where the Law prescribed certain formalities like registration the transfer of ownership takes place when such legal formalities are fulfilled. For example, in case sale of a car or a bike, conclusion of contract itself may not transfer ownership. Requisite formalities with Road Transport Authority are to be complied with.

12.4 CONCLUSION

When a contract of sale of goods is entered into parties mutually get rights and obligations. The party that has an obligation under the contract has to fulfil the obligation as per the contract. If a party that has an obligation under the contract has not full filled the obligation it amounts to breach of contract. The party that suffered the breach of contract can file a suit in the court claiming the remedies of Specific Performance of the Contract or Damages.

Legal Terms: Offer, Acceptance, Agreement, Contract, Coercion, Undue influence, Fraud, Misrepresentation, Mistake, Suit, Specific Performance, Damages.

12.5 SELF-ASSESSMENT QUESTIONS

1. Describe the importance of contract of sale of goods?
2. Define Contract of Sale of Good. Narrate its features.
3. Short Questions – 1. Goods 2. Price 3. Perishable goods

12.6 SUGGESTED READINGS

1. Law of Sale of Goods by Dr. Avtar Singh
2. Sale of Goods Act by K. Bangia
3. Principles of the Law of Sale of Goods and Hire Purchase by Dr Avtar Singh

Dr. Ch. Sudhakara Babu

LESSON-13
CONDITIONS AND WARRANTIES

Objective of the Lesson: The lesson is intended to narrate the importance of terms and stipulations agreed upon by the seller and buyer while entering the contract of sale of goods.

Structure of the Lesson:

13.1 INTRODUCTION

While entering into contract of sale of goods the seller and buyer may agree upon various terms and stipulations on the basis of which they wanted conduct the sale and purchase of the goods. Such terms and stipulations may be either 1) a Condition or 2) a Warranty. Sections 11 to 17 of the Sale of Goods Act, 1930 deal with the Conditions and Warranties in a Contract of Sale of Goods.

13.2 CONDITIONS AND WARRANTIES

Condition: Section 12 (2) defined a condition as 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. A condition in a contract of sale of goods is an important and essential stipulation which is to complied with in full. If it is not fulfilled as per the contract, the party that suffered the nonfulfillment can treat the contract as repudiated i.e., rejected or cancelled.
Conditions are of two types – 1. Express conditions 2. Implied conditions. Express condition is the condition that the seller and buyer have agreed upon by words spoken or written. Implied condition is a condition that is understood by circumstance and which is not expressly agreed upon.

Warranty: Section 12(3) defined a warranty as 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. A warranty is not an essential or important stipulation and it is a stipulation or term which is collateral to the mainpurpose of the contract. If a warranty is not fulfilled, the party that suffered the nonfulfillment can file a suit claiming damages only and such party cannot reject the contrat or treat it as cancelled.

Warranties are of two types – 1) Express Warranty 2) Implied warranty.
According to Section 12(4) 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.

13.3 Express and Implied Conditions

Sale of Goods Act, 1930 has given a lot of liberty to the parties to the Contract of Sale of Goods to have the conditions and warranties of their choice. Section 12 (4) specifically states that 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.

Any express condition may be agreed upon by the seller and buyer. The Act did not specify that some condition must be an express condition in the contract. Even though a condition is agreed upon as an express condition in the contract, Section 13 (1) states that where a contract of sale is subject to any condition to be fulfilled by the seller, the buyer may waive the condition or elect to treat the breach of the condition as a breach of warranty and not as a ground for treating the contract as repudiated.

Further the Act has stated that stipulation as to time cannot be a condition. Section 11 states that unless a different intention appears from the terms of the contract, stipulations as to time of payment arc not deemed to be of the essence of a contract of sale. Whether any other Stipulation as to time is of the essence of the contract or not depends on the terms of the contract.

13.3.1 Implied Conditions: The Act though not specified express conditions, has stated, in Sections 14,15.16 and 17, the implied conditions which become part of every contract of sale of goods. The following are the implied conditions:

1. Implied condition that seller has right to sell the goods (Section 14)
2. In case of sale of goods by description, that the goods shall correspond to description (Section 15)
3. Where the buyer, expressly or by implication, makes known to the seller the particular purpose for which the goods are required, there is an implied condition that the goods shall be reasonably fit for such purpose. (Section 16 (1))
4. 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. (Section 16 (2))
5. An implied condition as to quality or fitness for a particular purpose may be annexed by the usage of trade. (Section 16 (3))
6. An express condition does not negative a warranty or condition implied by this Act unless inconsistent therewith.(Section 16 (4))
7. In Sale by Sample Section 17 (2) imposes the following three implied conditions –
   (a) that the bulk shall correspond with the sample in quality;
   (b) that the buyer shall have a reasonable opportunity of comparing the bulk with the sample;
   (c) that the goods shall be free from any defect, rendering them unmerchantable, which would not be apparent on reasonable examination of the sample.

When there is a breach of condition by the seller, the buyer may –

a) treat the contract as repudiated and can avail his legal remedies
b) waive the condition and may go with the performance of the contract
c) treat the breach of condition as a breach of warranty and may not repudiate the contract and go with the performance of contract.
d) When there is a breach of condition by the buyer, the seller may –
e) treat the contract as repudiated and can avail his legal remedies
f) waive the condition and may go with the performance of the contract
g) treat the breach of condition as a breach of warranty and may not repudiate the contract and go with the performance of contract.

13.4 EXPRESS AND IMPLIED WARRANTIES

Sale of Goods Act, 1930 has given a lot of liberty to the parties to the Contract of Sale of Goods to have the warranties of their choice. Section 12 (4) specifically states that 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.

Any express warranty may be agreed upon by the seller and buyer. The Act did not specify that some warranty must be an express warranty in the contract. Even though a condition is agreed upon as an express condition in the contract, Section 13 (1) states that where a contract of sale is subject to any condition to be fulfilled by the seller, the buyer may waive the condition or elect to treat the breach of the condition as a breach of warranty and not as a ground for treating the contract as repudiated.

Further the Act has stated that stipulation as to time can be a warranty. Section 11 states that unless a different intention appears from the terms of the contract, stipulations as to time of payment arc not deemed to be of the essence of a contract of sale. Whether any other Stipulation as to time is of the essence of the contract or not depends on the terms of the contract.

13.4.1 Implied Warranty: The Act though not specified express warranties, has stated, in Sections 14 and16 the implied warranties which become part of every contract of sale of goods. The following are the implied warranties:

1. an implied warranty that the buyer shall have and enjoy quiet possession of the goods. (Section 14 (b))
2. 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 when the contract is made. (Section 14 (c))
3. An implied warranty or condition as to quality or fitness for a particular purpose may be annexed by the usage of trade. Section 16 (3))
4. An implied warranty or condition as to quality or fitness for a particular purpose may be annexed by the usage of trade. Section 16 (4))

When there is a breach of warranty by the seller, the buyer may –

a) waive the breach and go with performance of contract
b) file a suit for Damages

When there is a breach of warranty by the buyer, the seller may

a) waive the breach and go with performance of contract
b) file a suit for Damages.

13.5 CONDITION VIS-À-VIS WARRANTY

Section 12 (4) states that 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.

According to Section 13 (1) where a contract of sale is subject to any condition to be fulfilled by the seller, the buyer may waive the condition or elect to treat the breach of the condition as a breach of warranty and not as a ground for treating the contract as repudiated.

The court may exempt the fulfilment of any condition or warranty, express or implied, on the ground of impossibility of performance or any other such ground.

Legal Terms: Express, Implied, Condition, Warranty, Suit, Damages, Repudiation
Self-Assessment Questions:

1. Define and distinguish condition and warranty.
2. Describe the Implied Conditions and Warranties in a contract of sale of Goods.

SUGGESTED READINGS

1. Law of Sale of Goods by Dr. Avtar Singh
2. Sale of Goods Act by K. Bangia
3. Principles of the Law of Sale of Goods and Hire Purchase by Dr Avtar Singh

Dr. Ch. Sudhakara Babu

LESSON-14
TRANSFER OF PROPERTY

OBJECTIVE OF THE LESSON

On sale of goods the property transfers from seller to buyer. How the transfer operates requires a study. The lesson is intended to highlight how rights of the seller transfers to buyer. Both the important rights – possession and title to the goods are transferred.

STRUCTURE OF THE LESSON:

14.1 INTRODUCTION

The purpose of entering into the contract of sale of goods is the selling and buying of goods by the seller and the buyer. When the contract is performed as per the contract the property that means the goods are to be transferred from seller to buyer. Sections 18 to 30 of Sale of Goods Act, 1930 deal with the transfer of property i.e. goods.

14.2 Transfer of Property in Goods:

Transfer of Property involved two important things:

a) Transfer of Possession
b) Transfer of Title

Every property owner shall have four important rights: 1. Right to ownership 2. Right to possession 3. Right to use and enjoyment of property and 4. Right of alienation i.e., transfer. The first two rights are the original rights of owner and the other two are consequential rights. If the partied have not decided otherwise, the property in goods transfers immediately on completion of respective roles by the seller and buyer. The may decide even otherwise. There may be different circumstances in which property transfers in case of sale of goods. The transfer property in goods takes place in case of possession and title in the following ways under Sale of Goods Act:

14.3 Transfer of Possession

Sections 18 to 26 of the Act deal with the rules relating to the transfer of possession of goods under a contract of sale of goods. For the purpose of delivery of possession of goods, goods are divided into two types –

1. Specific Goods or Ascertained Goods
2. Unspecific Goods or Unascertained Goods

Specific or ascertained goods may again be divided into two –

1. Ascertained goods in deliverable state
2. Ascertained goods in non-deliverable state

14.3.1 Delivery of Possession of Ascertained or Specific Goods

Section 19(1) states that 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 he transferred.

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.

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. (Section 20)

Section 21 states that 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.

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.

14.3.2 Delivery of possession of Unspecific Goods: Unspecific or unascertained goods are the goods that are not yet manufactured or made or received. The goods which form the subject of a contract of sale may be either existing goods, owned or possessed by the seller or future goods. According to Section 18 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. Till the goods are ready, made or manufactured and become ascertainable as a good the seller cannot transfer the goods to the buyer and the buyer cannot take possession of the goods.

According to Section 23 of the Act where there is a contract for the sale of unascertained or future goods by description and goods of that description and in a deliverable state 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, the property in the goods thereupon passes to the buyer. Such assent may be express or implied, and may by given either before or after the appropriation is made Delivery to carrier.
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.

14.3.3 Delivery of Possession in Other cases:

There may be two other occasions of entering into contract of sale of goods- 1. Delivery of goods to buyer on approval or “on sale or return” basis, and 2. Delivery of goods to buyer on reservation of right of disposal.
Section 24 deals with the delivery of goods to buyer on approval or “on sale or return”.
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.

The second occasion is delivery of goods to buyer on reservation of right of disposal. Section 25 states that where there is a contract for the sale of specific goods or where goods are subsequently appropriated to the contract, the seller may, by the terms of the contract or appropriation, reserve the right of disposal of the goods until certain conditions are fulfilled. In such case, notwithstanding the delivery of the goods to a buyer or to a carrier or other bailee for the purpose of transmission to the buyer, the property in the goods does not pass to the buyer until the conditions imposed by the seller are fulfilled.

Section 25 further provided that where goods are shipped or delivered to a railway administration for carriage by railway 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, the seller is prima facie deemed to reserve the right of disposal. Where the seller of goods draws on the buyer for the price and transmits to the buyer the bill of exchange together with the bill of lading or, as the case may be, the railway receipt, to secure acceptance or payment of the bill of exchange, the buyer is bound to return the bill of lading or the railway receipt if he does not honour the bill of exchange; and, if he wrongfully retains the bill of lading or the railway receipt, the property in the goods does not pass to him.

14.4 RISK ON TRANSFER OF GOODS

When the goods are to be transferred from seller to buyer who has to bare the risk is an intriguing question. 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. 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.

14.5 DELIVERY OF TITLE

As stated above on sale and purchase goods, the seller has to deliver the right in the goods to the buyer and such delivery is of two types – the delivery of possession of goods and deliver of title of goods. Delivery of title means passing of right of ownership. Sections 27 to 30 of Sale of Goods Act, 1930 deal with the delivery of title.

Deliver of title by the seller to the buyer depends upon the fact that who sold the goods to the buyer. Goods may be sold by the following persons –

1. The owner of the goods
2. Non-owner of goods
3. One of Joint owners
4. Person in possession of goods

Sale by Owner of Goods: Where the owner of the goods sold the property when the last formality as per the contract or law is complied with, the ownership or title passes to the buyer.

Sale of goods by Non-owner: Section 27 of the Act deals with the sale by non-or owner. An Agent, may be Mercantile Agent, an Ostensible owner or a person in wrongful possession of goods may sell the goods.

Where goods are sold by a person who is not the owner thereof and who does not sell them under the authority or with the consent of the owner, the buyer acquires no better title to the goods than the seller had, unless the owner of the goods is by his conduct precluded from denying the seller's authority to sell. Where a mercantile agent is, with the consent of the owner, in possession of the goods or of a document of title to the goods, any sale made by him, when acting in the ordinary course of business of a mercantile agent, shall be as valid as if he were expressly authorised by the owner of the goods to make the same; provided that the buyer acts in good faith and has not at the time of the contract of sale notice that the seller has not authority to sell.

Sale by one of Joint owners: If one of several joint owners of goods has the sole possession of them by permission of the co-owners, the property in the goods is transferred to any person who buys them of such joint owner in good faith and has not at the time of the contract of sale notice that the seller has not authority to sell.

Person in possession of Goods: When the seller of goods has obtained possession thereof under a contract voidable, but the contract has not been rescinded at the time of the sale, the buyer acquires a good title to the goods, provided he buys them in good faith and without notice of the seller's defect of title.
In these ways the property in goods passes from the seller to the buyer both in possession and in title.

Legal Terms: Possession, Title, Mercantile Agent, Deliverable state, prima facie

14.6 SELF-ASSESSMENT QUESTIONS

1. Explain how transfer of property in goods take place on Sale of Goods?
2. Describe the law relating to transfer of possession of goods on sale of goods.
3. Describe how the transfer of title to goods from seller to buyer takes place under Sale of Goods Act, 1930?

14.7 SUGGESTED READINGS

1. Law of Sale of Goods by Dr. Avtar Singh
2. Sale of Goods Act by K. Bangia
3. Principles of the Law of Sale of Goods and Hire Purchase by Dr Avtar Singh

Dr. Ch. Sudhakara Babu

LESSON-15
RIGHTS OF UNPAID SELLER

OBJECTIVE OF THE LESSON

Contract of sale of goods transfers various rights of seller on property to buyer as per the contract. But, when the seller is unpaid the seller gets various other rights on goods. The rights such unpaid seller gets on the goods are analysed in this chapter.

STRUCTURE OF THE LESSON

15.1 INTRODUCTION

Contract of Sale of Goods gives mutually rights and obligations to both seller and buyer. Seller's important right is to receive price of the goods from buyer and his important duty is to deliver good to buyer. If the seller has not received the whole of the price i\he is called the unpaid seller. The unpaid sellers position that is his rights and powers are important in Sale of Goods Act.

15.2 UNPAID SELLER – DEFINITION

The seller of goods is deemed to be an "unpaid seller" (a) when the whole of the price has not been paid or tendered; (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" 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.

15.3 RIGHTS OF UNPAID SELLER

Section 46 conferred three important rights on the unpaid seller. The unpaid seller of goods has by implication of law shall have –

(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.

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.

15.4 UNPAID SELLER'S LIEN

Lien is right to detain or retain the goods till the dues on the goods are paid off. The unpaid seller of goods who is in possession of them is entitled to retain possession of them until payment or tender of the price in the following cases, namely (a) where the goods have been sold without any stipulation as to credit; (b) where the goods have been sold on credit, but the term of credit has expired; (c) where the buyer becomes insolvent. The seller may exercise his right of lien notwithstanding that he is in possession of the goods as agent or bailee for the buyer.

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: The unpaid seller of goods loses his lien thereon (a) 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; (b) when the buyer or his agent lawfully obtains possession of the goods; (c) by waiver thereof. The unpaid seller of 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.

15.5 RIGHT OF STOPPAGE OF GOODS

The other right of unpaid seller is Right of Stoppage of Goods in Transit. When the buyer of goods becomes insolvent, the unpaid seller who has parted with the possession of the goods has the right of stopping them in transit, that is to say, he may resume possession of the goods as long as they are in the course of transit, and may retain them until payment or tender of the price.

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 in that behalf takes delivery of them from such carrier or other bailee. If the buyer or his agent in that behalf obtains delivery of the goods before their arrival at the appointed destination, the transit is at an end. If, after the arrival of the goods at the appointed destination, the carrier or other bailee acknowledges to the buyer or his agent that he holds the goods on his behalf and continues in possession of them as bailee for the buyer or his agent, the transit is at an end and it is immaterial that a further destination for the goods may have been indicated by the buyer. If the goods are rejected by the buyer and the carrier or other bailee continues in possession of them, the transit is not deemed to be at an end, even if the seller has refused to receive them back. When goods are delivered to a ship chartered by the buyer, it is a question depending on the circumstances of the particular case, whether they are in the possession of the master as a carrier or as agent of the buyer. Where the carrier or other bailee wrongfully refuses to deliver the goods to the buyer or his agent in that behalf, the transit is deemed to be at an end. Where part delivery of the goods has been made to the buyer or his agent in that behalf, the remainder of the goods may be stopped in transit, unless such part delivery has been given in such circumstances as to show an agreement to give up possession of the whole of the goods.

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. 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.

The right of stoppage in transit and vendor's lien have the following features in common:

(i) Both rights are exercisable when there is unpaid price.
(ii) Both rights are lost when the buyer lawfully obtains possession of the goods.
(iii) Both the rights can be exercised when the buyer becomes an insolvent. For the purposes of the Sale of Goods Act a person is treated as insolvent when he cannot pay his debts as they become due or has ceased to pay his debts in the ordinary course of business.

The following features of distinction are noteworthy:
(i) The Vendor's lien can be exercised only so long as the goods are in the seller's possession. The right of Stoppage in transit can be exercised even after the seller has delivered the goods to a middleman (usually the carrier of goods) and the goods are in process of transmission to the buyer so long as they are in the course of transit. For this reason stoppage in transit is regarded as an extension of the right of lien.
(ii) The lien can be exercised when the period of credit stipulated for between the parties has expired. The right of stoppage in transit cannot be exercised in such circumstances. It can be exercised only when the buyer becomes insolvent.

Legal Terms: Lien, Stoppage in Transit

15.6 SELF -ASSESSMENT QUESTIONS:

Describe the Rights of Unpaid Seller?

SUGGESTED READINGS:

1. Law of Sale of Goods by Dr. Avtar Singh
2. Sale of Goods Act by K. Bangia
3. Principles of the Law of Sale of Goods and Hire Purchase by Dr Avtar Singh

Dr. Ch. Sudhakara Babu

LESSON 16

COMPANIESACT, 2013 AND CLASSIFICATION OF COMPANIES

OBJECTIVE OF THE LESSON

To impart knowledge about the company, object of Companies Act, 2013, the characteristics of a company, the advantages and disadvantages of a company and kinds of companies.

Structure of the lesson

16.1. INTRODUCTION:

Company law is a branch of law that governs the formation, regulation, and dissolution of companies. It aims to regulate corporate governance, ensuring transparency, accountability and ethical business practices in the corporate sector.The law governing companies in India is the Companies Act, 2013, which replaced the earlier Companies Act, 1956 to modernize company law and match it with international standards. This Act provides provisions relating to company formation, management, rights and duties of shareholders and directors, and corporate restructuring.

16.2. MEANING, DEFINITION OF A COMPANY

16.2.1. Company Meaning

A company is an association of individuals formed for some common purpose. It is a voluntary association of persons who contribute capital which is divisible into parts, known as shares. It is an artificial person created by a process of law and it has a perpetual succession and a common seal.

16.2.2. Definition

According to Prof. Lindley, company is defined as “an association of many persons who contribute money or money’s worth to a common stock, and employ it in some common trade or business i.e., for a common purpose and who share the profit or loss arising there from”.

That is, the common stock so contributed is denoted in money and it is the capital of the company. The persons who contribute the capital are members or share holders. The proportion of capital to which each member is entitled is his share. Shares are always transferable although the right to transfer them is often more or less restricted. Justice James defined the company as“an association of persons united for some common object”.

According to Section 2(20) of the Companies Act 2013, company means a company incorporated under this Act or under any previous company law.

A company according to the new social economic thinking is a social institution having duties and responsibilities towards the community development and the modern companies Act therefore contains a large number of provisions for protection of the interest of the public.

According to JusticeP.N.Bhagwati the concept of company has undergone radical transformation in the last few decades. The traditional view that the company is the property of holders is now an exploded myth. Today, company is a living vital and dynamic social organization with firm and deep rooted affiliations with rest of the community in which it functions.

16.3 OBJECT OF COMPANIES ACT, 2013

The object of the Companies Act, 2013 is to modernize corporate regulation in India by ensuring transparency, accountability, and good governance.The Act aims to protect the interests of stakeholders, promote ethical business practices, and encourage entrepreneurship while simplifying compliance. It introduces provisions for corporate social responsibility, enhanced disclosures, and stricter penalties for fraud to strengthen investor confidence. By replacing the outdated Companies Act, 1956, it aligns Indian corporate law with global standards, fostering ease of doing business and sustainable growth. Ultimately, its objective is to balance corporate efficiency with social responsibility, ensuring fair conduct in the corporate sector.

16.4 CHARACTERISTICS OF A COMPANY

A company after incorporation will become a body corporate and acquires a corporate personality apart from its members. A company also acquires certain characteristics or advantages like perpetual succession, limited liability after its incorporation.

16.4.1 Separate Legal Entity

A company formed and registered under the CompaniesActwill acquire a distinct legal entity apart from its members. It is considered as an artificial person in the eye of law which is invisible and intangible. It is a fiction of law with legal, but no natural or physical existence. Unlike in case of partnership the company will have a separate juristic entity
Salomon Vs Salomon Co Ltdis a leading case in which the English courts explained the principle of corporate personality. Salomon was a shoe manufacturerand his business was in a sound condition. He incorporated a company named Salomon and Co Ltd. for the purpose of taking over and carrying on his business. He sold his business for the sum of $ 39,000 to Saloman and Co. Ltd.and his wife, one daughter and four sons were only the members of the company.

Salomon took 23, 000 shares of $ 1 each and $ 10, 000 debentures in the company. The debentures gave Salomon a charge over the assets of the company as the consideration for the transfer of the business. One share of $ 1 each was subscribed by the remaining six members of his family. Saloman and his two sons became the directors of this company. Saloman was the managing Director. After a short duration, the company went into liquidation. At the time of liquidation, its assets were found to be worth $6, 000 and its liabilities amounted to $ 17, 000 of which $ 10, 000 were due to Salomon (secured by debentures) and $ 7, 000 due to unsecured creditors.

The unsecured creditors claimed that Salomon and the company were one and the same person and that the company was a mere agent for Salomon and hence they should be paid in priority to Salomon. But the court held that the company was, in the eyes of law, a separate person independent from Salomon and was not his agent. Salomon, though virtually the holder of all the shares in the company, was also a secured creditor and was entitled to repayment in priority to the unsecured creditors.

16.4.2Perpetual Succession

A company is an artificial person so it never dies. Its life does not depend on the life of its members. It continues to exist even in case of death of all itsmembers.Asit is created by law it can be put an end only by the process of law. Unlike a natural person a company never dies. It is an entity with a perpetual succession. Its existence is not affected by the death, lunacy or insolvency of its members.

16.4.3 Limited Liability

In a company limited by shares, the liability of members is limited. The liability of the members of such company is limited to the nominal value of the shares taken by them and if this has not been paid by him fully he can be called to pay the unpaid value. If thevalue of a share in a company is Rs.10 and a member has already paid Rs.7 per share, he can be called to pay not more than Rs.3 per share during the lifetime of the company. In a company limited by guarantee, the liability of members is limited to such amount as the members may undertake to contribute to the assets of the company in the event of its being wound up.

16.4.4 Separate Property

As the company is a legal person distinct from its members, it can own, enjoy and dis. pose of the property in the name of the company. Although, the capital and assets of the company are contributed by its shareholders, they are not the private and joint owners of the property of the company. The property of the company is not the property of the shareholders; it is the property of the company.

16.4.5 Transferability of shares

The capital of a company is divided into parts, called shares and these shares are, subject to certain conditions, freely transferable.According to Section 44 of the Companies Act, 2013, shares and debentures are transferable and movable property of a company and they can be transferred in the manner provided by the Articles of Association. When the joint stock companies were established, the object was that the shares should be capable of being easily transferred.

16.4.6 Common seal

A company is a juristic person with a perpetual succession and a common seal. As the company is an artificial person which has no physical existence, it can act through its agents and all such contracts entered into by its agents must be under the seal of the company. The common seal acts as the official signature of the company.

16.4.7 Capacity to sue and be sued

A company can sue and be sued in its corporate name. On incorporation, a company acquires separate and independent legal personality. As a legal person, it can sue and be sued in its name.

Thus, after incorporation a company will become a body corporate and will acquire the above discussed characteristics or advantages.

16.5 DISADVANTAGES OF A COMPANY

In certain cases like fraud or to determine the character of a company the corporate veil of the company may be lifted.

1. Lifting the Corporate Veil

The company has a corporate personality which is distinct from its members. It is an artificial person in the eye of law which is different from its members. That is, there is a veil or curtain between the company and its members. But in cases where the corporate personality is abused to shield illegal or unethical practices the corporate veil can be lifted by the judiciary. Thusto prevent the fraud the court may lift the corporate veil or remove the curtain between the company and its members or crack the shell of corporate personality and look at the persons behind the company who are the real beneficiaries of the corporate fiction.

The corporate veil is lifted in the following cases:

a. Determination of the character

b. Where company is a mere cloak or sham

c. Where the company is acting as an agent of the shareholders

d. Protection of revenue.

2.Statutory Exceptions under the Companies Act, 2013

a. **Number of Members below Statutory Minimum (Sec. 3A)**
If a company carries on business for more than six months after its membership falls below the statutory minimum (two in case of a private company and seven in case of a public company), every person who is aware of this fact and continues as a member during that period becomes **severally liable for all debts contracted after six**

months. Only continuing members can be sued, not those who have withdrawn. Liability arises only if the member is aware of the shortfall in membership.

b. Failure to Refund Application Money (Sec. 39(3))
Where a company fails to allot shares and refund application money within the prescribed period (15 days after 30 days of issue of prospectus), the **directors are jointly and severally liable** to repay the money with interest. This provision ensures investor protection and accountability of directors.

c. Misdescription of Company's Name (Sec. 12(3) & Sec. 12(8))
If an officer or agent of a company enters into a contract or signs negotiable instruments without properly mentioning the company's name and registered office, he becomes **personally liable**. For example, if a bill of exchange or promissory note is signed without clarifying that it is on behalf of the company, the officer is personally responsible unless the company has already discharged the liability.

d. Fraudulent Trading (Sec. 339)
During winding up, if it appears that the company's business has been carried on with intent to defraud creditors or for fraudulent purposes, the tribunal may declare that persons knowingly involved are personally liable without limitation for the company's debts. Such declaration can be made on the application of the liquidator, creditor, or contributory.

e. Holding and Subsidiary Companies (Sec. 129 & Sec. 2(87))
Although holding and subsidiary companies are separate legal entities, certain exceptions apply:
At the end of the financial year, a holding company must present consolidated financial statements along with its own accounts, showing the collective performance and financial position of the group.
Courts may, based on facts, treat a subsidiary as merely a branch or department of the holding company, thereby limiting its separate identity

1. Advantages of Lifting the Corporate Veil

1. **Discourages Fraud:** By holding individuals accountable, it deters the misuse of the corporate structure to carry out fraudulent activities.
2. **Protects Creditors and Stakeholders**: Courts can ensure that shareholders or directors do not take undue advantage of the limited liability status at the expense of creditors.
3. **Upholds Justice and Fairness:** It prevents people from escaping personal liability by hiding behind the corporate entity, thus promoting justice.
4. **Ensures Compliance with Law:** By lifting the veil in cases of non compliance, courts ensure that companies and their members abide by regulatory standards.

16.6. CLASSIFICATION OF COMPANIES

Companies can be classified on the basis of corporation, nature of liability, extent of public interest, ownership, nationality etc.The following are the different kinds of companies.

I. **On the Basis of Incorporation**

A company can be incorporated in accordance with the provisions of an Act or legislation or a statute. The provisions of the particular Act under which it was established governs its working. Companies of this kind are of three types. They are,

a. **Statutory Companies:** These are the companies which are created under a special Act of the Parliament or State Legislature, e.g., the Reserve Bank of India, the State bank of India, the Life Insurance Corporation, etc. these are mostly concerned with public utilities, e.g., railways, electricity companies and enterprise of national importance.

b. **Registered Companies:**Companies which are registered under the Companies Act, 1956, or were registered under any of the previous companies Acts are called registered companies. A vast majority of companies we come across belong to this category. Tata Motors Limited, Reliance Telecommunication Limited, EID Parry Limited, etc belong to this category.

c. **Chartered Companies:** Companies established as a result of a charter granted by the King or Queen of a country is known as chartered companies. The charter issued, governs their functioning. Example – Bank of England, East India Company, etc.

II. On the Basis of Liability

On the basis of the extent of liabilities of the shareholders such companies are divided into three categories.

a. Companies Limited by Shares

Where the liability of the members of a company is limited to the amount unpaid on the shares such a company is known as a company limited by shares. If the shares are fully paid, the liability of the members holding such shares is nil.

b. Companies Limited by Guarantee

In a company limited by guarantee the liability of a shareholder is limited to the amount he has voluntarily undertake to contribute to meet any deficiency at the time of its winding up. Such a company may or may not have a share capital. If it has a share capital a member's liability is limited to the amount remaining unpaid on his share plus the amount guaranteed by him. This type of company is started with the object of promoting science, arts, sports, charity, etc. it is clear that its objective is not profit earning. It gets subscription from its members and donations and endowments from philanthropists.

c. Unlimited Liability

A company without limited liability is known as an unlimited liability. In case of such a company, every member is liable for the debts of the company, as in case of ordinary partnership, is proportion to his interest in the company. In other words, their liability extends to their privateproperties also in the event of winding up. Unlimited companies are almost non- existent.

III. **On the Basis of Nationality**

They are of two types' viz., domestic companies and foreign companies.

a. **Domestic Company**: Companies registered under the Companies Act, 2013 or under earlier Acts are considered as domestic companies.

b. Foreign Company: Foreign company means a company incorporated outside India but having a place of business in India. It has to furnish to the authorities the full address of the registered or principal office of the company, list of its directors, names and addresses of the residents in India authorized to receive notices, documents, etc.

IV. On the Basis of Number of Members

a. Private Company

A private company means a company which by its articles

i. restricts the rights to transfer its shares

ii. Limits the number of its members minimum 2 and maximum number of members 200 (excluding the employees)

iii. Prohibits any invitation to the public to subscribe for any shares or debentures of the company. The name of the company must end with the words 'private limited'.

b. Public Company

The public is invited to subscribe to the shares of the company usually by issuing a prospectus. Shares are easily transferable. A public company must have at least 7 persons to form and no maximum limit as to its number of shareholders or members. The name must end with the word 'limited'.

V. On the Basis of Control / Ownership

a. **Holding Company and Subsidiary Company**

A company is known as the holding company of another company if it has control over that other company. A company becomes a holding company of another

i) if it can appoint or remove all or majority of the directors of the latter company or

ii) if it holds more than 50% of the equity share capital of the latter or

iii) if it can exercise more than 50% of the total voting power of the latter. A company is known as a Subsidiary of another company when control is exercised by the latter (called holding company). Over the former called a subsidiary company.

b. **Government Companies**

A Government company is one in which not less than 51% of the paid up capital is held by the Central Government or by any one or more State Governments or partly by the Central Governments and partly by one or more State Governments. Examples: Bharath Heavy Electricals Limited, Steel Authority of India Limited, etc. A subsidiary of a Government company is also treated as a Government company. A Government company also enjoys a separate corporate existence. It should not be identified with the Government and its employees are not Government employees.

c. **One man company:** These are companies in which one man holds virtually the whole of the share capital with a few extra members holding the remainder who may be his relations or nominees.

DISTINCTION BETWEEN PUBLIC COMPANY AND PRIVATE COMPANY

Point of Distinction	Public Company	Private Company
Minimum No. of Members	7 persons	2 persons
Maximum No. of Members	No limit	Not more than 200 members
Name of the Company	Must end with "Limited"	Must end with "Private Limited"
Articles of Association (AOA)	Can have its own Articles or adopt Table A of the Companies Act	Must prepare its own Articles of Association
Commencement of Business	Needs certificate of commencement before starting business	Can commence business immediately upon incorporation
Invitation to Public	May invite public to subscribe to shares/debentures via prospectus	Cannot invite the public to subscribe
Transferability of Shares	No restriction on transfer of shares	Restricted transfer of shares as per Articles
Qualification Shares	Directors must acquire prescribed qualification shares	Directors need not acquire qualification shares
Quorum	Minimum 5 members must be present	Minimum 2 members must be present
Issue of Prospectus	Can issue a prospectus	Prohibited from issuing a prospectus
Issue of Subsequent Shares	New shares offered first to existing shareholders (rights issue)	Rights issue does not arise
Issue of Share Warrants	| Can issue share warrants	Cannot issue share warrants
Number of Directors	At least 3 directors	At least 2 directors
Statutory Meetings	Compulsory	No such obligation
Managerial Remuneration	Cannot exceed 11% of net profit	No such restriction

DISTINCTION BETWEEN PARTNERSHIP FIRM AND JOINT STOCK COMPANY DIFFERENCE

Point of Difference	Partnership Firm	Joint Stock Company
1. The Acts	Governed by the Indian Partnership Act, 1932	Governed mainly by the Companies Act, 2013
2. Registration	Registration is optional	Registration is compulsory
3. Number of Members	Minimum: 2 persons; Maximum: 10 (banking) or 20 (other businesses)	Minimum: Public – 7, Private – 2; Maximum: Public – unlimited, Private – 50 (excluding employee members)
4. Legal Status	No separate legal existence	An artificial person created by law
5. Liability	Joint, several, and unlimited liability of partners	Liability limited to the unpaid amount of shares held
6. Transfer of Shares/Interest	A partner cannot transfer interest without consent of all partners	Shares are freely transferable
7. Management	Managed by all partners or any one acting for all	Managed by a Board of Directors elected by members
8. Stability	Not stable; affected by death, insanity, or insolvency of partners	Stable; unaffected by such contingencies
9. Procedural Complexities	Simple procedures for formation and dissolution	Formation and winding up involve many legal formalities
10. Financial Resources	Limited capital contribution and finance	Wide scope for mobilizing larger resources
11. Membership	Only individuals can be members	Institutions can also become members by purchasing shares
12. Nature	Relationship between persons sharing profits/losses	An artificial person
13. Mutual Relationship of Members	Each partner is an agent of the others	Members are not agents or representatives of one another
14. Audit	Audit of accounts is not compulsory	Annual audit of accounts by a chartered accountant is compulsory
15. Dissolution	Can be mutually dissolved at any time	Legal formalities for winding up are extensive

16.7 SUMMARY

The Companies Act, 2013 is a landmark legislation in India that governs the formation, regulation, and dissolution of companies, replacing the Companies Act, 1956. Its objective is to enhance corporate governance, ensure transparency, protect stakeholders, and align Indian corporate law with global standards. The Act classifies companies into various categories such as public companies, private companies, one-person companies, small companies, and producer companies, based on ownership, liability, and size. It also distinguishes companies as limited by shares, limited by guarantee, or unlimited companies. This classification ensures appropriate regulation, compliance, and accountability tailored to each type of business entity.

16.8 TECHNICAL TERMS

Public Company, Private Company, Company Limited by Shares,Company Limited by Guarantee,Subsidiary Company, Fraudulent Trading,Key Managerial Personnel,Corporate Veil.

16.9 SELF ASSESSMENT QUESTIONS

1. Discuss the objectives of the Companies Act, 2013.
2. Explain the classification of companies under the Companies Act, 2013.
3. Analyze the concept of "lifting of the corporate veil."
4. Examine the statutory exceptions to the principle of limited liability**.**

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Lesson 17

FORMATION OF A COMPANY

OBJECTIVE OF THE LESSON

The objective of the lesson on Formation of a Company is to provide a clear understanding of the legal and procedural framework involved in establishing a corporate entity. It aims to familiarize students with the essential documents such as the Memorandum of Association, Articles of Association, and Prospectus, and their significance in defining the scope, governance, and capital-raising activities of a company. The lesson also seeks to develop analytical skills to evaluate compliance requirements, doctrines, and liabilities, thereby preparing students to apply theoretical knowledge in practical business scenarios and make informed managerial and entrepreneurial decisions.

Structure of the lesson

17.1 INTRODUCTION

The formation of a company is a legal process by which a business entity is incorporated and recognized by law. This process is governed by the Companies Act, 2013 in India, and it involves several stages: Promotion, Incorporation or Registration and ccommencement of bbusiness. Each stage includes specific steps and legal formalities to ensure that the company complies with the law and is properly organized for its intended operations.

17.2 Stages in the Formation of a Company

17.2.1 Promotion

Promotion is the initial stage in the formation of a company. It is the process by which the idea of forming a company takes a definite shape resulting in its incorporation.It involves conceiving the idea for the business and organizing the necessary resources to establish it.

Promoter

A promoter is a person or group of persons who undertake the initial steps to create and set up a company. They play a crucial role in the formation process, as they are responsible for bringing together the resources, ideas, and individuals necessary to establish the business. Promoters carry out several essential activities to give the company a legal identity, including developing the business idea, securing initial funding, and completing the registration process.

Palmer explains the significance of the promoter in the following words. “A Promoter starts a scheme of forming a company, gets together the Board of Directors, retains bankers and solicitors, prepares or gets prepared memorandum and articles of association, provides the preliminary expenses, drafts the prospectus. He is the person who undertakes to form a company with reference to a given project and takes the necessary steps to get it going”.

They may be entrepreneurs or professionals who organize the resources and make the necessary preparations for incorporation of a company. They are responsible for identifying business opportunities, gathering required resources, preparing necessary documents, and ensuring compliance with the initial formalities.

17.2.2 Roles and Responsibilities of a Promoter

1. Conceiving the Business Idea:

The promoter is usually the one who comes up with the initial business concept or identifies an opportunity in the market.They decide on the type, structure, and scale of the business, determining the company’s purpose, products or services, and target market.

2. Conducting Feasibility Studies:

Promoters are responsible for evaluating the viability of the business idea by conducting feasibility studies, including financial, market, and legal issues.This assessment ensures that the company has a sound foundation and minimizes risks for future stakeholders.

3. Organizing Resources:

Promoters arrange the capital, human resources, physical infrastructure, and technology required to establish the company. They may invest their own funds initially and seek additional funding from other investors, including family, friends.

4. **Obtaining Approval for Company’s Name:**

The promoter applies to the Registrar of Companies (ROC) to secure an approved name for the company. The chosen name must comply with the guidelines specified in the Companies Act, 2013, and should not be identical or too similar to any existing company name.

5. Drafting Legal Documents:
Promoters prepare the Memorandum of Association and Articles of Association, which define the objectives, scope, and governance of the company.
These documents are essential for incorporating the company and are submitted to the registrar of companies along with the application for incorporation.

6. Appointing Directors and Other Officers:
The promoter selects and appoints the first directors and key officers of the company who havethe required skills and qualifications to manage and oversee the company's operations.

7. Pre-Incorporation Contracts:
Promoters may enter into pre-incorporation contracts with vendors, suppliers, and service providers on behalf of the company. These contracts are made before incorporation and help secure necessary resources, premises, and supplies for the company's operations.

8. Raising Initial Capital:
For public companies, promoters may issue a prospectusinviting the public to invest in the company's shares. The prospectus includes important details about the company's business model, objectives, and financial projections to attract potential investors.

17.2.3 Legal Status and Liability of Promoters

Promoters have a fiduciary duty to act in the best interests of the company and its prospective shareholders. However, promoters do not legally represent the company before its incorporation.There is no sstatutory ddefinition of the term promoter. The Companies Act, 2013 does not explicitly define a promoter but identifies their roles and responsibilities during the formation process.

Fiduciary Duty: Promoters must act honestly and in good faith. They should not make secret profits or engage in any activities that conflict with the interests of the company.

Liability: If a promoter breaches their fiduciary duties, they can be held liable to compensate the company for any losses. If they make secret profits, they may be required to pay those back to the company.

Liability for Pre-Incorporation Contracts: Contracts made by promoters on behalf of the company before incorporation are not binding on the company unless ratified after incorporation. If the company does not ratify these contracts, the promoter may be personally liable for them.

17.2.4 Promoter's Remuneration

Promoters may be compensated in the following ways:

1. Shares: Promoters may receive shares as a form of payment, making them part-owners of the company.

2. Commission: They may receive a commission based on capital raised, such as a percentage of funds gathered from investors.

3. Professional Fees: Professional promoters are often paid fees for their services if they are hired for a one-time project.

4. Profit-sharing: In some cases, promoters may receive a share of the company's profits as a reward for their initial efforts.Any remuneration paid to the promoters must be disclosed in the prospectus, if it is paid within the preceding 2 years from the date of the prospectus.

Thus, promoters play a crucial role in the creation of a company, from conceiving the business idea to handling the legal and financial aspects of its incorporation. They are instrumental in organizing resources, drafting key documents, raising capital, and ensuring compliance with the necessary legal requirements. While theydo not have an official status after incorporation, their contributions to a company's establishment are essential for its future success.

17.3 INCORPORATION / FORMATION OF A COMPANY

Incorporation is theprocess of registering the company with the Registrar of Companies to give it the legal status as a separate entity. It is the legal process through which a company is formed and registered under the relevant laws, granting it legal status as a distinct entity separate from its members.

Importance of Incorporation

This process is important as it provides the company with various legal protections and responsibilities, including limited liability for its members. In India, the incorporation of a company is governed primarily by the Companies Act, 2013.

1. Object of Incorporation:

a.Toacquire a separate legal entity that can own assets, incur liabilities, and enter into contracts in its own name.

b.To limit the liability of shareholders to the extent of their shareholdings, thus protecting personal assets from the debts of the company.

c.To enable the company to raise capital by issuing shares or debentures to the public.

2. Types of companies:

Private Companies: Limited by shares or guarantees and restricts the transfer of shares. It can have a minimum of 2 and a maximum of 200 members.

Public Companies: Can raise capital from the public and have a minimum of 7 members, with no upper limit on membership. They can be listed on stock exchanges.

One Person Company (OPC): It is a new form of private company with only one person as a member. It has a separate legal entity with limited liability to its sole member.

17.4 Steps in the incorporation process

To registerthe company with the registrar of companies, the promoter has to initiate the following steps:

17.4.1 Approval for the proposed name:
A company can choose any name but it should not closely resemble the name of an existing company. Hence the promoter has to get the approval from the registrar for the proposed name of the company. So the promoters must apply to the Registrar of Companies (ROC) to reserve a unique name for the company. The name must comply with the naming guidelines specified under the Companies Act, 2013 and must not be identical or too similar to any existing company names. This can be done online through the Ministry of Corporate Affairs (MCA) portal using the RUN (Reserve Unique Name) form.

17.4.2 Preparation of Documents: The following documents must be prepared and be submitted to the registrar of companies of the State in which the registered office of the company is situated.

i. Memorandum of Association: This is an important document which outlines the company's objectives, the scope of its activities, and its relationship with the outside world. It should contain the name, the place where the registered office is situated and the objects of the company's business. It should specify the authorized capital of the company and the division of shares and whether the liability of the members is limited by shares or by guarantee. It should be printed and duly stamped, signed and witnessed. A minimum of two persons in the case of a private company and seven in the case of a public company must be the subscribers of the memorandum of association .

ii. Articles of Association: This document specifies the internal rules and regulations governing operations of the company.That is, Articles of Association contains the regulations connected with the internal management of the company. This document must also be duly stamped and signed by the signatories to thememorandum and witnessed.

i. **Original letter of** approval **of Name**: Original letter of approval of name obtained from the Registrar shall be submitted.

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ii. **List of directors and affidavit from the directors and subscribers:**
The list of directors who have consented to be its directors along with their details and address must be filed.The directors have to give the affidavit confirming their willingness to act as the directors of the company, confirmation of their identification and address and a declaration that they are not disqualified from being appointed as directors under the law..They should also undertake to take the necessary qualification shares and pay for them.

vi.Address of the registered office:
The official address from where the company will operate shall be mentioned with relevant documents.

vii. Declaration of Compliance:
A declaration stating that all the requirements of law relating to registration have been complied with. This declaration must be given by an Advocate of the Supreme Court

or High Court, or by a Chartered Accountant who is engaged in the formation of the company or by a person named in the Articles of Association as a director or secretary of the company.

viii.Payment of Fees: The company must pay the prescribed registration fee, which varies based on its authorized capital.

17.4.3 E-Filing in Company Registration

E-filing refers to the electronic submission of documents and forms required for the registration and compliance of companies with the regulatory authorities. In India, e-filing is introduced as a part of the Ministry of Corporate Affairs (MCA) initiative to streamline the incorporation process and enhance transparency, efficiency, and accessibility for businesses. This system allows companies and professionals to filenecessary documents online, reducing the need for physical submissions and making the process faster and more efficient.

Thus, for the incorporation of a company certain documents are crucial. The Memorandum of Association and Articles of Association are the important documents that define the company's structure and operational guidelines. Additionally, the declaration of compliance, affidavits, identification documents, and proof of the registered office ensure that the company meets all regulatory requirements. Proper preparation and submission of these documents to the Registrar of Companies are essential for incorporation and to secure the legal identity of the company.

17.5 Issuance of Certificate of Incorporation:

The registrar will scrutinize all the documents and if he is satisfied that all the legal requirements are complied with for registration of the company he will issue the certificate of incorporation. This certificate of incorporation is a conclusive evidenceto show that the company has been duly registered.

17.5.1 Effects of Incorporation:

a. After incorporation the company will be recognized as a separate legal entity distinct from its members.

b.Itwill have perpetual succession and continues to exist regardless of changes in membership.

c. It can enter into contracts, own property, and it can sue and be sued in its own name.

17.5.2 Commencement of Business

After incorporation, a public company must fulfill some additional requirements to start its business operations officially where as a private company can commence its business immediately on getting the certificate of incorporation.

17.5.3 Certificate of Commencement of Business

A Public company has to obtain another certificate i.e, Certificate of Commencement of Business to start its business. To obtain Certificate of Commencement of Business it has to comply certain conditions. A public company must issue a prospectus or a statement in lieu of a prospectus to invite the public to subscribe to its shares. Once the minimum subscription amount is received and other financial and regulatory requirements are met, the company can apply for the Certificate of Commencement of Business.

Issue of Prospectus

The Board of directors should arrange for drafting a prospectus when it wants to approach the public for securing capital. A prospectus contains all essential points which would induce the investing public to apply for shares in the company. A copy of the prospectus must be delivered to the Registrar before issuing to the public. Minimum Subscription

A company can proceed to allot shares only if minimum subscription specified in the prospectus has been collected in cash.

Statement in Lieu of Prospectus

Where the promoters raise the entire capital through private arrangement, there is no need to issue a prospectus. However, a statement in lieu of prospectus, the contents of which are similar to a prospectus, must be prepared and filed with the Registrar at least three days before allotment.

Filing of further documents

The following documents are to be filed with the Registrar;

i) A declaration that the minimum subscription stated in the prospectus has been collected in cash

ii) A declaration stating that each director has paid in cash for the application andallotment on the shares taken up by them

iii) A declaration that no money has become refundable to applicants because of its failure to obtain permission for shares or debentures to be dealt in on any recognized stock exchange

iv) A statutory declaration by the secretary or one of its directors stating that the above requirements have been complied with.

17.5.4 Issuance of Certificate of Commencement of Business

If the Registrar is satisfied that all the requirements are complied with for commencement of business he will issue the certificate for commencement of business. Onlyafter obtaining this certificate; a public limited company can start its business.

17.6 Post-Incorporation Filings:

After incorporation, companies must continue to comply with various regulatory requirements through e-filing, which includes:

Filing annual returns and financial statements.

Updating changes in directors, registered office, and share capital. Filing resolutions passed in board meetings or general meetings etc.

17.7 SUMMARY

The lesson on Formation of a Company explains the sequential process of establishing a corporate entity. It begins with an introduction to company formation and highlights the stages, starting with promotion, where promoters identify opportunities, assume responsibilities, and understand their legal status, liabilities, and remuneration. It then covers incorporation, detailing steps such as approval of the proposed name, e-filing of registration documents, and issuance of the Certificate of Incorporation. The lesson further explores the effects of incorporation, commencement of business, and the issuance of the Certificate of Commencement. Finally, it emphasizes post-incorporation filings essential for compliance and governance

17.8 TECHNICAL TERMS

Promoter, Promotion, Memorandum of Association(MoA), Articles of Association (AoA), Prospectus, Certificate of Incorporation, Commencement of Business Certificate, E-Filing, Post-Incorporation Filings.

17.9 SELFASSESSMENT QUESTIONS

1. What is the role of a promoter in the formation of a company?
2. Name any two legal liabilities of promoters.
3. What is the significance of the Certificate of Incorporation?
4. Which document defines the internal rules and regulations of a company?
5. What is meant by commencement of business for a public company?
6. List any two post-incorporation filings required for compliance

17.10 RFERENCE

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Lesson 18

MEMORANDUM OF ASSOCIATION, ARTICLES OF OF ASSOCIATION AND PROSPECTUS

Objective of the lesson
The objective of this lesson for students is to provide a clear understanding of the foundational legal documents of a companyMemorandum of Association, Articles of Association, and Prospectus. It aims to equip students with knowledge of how these documents define a company's scope, internal governance, and capital-raising mechanisms. By studying them, students learn the regulatory framework, investor communication, and compliance essentials, enabling them to make informed managerial and strategic decisions in corporate environments.

Structure of the lesson

18.1. Introduction

18.2 Memorandum of association

- **18.2.1 Contents of memorandum of association**
  - **18.2.1.1 Name clause**
  - **18.2.1.2 Registered office clause**
  - **18.2.1.3 Objects clause**
  - **18.2.1.4 Liability clause**
  - **18.2.1.5 Capital clause**
  - **18.2.1.6 Subscription clause**
- **18.2.2 Alteration of memorandum of association**
- **18.2.3 Doctrine of ultra vires**

18.3 Articles of association

- **18.3.1 Contents of articles of association**
- **18.3.2 Alteration of articles of association**

18.4 Memorandum and articles – distinction

18.5 Doctrine of constructive notice

18.6 Doctrine of indoor management

18.7 Prospectus

- **18.7.1 Contents of a prospectus**
- **18.7.2 Liability for misstatements in prospectus**

18.8 Summary

18.9 Technical Terms

18.10 Self-Assessment

18.11 Reference

18.1. INTRODUCTION

The study of the Memorandum of Association, Articles of Association, and Prospectus forms a vital foundation for students in understanding corporate law and governance. These documents collectively define a company's identity, objectives, internal rules, and methods of raising capital. The Memorandum outlines the scope and purpose of the company, the

Articles regulate internal management and decision-making, while the Prospectus communicates essential information to potential investors. By exploring these, students gain insights into legal compliance, transparency, and strategic planning, enabling them to appreciate how businesses are structured and governed in practice.

18.2 MEMORANDUM OF ASSOCIATION

Memorandum of Association is one of the essential documents, which has to be filed with the Registrar of Companies at the time of incorporation of a company. It is a document, which sets out the constitution of the company and contains the fundamental conditions on the basis of which the company will be incorporated.The Memorandum of Association (MOA) represents the charter of the company. It is a legal document prepared during a company's formation and registration process. It defines the company's relationship with shareholders and specifies the objectives for which the company has been formed.

The company can undertake only those activities mentioned in the Memorandum of Association. That is, the MOA lays down the limitations beyond which the company's actions cannot go. When the company's actions are beyond the limitations of the MOA, such actions will be considered ultra vires and thus void.Under the Companies Act, 2013, the MOA must be draftedin a specific format and must include several key components.

18.2.1 CONTENTS OF MEMORANDUM OF ASSOCIATION

The following are the main contents of the MOA:

18.2.1.1 NAME CLAUSE

The name clause specifies the name of the company. The name of the company should not be identical to any existing company. If it is a private company, then it should have the word 'Private Limited' at the end. In the case of a public company, it should have the word "Limited" at the end of its name. For example, if it is a private company it has to be mentioned as"ABC Private Limited"and in the case of the public company it has to be mentioned as "ABC Ltd". The name should be in compliance with the provisions laid down in the Companies Act and Rules.

Rules regarding name
i) undesirable name to be avoided
ii) identical name to be avoided
iii) injunction if identical name adopted
iv) limited or private limited as the last word or words
v) prohibition of use of certain names
vi) restriction on use of certain key words as part of name

1.8.2.1.2 REGISTERED OFFICE CLAUSE

This clause states the name of the state where the registered office of the company is to situated. The registered office clause is important for two reasons. First, it ascertains the domicile and nationality of a company. Second, it is the place where various registers relating to the company must be kept and to which all communications and notices must be sent.

18.2.1.3 OBJECTS CLAUSE

The object clause is the most important clause in the memorandum of association of a company. This clause states the objective with which the company is formed.The company must carry out its business activities to fulfill the objectives mentioned in this clause. It helps to protect the interests of the stakeholders since the company must operate within the scope of its objects clause and should not engage in any activities not specified in this clause.

It serves a twofold purpose;
1) it gives an idea to the prospective shareholders the purpose for which their money will be utilized;
2) it enables the persons dealing with the company to ascertain its powers.

The objectives can be further divided into the following 3 subcategories:

Main Object: It states the main business of the company

I**ncidental Objects:** These are the objects ancillary to the attainment of main objects of the company

Other objects: Any other objects which the company may pursue and are not covered in above (a) and (b)

18.2.1.4 LIABILITY CLAUSE

This clause states the nature of liability of the members of the company in case of any loss or debts incurred by it. In the case of an unlimited company, the liability of the members is unlimited. Whereas, in the case of a company limited by shares, the liability of the members is restricted by the amount unpaid on their share. For a company limited by guarantee, the liability of the members is restricted by the amount each member has agreed to contribute.

18.2.1.5 CAPITAL CLAUSE

The memorandum of a company limited by shares must state the authorized or nominal share capital, the different kinds of shares, and the nominal value of each share. That is, this clause gives details regarding the maximum capital, a company can raise which is known as authorized or nominal capital of the company. It provides the maximum amount of capital that can be issued to the company shareholders. It also explains the division of such capital amount into the number of shares of a fixed amount each. It will also specify the type of shares the company is authorised to issue, i.e. equity shares, preference shares, or debentures.

18.2.1.6 SUBSCRIPTION CLAUSE

This clause is also known as Association clause. This clause provides that those who have agreed to subscribe to the memorandum must signify their willingness to associate and form a company. The memorandum has to be signed by each subscriber in the presence of at least one witness who must attest the signature. Each subscriber must write opposite to his name the number of shares he shall take. In case of a private company there must be atleast two subscribers and in case of a public company there must be atleast seven subscribers to the memorandum of association.

18.2.2 ALTERATION OF MEMORANDUM OF ASSOCIATION

Section 13 0f the Companies Act, 2013 provides that a company may by a special resolution and after complying with the procedure specified alter the provisions of its memorandum.

1. **Change of name**

A company may change its name by a special resolution and with approval of the Central Government signified in writing in case of deletion or addition of the word "private" on the conversion of a public company into a private company or vice versa.If a company registered by a name which, in the opinion of the Central Government, is identical with or too nearly resembles, the company may change its name by ordinary resolution with the previous approval of the Central Government within 12 months.

The Secretary has to follow the following procedure for change of name

a. He should make an application with prescribed fees to know the availability of the changed name.

b. Once the Registrar informs the availability of the changed name, the Board meeting should convene a general meeting to pass a special resolution.

c. Copy of special resolution signed by the chairman should be filed with the registrar with 30 days of passing the resolution.

d. Apply to the registrar for a fresh certificate of incorporation and the company has to get fresh certificate of incorporation.

2. Change of registered office

a. The registered office from one place to another place within the same state can be changed after passing a special resolution and a copy of it has to be filed with the registrar of companies. This change of address has to be informed within 30 days to the Registrar with supportive documents.

b. To change Registered Office from one State to aanother state the company has to pass special resolution and has to obtain the approval from the Central Government. A copy of it has to be filedwith the registrar of companies of both the states within 30 days of passing the resolution.

3. Alteration of Objects clause

Object clause is the most important clause in the MOA. It can be altered by passing special resolution. The altered copy along with minutes should be filed with the registrar of companies.

The objects clause can be altered so as to enable the company

i) To carry on its business more economically or more efficiently

ii) To attain its main purpose by new or improved means

iii) To enlarge or change the local area of its operation

iv) To carry on some business which under existing circumstances may conveniently or advantageously be combined with the objects specified in the memorandum

v) To restrict or abandon any of the objects specified in the memorandum

vi) To sell or dispose of the whole, or any of the undertaking

vii) To amalgamate with any other company or body of persons.

4. Change in liability clause
A company limited by shares or guarantee cannot change the Memorandum so as to impose any additional liability on the members or to compel them to buy additional shares of the company unless all the members agree in writing to such change either before or after the change.

5. Change in CapitalClause
Change in the capital clause which may involve increase, reduction or reorganization of capital, will be done by passing ordinary or special resolution as required by the circumstances.

18.2.3 DOCTRINE OF ULTRA VIRES

An act ultra vires the company - A company has the power to do all such things as are –

1. Authorized to be done by the CompaniesAct,
2. Essential to the attainment of its objects specified in the memorandum,
3. Reasonable and fairly incidental to its objects.

A company has the power to carry out the objects set out in the memorandum and also everything which is reasonably necessary to enable it to carry out those objects. Any activity not expressly authorized by the memorandum are ultra vires of the company. Otherwise, the term ultra vires means that the doing of the act is beyond the legal power and authority of the company.

If an act is ultra vires the company i.e., it is outside the scope of the company's objects, it is wholly void and inoperative and will not be binding on the company. Even the whole body of shareholders cannot ratify it.

18.3 ARTICLES OF ASSOCIATION

The Articles of Association (AOA) is an important document that deals with the rules relating to internal management and governance structure of a company. Under the Companies Act, 2013, every company registered in India must have its own AOA.As per Sec.2(5) of the Companies Act ,2013, "Articles of Association of a company is a document as originally framed or as altered from time to time in pursuance of any previous companies law or of this Act. The articles of association are the rules and regulations of a company framed for the purpose of internal management of its affairs. The articles are framed for carrying out the aims and objectives of the Memorandum of Association. While a MOA defines the powers of the company and are meant for the benefit of the creditors, outside public as well as the shareholders, the AOA define the powers of the officers of the company , lays down procedures to be followed for general management and are for the benefit of the shareholders.
Articles establish a contract between the company and the members and between the members inter-se.

18.3.1 CONTENTS OF ARTICLES OF ASSOCIATION

Articles of Association of a company generally deals with the following matters:

1. Adoption of preliminary contracts
2. Different classes of shares and their rights
3. Procedure of issue, transfer, transmission, forfeiture, reissue etc of shares

4.Appointments, powers, duties, qualifications etc. of auditors, directors, managers, secretary, managing director etc.
5.General Meetings, proxies, polls,
6.Board Meetings and proceedings thereof
7.Voting rights of members
8.Borrowing powers of directors, dividends and reserves
9.Issue, allotment, alteration, reorganization, consolidation etc.of share capital
10.Keeping of books of accounts and their audit
11.Arbitration provisions etc.
12.winding up
13.In case of private companies, the AOA must contain the three restrictions as given in Sec.2(68) namely restriction on right of members to transfer shares, limitation of number of members to 200 and prohibition of invitation to public for subscription of its securities.

In the case of companies with the liability limited by guarantee, the articles must also state the number of members with which the company is to be registered. It must also state the extent of liability in the event of winding up.

18.3.2 ALTERATION OF ARTICLES OF ASSOCIATION

The AOA can be altered through a special resolution passed by the shareholders, following the procedure mentioned in the Companies Act, 2013. Any changes must comply with the legal requirements and should be filed with the Registrar of Companies within 15 days of passing the resolution.

18.4 MEMORANDUM AND ARTICLES – DISTINCTION

MOA is defined in section 2(56)of the Companies Act and covered in Section 4 of the Act, AOA is defined in section 2(5)of the Companies Act and covered in Section 5 of the Act.

1. Content and Scope :MOA is the charter or the constitution of the company and defines the objects and scope of its activities. AOA of the company is a document, which deals with bylaws to regulate the internal management of the company.
2. Relationship between company,members and outsiders: MOA defines the relationship of the company with the outside world, whereas AOA deals with the right of the members of the company inter-se and also establishes the relationship of the company with the members.
3. Alteration:MOA cannot be altered except in the manner and to the extent provided by the Act, whereas the AOA being only the bylaws of the company can be altered by a special resolution.
4. Supremacy: Memorandum is a supreme document of the company, whereas articles are subordinate to the memorandum.
5. Ultra-vires acts:A company cannot go beyond the provisions contained in the memorandum, and if it does, it would be ultra-vires acts of the company, anything done against the provisions of Articles, but if it isnot ultra-vires of the Memorandum, it can be ratified.

18.5 DOCTRINE OF CONSTRUCTIVE NOTICE

The Memorandum and Articles of association of every company are required to register with the registrar of companies. On registration they become public documents and are open for public inspection on payment. Everyone dealing with the company, whether a shareholder or an outsider, is presumed to have read the two documents. This deemed knowledge of the two documents and their contents is known as the constructive noticeof memorandum and articles of association.

18.6 DOCTRINE OF INDOOR MANAGEMENT

The outsiders dealing with the company are entitled to assume that as far as the internal proceedings of the company are concerned, everything has been regular done. They are presumed to have read these documents and to see that the proposed dealing is not inconsistent therewith, but they need not inquire into regularity of the internal proceedings as required by the memorandum and the articles. They can presume that all is being done regularly. This limitation of the doctrine of constructive notice is known as the "doctrine of indoor management".

EXCEPTIONS

1. Knowledge of Irregularity: Where a person dealing with a company has actual or constructive notice of the irregularity as regards internal management, he can't claim the benefit under the rule of indoor management.

In Howard V. Patent Ivory Company, the directors of a company has the power to borrow any amount up to $ 1, 000 without the approval of the shareholders in general meetings. But for any amount beyond $ 1, 000 they had to obtain the consent of the shareholders in the generalmeeting. The directors themselves lent to the company an amount in excess of the borrowing powers of the company without the consent of the shareholders in the general meeting. Hence the company was liable to them only for $ 1, 000.

2. Negligence : Where a person dealing with a company could discover the irregularity if he had made proper inquiries he can not claim the benefit of the rule of indoor management.

3. Forgery: The indoor management does not apply where a person relies upon a document that turns out to be forged. A company can never be held bound for forgery committed by its officers.

4. Acts outside the scope of apparent authority: If an officer of a company enters into a contract with a third party and if the act of the officer is beyond the scope of his authority, the company is not bound.

18.7 PROSPECTUS

Prospectus is a document inviting the public to subscribe shares or debentures of the company. It is an invitation issued to the public to take shares or debentures of a company or to deposit money with the company.

A public company can raise the necessary capital for business from the general public by means of the public issue. After the receipt of certificate of incorporation, if the promoters of a public limited company wishes to issue shares to the public, they will issue a document called prospectusto raise the funds. It is an invitation to the public to subscribe to the share capital of the public company.

Any document described as a prospectus and include any notice circular, advertisement or documents inviting deposits from the public or inviting offer from the public for the purchase of any shares in or debentures of a body corporate.

The prospectus issued by or on behalf of a company must be dated and this date is regarded as the date of its publication. A prospectus must contain the necessary information to enable the public to decide whether or not to subscribe for its shares.

18.7.1 CONTENTS OF A PROSPECTUS

1. General Information

Name and address of registered office of the company
Details of letter of intent \ industrial license
Name of stock exchange where listed
Date of opening, closing of the issue
Name, address of lead manager, bankers to the issue, brokers to the issue
Underwriting arrangement

2. Capital Structure of the company

Authorized, issued, subscribed, paid up capital of the company should be mentioned

3. Details of the issues

Object of the issues
Tax benefits available to the company
Rights of the information holders and terms of payment
Authority for the issues and details of resolution passed for the issues

4. Details about the company management

History, main objects, present business of the company, subsidiaries of the company.

5.Promoters and their background

Name, address, occupation of manager, managing director and their relationship with the company.

5. Details about the Project

Cost of the project and means of financing,
Location of the project
Plant & machinery for the projects
Infrastructure facilities for raw materials
Expected date of trail production and commercial production
Schedule of implementation of the projects

6. Financial Information

A report from the auditors on profit and losses of the company Asset and liabilities of the company
Rate of dividend paid by the company

7. Statutory and other Information

Minimum subscription as laid down in the SEBI guidelines Underwriting Commission and brokerage
Fees payable to the lead manager
Date of listing on stock exchanges

8. Other Information

In respect of any issue made by the company and other listed companies underthe same management, the following details; Name of the company, year of issue, types of issue, amount of issue and date of ccompletion of the projects Procedure and time schedule for allotment and issue of certificates Management perception of risk factors Procedure for making application and availability of forms, prospectus and mode of payment Changes in directors and auditors in the last 3 years.

18.7.2 LIABILITY FOR MISSTATEMENTS IN PROSPECTUS

A. **Civil Liability**

A person who has been induced to subscribe for shares in a company on the basis of misstatements or omission of required details in the prospectus may have a remedy either against the company or against the promoters or directors. Of the company.

Remedies against the company

a. Recession of contract

Where a person has purchased the shares of a company on the faith of a prospectus which contained misleading, but not necessarily fraudulent statement, he can seek rescission of the contract.

b. Claim for damages

The shareholders have to return the shares to the company and can claim the money with interest from the company.

Remedies against the directors and promoters

Any person who has purchased shares or debentures on the faith of the prospectus containing untrue statement may sue directors, promoters and experts

a. Damages for deceit or fraud: Any person induced to invest in the company by fraudulent statement in the prospectus can sue the company and persons responsible for damages for deceit.

b. The shares should be first surrendered to the company before the company is sued for damages.

c. Compensation: The above persons shall be liable to pay compensation to every person who subscribes for any shares or debentures, for their loss or damages sustained by reason of any untrue statement included therein.

B. CRIMINAL LIABILITY

Every person who authorizes the issue of prospectus shall be punishable for untrue statements with imprisonment for a period of six months to ten years (or a minimum of three years if public interest is involved) or a fine up to three times the fraud amount, or with both.

18.8 SUMMARY

The Memorandum of Association (MOA), Articles of Association (AOA), and Prospectus are foundational documents of a company. The MOA defines the company's objectives, scope of operations, and relationship with the external world. The AOA governs internal management, rules, and regulations between the company and its members. Together, they establish the company's legal identity and framework. The Prospectus, issued to the public, provides details about the company's business, financial position, and investment opportunities, enabling potential investors to make informed decisions. These documents ensure transparency, accountability, and compliance with corporate laws, forming the backbone of corporate governance.

18.9 TECHNICAL TERMS

Name Clause, Registered Office Clause, Object Clause, Liability Clause, Capital Clause, Association Clause, Internal Regulations, Provisions on issue, transfer, and rights of shares, Dividend Policy, Board of Directors, Meetings, Winding Up, Invitation to Public, Minimum Subscription, Underwriting, Statement in Lieu of Prospectus, Misrepresentation.

18.10 SELF ASSESSMENT QUESTIONS

1. What is the main purpose of the Memorandum of Association in company formation?
2. Name two key differences between the Memorandum of Association and Articles of Association.
3. Which document governs the internal management of a company?
4. What is meant by the term “ultra vires” acts in relation to the Memorandum of Association?
5. What is a prospectus, and why is it important for investors?
6. What are the possible liabilities for misstatements in a prospectus?

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LESSON 19

COMPANY MEETINGS AND RESOLUTIONS

OBJECTIVE OF THE LESSON

The objective of this lesson is to provide learners with a clear understanding of different types of company meetings, their legal requirements, roles of committees, and the significance of resolutions. It aims to build knowledge of corporate governance practices, stakeholder responsibilities, and decision-making processes essential for effective organizational management.

STRUCTURE OF THE LESSON

19.1 INTRODUCTION

A company as a legal entity is capable of acting in its own name, but it is an artificial person which has no physical existence. It has no mind of its own. So it can act only through its members or directors of the company. It can express its will only through resolutions passed at meetings of its members. Hence the meetings are very important for transacting and implementation of business policies.Company meetings must be convened and held in compliance with the provisions of the Companies Act, 2013 and the Rules framed thereunder.

19.2 REQUISITES OF A VALID MEETING

A meeting of any kind, to be valid, must satisfy the following conditions.

1. It must be properly convened. That is, it should be called by the proper authority entitled to call the meeting.
2. The proper authority to convene the meeting is the Board of directors, shareholders or the Company Law Board
3. It must be legally constituted. This means that the meeting should have a proper chairman, there must be quorum for the meeting.
4. Proper notice of the meeting must be given.
5. It should be conducted according to the provisions of the Act and the Articles.
6. It should be properly conducted.

19.3 NOTICE OF MEETING

A Notice of Meeting of a Company is a document informing the members or directors of a company about an upcoming meeting. The notice shallspecify the date, time and place of the meeting and the general nature of the business to be transacted at the meeting.

19.4 KINDS OF MEETINGS

Company meetings are classified as,

i. Shareholders' meetings:

4. Statutory meeting
5. Annual General Meeting (AGM)
6. Extraordinary General Meeting (EGM)

ii. Class meetings:

3. Directors meeting
4. Creditors meeting
5. Debenture holders meeting

19.4.i MEETINGS OF SHAREHOLDERS

19.4.i.1 STATUTORY MEETING

The first meeting of the shareholders of a public limited company which is mandatory as per the Companies Act is known as statutory meeting. Every public limitedcompany, limited by shares and limited by guarantee must compulsorily hold this meeting within 6 months and not earlier than one month from the date on which the company is entitled to commence business. This is held only once in the life time of the company.

The object of the meeting is to give an opportunity to the shareholders to know important details of the company formation, the details of its capital issue, properties that have been acquired, etc. Along with the notice convening the meeting, a report called statutory report must also be sent to all the members at least 21 days before the date of the meeting.

This meeting provides an opportunity to members to discuss various matters relating to the contents of statutory report. They can also effect any modification to the contracts mentioned in the prospectus.

CONTENTS OF STATUTORY REPORT

1. Details of shares issued for cash and those issued for consideration other than cash.
2. Total amount of receipts and payments upto a date within 7 days of the report.
2. A statement of the preliminary expenses.
3. Particulars of contracts for approval and proposed modification
4. Particulars of commission or brokerage paid or to be paid to directors on issue of shares or debentures.
5. Details of directors, managing directors, manager and secretary etc.

The statutory report must be certified as correct by at least two directors, one of whom must be a Managing Director. As far as the cash received on shares allotted and other receipts and payments they must be certified by an auditor. A certified copy of the statutory report must be filed with the Registrar. Members can inspect the list of members and the number of shares held by them.

CONSEQUENCES OF DEFAULT

If any default is made in holding the statutory meeting within the prescribed time or in filing the statutory report to the Registrar, every director or other officer in default is punishable with a fine upto Rs.5,000.Further, the court can order even winding up of the company on a petition filed by a member of the company. This shows the significance of the statutory meeting.

19.4.i.2 ANNUAL GENERAL MEETING (AGM)

Section 96 provides that every company, other than a one-person company is required to hold an annual general meeting every year.

TIME OF HOLDING OF AGM

1. Annual general meeting should be held once in each calendar year. 2. First annual general meeting of the company should be held within 9 months from the closing of the first financial year. Hence it shall not be necessary for the company to hold any annual general meeting in the year of its incorporation.

3.Subsequent annual general meeting of the company should be held within 6 months from the date of closing of the relevant financial year.

4.The gap between two annual general meetings shall not exceed 15months.

5.A one-person company is exempt from holding an AGM.

BUSINESS TO BE TRANSACTED

AGM is called for the purpose of transacting ordinarybusiness. The term ordinary business for which AGM is called for includes:
1. Passing of annual accounts
2. Declaration of dividends
3. Election of directors
4. Appointment and fixation of remuneration of auditors.

SPECIAL BUSINESS

Any other item of the agenda, except the above four is considered as sspecial bbusiness. For eexample rremoval of Director, issue of rights or bonus shares, election of a person other than a retiring person as a director etc.

EXTENSION OF VALIDITY PERIOD OF AGM

In case, it is not possible for a company to hold an annual general meeting within the prescribed time, the Registrar may, for any special reason, extend the time within which any annual general meeting shall be held. Such extension can be for a period not exceeding 3 months. No such extension of time can be granted by the Registrar for the holding of the first annual general meeting.

DATE, TIME AND PLACE FOR HOLDING AN ANNUAL GENERAL MEETING

An annual general meeting can be called during business hours, that is, between 9 a.m. and 6 p.m. on any day other than nnational hholidays. It should be held either at the registered office of the company or at some other place within the city, town or village in which the registered office of the company is situated. The Central Government is empowered to exempt any company from these provisions, subject to such conditions as it may impose. In case of Government company, the Central Government may approve such other place for holding AGM, if the place is other than registered office.

CONSEQUENCES OF DEFAULT IN HOLDING AGM

Section 99 provides that if any default is made in complying or holding a meeting of the company, the company and every officer of the company who is in default shall be punishable with fine which may extend to one lakh rupees and in case of continuing default, with a further fine which may extend to five thousand rupees for each day during which such default continues.

If any default is made in holding the annual general meeting of a company, any member of the company may make an application to the Tribunal to call or direct the calling of, an annual general meeting of the company and give such directions as the Tribunal thinks expedient. Such directions may include a direction that one member of the company present in person or by proxy shall be deemed to constitute a meeting.

Thus, the shareholders get an opportunity to discuss the affairs of the company, to review the performance of the company and to take necessary steps for protecting their interests.

19.4.i.3EXTRA ORDINARY GENERAL MEETING (Section 100)

Any meeting other than the statutory meeting and the AGM of the company is called extraordinary general meeting. It is convened for transacting any urgent or special business which cannot be postponed till the next AGM.

An extraordinary general meeting may be convened by the Board of directors on its own, or on the requisition of the members subject to certain conditions.

It may be convened by:
(i)Board of directors on its own or
(ii)On the requisition of the members or
(iii)If the Board of directors fails to call the meeting within 21 days and the meeting is not held within 45 days of requisition, the requisitionists themselves may call the meeting within three months from the date of the requisition.
(iv)Tribunal: Section 98 provides that if for any reason it is impracticable to call a meeting of a company or to hold or conduct the meeting of the company, the Tribunal may, either suo motu or on the application of any director or member of the company who would be entitled to vote at the meeting:

(a) order a meeting of the company to be called, held and conducted in such manner as the Tribunal thinks fit; and

(b) give such directions as the Tribunal thinks expedient. Such directions may include a direction that one member of the company present in person or by proxy shall be deemed to constitute a meeting.

19.4.ii CLASS MEETINGS

19.4.ii.1 MEETINGS OF THE BOARD OF DIRECTORS

Meetings of directors are called Board meetings. They are very important because all important matters relating to the company and its policies are decided there at.

PROVISIONS REGARDING BOARD MEETINGS

The Board meeting must be held at least once in every three calendar months. At least four such meetings should be held in every year. The notice of every Board meeting must be given by writing to every director. The quorum for the Board meeting shall be one third of the total strength of the Board (any fraction beingrounded off as one) or two directors whichever is higher. The Board is entitled to exercise all such powers and to do all such acts as the company is authorized to do. However, the Companies Act imposes certain restrictions on the powers of the Board.

MEETINGS OF COMMITTEE OF DIRECTORS

Since it is not possible for the Board to devote time to carry on investigation on different matters, the Board may delegate their powers to committees, if the Articles of Association so provides. The Board is empowered to delegate the following powers to any committee of directors.

a) The power to borrow money.

b) The power to invest the funds of the company
c) The power to make loans, etc.

19.4.ii.2 MEETINGS OF CREDITORS

Meetings of creditors are to be held when the company proposes to make a scheme of arrangements with its creditors.

19.4.ii.3 MEETINGS OF DEBENTURE HOLDERS

Such meetings are to be convened when the company wants to change the terms of security or to modify the rights, or to change the rate of interest payable, etc

19.5 OTHER ASPECTS OF MEETINGS

19.5.1 PROXIES

The term 'Proxy' may refer to a person who is authorized by a member for the purpose of attending the meeting. It also means the instrument by which the proxy is authorized.

Members of a company having a share capital have a right to appoint proxies. Proxy need not be a member of the company. Proxy can attend a meeting but he has no right to speak. Proxy cannot vote except on a poll. A member can appoint more than one proxy. The proxy form must be in writing, duly signed by the appointer and stamped.It must be submitted at the company's office 48 hours before the commencement of the meeting.

19.5.2 QUORUM

The word 'quorum' means the minimum number of members required to be personally present at a meeting for validly transacting any business. Usually the quorum is fixed by the Articles. The quorum shall be two members personally present in the case of a private company and five in case of public company.

The quorum for the Board meeting shall be one third of the strength or two directors whichever is higher. However, the Articles may provide a larger number. For calculating quorum, proxies should not be counted and only members present in person must be considered. Quorum should be present throughout the meeting. Any resolution passed in the absence of a quorum is not valid. If quorum is not present, the meeting itself stands adjourned.

19.5.3 AGENDAOF MEETING

Agenda means the list of business to be transacted at the meeting. It is generally prepared by the secretary in consultation with the chairman.

19.5.4 MINUTES OF MEETING

The term minutes refers to accurate official record of decisions taken at various company meetings. Every company must keep the minutes book containing summary of all proceedings of general and board meetings. Minutes should be brief and factual. It should be so accurate as not to give for misinterpretation. It should be free from superfluous words.

The following particulars should be present in the minutes;
i. Nature of the meeting
ii. Date, time and place of the meeting
iii. Names of Chairman, directors, secretary and number of members attended
iv. Business of the meeting in the order set out in the agenda
v. Approval of the minutes of the last meeting
vi. Resolutions passed in the meeting
vii. Chairman's signature with date

19.6 COMMITTEES

Different committees may be established to consider, investigate, take action on or report on certain issues. The Committees may also examine the feasibility of a mechanism through which the government could settle cases involving violations under the Companies Act.

Different committees may be establishedunder the provisions of the Companies Act 2013 for the following purposes:

FOR THE EASE OF THE BOARD OF DIRECTORS

At times it is practically difficult to organize board meetings that suit the convenience and other commitments of each director. By having smaller committees, the convenience and commitments of the director also get addressed effectively.

For Good Corporate governance

The Board in order to achieve the desired results has to concentrate more on selected team members on particular business dealings and issues. For maintaining the Corporate social responsibility, shareholders as well as stakeholder's relationship etc. different specialized companies may be constituted.

As per Companies Act 2013, the companies are required to constitute the following Mandatory Committees:

19.6.1 AUDIT COMMITTEE

Every listed company, every other public company, havingpaid up capital of Rs.100 crores or more or which have, in aggregate, outstanding loans or borrowings or debentures or deposits exceeding Rs.50 crores has to constitute the Audit committee.

COMPOSITION OF THE AUDIT COMMITTEE: The Audit Committee shall comprise of a minimum of 3 directors with a majority of directors being independentdirectors. Additionally, the members of the Audit Committee shall be persons of integrity and with an ability to understand the financial statement.

Functions performed by the Audit Committee are as follows:

1. To give recommendations for the appointment, remuneration, and terms of appointment of the auditor of the company.
2. At the Annual General Meeting, Chairman of the Audit Committee shall be present to answer shareholder queries.
3. While considering the Auditor's report, the Auditor of a company and the keymanagerialpersonnel shall have a right to be heard in the meeting of the audit committee but shall not have the right to vote.

4. Every listed company and a company which has accepted deposits from the public and the company has borrowed money from Bank and PFI's in excess of Rs. 50 croreshas to establish a Vigil Mechanism Policy.

19.6.2 NOMINATION AND REMUNERATION COMMITTEE

Every listed company, every other public company havingpaid up capital of Rs.100 crores or moreor which have, in aggregate, outstanding loans or borrowings or debentures or deposits exceeding Rs.50 crores has to establish Nomination and Remuneration Committee.

COMPOSITION OF THE NOMINATION AND REMUNERATION COMMITTEE: The Nomination and Remuneration Committee shall comprise of 3 or more non-executive directors, out of them more than half of the the directors shall be an independent directors.

The chairman of the company can be appointed as a member of the Nomination and Remuneration Committee but shall not chair the committee.

Functions performed by the Nomination and Remuneration Committee:
1. To identify the person who is qualified to be a director and can be appointed in the senior management of the company in accordance with the criteria laid down by the Board of the directors.
2. Can recommend to the board, the appointment and removal of the person.
3. Shall specify the approach for the effective mechanism of the company.
4. Can evaluate the performance of the Board and the Individual Director.

19.6.3 STAKE-HOLDER RELATIONSHIP COMMITTEE

A company having more than 1000 members, debenture holders, deposit holders or security holders is required to constitute the Stake-holder Committee.

Composition of the Stake-holder Relationship Committee: Consists of a
Chair person who shall be a non-executive director and other members as may be recommended by the Board.

FUNCTIONS PERFORMED BY THE STAKEHOLDER RELATIONSHIP COMMITTEE: Transfer of shares, split-up or sub-division and consolidation of shares, issue of new and duplicate share certificates, registration of Power of Attorneys, probates, letter of transmission or other documents, to resolve the stakeholder's grievances.

19.6.4 CORPORATE SOCIAL RESPONSIBILITY COMMITTEE (CSR)

The Corporate Social Responsibility Committee is appointed by the Board of Directors to promote the culture that emphasizes and sets high standards for corporate social responsibility and reviews corporate performance against those standards. The Committee will consider the impact of the Corporation's businesses, operations and programs from a social responsibility perspective, taking into account the interests of shareholders, clients, employees, communities and regulators.

COMPOSITION, MEETINGS AND PROCEDURES OF CSR COMMITTEE

The Committee will consist of 3 or more Directors, each of whom shall have been determined to be independent in accordance with the Corporation's Corporate Governance guidelines. Committee members and the Committee Chairman will be appointed annually by the Board on the recommendation of the Corporate Governance and Nominating Committee and serve at the pleasure of the Board.

The Committee may form sub committees for any purpose and may delegate to such sub committees or to members of the Corporation's management such powers and authority as it deems appropriate. The Committee shall meet as frequently as necessary to fulfil its duties and responsibilities, but not less than 3 times per year. A meeting of the Committee may be called by its chairman or any two members. Minutes of its meetings will be approved by the Committee and maintained by the Corporation on behalf of the Committee. The Committee will report its activities to the Board.

RESPONSIBILITIES AND DUTIES OF CSR COMMITTEE

The Committee shall provide oversight of the Corporation's operations and programs regarding employee community involvement public policy, advocacy, and political contributionsenvironmental management and corporate social responsibility of suppliershuman rights, as reflected in the Corporation's policies and actions toward employees, suppliers, clients and communities Corporation's operations and initiatives that can create a positive or negative impact from a social responsibility perspective.

19.7 RESOLUTION

When a proposal place before the meeting is passed by the meeting, it becomes a resolution. A resolution thus reflects the decision of the majority. In other words, the decisions of the company are made by resolutions of its members passed at meetings of members. A proposal and accepted by the members becomes resolution.

KINDS OF RESOLUTION

19.7.1 ORDINARY RESOLUTION

Any resolution passed by a simple majority is an ordinary resolution. Simple majority means that 51 percent or more of the votes have been cast in favour of the resolution.

When ordinary resolution is necessary?

a) Adoption of audited accounts, director's report and auditor's report
b) Appointment of auditors
c) Election of directors in place of those retiring
d) Declaration of dividend
e) Issuing shares at a discount
f) Removing a director before the expiry of his term
g) Appointing a director in the place of removed director

19.7.2 SPECIAL RESOLUTION

Special resolution is one which is required for transacting any special business. It has to be passed by a three-fourths majority. In other words, the votes cast in favour of the resolution must exceed three times the votes cast against it. The notice calling the meeting should specify the intention to pass the resolution as a special resolution. Notice must be given at least 21 days before the date of the meeting. When special resolution is required? a) Altering the objects clause of the Memorandum b) Changing the place of the registered office from one State to another c) Altering the Articles of Association d) Reducing the Share Capital e) Making loans to other companies under the same management f) Paying interest out of capital in certain cases g) Voluntary winding up of the company

RESOLUTION REQUIRING SPECIAL NOTICE This type of resolution does not belong to a separate category. However, the mover of the proposed resolution must give a special notice of 14 days to the company. On receipt of this resolution, the company in turn has to give notice to the members at least 7 days before the date of the meeting. Where it is not practicable, it can publish it in a newspaper.

Items requiring special notice a) Appointing an auditor other than a retiring auditor b) Passing a resolution that a retiring auditor should not be appointed c) Removing a director before the expiry of his term d) Appointing a director in place of the removed director

19.8 VOTING AND POLL

Voting means expressing one's statement either for or against a proposed resolution, called motion. In a company meeting voting can be by way of acclamation of voice, show of hands and poll.

19.8.1 VOTING BY ACCLAMATION OF VOICE

Those favouring the motion are requested to say 'yes' or those who are against it are requested to say 'no'. The intention of the members is ascertained by the volume of sound.

19.8.2 VOTING BY SHOW OF HANDS

Members favouring a resolution are asked to raise their hands and the number is counted. Similar procedure is adopted to count the number of members who are against it. Thus the resolution is declared passed or lost.

19.8.3 VOTING BY POLL

When dissatisfied with the result of voting by show of hands, a poll may be demanded. Here each member records his vote on a voting card for or against the resolution. The voting rights of a member are in proportion to his share of the paid up equity capital of the company. Either the chairman on his own motion or on demand by prescribed number of members present in person or by proxies can order poll. Proxy is allowed to vote in a poll.

19.9 SUMMARY

This lesson explains the importance of company meetings and resolutions in corporate governance. It covers statutory, annual general, and extraordinary general meetings, along with board and class meetings. Essential aspects such as notice, quorum, proxy, agenda, and minutes are highlighted to ensure validity. The role of committees—including audit, nomination and remuneration, stakeholder relationship, and corporate social responsibility—is emphasized for effective management. Different types of resolutions—ordinary, special,

and those requiring special notice—are discussed to show how decisions are formalized. Voting methods like voice, show of hands, and poll illustrate how shareholder participation shapes company policies and accountability.

19.10 TECHNICAL TERMS

Statutory Meeting, Annual General Meeting (AGM), Extraordinary General Meeting (EGM) ,Notice of Meeting, Quorum, Proxy, Board of Directors Meeting, Committee, Audit Committee, Nomination and Remuneration Committee, Stakeholder Relationship Committee,Corporate Social Responsibility (CSR) Committee, Ordinary Resolution, Special Resolution, Resolution Requiring Special Notice, Agenda, Minutes, Voting, Poll.

19.11 SELF ASSESSMENT

PART – A

1.What is the meaning and requisites of a valid meeting?
2. What are the different kinds of meetings and what is a proxy?
3. What are the main contents of a statutory meeting ?
4. What are minutes of a meeting ?
5. what is an agenda?
6. When is an ordinary resolution required ?

PART – B

1. What are the different types of company meetings and their purposes?
2. What is a statutory meeting and statutory report, and what are their contents?
3. What are the objectives of the Annual General Meeting, Extraordinary General Meeting, Board Meetings, and Committees of Directors?
4. What are the applicability, composition, and functions of key committees such as Audit, Nomination & Remuneration, CSR, and Stakeholders' Relationship Committee?
5. What are the different kinds of resolutions passed in a company, and what other aspects of meetings (quorum, proxy, agenda, minutes, notice) should be understood?

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LESSON 20

WINDING UP OF COMPANY

Objective of the lesson

The objective of this lesson is to provide students with a comprehensive understanding of the concept, types, and procedures of winding up a company. It aims to develop analytical skills to evaluate legal frameworks, apply knowledge to real cases, and appreciate the implications for stakeholders in corporate governance.

Structure

20.1 Introduction

Winding up of a company is the process by which a company ceases to exist. It involves liquidating assets, settling liabilities, and distributing any surplus among shareholders. While dissolution marks the legal end of a company, winding up is the procedural path leading to that end.For students, understanding winding up is crucial because it connects corporate law, finance, and strategic management. It also highlights the importance of compliance, ethical responsibility, and risk management in business.

20.2 Meaning and Concept

Winding up of a company refers to the legal process of closing its operations, liquidating assets, and settling liabilities before dissolution. It ensures fair distribution among creditors and shareholders. Unlike dissolution, which ends legal existence, winding up is the procedural path leading to closure, protecting stakeholders and maintaining corporate integrity.

20.2.1 Winding up vs. Dissolution

Winding up and dissolution are closely related but distinct concepts in corporate law. Winding up refers to the process of liquidating a company's assets, settling its liabilities, and distributing any surplus among shareholders. It is a procedural stage that ensures creditors and stakeholders are fairly treated before closure.

Dissolution, on the other hand, is the final legal act that terminates the company's existence as a corporate entity. Thus, winding up is the journey toward closure, while dissolution is the destination. Together, they safeguard corporate integrity, protect stakeholder interests, and mark the end of a company's lifecycle.

20.2.2 Importance of winding up in corporate governance

Winding up plays a vital role in corporate governance by ensuring accountability, transparency, and fairness during closure. It protects creditors' rights, safeguards shareholder interests, and upholds legal compliance. Proper winding up prevents misuse of assets, maintains trust in corporate systems, and reinforces ethical responsibility in managing business failures.

20.2.3 Situations leading to winding up

Situations leading to winding up of a company arise from financial, legal, and strategic challenges. A common cause is inability to pay debts, where creditors seek liquidation to recover dues. Continuous losses may erode capital, prompting shareholders to close operations voluntarily. Fraudulent practices or regulatory non-compliance can trigger compulsory winding up by tribunals. Severe shareholder disputes may also make continuation impractical. In rare cases, winding up occurs on public interest grounds to safeguard society. Additionally, startups may opt for voluntary exit when market conditions change. Each situation reflects the importance of governance, compliance, and responsible closure.

20.3 Types of Winding Up

Winding up of a company can be compulsory, ordered by a tribunal due to insolvency, fraud, or public interest, or voluntary, initiated by members when solvent or creditors when insolvent. Additionally, modern laws allow fast-track exits and liquidation under insolvency codes, ensuring fair settlement and responsible closure of businesses.

20.3.1 Compulsory Winding Up (by Tribunal)

Compulsory winding up occurs when a tribunal orders closure of a company due to insolvency, fraud, or public interest concerns. Initiated through petitions by creditors, shareholders, or government authorities, the tribunal appoints a liquidator to realize assets, settle liabilities, and ensure fair treatment of stakeholders before dissolution.

20.3.1.1 Initiated by creditors, shareholders, or government

Compulsory winding up may be initiated by creditors seeking repayment of debts, shareholders facing disputes or losses, or the government acting in public interest. A petition is filed before the tribunal, which examines grounds such as insolvency or misconduct, and appoints a liquidator to oversee closure and settlement of liabilities.

20.3.1.2 Grounds: inability to pay debts, fraudulent conduct, public interest

Compulsory winding up by a tribunal is generally ordered on specific legal grounds. The most common is inability to pay debts, where a company fails to meet financial obligations and creditors seek liquidation. Another ground is fraudulent conduct, such as misrepresentation, diversion of funds, or unlawful activities, which undermine stakeholder trust and corporate integrity. Finally, winding up may be directed in the public interest, when a company's operations threaten economic stability, public safety, or national welfare. These grounds ensure that winding up serves as a corrective measure, protecting creditors, shareholders, and society at large.

20.3.2 Voluntary Winding Up

Voluntary winding up occurs when a company's members or creditors themselves decide to close operations without tribunal intervention. It is initiated through a resolution passed in a general meeting. If the company is solvent, Members' Voluntary Winding Up takes place, supported by a declaration of solvency from directors. If insolvent, Creditors' Voluntary Winding Up is initiated, where creditors play a central role in appointing the liquidator and supervising asset distribution. This process ensures orderly closure, compliance with statutory requirements, and fair settlement of liabilities, reflecting responsible corporate governance and protecting stakeholder interests during business termination.

20.3.2.1 Members Voluntary Winding Up → when company is solvent

Members' voluntary winding up occurs when a solvent company decides to close operations through a resolution passed in a general meeting. Since the company can pay its debts, directors must file a Declaration of Solvency affirming that liabilities will be settled within a specified period. A liquidator is then appointed to realize assets, discharge obligations, and distribute any surplus among shareholders. This process is orderly, transparent, and avoids tribunal intervention. It reflects responsible governance, allowing members to exit gracefully while ensuring creditors are protected and shareholders receive fair value from the company's remaining resources.

20.3.2.2 Creditors Voluntary Winding Up → when company is insolvent

Creditors' voluntary winding up occurs when a company is insolvent and unable to meet its financial obligations. In this case, members pass a resolution to wind up, but creditors play the dominant role in the process. A meeting of creditors is convened, where they appoint the liquidator and may form a committee to supervise liquidation. The liquidator collects and sells assets, settles liabilities in order of priority, and reports progress to creditors. This procedure ensures fairness, transparency, and protection of creditor interests, while allowing an orderly closure of the company under statutory compliance.

20.3.3 Other Modes

Apart from compulsory and voluntary winding up, companies may also close through other modes provided under modern corporate and insolvency laws. One such option is the Fast-Track ExitScheme, designed for defunct or small companies, allowing them to apply directly to the Registrar of Companies for removal of their name. Another mode is liquidation under the Insolvency and Bankruptcy Code (IBC), 2016, where insolvency proceedings may lead to liquidation if resolution plans fail. These mechanisms simplify closure, reduce tribunal burden, and ensure efficient settlement, offering businesses a structured and legally compliant exit route.

20.3.3.1Fast-track exit schemes

Fast Track Exit (FTE) schemes are simplified mechanisms introduced by regulators to allow defunct or inactive companies to close operations quickly without undergoing lengthy tribunal procedures. Under this scheme, companies that have ceased business activities, have no significant assets or liabilities, and meet prescribed eligibility criteria can apply directly to the Registrar of Companies (RoC) for removal of their names from the register. The process involves filing necessary documents, affidavits, and indemnity bonds, ensuring compliance and transparency. FTE schemes reduce administrative burden, save costs, and provide an efficient legal exit route for small or dormant companies.

20.3.3.2Winding up under Insolvency and Bankruptcy Code (IBC)

The Insolvency and Bankruptcy Code (IBC), 2016 provides a structured framework for resolving insolvency and, if resolution fails, for winding up companies. When a corporate debtor defaults on payments, creditors or the company itself may initiate insolvency proceedings before the National Company Law Tribunal (NCLT). A resolution professional is appointed to manage affairs and attempt revival through a resolution plan. If no viable plan is approved within the prescribed time, the company proceeds to liquidation under IBC. Assets are sold, liabilities settled in priority order, and the company is dissolved, ensuring fairness, transparency, and creditor protection.

20.4 Legal Framework

In India, winding up is governed by the Companies Act, 2013 (Sections 270–365) and the Insolvency and Bankruptcy Code, 2016**,** with the National Company Law Tribunal **(**NCLT**)** overseeing proceedings. The Official Liquidator and Insolvency Professionals play crucial roles in managing assets, settling liabilities, and ensuring compliance. Globally, the UK Insolvency Act, 1986 and the US Chapter 7 Bankruptcy Code provide structured liquidation processes. While India emphasizes tribunal-led governance, the UK and US focus on creditor rights and efficient liquidation. Comparative analysis highlights differences in procedures but a common goal of protecting stakeholders and ensuring fair corporate closure.

20.4.1 Indian Context

20.4.1.1 Companies Act, 2013 (Sections 270–365)

Sections 270–365 of the Companies Act, 2013 provide the statutory framework for winding up of companies in India. These provisions outline both compulsory winding up by the National Company Law Tribunal (NCLT**)** and voluntary winding up initiated by members or creditors. They specify grounds such as inability to pay debts, fraudulent conduct, or actions against public interest. The Act details procedures for filing petitions, appointment of liquidators, settlement of liabilities, and distribution of assets. It ensures transparency, accountability, and protection of stakeholders, making winding up a structured legal process that culminates in the company's dissolution

20.4.1.2 Insolvency and Bankruptcy Code, 2016.

The Insolvency and Bankruptcy Code (IBC), 2016 is India's comprehensive legislation for resolving insolvency and liquidation of companies. It consolidates scattered laws into a single framework, ensuring time-bound processes for debt resolution. Creditors or the company itself may initiate proceedings before the National Company Law Tribunal (NCLT) upon default. A Resolution Professional manages affairs, seeking revival through a resolution plan. If no plan is approved within the statutory period, the company proceeds to liquidation, where assets are sold and liabilities settled in priority order. IBC promotes transparency, creditor protection, and efficient closure of distressed businesses.

20.4.1.3 Role of National Company Law Tribunal (NCLT)

The National Company Law Tribunal (NCLT) is the primary adjudicating authority for matters related to company law, including winding up proceedings. It has the power to order compulsory winding up on grounds such as insolvency, fraud, or public interest. NCLT oversees petitions filed by creditors, shareholders, or government authorities and appoints liquidators or resolution professionals to manage the process. It ensures compliance with statutory provisions, protects stakeholder interests, and supervises distribution of assets. By providing a specialized forum, NCLT streamlines corporate dispute resolution, insolvency proceedings, and winding up, ensuring transparency, accountability, and efficient closure of companies

20.4.1.4 Role of Official Liquidator and Insolvency Professionals

The **Official Liquidator** is appointed by the National Company Law Tribunal (NCLT) to oversee compulsory winding up of companies. Their role includes taking custody of company assets, realizing them, settling liabilities, and ensuring compliance with statutory requirements before dissolution. In voluntary winding up or under the Insolvency and Bankruptcy Code (IBC), 2016**,** Insolvency Professionals (IPs) are appointed to manage the process. They act as resolution professionals or liquidators, conducting creditor meetings, preparing resolution plans, and supervising liquidation if revival fails. Together, they ensure transparency, fairness, and protection of stakeholder interests during corporate closure.

20.4.2 Global Perspective

Globally, winding up is governed by structured laws ensuring fairness and creditor protection. The UK Insolvency Act, 1986 provides detailed liquidation procedures, while the US Chapter 7 Bankruptcy Code enables asset liquidation for debt settlement. Comparative analysis highlights differences in process but a shared goal of transparent, equitable corporate closure.

20.4.2.1 UK: Insolvency Act, 1986

The UK Insolvency Act, 1986 governs company liquidation, administration, and bankruptcy. It provides procedures for compulsory winding up by courts and voluntary winding up by members or creditors. The Act emphasizes creditor protection, fair asset distribution, and structured closure, ensuring transparency and accountability in corporate insolvency proceedings.

20.4.2.2US: Chapter 7 Bankruptcy (liquidation)

Chapter 7 Bankruptcy under the US Code provides for liquidation of insolvent businesses or individuals. A court-appointed trustee collects and sells assets, then distributes proceeds to creditors in priority order. It offers debt relief through discharge, ensuring fairness, transparency, and structured closure when repayment or reorganization is not feasible.

20.4.2.3Comparative analysis of procedures and stakeholder protection

India's Companies Act, 2013 and IBC, 2016 emphasize tribunal oversight and creditor protection. The UK Insolvency Act, 1986 ensures structured liquidation, while the US Chapter 7 Bankruptcy prioritizes swift asset distribution. Despite procedural differences, all frameworks aim at transparency, fairness, and safeguarding stakeholder interests during corporate closure.

20.5 Procedure of Winding Up

20.5.1Petition/Resolution for winding up

Winding up begins with a petition or resolution. A petition may be filed by creditors, company, or government before the NCLT for compulsory winding up. Alternatively, members pass a special resolution for voluntary winding up. Both initiate legal proceedings, leading to appointment of a liquidator and structured closure.

20.5.2Appointment of liquidator

In winding up, a liquidator is appointed to manage the company's closure. In voluntarywinding up, members or creditors nominate the liquidator, while in compulsory winding up, the National Company Law Tribunal (NCLT) appoints an Official Liquidator. Their role is to realize assets, settle liabilities, and ensure dissolution.

20.5.3 Collection & valuation of assets

In winding up, the liquidator collects all company assets, including property, receivables, and investments. These are carefully valued to determine realizable worth. Accurate valuation ensures fair distribution among creditors and shareholders. The process emphasizes transparency, accountability, and maximization of asset recovery before liabilities are settled and dissolution occurs.

20.5.4 Settlement of liabilities (secured creditors, unsecured creditors, employees, government dues)

In winding up, liabilities are settled in a priority order. Secured creditors are paid first from realized assets, followed by unsecured creditors. Next, dues to employees such as wages and benefits are cleared. Finally, government dues like taxes are settled. This hierarchy ensures fairness and structured distribution during liquidation.

20.5.5 Distribution of surplus to shareholders

After settling all liabilities in winding up, any surplus funds are distributed among shareholders. Preference shareholders receive dues first, followed by equity shareholders. The liquidator ensures fair allocation based on shareholding rights. This final step completes the process, marking the company's dissolution and closure with equitable stakeholder satisfaction.

20.5.6 Dissolution order by Tribunal

After completion of liquidation, the National Company Law Tribunal (NCLT) issues a dissolutionorder declaring the company dissolved. This marks the legal end of its existence. The order ensures all assets are realized, liabilities settled, and surplus distributed, providing a transparent, final closure of corporate affairs

20.6 Case Studies

Kingfisher Airlines (India): Financial distress and winding up petitions.

Kingfisher Airlines, once a leading Indian carrier, faced severe financial distress due to mounting debts, unpaid salaries, and grounded aircraft. Creditors filed winding up petitions as the company defaulted on loans and tax obligations. Its collapse highlighted governance failures, excessive borrowing, and regulatory challenges in India's aviation industry.

LehmanBrothers(US):Globalinsolvencyimpact.

Lehman Brothers, once a major US investment bank, filed for bankruptcy in September 2008, marking the largest corporate insolvency in history. Its collapse was triggered by excessive exposure to subprime mortgages and risky financial derivatives. The bankruptcy sent shockwaves across global markets, eroding investor confidence and freezing credit flows. Financial institutions worldwide faced liquidity crises, leading to government bailouts and regulatory reforms. The event highlighted systemic risks in interconnected economies and underscored the need for stronger oversight, risk management, and transparency in financial markets. Lehman's downfall remains a pivotal lesson in global corporate insolvency and financial stability

STARTUPS:VOLUNTARY WINDING UP DUE TO MARKET EXIT

Many startups voluntarily wind up when market conditions become unfavorable or growth prospects diminish. Founders may choose closure to avoid mounting losses, repay creditors, and exit responsibly. This process ensures compliance with legal requirements, protects stakeholders, and allows entrepreneurs to redirect resources toward new ventures or opportunities.

Winding up impacts multiple stakeholders: employees lose jobs and financial security, creditors face delayed or reduced repayments, and investors risk losing capital. The broader economy suffers from reduced market confidence, disrupted supply chains, and declining industry stability. It underscores the importance of sound governance and proactive financial management

20.7 SUMMARY

Winding up of a company is the legal process through which a business ceases operations, its assets are liquidated, liabilities settled, and any surplus distributed among shareholders before dissolution. It may occur voluntarily, when members or creditors decide to close the company, or compulsorily, through tribunal intervention due to insolvency, fraud, or public interest. The procedure involves appointment of a liquidator, realization of assets, repayment of debts, and compliance with statutory requirements. Understanding winding up is vital for students as it integrates corporate law, finance, and governance, highlighting both practical challenges and ethical responsibilities in business closure.

20.8 TECHNICAL TERMS

Winding Up: Process of closing a company by liquidating assets.
Dissolution: Legal termination of a company's existence.
Liquidator: Person appointed to manage the winding up process.
Tribunal (NCLT): Judicial body overseeing corporate insolvency in India.
Insolvency: Inability to pay debts as they fall due.
IBC (2016)**:** Insolvency and Bankruptcy Code, India's framework for insolvency resolution.

20.9 SELFASSESSMENT QUESTIONS

1. Differentiate between winding up and dissolution.
2. Explain the difference between members' voluntary winding up and creditors' voluntary winding up.
3. What are the main grounds for compulsory winding up by a tribunal?
4. Outline the procedure of winding up under the Companies Act, 2013.
5. Discuss the role of the liquidator in winding up.
6. Compare winding up provisions in India and the US.
7. Analyze the impact of winding up on stakeholders using Kingfisher Airlines as an example.

20.10 SUGGESTED READINGS

1. Companies Act, 2013 – Ministry of Corporate Affairs, Government of India.
2. Insolvency and Bankruptcy Code, 2016 – IBBI publications.
3. Avtar Singh, Company Law.
4. Taxmann Publications, Guide to Insolvency and Bankruptcy Code.
5. Mayson, French & Ryan, Company Law (UK context).
6. Altman, E.I., Corporate Financial Distress and Bankruptcy.

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