CONTRACTS, AGREEMENTS AND
PUBLIC POLICY IN INDIA
We dedicate this book to the founding faculty members of NLSIU

Professor N. R. Madhava Menon
Professor N. L. Mitra
Professor V. S. Mallar
Professor A. Jayagovind
Professor V. Vijayakumar
Professor S. V. Joga Rao
# CONTENTS

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Development of Mercantile Law In Franchising Contracts In India</td>
<td>01</td>
</tr>
<tr>
<td></td>
<td>Dr. Sairam Bhat And Megha Mehta.</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Contractual Aspects In Private Commercial Space Ventures</td>
<td>46</td>
</tr>
<tr>
<td></td>
<td>Dr. Sandeepa Bhat.</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Telecom Contracts of VoIP</td>
<td>63</td>
</tr>
<tr>
<td></td>
<td>Shreekanth Katti And Nayan Jain</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Surrogacy Contracts</td>
<td>79</td>
</tr>
<tr>
<td></td>
<td>Dr. Sairam Bhat And Jashanjot Kaur</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Power Purchase Agreements</td>
<td>107</td>
</tr>
<tr>
<td></td>
<td>Dr. Sairam Bhat And Rohith Kamath</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Contractual Aspects of Joint Venture Agreements</td>
<td>125</td>
</tr>
<tr>
<td></td>
<td>Surbhi Shah And Anirudh Majumdar</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>The Conflict Between Wills And Family Agreements</td>
<td>161</td>
</tr>
<tr>
<td></td>
<td>Aditya Wakhlu And Dhruv Jadhav</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Unfair Terms In Indian Contracts And Their Regulation</td>
<td>179</td>
</tr>
<tr>
<td></td>
<td>Arijeet Shukla And Prakhar Agarwal</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Doctrine of Economic Duress</td>
<td>202</td>
</tr>
<tr>
<td></td>
<td>Pragy Kaushik And Ritika Bansal</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>The Law on Hypothecation</td>
<td>229</td>
</tr>
<tr>
<td></td>
<td>Sanjana M And Sharvari Kothawade</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Employment Bonds</td>
<td>245</td>
</tr>
<tr>
<td></td>
<td>Amol Mehta And Mohnish Mathew</td>
<td></td>
</tr>
</tbody>
</table>
12. Pre-Nuptial Agreements ................................................................. 260
   Vani Sharma

13. An Analysis of Arbitration Clauses in Indian Contract Law ............ 293
    Aniruddh Nigam And Siddharth S. Aatreya

14. Arbitration And Standard Form of Contracts ............................... 318
    Bhavna Mishra

15. Click Wrap (Dis)Agreements ...................................................... 337
    Sharan Bhavnani And Madhavi Singh

16. Patent Indemnification In Intellectual
    Property Licensing Agreements .................................................. 368
    Pranav Mehta And Aditya D’ Souza

17. Confidentiality And Privacy Clauses In Contracts
    With Social Networking Sites ...................................................... 390
    Nishi Ankita Kujur

18. Image Rights In Sports Contracts .............................................. 412
    Nikita Garg

19. Escrow Agreements ................................................................. 433
    Kshitij Sharma
FOREWORD

National Law School of India University, Bengaluru is one of the premier law institutions of India, established with the aim of imparting to students, researchers and faculty members, the knowledge, skills and ability to overcome upcoming challenges in the legal arena. The university encourages quality publications on cutting edge legal issues, which demonstrate not only the traditional principles of law taught in classrooms, but also ‘law in action’ and the various challenges in implementation.

A fine example of this commitment is the book titled “Contracts, Agreements and Public Policy in India” published under the editorship of Dr. Sairam Bhat (Associate Professor, NLSIU). This pioneering work on Contract Law Jurisprudence showcases a novel perspective on the changing scenario in the day-to-day contractual issues of the contemporary business world.

Contracts have become indispensable to every realm of the lives of individuals and corporations alike. Advances in the fields of science, technology, and communication have given rise to a plethora of issues concerning the privacy and consent of individuals in contracts concluded online. While contracts for franchises and hypothecation have been around for long, unforeseen challenges constantly emerge. Further, as arbitration acquires prominence as a near sine qua non in commercial contracts, the evolution of the approach of the Indian judiciary is of pivotal significance, in the interpretation, construction, and enforcement of the agreements involved.

The law governing contracts has now expanded its reach into family relations as well, with the enforceability of pre-nuptial agreements and family arrangements, and their conflict with wills coming to the fore, along with hitherto unregulated surrogacy contracts. Also encompassed within this discipline of law are joint venture agreements, patent indemnifications, and escrow agreements, all of which have been ably discussed in this book.
It is indeed gratifying to note that all the writers, most of whom are relatively young, have shown outstanding skills in conducting in-depth research of each of these emerging areas of commercial law. I sincerely hope that this book would commend itself to the entire academic community, including students, researchers, policy makers, and general readers.

The contribution of the students of NLSIU is praiseworthy. I congratulate Dr. Sairam Bhat and his entire team for their sincere efforts in the publication of this work, and wish them all success in this endeavour.

Prof. (Dr.) R. Venkata Rao  
Vice-Chancellor  
National Law School of India University  
Bengaluru
NLSIU continues to exhibit its calibre in the field of legal education with the first of its kind ‘Book Series’ to be exclusively published under the NLSIU banner. NLSIU has been at the forefront of developing legal research since its establishment in 1987, and continues to deliver the pioneering and path-breaking initiatives expected of it. The second in the series on Contracts, this book reflects the exceptional contribution of the NLSIU community in strengthening research-based education and publications in the legal sphere.

The objective of this book is to draw attention to emerging areas of contracts and contract law in India, of a wide audience ranging from students, practitioners, academicians, researchers to legal advisors and the business community. While the Indian Contract Act, 1872, is the foundation governing contractual relations in India, modern types and forms of contracts have posed challenges in terms of business methods, construction of terms and interpretation of the law on contracts. This book adopts a unique approach in applying known principles of contract law to topics of current interest, while capturing succinctly the existing stance of the judiciary as well as tracing recent developments and their impact on commercial relationships.

The distinct feature of the articles is their analytical structure, which examines the enforceability of clauses, acceptable terms, scope of application, remedies provided for and the kind of business models that drive the drafting of modern contracts. This is not limited to commercial contracts; rather, the book also offers a social perspective on issues like pre-nuptial agreements, surrogacy agreements and the conflict between wills and family arrangements unique to Indian society. Thus, the questions raised therein are pertinent not only from a legal point of view, but also from broader angles of public policy.
This book is completely an outcome of the dynamic leadership, enthusiastic support and visionary guidance of our Vice Chancellor, Prof. (Dr.) R. Venkata Rao. I wholeheartedly thank Registrar, Prof. (Dr.) O. V. Nandimath for encouraging and facilitating this endeavour.

I also express my heartfelt gratitude to NLSIU senior faculty Prof. V S Mallar, Prof. M K Ramesh and Prof. T V Subba Rao, whose teaching, guidance and mentorship have been invaluable.

I thank the authors for producing articles of the highest quality, and the editorial team, for reviewing the submissions received and ensuring finality to this publication.

Dr. Sairam Bhat  
Associate Professor of Law  
NLSIU, 2015
DEVELOPMENT OF MERCANTILE LAW IN FRANCHISING CONTRACTS IN INDIA

Dr. Sairam Bhat* and Megha Mehta**

ABSTRACT

This article traces the development of mercantile law in Franchising Contracts in India through judicial application of Contract law to, and interpretation of clauses commonly included in, such agreements. It shows that Franchises are akin to Trademark licensing agreements which give the Franchisor the right to impose controls on the Franchisee to protect its goodwill even if these are enforced through a standard contract weighing against the latter. However, exercising an excessive degree of control may make the Franchisor vicariously liable for the Franchisee’s negligence.

This article argues that the Franchisor ought to execute a disclosure document to equalize bargaining power and exercise only that degree of control which is necessary for the protection of its Trademark. The Franchisee should negotiate for reasonable notice and compensation in the event of termination. Therefore it shows how both parties may pre-empt solutions to legal claims at the outset of the Contract.

INTRODUCTION

With changing lifestyles, growing income levels, increasing demand from consumers and the advent of modern retailing, the Franchise market is growing rapidly. In spite of the rapid growth of franchising in recent years, it constitutes, as of now, about 4 percent of the total retail sales in India. In developed markets, such as the United States, franchising accounts for more than 50 percent of

* Associate Professor of Law, National Law School of India University, Bengaluru.
**Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
total retail sales.\(^1\) This is indicative of the enormous potential that lies ahead for the growth of franchising in India.

Another important factor that promotes the growth of franchising is the huge entrepreneurial energy and skills that are available in the country and this is generated and supported by the demographics wherein more than 50 percent of the population is less than 25 years of age and eager to start their own business ventures. The presence of a large Indian population all over the world, including the United States, and increasing international travel is contributing to easy recognition of foreign brands and the Indian media is doing a great job in fueling demand for foreign and local brands.

While franchising as a business model has been known in India for decades there is clearly an unprecedented interest in adopting this model in recent times as is evident from the growth rate of the Indian economy.\(^2\) There are already more than 600 franchising systems operating in the country including a large number of foreign and particularly American brands such as McDonald’s, Pizza Hut, UPS, Medicine Shoppe, Kodak, Gold’s Gym and KFC. Many homegrown companies\(^3\) are also adopting franchising in a large number of areas of the economy for example, computer education, restaurants, health care, courier logistics, beauty parlors and apparel. Franchising affords entrepreneurs a chance to build commercial infrastructure and develop domestically oriented

\(^1\) The United States of America stands at the forefront of the franchise boom. Today, the legal environment in the United States is highly conducive to the healthy growth and evolution of franchising. With more than 50% of total retail businesses in the United States, 45% in Canada and 26% in Australia choosing a franchise model for expansion, the impact of franchising on retail industries across the globe is considerable. To foster the rapid and sustained growth that this channel brings it is critical that laws to regulate the franchising business exist.

\(^2\) The Franchising Association of India was set up as a membership association of franchisors, franchisees and other related interests. This is a recognized association and by virtue of being a member of the World Franchising Council is closely linked with other WFC-member associations in countries around the world including the International Franchise Association.

\(^3\) For example the Nilgiris stores and the retail provision store MORE, from the Aditya Birla group.
businesses in an efficient and profitable manner.4

Franchising refers to the method of practicing and using another person’s philosophy of business. In a Franchise the business model is already successful and earning good revenue. There is no need to reinvent the wheel, i.e. operations and training systems are already in place. To run one’s own operations requires more time and is costly to small business owners whereas low cost franchising is more organised from the start of the business. Quick returns are possible and with the availability of more opportunities, an investor can choose better returns.5

The ‘Franchisors’6 authorize the proven methods and Trademarks of their businesses to the ‘Franchisee’7 for a fee and a percentage of gross monthly sales. Usually the Franchisor also provides various tangibles and intangibles such as national or international advertising, training, and other support services to the Franchisee. Franchise agreements typically last for five to twenty years, and premature cancellation or termination of contracts mostly bears serious consequences for Franchisees.8 These agreements are enforced by the applicable Franchise laws in whichever jurisdiction the Franchise operates in.

‘Franchise laws’ refer to a collection of legislation and case law which govern and affect the Franchise system and Franchise relationship. Foreign jurisdictions such as Australia, Canada and the United States have special legislations for Franchises which have strict disclosure requirements. Different states in America also have their own ‘Franchise relationship’ laws regulating the termination and

6 The franchisor is the person who owns the brand and agrees to license its use to the franchisee.
7 The Franchisee is the person who undertakes to run the business for the Franchisor and is licensed to run the business and use the brand name.
renewal of Franchise agreements. 9) However there is no ‘official’ Franchise law in India as in some western countries. Instead a combination of legislations, regulations and case law determines how franchising relationships and business operations are conducted.

The article traces the development of mercantile law in relation to Franchise Contracts in India. In this article we have explained how a Franchise agreement is akin to a Trademark licensing agreement in which the Franchisor must exercise control over the Franchisee’s operations in order to prevent the misuse of their Trademark and preserve their goodwill. The Franchisor may also impose non-compete covenants and confidentiality clauses to protect the intellectual property, knowhow, and the business model which it has licensed to the Franchisee under the agreement.

The problem that arises is that such contracts are standard contracts which favour the Franchisor’s interests and give it the unilateral right to terminate the contract without giving the franchisee any notice or good cause, notwithstanding heavy investment made by the latter. However, courts have interpreted it as a commercial contract entered into between business persons who enjoy equal bargaining power and have rejected claims of duress and unconscionability arising out of such contracts. On the other hand, the Franchisor can be held vicariously liable for the Franchisee’s actions if the control it exercises over the Franchisee extends beyond what is necessary for the protection of its Trademark or if a third party perceives the Franchisee to be acting on behalf of the Franchisor and exercising the Franchisor’s authority.

This article analyzes Franchise disclosure laws and relationship laws as well as case laws in order to evolve guidelines for better drafting of rights and liabilities in a Franchise Contract. In so doing, it provides solutions for the common grievances arising, for both the Franchisor and the Franchisee, out of Franchise agreements.

The article begins by describing how a Franchise system generally works and the laws applicable to a Franchise Contract. It explains the reasoning adopted by courts in rejecting the plea of unconscionability in Franchise agreements and the way in which modifications in the original agreement can be enforced. It argues that while a Franchise agreement contains elements of a sale of business, it is akin to an employment or agency agreement.

It proceeds to look at the enforceability of negative covenants in the agreement. It explains how a Franchisor may enforce a non-compete covenant provided it is reasonable, operates for a limited period of time and only during the continuation of the agreement. The Franchisor will also have remedies if the Franchisee or their employee divulges confidential information to unauthorized parties. It argues that since a Franchise agreement may also contain a Trademark licensing agreement, the Franchisor as well as the Franchisee will have a statutory remedy for the infringement of the trademark, provided it is registered. The Franchisor may also restrain the Franchisee from using the Trademark post termination of the Franchise.

An analysis is then made of the circumstances in which a Franchise can be terminated. Usually the Franchisor is required to prove that a fundamental breach of contract has occurred as well as give reasonable notice in order to terminate the agreement. This article argues that if the Contract so provides, the Franchisor may terminate the agreement without assigning any cause or giving any notice. If the Franchisee is an agent, they may get compensation for investment made in developing the Franchise. However, Courts have usually upheld termination clauses if the terms have been freely negotiated by the parties.

On the other hand, the Franchisor may be vicariously liable for the Franchisee’s negligence or fraud. Greater the control the Franchisor exercises over the Franchisee, greater is the risk of liability, even though such control is necessary for the protection of its Trademark and goodwill. If a third party is led to believe that the Franchisee was acting on behalf of the Franchisor and not in
an independent capacity, the Franchisor may be held liable under agency by Estoppel.

There is a need for contractual provisions to balance the Franchisor’s need to exercise control over the Trademark with the Franchisee’s right to recover its investment, and a consumer’s right to cause of action for the franchisee’s negligence. The article concludes by suggesting how the parties in a Franchise should draft the agreement to achieve this balance.

**UNDERSTANDING FRANCHISING**

The British Franchise Association, International Franchise Association and the Code of Ethics of the European Franchise Association, which are authoritative sources in this business, have defined the business format of franchising in different terms. However, a common thread can be drawn through them. Those common terms are:

1. A Franchise involves a contractual relationship between the parties whereby one party [Franchisor] licenses the other party [Franchisee] to carry on business under the Franchisor’s name;

2. A certain degree of control is exercised by the Franchisor over the Franchisee regarding the manner in which it carries on that business;

3. Provision of assistance to the Franchisee by the Franchisor for starting up and /or carrying on that business

4. The business of the Franchisor and the Franchisee are, however, separate as the Franchisee has to fund and risk his own capital.¹⁰

American law broadly defines a Franchise as ‘a business relationship in which a company with a product or service, i.e., Franchisor; arranges for those products or services to be distributed and in some cases produced, by a group of dealers-the Franchisees’.¹¹


In India, the legal definition of Franchise is as provided in Section 47 of the Finance Act, 1994:

‘an agreement by which the Franchisee is granted representational right to sell or manufacture goods or to provide service or undertake any process identified with Franchisor, whether or not a trade mark, service mark, trade name or logo or any such symbol, as the case may be, is involved’.

In addition to this, the Electricity Act, 2003 defines ‘Franchisee’ as ‘a person authorized by a distribution licensee to distribute electricity on its behalf in a particular area within his area of supply.’

In a nutshell, franchising is a business system whereby the Franchisor grants a license to the Franchisee to use the Franchisor’s diverse Intellectual Property Rights, namely, know-how, Designs, Brands, Trademarks, Patents, and Trade Secrets along with the Franchisor’s proven name, reputation and marketing techniques to market the Franchisor’s products or services in return for a sum of money. The Franchisor provides training and continuous assistance to the Franchisee.

**FRANCHISE CONTRACTS**

A Franchise business venture is primarily a contract between the Franchisor and the Franchisee. The Franchisor licenses the use of their Trademark, trade name and thus their goodwill to Franchisee, in order to sell their products and/or services. This relationship is more often than not created by a Franchise Contract which contains certain terms and conditions governing such use. The Franchisor often poses some regulations that the Franchisee must adhere to in order to fulfill the obligations of the Contract.

A Franchise Contract therefore facilitates the use of one party’s goodwill by another party in exchange for a certain License Fee and Royalty on the sales. 

---

12 Sec 2(27), Electricity Act, 2003.

13 *Hill v Mobile Auto Trim Inc* 725 SW2d 168, 177 (Tex 1987).
It benefits both the parties. The Franchisee does not have to cultivate an image before it goes into business, as there is support in starting up their business and they can be assured of sales depending on the market popularity of the Franchisor. It gains an advantage in establishing its business as compared to a novice start up which is unknown and is yet to develop the successful operating or marketing strategies which the Franchisor possesses.

Further, it is a business separate from that of the Franchisor so it’s a convenient way to enter the realm of entrepreneurship. The Franchisor benefits because it can reach a wider market without itself having to expand or invest. This is especially advantageous in the case of remote areas or underdeveloped markets. It may increase its goodwill support, thus ensuring better sales, provided the Franchisee operates as per the framework of the Contract. Franchise Contracts are unlike contracts for the sale of business because the Franchisor retains considerable control over the operations of the Franchise.\(^{14}\)

In India, a Franchise agreement will be governed by the Indian Contract Act, 1872 as well as the Specific Relief Act, 1963. The latter provides for both specific enforcement of covenants in a contract and remedies for breach of contract in the form of damages. If a party to a Franchise agreement commits Breach of Contract, the aggrieved party has the option to initiate a suit for specific performance in Indian Courts and apply for relief in the form of a temporary or permanent injunction, which may be granted at the discretion of the Court, considering the balance of convenience and the interests of justice. An order granting or rejecting an injunction may be appealed by an aggrieved party. However no injunction can be granted to prevent breach of a contract, the performance of which would not be specifically enforced.\(^{15}\)

Taxation Laws, Property Laws, Insurance Law and Labour Laws also apply to Franchises. With the advent of the Competition Act, 2002, the Restrictive Covenants provided for in the Franchise agreement will come under the scrutiny of the Competition Commission of India. Additionally, laws and regulations applying to specific sectors of goods and services will apply to the franchise

---

\(^{14}\) ibid.

\(^{15}\) Sec 41(e), Specific Relief Act, 1963.
as well depending on the nature of the Franchised business. Business is developed using the name, getup, image and identity of the Franchisor. The way to run the business is part of confidential know-how of the scheme. Thus franchise contracts will include covenants for the protection of intellectual property as well.

The Franchisee pays a Franchise fee to the Franchisor to run this venture, though it may withhold such Royalty payments on grounds of supply of defective goods or non performance of required services by the Franchisor.

**Do Franchise agreements contain unconscionable terms?**

Franchise Contracts are usually standard form contracts prepared by the Franchisor. Franchisees often criticize such ‘standardization’ of contracts as unfair and unconscionable, as the Franchisor presents it to the Franchisee on a ‘take it or leave it’ basis. In order to determine whether a contract is unconscionable or not, Courts have to determine whether, in light of the commercial background and the circumstances at the time the contract was made, the complaining party had no viable choice but to enter into the contract, and the clauses were so one-sided as to be unconscionable.

A preprinted standardized contract, while non-negotiable, is not necessarily unconscionable, since the plaintiff does not have to enter into it. It has been found in most cases that Franchise agreements are not unconscionable, primarily because they are Commercial Contracts as opposed to Consumer Contracts, involving people who are familiar with bargaining and the process of allocating

---

17 Terms such as royalty sharing, profit sharing, etc are also used.
An ordinary consumer has no choice but to sign an adhesion contract if they are to obtain a service such as an Insurance Policy or Car Rental. Though franchising is a unique business model, the Franchisee may always opt for another business arrangement if the Franchise Contract is not feasible.

Neither consumers nor Non-Franchisee commercial parties can avail of the special legislative protections granted to Franchisees. The existence of Franchise disclosure laws ensures that the Franchisee is informed of the material details of the Franchised business. In the United States, 15 states as well as the Federal Trade Commission have adopted Franchise disclosure and regulation laws. The Franchisor must execute a Franchise Disclosure Document to the Franchisee 14 days prior to the signing of any agreement or giving of consideration in accordance with the Uniform Franchise Offering Circular (UFOC) Guidelines laid down by the FTC.

Franchise legislations in all provinces of Canada mandate a disclosure document. The Franchising Code of Conduct in Australia also mandates a disclosure document 14 days prior to the signing of the Contract. Franchisees in the USA can sue for damages or Rescission of the Contract in the event of Misrepresentation or Fraud by the Franchisor or any violation of the disclosure Laws. Under Canadian Law as well, the Franchisee may claim damages for

---

22 Boatland Inc v Brunswick Corp 558 F2d 818, 823 (6th Cir 1977).
24 ibid.
any misrepresentation made in the disclosure document\textsuperscript{29} as well as rescind the agreement on non-delivery of such document.\textsuperscript{30} The Franchisor would be liable, on such Rescission, to compensate the Franchisee for any investment undertaken in setting up the Franchise.\textsuperscript{31} Further, the Franchisee in commercial contracts has the option of legal consultation and hence cannot complain of unreasonable terms and conditions in the contract.

But in case of ambiguous terms, the Courts may go beyond the Franchise agreement and rely on external evidence. Ambiguity is not established by the mere fact that the conflicting parties assert different meanings to the terms in the Contract—if that had been the case, every Franchise agreement under dispute would have been labeled as ambiguous. Usually, the standard for determining ambiguity is whether reasonably intelligent persons, upon reading the Contract, would honestly differ as to its meaning.\textsuperscript{32} The Courts must also determine whether ambiguity exists by applying the ordinary meaning of the words used in a Contract.\textsuperscript{33}

\textit{Modification of Franchise agreements}

Another situation in which the original Franchise agreement will not be relied upon is when there is a modification to the original contract. Sometimes one of the parties, usually the Franchisee, will contend that an oral or written agreement was made after the Contract was initially entered into, thereby modifying the agreement or supplementing it. The alleged modification might contain additional promises by the Franchisor not contained in the original agreement or a representation made by them that might amount to excusing the Franchisee’s failure to comply in certain situations. Therefore the issue arises

\begin{itemize}
\item \textsuperscript{29} \textit{Arthur Wishart Act (Franchise Disclosure) SO 2000, c 3, s 7.}
\item \textsuperscript{30} \textit{Arthur Wishart Act (Franchise Disclosure) SO 2000, c 3s 6(2).}
\item \textsuperscript{31} \textit{Arthur Wishart Act (Franchise Disclosure) SO 2000, c 3s 6(6).}
\item \textsuperscript{32} \textit{Canada Dry Corp v Nehi Beverages Co 723 F 2d 512, 519 (7th Cir 1983).}
\item \textsuperscript{33} \textit{Lafayette Beverages Distributors Inc v Anheuser-Busch Inc 543 F Supp 1137, 1148 (ND Ind 1982).}
\end{itemize}
as to whether the alleged modification is enforceable.\textsuperscript{34}

In Common Law, modification of an existing agreement requires consideration on both sides; otherwise the modification is unenforceable on account of the doctrine of past consideration.\textsuperscript{35} However, under the Uniform Commercial Code of America, no separate consideration is required, and a modification may be enforced, provided that it was made in good faith and not as a means of evading contractual obligations.\textsuperscript{36} Under the Indian Contract Act, if the parties to a Contract agree to substitute a new contract for it, or to rescind or alter it, the original contract need not be performed.\textsuperscript{37}

\textbf{Whether a Franchisee agreement is sale-cum-license agreement or whether it is an extended employment-agency agreement?}

Courts have often grappled with the dilemma of whether to interpret a Franchise agreement as an employment agreement or one for sale of business. Courts in the USA have held that a Franchise agreement has elements of both, but it is difficult to entirely place it into the sale of business category since the Franchisor retains a substantial measure of control over most aspects of the Franchisee’s endeavors via the terms of the Franchise agreement.\textsuperscript{38} A Franchise agreement; in fact, closely approximates an employment-agency agreement.

\textbf{ENFORCEABILITY OF NEGATIVE COVENANTS IN FRANCHISE AGREEMENTS}

Disputes often arise from the provisions of the Franchise agreement, which delineate the rights and the obligations of both the Franchisor and the

\textsuperscript{34} W Michael Garner, \textit{Franchise and Distribution Law and Practice} (1st edn, Clark, Boardman and Callaghan 1990) ch 8, p 22.

\textsuperscript{35} Barnhart v Dollar Rent A Car Systems Inc 595 F 2d 914, 918 (3d Cir 1979); Ruffin v Mercury Record Productions Inc 523 F 2d 222 (6th Cir 1975).

\textsuperscript{36} Hill (n 13).

\textsuperscript{37} Sec 62, Indian Contract Act, 1872.

\textsuperscript{38} See Singleton v International Dairy Queen Inc 332 A 2d 160, 161-63 (Del Super Ct 1975).
Franchisees. In *Interstate Automatic transmission Co Inc v WR McAlpine Co Inc*\(^{39}\) a covenant restricting the Franchisee from engaging in any business competing with that of the Franchisor within the license area or within 10 miles of such area for a year was upheld as reasonable. In *Budget Rent a car Corp of America v Fein*,\(^{40}\) a covenant prohibiting competition in the entire western hemisphere for two years was struck down as unreasonable. In *Bloor v Falstaff Brewing Corp*,\(^{41}\) the Franchisee agreed to use ‘best efforts’ to promote and maintain high volume of sales. However, on account of decline in local brewers, distribution of beer in the market became unprofitable and hence the Franchisee discontinued sales in those sectors. It was held that personal financial difficulty or economic hardship did not excuse compliance with the ‘best effort’ clause. The Franchisee must prove that despite best efforts the business was not profitable.

As observed from judgments, three covenants most commonly form a bone of contention between the Franchisor and the Franchisee in the Indian jurisdiction: Confidentiality clauses, Non-Compete Covenants and clauses dealing with Intellectual Property Rights.\(^{42}\)

As a condition to granting the Franchise, the Franchisor customarily binds its Franchisees to one sided covenants ‘not to compete’. Such covenants can be analyzed either as restrictive covenants or exclusive dealing arrangements. These broadly worded covenants, in effect, restrain the Franchisee from being associated with any business which is similar to that of the Franchisor during the term of the Franchise agreement. The ‘Non-Compete Clause’ can also be a post-term restriction which prohibits the Franchisee from operating a competing Franchise within a certain geographic area for a specific length of time after termination of the Franchise relationship. The enforceability of such clauses varies widely and depends on its reasonableness. But can such obligations be one sided?


\(^{40}\) 342 F 2d 509 (5th Cir 1965).

\(^{41}\) 601 F 2d 609 (2d Cir 1979).

In *Modern Food Industries India Ltd v Krishna Bottlers Ltd*, the Franchisor provided concentrate to the Franchisee to manufacture and bottle aerated drinks and distribute them in the city of Hyderabad. The agreement prohibited the Franchisee from selling similar products, but the Franchisor contracted with other agents to sell their drinks as the Franchisee had failed to perform its obligations. When the Franchisee undertook to manufacture drinks substantially similar to that of the Franchisor’s business for a third party, the Franchisor sought an injunction restraining it from doing so.

The Court held that the balance of convenience was in favour of the Franchisee, and declined to grant the injunction. The Franchisor had not approached the court with clean hands, as under the Contract, the Franchisor had the liberty to enter into contract with others so as to affect the profitability of the Franchisee. The view of the Court was that injunctions should be granted only in exceptional situations. If the injunction was granted, the Franchisor would not be too affected as it had already appointed other distributors for the drinks whereas the Franchisee would suffer irreparable loss as it had stopped production of its own drinks to manufacture drinks for the third party and had undertaken heavy investment for the same.

On the other hand it was observed by the Supreme Court in the case of *Gujarat Bottling Co Ltd v Coca Cola Company* that:

> There is a growing trend to regulate distribution of goods and services through Franchise agreements providing for grant of Franchise by the Franchisor on certain terms and conditions to the Franchisee. Such agreements often incorporate a condition that the Franchisee shall not deal with competing goods. Such a condition restricting the right of the Franchisee to deal with competing goods is for facilitating the distribution of the goods of the Franchisor and it cannot be regarded as in ‘restraint of trade’.

---

43 *Modern Food Industries India Ltd v Krishna Bottlers Ltd* AIR 1984 Del 119.
44 *Coca Cola* 1995 SCC (5) 545.
45 The words ‘restrained from exercising a lawful profession, trade or business’, do not mean an absolute restriction and are intended to apply to a partial restriction, a restriction limited to same particular place; *Mahbub Chander v Raj Coomar* 1874 XIV Bengal Law Reports 76.
However the Court held that any such restrictive clause which operates post-termination of a contract violates Section 27\(^46\) of the Indian Contract Act and is unenforceable.

In conclusion, although Non-Compete Clauses in Franchise agreements are not in restraint of trade, they may be struck down if excessively harsh or unreasonable. Great care should therefore be taken in drafting a restrictive or negative covenant; if the same is very onerous to a single party, the Court may refuse to enforce it in its entirety. Protection of confidentiality and post-term restriction on competition are issues that the Franchisor must consider very carefully before finalizing the form of a Franchise agreement.

Recently in *Manish v Sandeep*\(^47\) the plaintiff, the proprietor of ‘Professional Tutorials’, entered into an agreement with the defendant by which the latter was granted the Franchise for the use of ‘P.T. Training Courses’ at Bhopal. It was stated in the agreement that the plaintiff has developed and conducted training courses called ‘P.T. Training Services’ and that the Franchisee could not conduct training courses similar to those covered under the agreement: ‘Clause 5 (b) Following expiry or termination of this agreement, by whatever reason, the Franchisee agrees not to conduct ‘the same or similar courses’ directly or indirectly, as those covered under this agreement, for a period of six months.’\(^48\)

Though the agreement was renewed for a four year period, the Franchisee terminated the Contract less than a year after renewal without giving written notice three months in advance as was required. The Franchisor sought a Temporary Injunction to enforce the Non-Compete Clause. The issue was whether the aforesaid negative covenant was in restraint of trade and therefore void under Section 27 of the Indian Contract Act. The Trial Court held that Clause 5 (b) was in restraint of trade, the agreement was prima facie

---

46 An agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind, is void to that extent.
47 2002 (3) MPHT 565.
48 It was held that the stipulation in Clause 5 (b) was not in restraint of trade. ibid [12] (SP Khare J).
unenforceable and declined to grant relief to the Franchisor. This was reversed by an appellate order of the High Court.

The main observation of the High Court while granting the injunction was that the Franchisee had derived the benefit of having access to the expertise developed in the training courses. Hence it could not independently conduct training courses similar to those covered under the agreement during the subsistence of the contract. This was a valid stipulation as per the law laid down in the *Coca Cola* case. In a Franchise agreement, such a negative covenant is for the advancement of trade. It would not be in restraint of trade but necessary for overall business interest. The Covenant operated for a limited period of time and only for the courses covered under the agreement. Hence, it was permissible for the smooth flow of trade and commerce.

Section 3(4) of the Competition Act, 2002 states that any agreement among enterprises or persons at different stages or levels of the production chain in different markets, in respect of production, supply, distribution, storage, sale or price of, or trade in goods or provision of services, including tie-in arrangement; exclusive supply agreement; exclusive distribution agreement; refusal to deal or resale price maintenance shall be a void agreement if such agreement causes or is likely to cause an Appreciable Adverse Effect On Competition (‘AAE’) in India. Thus vertical agreements shall be void only if such agreements cause an AAE on competition. When analyzed as restrictive covenants or exclusive dealing arrangements, such Non-Compete Covenants shall be observed according to the rule of reason. In the USA, Courts have generally been quick to recognize the important business considerations served by Non-Competition Clauses in Franchise agreements and have found them to be enforceable under Anti-trust laws.

49 Such an order of interim injunction can be granted to prevent the Breach of the Contract. See Order 39, rule 2, Civil Procedure Code, 1908.
50 *Coca Cola* (n 44).
51 *Ungar v Dunkin Donuts of America* 531 F 2d 1211 (3d Cir 1976 ).
Covenants for the protection of Intellectual Property Rights [IPR] are also very common. Ordinarily, Franchise agreements contain a clause dealing with confidentiality in relation to know-how and other forms of intellectual property and provide that the Franchisor will have legal recourse in cases where:

1. An employee comes into possession of a Trade Secret, know-how and confidential information in the normal course of business and either carelessly or deliberately passes off the information in the normal course of business\textsuperscript{53}

2. An unauthorized person incites such an employee to provide him with such information\textsuperscript{54} or

3. Under a license for the use of know-how, a licensee is alleged to have breached an expressed or implied condition.\textsuperscript{55}

**FRANCHISING AND ISSUES IN TRADEMARK LICENSING**

The crux of a Franchise agreement is the Trademark license. As the Franchisor is lending his Trademark to another operator, it is only fair for it to regulate its use, to that extent as is necessary, to ensure that the standards of the Franchisor are met and the Trademark is not misused. A Trademark licensing agreement is an agreement where the Franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a plan of the Franchisor.

The allegedly weak enforceability of IPR in India raises it as an issue of vital importance to any Franchisor in India. This is because violation of trademark rights may result in the gradual erosion of the saleability of the Franchisor’s products. The Madras High Court had observed in *Vivekananda English Academy v Amoha Education Pvt Ltd*\textsuperscript{56} that many Franchisees continue using

\textsuperscript{53} V V Sivaram v Foseco India Ltd 2006 1 Kar LJ 386.

\textsuperscript{54} Electrosteel Castings Ltd v Saw Pipes Ltd and Ors 2005 (1) CHN 612 (Calcutta High Court).

\textsuperscript{55} Coca Cola (n 44).

\textsuperscript{56} Vivekananda Academy 2005 5 CTC 393.
the Trademark, technical know-how and other confidential information of the Franchisor even after the termination of the Franchise agreement. A Franchisor should, in such a situation, take advantage of the remedies which are available under intellectual property laws in India against the infringement and trafficking of Trademarks. The Trade Marks Act, 1999, provides for the registration and better protection of Trademarks and for the prevention of use of fraudulent marks on merchandise. A Trademark can be licensed to a ‘Registered User’ registered with the Registrar of Trade Marks by a joint application in writing by the registered proprietor and such user, as well as to an unregistered user by written agreement with the proprietor.

An aggrieved Franchisor has recourse to three courses of action against the violation of their Trademarks: (a) seeking an injunction, (b) an action for passing off, and (c) criminal action. In *Teju Singh v Shanta Devi*, the Court stated that infringement of a registered Trademark gives its proprietor a statutory remedy. A registered Trademark is considered infringed, if a person who not being the registered proprietor of the Trademark or a registered user, thereof, using by way of permitted use, uses in the course of a trade, a mark which is identical with or deceptively similar to the Trademark in relation to any goods. It should be borne in mind that the license to use a Trademark does not amount to an assignment of Trademark and therefore the original proprietor does not divest high right, interest or title in the mark through the license.

In *Pepsi Foods v Jai Drinks Ltd*, Pepsi reserved the right to terminate the Franchise agreement for violation of any of the stipulated clauses. Hence,

57 The Trademarks Act, 1999 provides protection for goods and services that are distinctive, afford provisions for periodical renewal of registration, assignment, protection against infringing use and passing off, classification of goods and services and recognition of the concept of well-known Trademarks.

58 Sec 49, Trademarks Act, 1999.

59 Sec 2(1)(r), Trademarks Act, 1999.

60 AIR 1973 AP 51.

61 Sec 29(1), Trademarks Act, 1999.

62 Caprihans India Pvt Ltd v Registrar of TN 1976 80 CWN 222 (Calcutta High Court).

63 1996 DRJI 711 (Delhi High Court).
it terminated the agreement on sub-standard production of drinks by the Franchisee, Jai Drinks. In spite of this, Jai Drinks continued production. The Contract had no clause stating the rights and obligations of parties in the event of termination, especially in relation to the use of the Trademark. Despite the absence of such a clause, the Court granted an injunction restraining the Franchisee from using the Trademark and affecting the Franchisor’s rights, and upheld Pepsi’s right to terminate the contract.

The *Vivekananda Academy*\(^{64}\) case is the most popular case on this subject. The appellant, Vivekananda Institute had changed its name to Amoha Education Institute. It had earlier entered into a Franchise agreement with Vivekananda English Academy. The Institute later terminated the agreement. The Franchisee sought to continue its business in the name of ‘Vivekananda’ as the Franchisor had changed its name. The Franchisor filed for an injunction to prevent this. The Franchisee claimed that neither was ‘Vivekananda Institute’ a trade name nor was the business registered as a partnership; hence the Franchisor had no remedy. Whereas the Franchisor claimed that it was well known that it had changed its name to Amoha and they had severed their ties with the Franchisee, hence the latter had no right to continue in the same name. The agreement provided that the Franchisee could not use the Franchisor’s trade mark or trade name after the termination of the agreement. Hence the appellants contended that the Franchisee sought to deceive the public by such misuse of Trademark.

The Court, deciding in favour of the Franchisor, held that the Franchisee had violated the restraint of trade clause in the agreement by continuing to do business even after termination of the Franchise. Given the distinctiveness acquired by the Franchisor in the trade circle by prior long and continuous use of ‘Vivekananda Institute’, the Franchisee could not deceive the general public into believing that it was still using the Franchisor’s services. The ‘goodwill’ of even an unregistered partnership, which has changed its name, cannot be misused by a Franchisee.

\(^{64}\) *Vivekananda Academy* (n 56).
In a similar case\textsuperscript{65} of misuse of Trademark that involved a fashion school; technical expertise, study material, etcetera relating to fashion designing and art had been Franchised to the defendants. The Franchisor contended that the defendants were using a similar Trademark to pass off their business as that of the Franchisor and using the same course material and expertise even after termination of the agreement. The Court ordered that post termination of the agreement, all relevant material, training know-how, and course design should be returned to the Franchisor, even though the use of the Trademark was not deceptively similar. Further, the defendants must advertise the severance of all connections with the Franchisor.

A Franchisee may also sue any third party for the infringement of the trademark. Under Section 52 of the Trademarks Act,\textsuperscript{66} a Franchisee/licensee can, as a registered user, sue for infringement of the Franchisor's Trademark. Indian Courts have restrained the misuse of the well-known Trademark LACOSTE by local traders, holding them liable for infringement and dilution of the mark. Further, it's not just the Trademark; the logo can also be protected from unauthorised use, as was decided in the case of Mercedes Benz, the German luxury car manufacturer. Once the geographical extent and duration of the use of the Trademark is established, unauthorized commercial use thereof in relation to any goods or business can be prevented.\textsuperscript{67}

In the United States, the Federal Lanham Act provides that a Trademark can be licensed only if the licensor exercises control over the use of the Trademark. The Trademark is associated with the quality of the product or service of the Franchise and hence steps for its protection are necessary.\textsuperscript{68} In India the

\textsuperscript{65} IEC School of Art and Fashion v Gursharan Goyal 1998 DLT 833 (Delhi High Court).

\textsuperscript{66} This right is not applicable to an unregistered Trademark. However the franchisee will still have a cause of action against any third party for passing off goods or services. See Sec 27, Trademarks Act, 1999.


Registrar of Trade Marks may on written application or even their own motion cancel the registration of the Trademark on grounds of non-compliance by the licensee with provisions in the licensing agreement.69 Hence there is some sort of statutory requirement that the Franchisor should exercise control over the use of its Trademark by the Franchisee and ensure compliance with the standards laid down in the Franchise agreement.70

**TERMINATION OF FRANCHISE AGREEMENTS**

**Fundamental Breach in a Franchise Contract**

A material or Fundamental Breach of a Franchise Contract will excuse performance by the other party and will give rise to a claim for Breach of Contract. A material breach of Contract may be interpreted as the breach of the very basis on which the contract was founded or loss of the objective which the contract sought to achieve. In order to estimate the materiality of Breach, the business setting and the needs of the Franchisor and the Franchisee need to be considered.71 Courts have acknowledged that the interest of the Franchisor in the relationship is based on protection of its trade name, trademark, goodwill and public image. Hence, a violation by the Franchisee of certain reasonable directions of the Franchisor, resulting in an adverse impact on the Franchisor’s image and business, will be a material breach of contract since it impairs the basic reason why the contract was entered into.

Thus, a Franchisee’s failure to use the approved syrups and topping in an ice cream, was considered as a material breach of contract.72 A restaurant’s failure to

---

69 Sec 50(1)(d), Trademarks Act, 1999.
71 Stanley Kopp (n 20) 65.
comply with local health codes\textsuperscript{73} or to adhere to standards of cleanliness\textsuperscript{74} was also considered as a valid ground for the Franchisor to terminate the Contract. Conviction for a crime committed in course of operation of Franchise has been held to be an incurable default.\textsuperscript{75} Further, failure to meet a reasonable sales quota,\textsuperscript{76} to develop a sales territory,\textsuperscript{77} or to cure defaults upon request by the Franchisor,\textsuperscript{78} are all justified grounds to uphold termination.

Many Franchise legislations in the USA treat the Franchise agreement as a standard contract in which there is an inherent inequality of bargaining power between the Franchisor and the Franchisee. The earlier view was that Franchisees are small businesses that are economically inherently weak to the Franchisor, and have no choice but to accept the Franchisor’s terms if they are to compete and gain a foothold in the market.

Hence there can be no termination unless there is ‘good cause’ or Material Breach of Contract as described above. Reasonable notice has to be given before the termination of the agreement. Termination should take place after a reasonable period of time from the commencement of business. The agreement must also have a ‘Cure Period’ within which the Franchisee would have the right to make good their default and avoid termination, such cure periods being prescribed in the statutes. Good cause is also required for non-renewal by the Franchisor.\textsuperscript{79}

Judicial opinion is now in favour of the Franchisor. The plea of inequality of bargaining power is no longer accepted by courts as the existence of Franchisee

\textsuperscript{73} Bonanza International Inc v Restaurant Management Consultants Inc 625 F Supp 1431, 1441 (ED La 1986).
\textsuperscript{74} Dunne Leases Cars & Trucks Inc v Kentworth Truck Co 466 A2d 1153 (RI 1983).
\textsuperscript{75} Gateway Bottling Inc v Dad’s Root Beer Co 53 FRD 585 (WD Pa 1971).
\textsuperscript{76} 33 Flavors of Greater Delaware Valley Inc v Bresler’s 33 Favors Inc 475 F Supp 217, 231 (D Del 1979).
\textsuperscript{77} Carlo C Gelardi Corp v Miller Brewing Co 502 F Supp 637, 652 (DNJ 1980).
\textsuperscript{78} Aring Equipment Co v Link-Belt Const Equipment Co Bus Franchise Guide (CCH) 8906 (Wis Cir Ct 1987).
\textsuperscript{79} Pitegoff (n 12) 297-99, 301.
disclosure laws has bridged the gap between the Franchisor and the Franchisee, and there are a large number of Franchisees who are economically as powerful as their Franchisors.\textsuperscript{80}

The US Supreme Court in \textit{Burger King Corporation v John Rudzewic}\textsuperscript{81} held that there was no disparity of bargaining power in the Franchise agreement between Burger King, the Franchisor and Rudzewic, the Franchisee as the latter was a sophisticated businessman who had at no point acted under any economic duress imposed by the Franchisor. The Court rejected the plea of lack of fair notice prior to termination, as Rudzewic was not only an experienced businessman but also an experienced accountant who had undertaken detailed negotiations with the Franchisor and had been represented by counsel throughout all transactions between them. Hence the contractual provisions were not merely boilerplate declarations in a lengthy contract unknown to the Franchisee and would have to be upheld.

It is therefore no longer necessary for the Franchisor to prove that a fundamental breach of contract has occurred in order to terminate the agreement. The Franchise may be terminated at the option of either party without assigning good cause or reasonable notice if provisions to that effect are included in the agreement.

\textit{Doctrine of recoupment}

Franchisees may still obtain relief under agency law. Agency coupled with interest is generally considered irrevocable. The presumption of a Franchisee while investing in a Franchise is that any initial losses incurred in running the Franchise will be compensated by capitalizing on the Franchisor’s goodwill and experience during the course of business. Any premature termination of the agreement without good cause will be unjust to the Franchisee. Courts have used the Agency Doctrine to hold that Franchise agreements where the Franchisee has made substantial investment and which were to be for an infinite period

\textsuperscript{80} ibid 289, 314.
\textsuperscript{81} 471 US 462.
of time cannot be terminated until a reasonable period of time has elapsed.\textsuperscript{82}

This principle was laid down in \textit{Glover v Henderson} \textsuperscript{83} as follows:

‘Where an agent is employed to perform an act which involves expenditure of labor and money before it is possible to accomplish the desired object, after the agent has in good faith incurred expense and expended time and labor, but before he has had a reasonable opportunity to avail himself of the results of this preliminary effort, it could not be permitted that the principal should then terminate the agency, and take advantage of the agent’s services, without rendering any compensation therefore’.

In \textit{Gibbs v Bardahl Oil Company},\textsuperscript{84} the Franchisee sought to recover the value of services rendered in the promotion and distribution of the Franchisor’s products on termination of the Franchise by the latter. The Supreme Court of Missouri, applying \textit{Glover},\textsuperscript{85} held that where the Franchisee had invested labour and money in promoting the Franchisor’s business, and the Franchisor had terminated the agreement and appropriated the benefits of the Franchisee’s efforts, without reasonable notice, the Franchisee was entitled to recover for the losses so sustained. The Court also noted that where an agent has partly performed the Contract, the principal cannot revoke it so as to injuriously affect the agent’s rights at time of such partial performance.

This is known as the ‘Doctrine Of Recoupment’. It is an Equitable Principle frequently applied to agreements which are terminable at will. Under this doctrine, it is unfair for the Franchisor to deny the Franchisee a fair opportunity to recoup its investment and take advantage of the business contacts and goodwill the latter has developed through the course of business. This is especially where the Franchisee has made a substantial capital investment.\textsuperscript{86}

\begin{footnotes}
\item[83] \textit{Glover v Henderson} (Glover) 25 SW 175 (Mo 1894).
\item[84] 331 SW 2d 614 (Mo 1960).
\item[85] \textit{Glover} (n 83).
\end{footnotes}
The principles outlined above can be found in the Indian Contract Act as well. Where an Agent has interest in the subject matter, the Agency cannot be terminated to the prejudice of such interest in the absence of an express contract to the contrary.\textsuperscript{87} The Contract Act also provides that the principal cannot revoke authority when it has been partially exercised, to the extent of such partial exercise.\textsuperscript{88} Where the Contract provides that the agency should be continued for any amount of time, the principal or agent is bound give compensation for any Revocation or Renunciation of Agency without sufficient cause.\textsuperscript{89} Reasonable notice has to be given of such Revocation or Renunciation or else either the principal or the Agent, as the case may be, will be liable for damages.\textsuperscript{90}

\textbf{‘Freedom of Contract’ and its application to termination clauses}

However Indian Courts have not considered the ‘doctrine of recoupment’ while adjudicating upon the termination of Franchise agreements. In most cases the Franchisor appoints the Franchisee as an independent contractor, not as an agent and Courts have applied the ‘freedom of contract’ theory in deciding the rights and liabilities of parties. Precedence is given to the terms and conditions of the contract as mutually negotiated by both the parties. Courts have not considered unjust conduct on the part of the Franchisor causing detriment to the Franchisee and the efforts undertaken by the Franchisee in building goodwill of the business.

A relevant Indian case is \textit{Classic Motors Ltd v Maruti Udyog Ltd}\textsuperscript{91} In this case, \textit{inter alia}, the clause in the Franchise agreement between the plaintiff [the Franchisee] and the defendant [the Franchisor], that was being contested was as follows:

\textsuperscript{87} Sec 202, Indian Contract Act, 1872.
\textsuperscript{88} Sec 204, Indian Contract Act, 1872.
\textsuperscript{89} Sec 205, Indian Contract Act, 1872.
\textsuperscript{90} Sec 206, Indian Contract Act, 1872.
\textsuperscript{91} 1997 IAD Delhi 190 (Delhi High Court).
Clause 21 Termination of Agreement: This agreement shall remain and continue in force and govern all transactions between the parties hereto until cancelled or terminated in the manner hereinafter expressed. Notwithstanding the provisions of any Clause hereof either party may by giving the other 90 days notice in writing terminate this Agreement without assigning any cause.

The main contention raised by the plaintiff was that Clause 21 was against Public Policy and was void by virtue of section 23 of the Indian Contract Act. A Franchisor should not be able to terminate the Franchise without assigning a valid and strong cause which goes to the root of the agreement. They further contended that a Franchise agreement stood on a different footing from that of other agreements; hence it was of a permanent nature and indeterminable in character. The plaintiff also pleaded that the agreement being a standard form of contract, it was offered on a ‘take it or leave it’ basis and the plaintiff was compelled to sign it.

The Delhi High Court made the pertinent observation that the clause in contention was applicable to both the parties. Also, the plaintiff was an educated rich businessman. He had access to independent legal advice. It was his fault that neither did he protest before signing the agreement nor did he take any steps to avoid the said Contract. Not only that, the plaintiff had affirmed the agreement and reaped all its ‘benefits’. He had challenged the said clause only post termination, which was ten years after the agreement had been signed. Placing reliance on *P Dasa Muni Reddy v P Appa Rao*, the Court ruled that the plaintiff at this stage had waived his right to challenge the disputed clause. After perusal of the facts of the case, the Court also noted that no ‘illegitimate means, amounting to or threatening a tort, crime or breach of contract’ had been used to make the plaintiff sign the contract. Hence there was no question of duress or coercion.

Regarding the question of public policy and unconscionability, the Court stated that this issue would only arise if the contract had been in the realm of public

92 AIR 1974 SC 2089.
93 See *M/S Unikol Bottlers Ltd v M/s Dhillon Kool Drinks (Unikol)* AIR 1995 DEL 25.
law and not in a commercial contract, where both parties were businessmen.\footnote{Shyam Gas Co v State of Uttar Pradesh AIR 1991 All 129.} In a private transaction, no restriction or fetter can be imposed on the parties regarding the manner and mode in which they contract. It did not agree with the plaintiff’s contention that a Franchise Contract was permanent and hence it could not be terminated without cause. After surveying American, English and Canadian case law on the subject it was found that Franchise Contracts in India are terminable, because mercantile and commercial Contracts are usually not intended to be permanent.\footnote{Martin Baker Aircrafts v Canadian Flight Equipment [1955] 2 All ER 722 (QB).}

In the instant case, there was an express provision which laid down the procedure for termination. Hence the Court concluded by saying that dealership agreements between private parties could never be permanent unless the parties included a provision to that effect in the agreement.

The Franchisee may not avail of an injunction to enforce their rights, even if the Franchisor has failed to comply with the terms of the agreement. Under Section 14 of the Specific Relief Act agreements which are determinable in nature, that is, can be terminated at will by the parties—cannot be specifically enforced.\footnote{Sec 14(1)(c), Specific Relief Act, 1963.} In \textit{Indian Oil Corp Ltd v Amritsar Gas Services},\footnote{Indian Oil Corp Ltd v Amritsar Gas Services, (1991) 1 SCC 533.} the Supreme Court struck down the restoration of distributorship to the distributor by an arbitrator, even though the termination was invalid. The agreement was terminable at the option of the defendant corporation and therefore could not be specifically enforced. The distributor could only claim compensation equivalent to loss of earnings for the 30 days period of notice which was required prior to termination.

Similarly where the agreement stated that it was terminable at the option of the Franchisor on the occurrence of any of the events specified therein, the Franchisee was barred from obtaining a temporary injunction staying the notices of termination.\footnote{Rajasthan Breweries Ltd v The Stroh Brewing Co AIR 2000 Delhi 450.} Importance is also given to other terms and conditions
of the Contract. In *Mittal Services v Escotel Mobile Communications Ltd*\(^99\) the Franchisee sought an injunction to restrain the Franchisor from appointing other Franchisees in the territory on the grounds that termination of the agreement was without notice. Therefore it was invalid and the subsisting agreement would continue to apply to the parties.

The Court however declined to grant an injunction on the grounds that since the agreement was in its nature determinable by giving a 90 days’ advance notice in writing, it could not be specifically enforced. Additionally, the agreement provided that the appointment of the Franchisee was on a non exclusive basis. The relevant clause was as follows:

\[
\text{Cl 5.2} \quad \text{The rights granted to the Franchisee under this Agreement are non-transferable and non-exclusive. Escotel may appoint any number of Franchisees as it deems fit in a given area and Escotel is further entitled, at its discretion, to curtail or in any manner vary the territorial limits within which a Franchisee is operating without assigning any reasons. The Franchisee shall be given a notice of any such variation. Such variation or curtailment shall not give rise to any cause of action in favour of the Franchisee against Escotel.}
\]

Therefore it was unnecessary to look into the validity of the termination as even during the subsistence of the agreement, the Franchisor had the right to appoint as many Franchisees in the given territory as they liked.

The issue of inequality in bargaining power came up explicitly in *M/s Unikol Bottlers Ltd v M/s Dhillon Kool Drinks*.\(^100\) The plaintiff bottled and distributed soft drinks manufactured under the defendant’s Trademark. The agreement provided for an arrangement of at least ten years so that the Franchisee could recoup its investment. However, the Franchisor had the right to terminate the agreement with immediate written notice if the Franchisee failed to correct any deficiency pointed out by the Franchisor in its operations within three months of sending written notice. The plaintiff failed to respond to the notices sent by

\(^99\) AIR 2003 DEL 410.

\(^100\) *Unikol* (n 93).
the Franchisor. The parties later negotiated a Supplemental Agreement which extended the date of termination by six months as follows:

Whereas in an effort to amicably resolve the issues, both parties have agreed to continue with the said Agreement up to September 30, 1992, subject to the condition that on September 30, 1992, the said Agreement shall terminate and expire as also certain further terms and conditions as hereinafter set out.

Post termination, the Plaintiff complained of inequality of bargaining power arising out of a Standard Form of Contract with a Multinational giant. It also claimed right to recover the heavy investment it had made. The contention was that the unilateral power of the Franchisor to terminate the Franchise was unconscionable, against public policy and therefore void under Section 16 and Section 23 of the Indian Contract Act. The Supplemental Agreement being collateral to the main agreement, it was liable to be declared void as well. It also contended that the Supplemental Agreement was by way of Novation and that forbearance to terminate the agreement could not be valid consideration for such Novation.

The Court considered the issue of unjust enrichment of the Franchisor at the expense of the Franchisee, but ultimately applied freedom of contract theory. It held that since the parties had mutually negotiated the extension of the termination date, there was no imposition of terms on the Franchisee. Further the Supplemental Agreement was held to be neither a Novation nor a collateral agreement but a valid rescission of the Contract under Section 62 of the Contract Act. The agreement of the parties to discharge each other from their mutual obligations under the Contract was adequate consideration. Just as the parties had created rights and obligations through mutual consent, they could terminate the same according to their free will.

The Court also pointed out that the Franchisee should have challenged the termination at the stage of issue of notice itself. However the Franchisee had accepted the draft of the Supplemental agreement sent by the Franchisor. This implied consent on behalf of the Franchisee to the eventual termination of the
The agreement also indicated that it was an ‘Amicable Settlement’ between the parties hence suggesting absolute free will. The plaintiff’s board of directors consisted of experienced businessmen and also included a solicitor. The agreement had been negotiated between the parties and a draft of the final agreement had been sent to the plaintiff for suggestions prior to its execution. The Court held that if a party complaining of an unfair contract does nothing to avoid it, it has no right to raise a grievance.\textsuperscript{101} Hence the arguments of undue influence and duress were struck down.

If it is the Franchisee that wrongfully terminates the agreement, Courts have allowed the Franchisor to claim lost future Royalties. Such damages will be reduced by any profits that the Franchisor may earn from new Franchisees in the same territory.\textsuperscript{102} The obligation on the Franchisee to make good the loss of Royalty exists even if it is bankrupt or suffering losses, provided the Franchisor can show the estimate of such lost profits.\textsuperscript{103}

**CONSUMER LIABILITY: WHETHER THE FRANCHISOR OR THE FRANCHISEE IS LIABLE FOR ‘DEFECT’ OR ‘DEFICIENCY’?**

A consumer of products or services offered by a Franchise may seek a remedy under the provisions of the Consumer Protection Act, 1986. The aim of the Franchise operation is that the consumer should perceive the Franchisee’s business to be that of the Franchisor and running in accordance with the same standards of quality found in the Franchisor’s own outlets. The consumer deals with the Franchisee under this belief. Thus, to make sure that the Franchisee does not negatively affect the goodwill of the Franchisor, the Franchise Contract imposes some terms and conditions on the Franchisee.

It was observed in cases filed against Kentucky Fried Chicken and McDonald’s in India as well as the USA that the Franchisor of a fast food chain has a lot

\textsuperscript{101} The Court referred to *North Ocean Shipping Co Ltd v Hyundai Construction Co Ltd* [1978] 3 All ER 1170 (QB)
\textsuperscript{102} *McAlpine v AAMCO Automatic Transmissions Inc* 461 F Supp 1232 (E D Mich 1978)
\textsuperscript{103} *Re Mid-America Corp* 159 BR 48 (Bankr M D Fla 1993)
to learn from the large number of lawsuits filed against fast food Franchises in the past. Consumer complaints originate due to an attitude of complacency on the part of the Franchisor. Once a brand name is established, Franchisors often take their consumers for granted and fail to ensure adherence to the required standards of hygiene that ought to be maintained in any food Franchise. Since a consumer is made to believe that both the business are same, the liability of a Franchisee is the same as that of the Franchisor. For example a lawsuit was led against a KFC outlet in Texas for allegedly serving sandwiches containing baby cockroaches. In another case against the McDonald’s Corporation, consumers were misled about the ingredients used in the preparation of products. The Corporation had to pay damages and was also asked to issue an apology.

The question which often arises is: should the Franchisor alone be held liable or should the liability be shared with the Franchisee? In Poona Bottling Co v Union of India, Poona Bottling was carrying on the business of manufacturing and bottling soft drinks. It purchased essences from M/s Parle Exports under a Franchise agreement. The terms of the Franchise agreement provided that:

M/s Parle Exports denies the creation of any relationship of Agency, Partnership or Joint Venture between the Bottler and the Company, making the Bottler fully responsible for any liability, loss, injury, or damage resulting from or claimed to result from acts of commission or omissions on part of the Bottler.

At the same time, restrictions were placed by the Franchisor on the Franchisee regarding the purchase of essences; the formula to be used in the manufacturing process, packaging material, location of the plant as well as the advertising strategy. The Franchisor Company was also given the right to inspection.

On the question of the extent of liability of Parle Exports, the Court held that as Poona Bottling independently carried out the entire manufacturing process, no contract of agency could be made out. Agency as a relationship exists only when the agent has the right to affect the principal’s legal position with respect to

104 01 CH 9137.
105 1981 (8) ELT 389 Del
strangers. Given the absence of such a right, the Court held that the prescribed controls were for the protection of the Franchisor’s Trademark interests and did not indicate that the Franchisee was acting on behalf of the Franchisor.

‘Control’ test for liability

Similarly in the United States as well, the enforcement of quality standards and the right to audit and inspection has been held to be ‘typical’ of most Franchise operations. However on the question of liability, it was seen in the US case of Kerl v Rasmussen Inc, that it is the degree of control which the Franchisor exercises over the Franchisee which forms the basis of the Franchisor’s liability in any legal action. The supervision and control test is applied: the more control the Franchisor has, the higher is the legal risk/liability. It was stated that:

‘Although Franchisees operate as separate businesses, Plaintiffs often look to the deepest pockets when developing a claim, which means that Franchisors are frequent targets in lawsuits. In nearly every case, liability hinges on how much control the Franchisor holds over its Franchisee. A Franchise has an independent nature, but a Franchisor must by necessity retain some control over the use of its names, goods or services’.

Thus while the primary liability is that of the Franchisee, the Franchisor owes a duty of care towards both the Franchisee and the consumer. The Franchisor may be vicariously liable for any injury caused to a third party by the Franchisee’s actions depending on the degree of control it has over the Franchisee’s operations. Traditionally, such control is characteristic of the Contract of agency. But the ‘Deep Pocket’ theory and the ‘Supervision and Control’ test may also project a Master-Servant relationship.

The problem arises as to whether a Franchisor should be held liable even if the control exercised by them only extended to matters necessary for protecting

---

107 682 NW 2d 328 (Wis Ct App 2004). See also Hill (n 13).
108 ibid (emphasis added); Patel, (n 4).
their reputation and Goodwill. Therefore, a distinction is made between controls that are necessary for the preservation of the Trademark and those that extend beyond such a need. The Franchisor will be liable only in the latter case. In *Nichols v Arthur Murray*, 109 a dance school Franchisor exercised the right to control operations, advertising strategies, the location and layout of the school and the hiring of employees. It was held such controls extended beyond the need to preserve the Trademark and that a relationship of agency existed.

**Nature of the relationship between the Franchisor and Franchisee**

The legal relationship between the two parties is instrumental in determining the nature and extent of liability incurred by the Franchisor in such an arrangement. While all Franchise agreements cannot be pigeon holed into one of the three categories of the existing settled legal relationships—Agency, Master and Servant, Independent Contractor—it has been noted that liability in most Franchise agreements is decided upon the kind of control the Franchisor exercises. The most important test for deciding liability is distinguishing between ‘Means Oriented’ and ‘Results Oriented’ control. 110

A principal has the right to determine how the results of an activity are to be accomplished by the agent. An independent contractor can operate at their own discretion, and is only responsible for the final results of the activity, that is *what* is to be accomplished.

In *Schlotzsky’s Inc v Hyde*, 111 the Franchise Contract as well as the operations manual put forth compulsory and detailed standards for food and service quality. However, the Contract did not make the Franchisee an agent of the Franchisor, nor did the Franchisor have control over the time, manner or method in which the Franchisee executed such standards. The Franchisor had hired an independent company to ensure that the Franchisee adhered to its requirements of quality. The Franchisee was alleged to have served tainted food to its customers. The Court held that the Franchisor was not liable for

---


the Franchisee’s negligence as it had no control over the aspect which primarily governed such conduct viz the manner and method of service.

The Franchisor may evade liability by including a clause in the contract which provides that the relationship between the contracting parties is that of principal to principal and not principal to agent. However, the contract may still be constructed by the Courts to be one of agency if the rights and liabilities assumed by the parties are in consonance with those found in the Indian Contract Act.112 Under the Act, an agent must conduct his business according to the directions given by the principal or the custom which is prevailing at the place of business,113 and must use reasonable diligence and skill.114 He must also render proper accounts to the principal115 and has the right to be indemnified by his employer for the consequences of all lawful acts done in the exercise of his authority.116

In Shalagram Jhajaria v National Co Ltd,117 the appellant was appointed as the exclusive distributor of the respondent’s goods. The agreement stated that transactions would be on a principal to principal basis. However it also provided that the appellant was to render proper accounts to the respondent and that it would be indemnified for any claims made with respect to defect in the quality of the goods. The respondent had the right to inspect the appellant’s warehouses and advise it in matter of sales and fixation of prices. In light of the other clauses, the clause excluding a relationship of agency between the parties was negated.

Similarly it was contested whether discounts given to distributors of pre-paid SIM cards were in the nature of commissions given to agents. The agreement clearly stated that the relation between the parties was that of two Independent Contracting parties and not that of Principal and Agent. Yet, it was held that it

112 Sections 182-238 of the Indian Contract Act, 1872 deal with agency.
113 Sec 211, Indian Contract Act, 1872.
114 Sec 212, Indian Contract Act, 1872.
115 Sec 213, Indian Contract Act, 1872.
116 Sec 222, Indian Contract Act, 1872.
117 1965 35 CompCas 706 (Calcutta High Court).
was a relationship of agency as a legal relationship was established between the mobile service provider and the consumer through means of the distributors.118

In M/S Escorts Ltd v Shivaji Tukaram Patil,119 in spite of payment made for the purchase of tractors, the Franchisee dealer did not deliver them to the customers. The Franchisee contended that the payments were sent to the Franchisor and hence they were not responsible for non delivery. The Franchisee and the Franchisor were held jointly and severally liable to compensate the complainants. On appeal, the Franchisor pointed that under the agreement the relationship between the Franchisor and the Franchisee was on a principal to principal basis and the dealer was not permitted to represent themselves as an agent in any circumstance.

However the dealer was bound to employ personnel and meet standards relating to the premises and equipment according to the directions of the Franchisor. The dealer was also authorized to appoint sub dealers. It was accepting money on behalf of the Franchisor and rendering accounts to them for the same. Hence the Court held that it was an agent under the Contract Act.

**Apparent agency**

Further, the Courts have held that ‘Apparent Agency’ may be established when the Franchisor, as the Principal of the Franchisee, may let it exercise some power which the Franchisor possesses through a certain act or omission.120 Some courts in the USA have held that a third party making a claim against the Franchisor needs to establish that they were under the impression that the Franchisee and the Franchisor were one and the same and that it was the Franchisor who created this appearance of authority.121

A pertinent question emerges to what extent can the display of Signs, Logos

---

118 Commissioner of Income Tax v Idea Cellular Limited 2010 325 ITR 148 (Delhi High Court).
119 2007 1 CPJ 247 (NCRDC).
120 Coca Cola (n 44) 4.
121 ibid.
and Emblems, create the impression that the Franchisor has apparent authority and to what extent is holding the Franchisor liable justified under this doctrine? After all, is not the purpose of a Franchise agreement to share good will and lead the consumer to believe that they are dealing with the main corporation?

In *Ross v Mobile Oil Corp*, a consumer who had slipped and fallen at the Franchisee service station claimed damages from the Franchisor oil corporation. The service station had Signs and Logos of only the oil corporation on display. The Court held that this was an inadequate basis to establish the apparent authority of the Franchisee. The signs were only an indication that the company’s products were sold there and such use of the Franchisor’s Trademark was the basis of any Franchise agreement. Hence the Franchisor was not liable.

Deviating from the above principles, in *Rogers v Night Riders* the Court of Appeal in UK held a Franchisor liable for the negligence of the Franchisee. In this case, the defendants operated a mini cab business called ‘Night Riders’. As was the convention, the cabs were owned by private individuals but they bore the Franchisor’s trade name. The plaintiff was traveling in one such cab when the door of the car flew open, collided into a stationary vehicle, and slammed back again, thereby injuring her. The Court justified its decision on the grounds that the defendant owed a duty of care to the plaintiff and it should have ensured that cabs carrying its trade name were not defective.

A seminal case which deals with both the control test as well as Apparent Agency is that of *Drexel v Union Prescription Centers Inc.* The plaintiff’s husband was mistakenly given a blood thinner by the Franchisee drug store whereas the prescription called for a diuretic, leading to his death. As is common in boilerplate Franchise Contracts, the Franchise agreement provided that the Franchisee would be an independent contractor and not an agent, employee or servant of the Franchisor. However the Court stated that such a clause per se cannot be determinative of the existence of an agency relationship and that

---

124 *Drexel* 582 F 2d 781 (3d Cir 1978).
the nature and extent of control exercised by the Franchisor over the Franchisee would have to be looked at i.e. control over ‘means’ versus that over ‘results’.

The Franchise agreement provided control over minute details of the Franchisee’s operations to the franchisor. Under the agreement, the Franchisee was required to conduct the business in strict accordance with the directions as may be promulgated from time to time by the parent company.

The control aspect by itself may be insufficient if it shown that there was nothing in the conduct of the parties that would have led a reasonable person to assume that a relationship of agency existed and place reliance on such a representation of agency. In fact, the Franchise agreement did provide a clause stating that:

The Owner (Franchisee) shall show his name (Corporate, Partnership or Individual) in connection with the use of such licensed mark following ‘Union Prescription Center’ in conjunction with the word ‘License’ or otherwise identify himself as the owner of the Union Prescription Center under a license from UPC, on all invoices, statements, letterheads, prescription blanks and other printed matter, as well as on all signs posted on the Union Prescription Center premises. Applications for local licenses or other entries in public records will be made in the Owner’s name.

However while deciding vicarious liability of Franchisors for the negligence of Franchisees, the Court have often gone beyond the ‘control’ test and looked at whether there was ‘Agency by Estoppel’. Under the Restatement (Second) of Agency two elements are required to be proved for Agency by Estoppel: first that that one party represented that another was his servant or agent, secondly this caused a third person to justifiably rely on the skill and care of such servant or agent.\(^{125}\) If the two elements are satisfied, the party would be responsible for the harm caused by lack of skill or care on part of the servant or agent.

In *Drexel*,\(^{126}\) the customers of the store were given no notice that it was owned and operated by an independent entity. Rather they were led to believe that

---

125 Restatement (Second) of Agency § 267 (1958).
126 *Drexel* (n 124).
they were dealing with the Franchisor, UPC. The bags, prescription labels and cash register receipts bore the UPC Trademark so did local advertising. The store was listed in the telephone directory as ‘Union Prescription Center’.

The representatives of UPC had the right to inspection. Under the agreement the Franchisee was required to ‘promote and advertise only with the logo, service mark, or insignia prepared and submitted by UPC’ to the Franchisee and the advertising strategy as well as the use of signs on prescription labels and business cards was to be as prescribed by UPC.

It was held that the Franchisor had created an appearance of ownership and control over the Franchisee which was deliberately designed to attract the general public. Further, the Franchisor had failed to apprise the public of its independence from the Franchisee. Hence the Franchisor could be held liable for the Franchisee’s negligence.

Therefore while the control exercised by the Franchisor over the Franchisee is necessary for the protection of its goodwill, it must ensure full compliance with its terms and conditions. Otherwise it may risk liability for ‘holding out’ the Franchisee as its agent. This is especially where the agreement itself instructs the Franchisee to distinguish itself as an independent entity and the Franchisor has the right to inspection for this purpose.

For a further exposition on Agency by Estoppel, one should refer to Australian law. The Franchisee is generally regarded as an independent Contractor and Franchise agreements tend to include standard clauses excluding liability under Agency Law. Yet, though a Franchise agreement may expressly exclude an agency relationship between the parties, this does not prevent a finding of ostensible authority. In *Donut King Australia Pty Ltd v Barber*, Sequin Close Pty Ltd entered into a master Franchise agreement with Donut King under

128 ibid.
which Sequin was authorized to contract with other potential Franchisees as sub Franchisees. Donut King was later sued for misrepresentations made by Sequin in one of its negotiations.

It was held that Sequin as the Sub-Franchisor was the agent of Donut King, the master Franchisor, and hence Donut King would be vicariously liable. A Sub-Franchisor not only promotes the master Franchisor’s interests like an ordinary Franchisee but also makes representations on its behalf to other potential Franchisees, hence creating legal relations between the Master-Franchisor and Sub-Franchisees.

The Indian Evidence Act states that when one person by his act or omission causes another person to believe a thing to be true and act upon such belief, neither he nor his representative shall be allowed in a suit between himself and the other person to deny the truth of that thing. Under the Contract Act, a principal is bound by an agent’s unauthorized acts or obligations to third persons if he had induced the belief that such acts and obligations were within the scope of the agent’s authority. Hence a Franchisor may be held vicariously liable under Indian law as well.

In an altogether different liability litigation; in *Kennedy v Western Sizzlin Corp.*, an employee of the Franchisee brought action against the Franchisor for several torts such as negligent hiring and retention. The plaintiff tried to establish that the manager of the Franchisee acted with the apparent authority of the Franchisor. However, nothing in the facts pointed out that there was anything to suggest such an apparent authority. The employee had sued the Franchisor for the Franchise manager’s alleged sexual harassment. However the Franchisor had no day-to-day control over the Franchisee and the manager. Hence the Franchisor was held not liable.

130 Sec 115, Indian Evidence Act, 1872
131 Sec 237, Indian Contract Act, 1872
132 857 So 2d 71 (Ala 2003)
However in *Petro Canada v British Columbia (Worker’s Compensation Board)* 133 the Franchisor Petro Canada was held to be in contravention of the Worker’s Compensation Act, 1996 which made employers responsible for the health and safety of workers at the workplace. The Franchise Contract stipulated that the Franchisee was an agent of the Franchisor and granted a high degree of control to the Franchisor over the workplace, including the right to conduct inspections. The Franchisor was held liable for failure to redesign the layout of the gas service station to prevent violent incidents such as robbery and ensure the safety of the Franchisee’s employees. Therefore where the Franchisor has control over the day to day management of the Franchise and its premises it may held be liable for failure to comply with statutory requirements.

The above cases and their reasoning cannot be generalized and said to be applicable in chain style Franchise operations. 134 However, there are no laws enacted solely for the purpose of regulating the growing business of franchising in India, even though many nations across the world have enacted such laws. The result is that when Franchisors enter India they are governed by a number of different statutes and codes rather than a single comprehensive enactment. The ability of the Franchisee to represent the Franchisor in dealings with third parties is the primary factor in deciding liability. The question of whether or not there was apparent agency is left to judicial interpretation of the terms of the Contract and the circumstances of the case.

**Drafting Rights and Liabilities in a Franchise Agreement**

In the absence of any special statute which lays down the rights and obligations in a Franchise, it is important that the Franchise agreement be comprehensively drafted so as to avoid the risk of leaving it open to judicial interpretation and therefore possibly jeopardizing the rights of the parties. From the Franchisor’s viewpoint it is important to avoid vicarious liability for their Franchisee’s actions, as well as ensure that their Intellectual Property and business strategies

133 2009 BCCA 396.

remain confidential and that their goodwill is protected. The Franchisee, on the other hand, has to protect their rights in the event of unjust termination of the agreement by the Franchisor.

The Franchisor cannot rely only on a clause excluding a principal-agent or employer-employee relationship to avoid vicarious liability under the Contract. The agreement must require the Franchisee to disclose that they are an independent entity to consumers in the course of business as well as in any material used for purposes of promotion or representation, such as business cards, cash receipts or advertising billboards.135 For example the promotional material used for Dominos' Pizza in India features the logo of Jubilant Foodworks, which holds the master Franchise in the country, alongside the Dominos logo.

The Franchise agreement should also make explicit the distinction between means oriented and results oriented control. While the Franchisor may retain controls which are necessary for the protection of their Trademark, the day to day operations should be under the control of the Franchisee. This especially includes matters of safety standards and employee relations. Any standards that the Franchisor wishes to impose in such matters must be in the form of recommendations, not as essential requirements in the Contract. Otherwise the Franchisor may held liable for failing to supervise the maintenance of such standards.136

The Franchisor should only make essential those standards which they are capable of enforcing. It has to ensure that the terms of the agreement are complied with in reality, especially where they have a right to inspection of the Franchisee outlet under the Contract. Any unenforced standards will go against the Franchisor in deciding liability.137

136 ibid 180-81.
137 ibid 174,180-81.
The Franchisor can however, require compliance with the applicable local laws or local health and safety regulations in the agreement, the methods to achieve compliance being at the Franchisee’s discretion. Hence the Franchisor can provide for the maintenance of quality control in daily operations without directly supervising, and incurring liability for the same. Modern Franchise agreements also provide for an ‘Insurance Clause’ stating that the Franchisee is responsible for procuring insurance for any liability arising out of the Franchise, and the Franchisor would also be covered under such insurance at the Franchisee’s expense.

Indian Courts have generally not considered the Doctrine of Recoupment. Termination of the Franchise agreement may be upheld even if it is undertaken without any sufficient cause or reasonable notice. Therefore the Franchisee should negotiate for the inclusion of a clause in the agreement stating that the Franchisor shall give reasonable notice prior to termination. Further it should compensate the Franchisee for loss of investment undertaken in the working or promoting of the Franchise on the rescission or premature termination of the agreement. Exception will be made only if the Franchisee has infringed the Franchisor’s Trademark or caused substantial damage to its Goodwill in relation to third parties.

Finally, regardless of the absence of any strict disclosure laws, the Franchisor should prepare a disclosure document prior to the execution of the agreement to enable the Franchisee to make an informed decision. According to UNIDROIT principles a model Franchise disclosure document should contain information about intellectual property rights, business experience of the Franchisor, any civil or criminal liability incurred by the Franchisor as well as bankruptcy proceedings involving the Franchisor and its affiliates. In addition to this it should also include the conditions for renewal or termination of the agreement, limitations on use of the Franchisor’s Trademark, information about Non-Compete

---

138 ibid.
139 ibid 176.
Covenants and details of the Royalties to be paid by the Franchisee.\textsuperscript{140} The drafters should ensure that any Restrictive Covenants operate for a reasonable period of time, and over a limited area during the subsistence of the contract.

If the Franchisor has fully disclosed the details of its operations and the terms and conditions of the agreement without any Misrepresentation or Fraud, it is better equipped to challenge claims of undue influence and inequality of bargaining power made against it by the Franchisee. This is especially if the Franchisee negotiates with the Franchisor for the alteration of contractual terms on the basis of such disclosure. This helps to prove that the contract was freely negotiated and was not a standard contract imposed on the Franchisee as in the case of an ordinary consumer.

\textbf{CONCLUSION}

The range of business opportunities for franchising in India extends from play schools, showrooms for big brands, café shops, travel agencies and entertainment to florists, pet care centers, baby shops and health centers.\textsuperscript{141} Hence a healthy legal environment is of great importance for franchising and should include provisions pertaining to all areas that fall within the ambit of franchising. This includes, \textit{inter alia}, commercial law relating to Contracts and joint ventures and intellectual property law for protection of Trademarks and know-how. Franchising is an outsourcing activity and hence the proposed model of contract varies based upon the degree of responsibility sharing and the payment structure of the Franchise.\textsuperscript{142}

Due to the uniqueness of the relationship between a Franchisor and a Franchisee, general principles of Contract law may not comprehensively satisfy the claims of both the parties. Courts may not take into account the Franchisee’s lack of


\textsuperscript{141} For business opportunities in franchising one can visit http://www.franchiseindia.com/. Franchising World is the most popular magazine in this sector of business.

\textsuperscript{142} In the electricity sector, model franchise agreements could be: Franchise for Metering and Billing, Franchise for Revenue Collection, Franchise for Minor/Major Operation and Maintenance, Franchise for Energy Purchase.
bargaining power, their right to disclosure of information, and to recoup the investment made in the Franchise. They also may not understand the conflict the Franchisor faces while deciding which aspects of the Franchisee’s business should be under their control for the best preservation of their Trademark and brand value. In this article we have shown the development of mercantile law in franchising contracts in India through judicial application of Contract law to, and judicial interpretation of clauses commonly included in, such agreements. The article has explained how parties to a Franchise ought to take this into consideration while drafting the contract.

The current legal framework favours the Franchisor. The Franchisor in a Franchise agreement not only licenses its Trademark or trade name, but also its business model, confidential know-how and Goodwill. Hence it has the right to control the Franchisees’ operations to ensure that the Franchisee does not damage its reputation. It can impose Non-Compete Covenants as well as confidentiality clauses in order to prevent its intellectual property from being shared with competitors. Courts have usually held Franchise Contracts to be Commercial Contracts and rejected claims of unconscionability. Franchisees have grown to be economically stronger and equipped with their own legal counsel. Mutual negotiation of terms between the parties has been a key factor in holding that no duress has taken place.

Lastly, a review of the standard default provisions contained in a Franchise agreement indicates that the Franchisor can terminate the agreement for a host of reasons. Many of these enumerated grounds for termination are subjective and require a discretionary evaluation by the Franchisor of the alleged discrepancy. Sometimes the Franchisor may terminate the agreement without

143 A review of the most current standard form franchise agreements utilized by the majority of fast food franchisors indicate that the default provisions contained in those agreements are extensive and covers every possible contingency from failure to service standards to failure to maintain a responsible credit rating.

144 It is not uncommon for a franchise agreement to contain a provision which provides that conduct by the franchisee which reflects unfavorably on the franchisor would be grounds for default. For more see: Phillip E Evans and Lanny Streeter, ‘The Franchise Agreement and Covenants Not to Compete: Antitrust Implications’ <http://ipmall.org/hosted_resources/IDEA> accessed, 23 June 2015.
assigning any cause whatsoever. In considering these extensive powers which are granted to the Franchisor, it should be kept in mind that the majority of judicial decisions on the subject have pronounced the opinion that the Franchisor does not have a corresponding fiduciary relationship to the Franchisee.145

On the other hand, the Franchisor may be held vicariously liable for the actions of the Franchisee if it exercises a high degree of control over the Franchisee’s operations or under the doctrine of agency by Estoppel. The problem is therefore two-fold: a Franchisor requires a certain degree of control and the right to terminate operations altogether if the Franchisee misuses its Trademark or damages its Goodwill. At the same time, the Franchisee has the right to recompense for the efforts it has put into developing the Franchise. A consumer has a right of action against both the Franchisor and the Franchisee for the latter’s negligence, as the Franchisor has not fulfilled its responsibility for quality control. The solution is therefore for the parties to a Franchise to draft the franchise contract in a manner that prevents such legal claims from arising in the future and not give the Courts leeway in interpreting the terms of the Contract.

Though it is not a statutory compulsion in India, the Franchisor may execute a disclosure document to the Franchisee which contains the material specifications of the Franchise agreement. This helps in defending against claims of unconscionability. The Franchisee should also use this as an opportunity to negotiate for modifications beneficial to their interests.

The Franchisor must ensure that the control it exercises over the Franchisee’s business is limited to what is necessary for the protection of its goodwill and does not extend to the manner and the method of the Franchisee’s operations. Restrictive covenants should not be unreasonable. It is essential that the agreement requires the Franchisee to distinguish itself as an independent entity in all the representations it makes to consumers, and that the Franchisor ensures compliance with this clause. In the absence of a special legislation dealing with the unique rights and liabilities in a Franchise, it is the responsibility of the parties to the agreement to include necessary safeguards in the Contract.

145 Picture Lake Campground v Holiday Inns Inc 497 F Supp 858, 869 (ED Va 1980).
**CONTRACTUAL ASPECTS IN PRIVATE COMMERCIAL SPACE VENTURES**

*Dr. Sandeepa Bhat B.*

**ABSTRACT**

Contract law has tremendous significance in the modern day commercial space activities. Since international space law developed primarily in the era of state oriented space activities, it has failed to address the manifold legal issues arising out of private commercial space ventures. The much expected national laws to regulate private space activities have also not developed in most parts of the world. In the wake of this, the private players have resorted to Contract law for the determination of their rights and liabilities. This recent interface between Contract law and space law has not yet been comprehensively dealt either at governmental level or at academic level. Therefore, this paper tries to bring forward various spheres of space activities having Contractual implications, and critically evaluates the trends in them. The paper concludes with the argument that the respite given by Contract law is temporary, and more permanent alternatives need to be found for the proper regulation of private space activities.

**INTRODUCTION**

Laws of Contract have been deeply rooted in the modern day commercial ventures beyond our imagination. One of the relatively recent entries to the long list of application of Contract laws is commercial space ventures. Ever since the entry of Sputnik into outer space in 1957, efforts were made in the direction of commercial utilization of the outer space. Space developments in the last six decades have yielded results in terms of Telecommunications, Tele-education, Tele-medicine, Remote sensing, Weather forecasting, Television broadcasting and Space Research. These results are clear indicators of the fact

---

*LL.M., Ph.D. Associate Professor of Law, The WB National University of Juridical Sciences, Salt Lake, Kolkata. Member, International Institute of Space Law (IISL), France.*

Since space activities were initially confined to States, early development of Space law in the International level focused solely in terms of regulating the State activities in outer space. The five treaties entered during 1960s and 70s delve into the regulation of different aspects of State oriented space activities.\footnote{The five major space treaties are; Treaty on Principles Governing the Activities of States in the Exploration and Use of Outer Space, including the Moon and Other Celestial Bodies (Outer Space Treaty) 1967, Agreement on the Rescue of Astronauts, the Return of Astronauts and the Return of Objects Launched into Outer Space (Rescue Agreement) 1968, Convention on International Liability for Damage Caused by Space Objects (Liability Convention) 1972, Convention on Registration of Objects Launched into Outer Space (Registration Convention) 1975 and Agreement Governing the Activities of States on the Moon and Other Celestial Bodies (Moon Agreement) 1979.} Unfortunately, the development of hard law at the International level in terms of Space Treaties took a halt after the Moon Agreement 1979. This has resulted in creating a legal void for nearly four decades, wherein the technology has developed manifold and space ventures have changed their identity. One of the significant structural changes in the space ventures is the shift from State-oriented activities to private sector oriented activities.

With the shift from State oriented space activities to private sector oriented space activities, the five space treaties were found inadequate to regulate the space activities. Some States have responded to this by enacting national space legislation to regulate the private space activities in their domestic levels, and others are making efforts in this direction.\footnote{India, for example, is currently in the process of enacting national space legislation.} Without any doubt, enacting National Space Legislations has been a challenge to every State due to their International Commitments under the space treaties. Hence, much is left to the parties involved to settle among themselves, which they have done primarily through private contracts. Therefore, Contract law has become an inevitable area of application in the Commercial Space activities. Contract of Guarantee, Indemnity, Waiver of Liability, Insurance etc are the most significant branches of Contract law having implications in space activities.
The specific aspects of space activities governed by Contract law are many and are difficult to pin down. The five major aspects that are attempted to be covered in this article are financing of private space activities, fixation of liability in case of damage caused by space objects, transfer of rights and obligations during the sale of Space Objects, Space tourism and Space Research.

**CONTRACTS IN PRIVATE SPACE FINANCING**

Investments in each space venture run into several billion dollars. Given this huge investment, the space industry, which comprises of individual start-up companies, is not in a position to afford it independently. Therefore, every Space Actor seeks investments from several creditors belonging to different States. Consequently, there would be a cluster of governing financial laws applicable to Space Ventures. This creates confusion as to the rights of each stakeholder creditor, leading to distrust among potential creditors. Such a lack of confidence, in the absence of uniform financial law, is fatal in raising capital for private space activities. What helps the space actors in such circumstances are independent contracts with the creditors outlining the rights and obligations *inter se* creditors and debtors.

Space financing contracts determine the jurisdiction of competent courts in resolving conflicts between the creditors and debtors. This is significant as the jurisdiction of the court looking into the issue is a preliminary question to be determined in each of the cases involving foreign elements. If it is left to the rules of Private International Law in case of Space activities, the creditors may find themselves in an unfavourable forum at the time of default by the debtors.

---

This would hamper their interests, and destroy their confidence to invest in Space Ventures. Hence, contracts play a pivotal role in prior determination of the jurisdiction and thereby provide certainty to the creditors as to the forum they need to approach in case of default. Moreover, with the increasing significance of international commercial arbitration, the parties to space financing have started resorting to arbitration or any other Alternative Dispute Resolution mechanism to settle their disputes by incorporating a clause in their Contracts.

A significant aspect of Space Financing is connected with the creditors’ right to recover their investments. Creditors are concerned about their priority in getting back the investments, default remedies available to them, protection of their rights during the insolvency of debtor etc. All these aspects bring lots of uncertainty in the minds of creditors, compelling them to think in terms of investments in other less risky ventures. These critical aspects of space investments are primarily handled by contractual terms. In order to bring the requisite transparency in the contractual terms and rights of the creditors, UNIDROIT has attempted in the international level to unify the private laws governing the space financing. UNIDROIT’s efforts have culminated into Cape Town Convention and Space Protocol, which jointly regulate different aspects of space financing.

The UNIDROIT System recognises respective interests of creditors in the space equipment financed by them. It maintains an International Registry


10 International Institute for Unification of Private Law (UNIDROIT) was initially setup in 1926 as auxiliary organ of the League of Nations. In 1940, after the demise of League of Nations, UNIDROIT was reconstituted as an independent intergovernmental organisation through a multilateral agreement in the form of UNIDROIT Statute. The objective behind the establishment of UNIDROIT is to harmonise and coordinate private laws, especially commercial laws, of different States to achieve uniformity. See <http://www.unidroit.org/about-unidroit/overview> Last visited, 12 June 2015.


13 Cape Town Convention read with the Space Protocol.
wherein the interests or notice of interests of creditors are recorded.\textsuperscript{14} Since
the Registry is an online registry, it is accessible to all potential creditors, who can calculate the risk of financing and make appropriate decision based on all necessary information available. The System provides for a simple rule of priority amongst the creditors in case of default by the debtor.\textsuperscript{15} It also provides for various remedies that are available to the creditors in case of default\textsuperscript{16} as well as in case of insolvency of the debtor.\textsuperscript{17} Thus the confidence of creditors to invest in risky Space Ventures would be boosted, and thereby, increasing foreign investments in Space activities are expected.

However, the UNIDROIT System is yet to win the confidence of States and has not yet entered into force in the field of Space Financing due to the failure of Space Protocol to obtain necessary ratifications.\textsuperscript{18} Therefore, in the current scenario, stakeholders primarily bank on private contracts to determine and realize/discharge their rights and obligations in space financing. Moreover, the private contracts have also been useful in seeking alternative means of financing through the launch of multiple payloads belonging to different players in a single mission.\textsuperscript{19} Such joint ventures help in sharing the cost involved in the launching of satellites, and therefore, are becoming increasingly popular in space industries.\textsuperscript{20}

\begin{footnotesize}
\begin{enumerate}
\item Cape Town Convention, Art. 16 read with Space Protocol, Chap III.
\item Chap. III, ibid and Chap. II, ibid.
\item Only four States have signed the Space Protocol and none has ratified it. See <http://www.unidroit.org/status-2012-space> accessed, 12 June 2015.
\end{enumerate}
\end{footnotesize}
Space activities are inherently risky not only due to the possible mistakes resulting in disasters but also due to the possibility of unexpected events during launch or post launch, which are beyond human control. International space treaties speak only about the liability of launching State/s for any damage caused by the space activities. Since the private players’ liability is not enumerated under the space treaties, States face the difficulty of shouldering the liability for private space activities without receiving any benefit. What comes to the rescue of States in any disaster attracting the liability is the contact with the private players.

Article VI of the Outer Space Treaty, while imposing responsibility on the appropriate State, mandates the State concerned to authorize and continuously supervise the space activities; both public and private. States discharge this responsibility by establishing appropriate licensing procedure for space activities. Licensing private space activities in various jurisdictions invariably involve the contractual clause of either shifting the liability to private players or alternatively a condition to reimburse the compensation amount paid by the State to the victims. In addition, the conditions are also imposed for the protection of environment and peaceful uses of outer space while carrying

21 See Outer Space Treaty read with Liability Convention, Art. VII.
23 Outer Space Treaty, Art. VI, states: “States Parties to the Treaty shall bear international responsibility for national activities in outer space, including the Moon and other celestial bodies, whether such activities are carried on by governmental agencies or by non-governmental entities, and for assuring that national activities are carried out in conformity with the provisions set forth in the present Treaty. The activities of non-governmental entities in outer space, including the Moon and other celestial bodies, shall require authorization and continuing supervision by the appropriate State Party to the Treaty.”
24 Shifting the liability can be seen under the laws of United States, Australia, Russia, Republic of Korea etc.
25 United Kingdom is an example of the States resorting to the method of reimbursement of compensation amount paid by the government.
on private space activities. These conditions are enforced by suspending or cancelling the licenses of private players in case of breach of conditions.

Contracts also help in the determination of individual liability of each player in case of joint space ventures. Though the space treaties advocate for joint and several liability for damage caused by space activities, there is no prohibition on apportionment of the extent of liability among the space players *inter se* without prejudice to the rights of the victim/s to receive compensation.\(^{26}\) In order to have clarity and to avoid unaffordable burden in the future, stakeholders prefer to have their extent of liability determined beforehand through appropriate contracts. Indemnity Contracts help the space players in receiving the reimbursement from the joint players in case of payment of amount to the victims in excess of agreed liability. The joint players may also enter into agreement to cross-waive the liability amongst them.\(^{27}\) Thus, the contract plays a pivotal role in channelling liability and allowing the parties to take calculated risks, along with suitable adjustments to shoulder risks, in space investments.

Space insurance has been useful in shouldering the risk of liability to a significant extent in the modern day Multibillion Commercial Space Activities.\(^{28}\) Any space disaster may result in twin blow to the space entity involved. On the one hand, the multibillion investments in the space object would be lost, and on the other hand, space object may also cause damage to others, attracting liability to compensate. Such a heavy burden of loss would make the space players bankrupt in the absence of insurance coverage. Insurance cover may be obtained for the hull of the space object, for compensating the damage caused to the parties involved and for meeting the third party liability. Insurance coverage

\(^{26}\) Liability Convention, Art. V (2).


also differs for different phases of space activities. Since there is no standard format for the Insurance Clauses, Terms and Conditions are negotiable in light of competition between several service providers and therefore, are finalised by way of contracts.

Providing coverage in case of space insurance has been a challenge for the Insurance companies due to the magnitude of loss and potential damage involved in case of accidents. Since the insurance companies face the risk of bankruptcy in individually affording insurance coverage for space activities, they have resorted to two primary methods in sharing the risk. One such method is in the form of creating the insurance pool by several insurance providers, thereby, contracting to shoulder liability to the extent each one of them can afford. The other method has been to resort for reinsurance contracts with several insurance companies by the primary insurance provider to the Space Industry.

**TRANSFER OF RIGHTS AND OBLIGATIONS DURING SALE OF SPACE OBJECTS**

One of the prominent aspects, which is not addressed by the International Space Treaties, is the legal implication of sale of space objects. Understandably, the drafters of space treaties did not foresee such possibilities as the space activities at that time were confined to scientific activities by the States, which were not the subject matter of sale. However, with the increasing private investments

---

29 It may be during pre-launch, launch, post-launch phases of space activity. Since the risk involved in different phases are different, the policy terms and conditions are also different. See ibid, pp. 114 - 116.


in Commercial Space Ventures, sale of space objects started to become reality. In the absence of any alternative, the legal implications of sale of space objects were left to the domain of private contracts.

Sale of space objects necessarily involves transfer of various rights in space objects and associated therewith. These rights include, but are not limited to, Ownership of Space Objects, use of Orbit and Spectrum, license to carry space activities, and use of signals and data transmitted by space objects. All these aspects are exclusively dealt under the contracts between sellers and buyers of space objects. Some aspects like the use of orbit and spectrum and license to carry space activities may additionally require the approval of State agencies in the respective State.33

Another important feature attached to the sale of space object is the status of obligations associated with the space objects. Obligations of the space actor towards the creditors are transferred from the seller to the buyer through Contracts. Significant consideration is also given to the rights of other associated stakeholders involved in ground segment activities,34 since the change of ownership should not ruin their business. Contracts may also be entered/renewed with them in connection with the rights enjoyed by them before sale. Liability for damage caused to third parties by the space activities is also transferred to the buyers during sale. Thus, Contract laws govern the shifting rights and obligations between the sellers and buyers during the sale of space objects.

Sale of space objects has got wide-ranging implications on appropriate States under international space treaty obligations. As per the provisions of

---

33 In United States, for example, licences are not transferable without the approval of Office of Commercial Space Transportation. 59 U.S. Code Sec. 50905.

Registration Convention, the launching state\textsuperscript{35} has to register the space object in its Appropriate National registry\textsuperscript{36} as well as in the International Registry maintained by the Secretary General of United Nations.\textsuperscript{37} Such registration has got far-reaching consequences leading to rights and obligations on the State concerned. First of all, as per Article VIII of the Outer Space Treaty,\textsuperscript{38} the State of registration exercises jurisdiction and control over the space objects and the personnel thereof. There is no mention on the transfer of State of registration under the space treaties. Hence, it is done through agreements between the States to avoid confusion.\textsuperscript{39} Similarly, the State of registration has got the right to receive astronauts and space objects under Article V of the Outer Space Treaty.\textsuperscript{40} In addition, although liability under space treaties is on all launching States,\textsuperscript{41} it may fall primarily on the State of registration since it is easy to identify the State of Registration for the Victim State.\textsuperscript{42} Thus, the questions about the above rights and obligations during the cross border sale of space objects are to be dealt under Contract law with separate agreements between the States concerned.

\begin{footnotesize}
\begin{enumerate}
\item As per Registration Convention, Art. I (a), ‘launching State’ means: “(i) A State which launches or procures the launching of a space object; (ii) A State from whose territory or facility a space object is launched.”
\item Registration Convention, Art. II.
\item Registration Convention, Arts. III & IV.
\item “A State Party to the Treaty on whose registry an object launched into outer space is carried shall retain jurisdiction and control over such object, and over any personnel thereof, while in outer space or on a celestial body.”
\item “States Parties to the Treaty shall regard astronauts as envoys of mankind in outer space and shall render to them all possible assistance in the event of accident, distress, or emergency landing on the territory of another State Party or on the high seas. When astronauts make such a landing, they shall be safely and promptly returned to the State of registry of their space vehicle.”
\item Liability Convention, Art. V: “Whenever two or more States jointly launch a space object, they shall be jointly and severally liable for any damage caused.”
\item State of registration is necessarily a launching State as per the definition under Art. I (c) of the Registration Convention. The victim State can easily identify the State of registration by referring to the UN Registry, and may put forward its claim for compensation with it.
\end{enumerate}
\end{footnotesize}
Yet another significant area of State concern in case of sale of space objects is the responsibility and liability of the State. As per Article VI of the Outer Space Treaty, ‘Appropriate State’ shall be responsible for its private space activities. It has the obligation to authorise and continuously supervise the private space activities. Under Article VII of the Outer Space Treaty as well as under the Liability Convention, the ‘Launching State/s’ shall be liable to pay compensation for the damage caused by private space activities. It is clear from the definition of the ‘launching State’ that there cannot be any change in the status of ‘launching State’ once the space object is launched. Sale of the space objects across jurisdictions brings in the question of ‘Appropriate State’ and State liable to pay compensation under the above provisions, which can only be sorted out with the agreements.

**SPACE TOURISM**

One of the most fascinating aspects of modern day space activities is space tourism. Dennis Tito, an American businessman, started the journey of commercial space tourism by being the first fee paying space tourist to reach the International Space Station (ISS) on 28 April 2001. He was followed by a few other wealthy businessmen. Space Adventures became the first private company to start commercial space tourism in association with Federal Space Agency of the Russian Federation. Though the 2003 Columbia disaster put a temporary hold on space tourism, it resumed in 2006. The Russian Soyuz vehicles are the only available transport to the ISS, and in 2010, the Russian Space Agency has again put a break to space tourism with a view to increase the capacity of Soyuz vehicles. It is expected that the space tourism would resume in 2015. Meanwhile, many private companies have started to develop

---


their technology for orbital and suborbital tourism with the successful journey of SpaceShipOne in October 2004. Space X, Space Adventures, Boeing Corporation, Virgin Galactic, XCOR Aerospace and Armadillo Aerospace are some of the leading players in this regard who have already booked several tourists to be carried into outer space.

Space tourism opens up many questions of law, which don’t find any answer under conventional space law. To start with, the aerospace flights pose the difficult question of applicable regime. Since they use aerodynamic elevation in airspace and centrifugal force in outer space, the basic question is whether it is aviation law or space law which governs aerospace activities? While addressing this concern, arguments are made by scholars for the development of a hybrid regime applicable for aerospace ventures. However, in the absence of such a hybrid regime, Contract law plays a pivotal role in the determination of many aspects of rights and obligations between the parties to space tourism.


52 ‘Hyperion’ is being developed by Armadillo Aerospace for suborbital flights. See Jeff Foust, ‘Has suborbital’s time finally arrived?’, <http://www.thespacereview.com/article/2039/1> accessed, 28 June 2015.


One of the crucial legal aspects of space tourism is the liability for damage caused to the tourists during flight. The tour operator would usually enter into agreements with the passengers for either waiver of liability or for limiting the liability for damage caused in the process. Contractual clauses would include provisions for settlement of disputes in the determination and payment of compensation. The substantive and procedural laws applicable in this process are also determined under the contracts. Added to this, contracts help in dealing with the crimes and tortious acts of the tourists against each other by helping in determining the court of competent jurisdiction and applicable laws.

Emergency assistance to the space tourists is another area of controversy, since the Space Treaties mention only the protection of astronauts and personnel during emergency landing. As the obligation to render emergency assistance stems from the principle of ‘astronauts as envoys of mankind’, extending such a privilege to space tourists has been mooted against by the great majority of space law scholars. However, the tour operators may make necessary arrangements with the States or private agencies of States, where the space objects make unintended landing, for rendering necessary assistance to the tourists. This would be necessary for building the confidence of tourists, and thereby, for promoting the space tourism.

Most of the space enthusiasts are interested in visiting and staying in the ISS, which has to be done by private contracts between the tour operators and ISS member States. The code of conduct for the space tourists at ISS or generally in outer space has to be specified under the contract to prevent the tourists from causing any damage to ISS or to outer space environment. In addition, the

---


57 Outer Space Treaty supplemented by Rescue Agreement, Article V.

space tourists and tour operators may also have to provide several undertakings to the States from which the tourists are carried to outer space.

**SPACE RESEARCH**

One of the most significant contributions of space exploration to mankind is in terms of space research. With the establishment of ISS, it is evident that space research is going to gain momentum in the near future. While it is expected to find cures for many diseases by producing more pure form of medicinal components in outer space due to zero gravity, space research would pose difficult legal questions in terms of obtaining and protecting intellectual property rights. One of the most significant forms of intellectual property rights to be in question in outer space activities is Patent rights.

Every investor in space research would be aspiring for Patent rights to get back his investment. Difficulty in determining the rights is obvious in case of joint research, which is inevitable in space inventions. This is not only due to the nature of outer space, but also due to the fact that every space research has to be coordinated from the ground segment by a group of people. So, inevitably the ground segment participants would be monitoring the activities of inventors in space, which gives an edge for them to document and file Patent applications before the space inventors return from outer space. As, except in the United

---


64 See Osvaldo Peinado, ‘5 Years Experience of Columbus Ground Segment Operations’, <http://elib.dlr.de/68282/1/Spaceops-GOM2.pdf> accessed, 28 June 2015.
States, the ‘first to file’ system\textsuperscript{65} of patenting is followed everywhere, the space inventors would be deprived of their patent rights due to the unscrupulous acts of ground segment players. Contracts between the space segment and ground segment players are the sole means of preventing such an injustice to the inventors. Added to this, the concerned State may also have to take contractual assurances from the inventors, before granting patents, to the effect that the inventions having significant public utility should be made publicly available on the basis of reasonable conditions.\textsuperscript{66}

Difficulties would also be encountered in cases of infringement of an earthly patent in outer space. Since there is no separate Patent law applicable in outer space, the parties to the dispute need to resort to appropriate municipal laws for the settlement of their disputes.\textsuperscript{67} However, it has been nearly impossible to zero down the applicable law based on any objective criteria.\textsuperscript{68} In addition, the jurisdictional questions are also found, since Article VIII of the Outer Space Treaty advocates for both Quasi-Territorial Jurisdiction (on space object) and personal jurisdiction (on personnel of space object) of State of registry without laying down any hierarchy between the two. In a hypothetical situation, if the Patent Infringement takes place on a space object registered in one state, and the infringer is carried to the outer space by a space vehicle registered in


another State, either both the States may claim jurisdiction, or both of them may decline to exercise jurisdiction by pointing against each other. Contract is the only way out to solve the above mentioned deadlocks in the determination of applicable law and jurisdiction to try the infringement of Patents.

**CONCLUDING REMARKS**

It is evident from the above discussions that Contract law has become an intrinsic part of Commercial Space activities. The void created by the absence of international developments in the outer space lawmaking during last three decades has been attempted to be filled by way of private contracts between the stakeholders. These contracts may be between the private players *inter se*, or between the private players and State/s. Therefore, the rights and obligations of all the stakeholders, including Space Operators, Investors, States, Crew members, Space Inventors, Tourists, and Insurance Companies, are primarily determined by contracts. Hence, the principles of Contract law run like a golden thread in the norms governing the regulation of private commercial space ventures.

While Contract law has provided respite for the stakeholders in private space activities, it should be kept in mind that the relief provided is temporary. In the long run, multiple contracts between multiple stakeholders would certainly bring forward the issues of conflicting interests. Since Contract laws are municipal in origin and application, determination of rights and obligations on the basis of conflicting Contract laws would be difficult for the adjudicating bodies. Even the basic questions relating to the validity of contracts would be difficult to answer due to the varying norms of conflict of laws. In addition, Contract law would be limited in its application to only those who are parties to the Contract, and therefore, many interpersonal relations that develop out of multiple commercial space launches69 cannot be covered under the traditional Contract law.

---

In the light of the above factors, it is advisable to have necessary progress in space law-making at the international level to deal with the plethora of legal issues emerging out of private commercial space ventures. Such an international effort would help in bringing uniformity and consistency in regulating private space activities at the global level, which is the prerequisite for orderly developments in the domain of Outer Space. The spirit of common rights and common benefits from outer space activities, as imbibed in the space treaties, can only be achieved by such a progressive development of space law with a view to regulate private space activities.
Abstract

Voice over Internet Protocol, popularly known as VoIP, is globally emerging as an effective, convenient and cheaper mode of communication. In India, it has begun gaining mass popularity not only amongst individual users but also with companies, especially those engaged in the IT/ITES sector, which are increasingly using it for the purpose of reducing their operations related costs. India’s Department of Telecommunications (DoT) has restricted the provisioning of VoIP while allowing “Logical Partitioning”, which enables companies to merge their voice and data networks while ensuring that there is no mixing of such voice and data traffic. This hugely contributes towards cost-saving for the companies. Further, it is interesting to note that the restrictions on VoIP services and the terms of usage of Logical Partitioning are majorly governed and regulated by license agreements and other terms and conditions that are devised by DoT, from time to time. This article focuses on the contractual aspect associated with VoIP in India and its significance.

Introduction

As technological advancements pave the way for convenient, flexible and cheaper modes of communication, Voice over Internet Protocol, more commonly known as VoIP, is slowly but steadily picking up as a revolution for today’s masses. Physical distances have been reduced to mere factual figures with technologies like VoIP facilitating increased reachability for its users. As the popularity of VoIP grows, governments are now becoming more interested in regulating it in a manner similar to the traditional telephone system, i.e., Public Switched Telephone Network (PSTN) services. However, in countries where the government has a strong control over the national telephone service
or where regulations are weak or where the market is captured by a dominant operator, VoIP continues to be either fully banned or be subject to enormous amount of restrictions, thereby preventing it from penetrating deep into the market. In India, Department of Telecommunications (DoT), Ministry of Communications & Information Technology opened the gates for VoIP for the first time in the year 2002, albeit with some restrictions. Ever since, the regulatory framework for VoIP has seen many changes, and today VoIP, in its limited form permitted in India, has become popular with individual users as well as businesses. As is the situation in other countries that are open to allowing VoIP, the Indian consumers are riding high on the VoIP culture while more and more companies engaged in the IT/ITES sector are adopting it in order to compress their middle-line. However, the prospect of access to unrestricted VoIP and its penetration into the huge Indian consumer base remains clouded with doubt. In this regard, it is interesting to note here that the various restrictions that have been imposed by DoT on VoIP from time to time have emanated from the license agreements signed by the telecom service providers with DoT. So in this manner, such license agreements constitute a major part of India’s legal framework regulating VoIP. In this article, we analyze the concept of VoIP, study the evolution of its regulatory framework in India, highlight the important aspects of license agreements executed between DoT and telecom service providers and various terms and conditions imposed by DoT on companies providing services in IT/ITES sector, and finally understand the significance of VoIP for businesses.

**IP Telephony**

Before we engage in a discussion about the contractual and technical issues associated with VoIP, it is imperative to first understand the concept of Internet Protocol Telephony. Internet Protocol Telephony, more commonly known as IP Telephony, is basically the exchange of information primarily in the form of speech while utilizing a mechanism that we all know as Internet Protocol.\(^1\) It is a communications protocol that was developed by the Internet Engineering

---

\(^1\) As defined by International Telecommunication Union- Telecommunication Standardization Sector (ITU-T) Study Group 2 (SG2).
Task Force (IETF)\textsuperscript{2} to support a Packet-Switched Network. Thus, IP Telephony is a general term that is used for such technologies that use the Internet Protocol’s Packet-Switched connections to exchange voice, fax, and other forms of information that have traditionally been carried over the dedicated circuit-switched connections of the Public Switched Telephone Network (PSTN).\textsuperscript{3}

\section*{Internet Telephony and VoIP}

According to the type of the underlying Internet Protocol (IP) network, i.e., the mode of transmission, IP Telephony can be broadly classified into two categories- Internet Telephony and VoIP. Internet telephony primarily involves the usage of the Internet rather than the PSTN to transmit ‘Real-Time’ audio from one Personal Computer (PC) to another (or in some instances to another telephone itself). However, in the case of VoIP, it is generally an IP technology suite (i.e., a private network) that is used rather than the public Internet.\textsuperscript{4} Since VoIP is usually a closed/private network, the technical hurdles are less daunting, which results in greater reliability in the transmission of voice packets than in Internet Telephony where the voice packets are transmitted on the Internet. Thus, the chances of having a Live or ‘Real-Time’ conversation are better in VoIP than in Internet Telephony.\textsuperscript{5}

Therefore, while Internet Telephony and VoIP are sub-sets of IP Telephony, the only actual difference between them is the medium of transmission, with the former using internet and the latter functioning over a privately managed network. For the purpose of discussion, the terms IP Telephony, Internet Telephony and VoIP shall be used interchangeably in this article, unless specifically mentioned to the contrary.

\textsuperscript{2} The Internet Engineering Task Force (IETF) is a large open international community of network designers, operators, vendors, and researchers concerned with the evolution of the Internet architecture and the smooth operation of the Internet, see https://www.ietf.org/about/.

\textsuperscript{3} See http://searchunifiedcommunications.techtarget.com/definition/IP-telephony accessed, 1 July 2015.


**How It Works**

While traditional telephone service compresses voice into a frequency on a wire, Internet Telephony compresses the voice into packets of data. In milliseconds, these data packets are sent over the Internet. When the data reaches the final destination, it is converted back to sound. If one uses Internet Telephony to call someone on the traditional phone network (PSTN), the Internet Telephony call is converted to sound once it reaches the network and the call is routed normally. Thus, the basic steps involved in originating an Internet telephone call are conversion of the analog voice signals to Digital Format (binary data) and compression/translation of the data into IP packets for transmission over the Internet; the process is reversed at the receiving end. This process is called modulation-demodulation, giving the term “Modem.” The communication usually takes place “Real-time.” Thus, the main difference between Internet Telephony and normal telephony is that whereas in normal Telephony, Circuit Switching Technology is used, Internet Telephony is based on Packet Switching Technology.

**Types of Internet Telephony**

As per the International Telecommunications Union (ITU), there are three types of Internet Telephony usage scenarios:

- **PC to PC Telephony over Internet**: This Telephony makes use of PCs at both the ends. This configuration needs similarly equipped Internet users requiring IP Telephony software and multimedia PC and both

---


8 ITU is the United Nations specialized agency for information and communication technologies – ICTs, see http://www.itu.int/en/about/Pages/default.aspx accessed, 25 June 2015.

the users are required to be logged on simultaneously. The main applications of this technique are chat rooms and corporate internal communications to avoid usage based telephone charges. It is also termed as “Pure Internet Telephony” in many countries. This form of Internet Telephony is allowed in India.

- **PC to Phone Telephony over Internet:** This is Telephony making use of Multimedia PC at one end to Plain Old Telephone System (POTS) at other end. Internet users with multimedia PC are able to call any phone or fax user and vice versa. The main motivation of providing this service is the reduced long distance charges for domestic and international calls with no QOS guarantees. Presently, PC calls from India are allowed only to telephones outside India. This form of Internet Telephony is banned in a large number of countries, due to the so called, ‘Toll Bypass’.

- **Phone to Phone Telephony over Internet:** This service is Internet based Telephony making use of POTS at both the ends. This configuration allows communication between any phone/mobile phone user and any other user. Interworking between IP network and circuit switched PSTN provided by Media Gateway, is the main requirement in this configuration. This is presently illegal in India.

**INTERNET TELEPHONY IN INDIA**

**Evolution of the Regulatory Framework through License Agreements**

**Till 2002:** Prior to 2002, any form of Internet Telephony was not permitted in India. The New Telecom Policy, 1999 (“NTP 1999”) provided that “All technologies should be equally permitted for the benefit of consumers.” However with regard to Internet Telephony, NTP 1999 provided that “Internet Telephony shall not be permitted at this stage. However, the government will continue to monitor the technological innovations and their impact on national development and review this issue at an appropriate time.” Accordingly, the old license applicable to Internet Service Providers (ISPs) was made liable to termination if Internet Telephony services in any form were offered by the ISPs.
April 2002- License Agreement for Provision of Internet Service (Including Internet Telephony): Upon recommendations of the Telecom Regulatory Authority of India (TRAI) and pursuant to the “Guidelines for Issue of Permission to Offer Internet Telephony Services” dated March 21, 2002 (Old Guidelines”), DoT opened the gates for Internet Telephony services with effect from April 1, 2002. Only the existing ISPs were permitted to offer Internet Telephony services upon signing the amended ISP license agreement called “License Agreement for Provision of Internet Service (Including Internet Telephony)” (“Old License Agreement”). Provisioning of Internet telephony service did not entail any financial implications to ISPs (no additional entry fee and license fee) in the beginning. However, Internet Telephony was permitted only in a limited way, as there were restrictions on the type of the technology and devices, which could be used. Clause 1.14 of Schedule C (Terms and Conditions) of the Old License Agreement provided that ISPs were permitted to provide Internet Telephony services through public Internet by use of Personal Computer (PC) or IP based Customer Premises Equipments (CPE) connecting the following:

(i) PC to PC: within or outside India
(ii) PC in India to telephone outside India
(iii) IP based H.323/ SIP terminal directly connected to ISP node to similar terminals, within or outside India.

Apart from this, voice communication to and from a telephone connected to PSTN/PLMN within country and use of E.164 numbering was prohibited in India.

---

10 Clause 1.14.1 of the License Agreement for Provision of Internet Service (Including Internet Telephony), see https://www.google.co.in/search?q=Licence+Agreement+for+Provision+of+Internet+Telephony&ie=utf-8&oe=utf-8&gws_rd=cr&ei=7gRjVZPsGsaLuATl0YG4AQ# accessed, 25 June 2015.


January 2006: DoT imposed a license fee of 6% of Adjusted Gross Revenue (AGR) earned from Internet telephony by ISPs with effect from January 1, 2006.

March 2006: DoT permitted Unified Access Service Licensee (UASL) and Cellular Mobile Service Providers (CMSP) to provide unrestricted Internet Telephony (i.e., within and outside India) and Internet access, by way of the following clauses:

License Agreement for Provision of Unified Access Services (“UASL Agreement”) signed with those persons operating Cellular Mobile Telephone Service:

Clause 2.2 (a)(i) of UASL Agreement provided as: “... Access Service Provider can also provide Internet Telephony, Internet Services and Broadband Services. If required, access service provider can use the network of NLD/ILD service licensee.”

License Agreement for Provision of Cellular Mobile Telephone Service (CMTS License Agreement):

Clause 2.1 (a) of CMTS License Agreement provided that: “… The Licensee can also provide Internet Telephony, Internet Services and Broadband Services. If required, the Licensee can use the network of NLD/ILD service licensee …”

However, none of these service providers commenced Internet Telephony services due to ambiguity in the term Internet telephony as it was not defined in respective licenses resulting in uncertainty in scope of the service. This highlights the extent to which the provisioning and regulation of Internet Telephony is dependent on these license agreements.


2007-License Agreement for Provision of Internet Services (“New License Agreement”):

Out of the total 128 Internet Telephony Service Provider (ITSP) licenses issued till October 2007, only 32 ITSPs actually commenced Internet Telephony services. The technologies permitted to provide Internet Telephony were not user friendly and knowledge of Personal Computer (PC) was a pre-requisite to use the Internet Telephony service provided by these ITSPs. Therefore in the beginning, with restrictive provisions on type of devices to be used, Internet Telephony did not gain popularity.\textsuperscript{15} Subsequently, DoT issued “Guidelines for Grant of License for Operating Internet Service” dated August 24, 2007 (“New Guidelines”) and a new license agreement called “License Agreement for Provision of Internet Services” (“New License Agreement”) was issued by DoT in October 2007. According to the New Guidelines, all ISPs were permitted to provide Internet telephony as per the Terms and Conditions prescribed in the New License Agreement.

Clause 2.2 (ii) of Part II of the New License Agreement defined the scope of service as follows:

“Internet Telephony: Internet Telephony means a service to process and carry voice signals offered through Public Internet by the use of Personal Computers (PC) or IP based Customer Premises Equipment (CPE) connecting the following:

a) \textit{PC to PC; within or outside India}  

b) \textit{PC / a device / Adapter conforming to standard of any international agencies like- ITU or IETF etc. in India to PSTN/PLMN abroad}.  

c) \textit{Any device / Adapter conforming to standards of International agencies like ITU, IETF etc. connected to ISP node with staticIP address to similar device / Adapter within or outside India. Explanation: Internet Telephony is a different service in its scope, nature and kind from real time voice service as offered by other licensed operators like Basic Service}

Further, Clause 2.2 (iii) provided that the scope of Internet Telephony permitted in India was only as that mentioned in Clause 2.2 (ii). Further, Clause 2.2 (v) provided that a licensee was not permitted to have PSTN/PLMN connectivity and that voice communication to and from a telephone connected to PSTN/PLMN and following E.164 numbering was prohibited in India.¹⁶

Therefore, as per the conditions imposed under the New License Agreement, though Internet Telephony to and from a telephone connected to PSTN was still prohibited in India, the provision for allowing user-friendly devices/adapter to make calls through Internet Telephony significantly contributed towards making this technology accessible to people.

**2008- Introduction of Logical Partitioning:** TRAI recommended that ISPs be allowed to provide unlimited Internet Telephony across India in order to bring down the tariffs of NLD and ILD calls. However, DoT returned these recommendations back to TRAI for further review. However, DoT revised the Terms and Conditions applicable to Other Service Providers (OSPs)¹⁷ (“Revised Terms and Conditions”) vide letter no.18-2/2008-CS-I dated August 5, 2008 and made way for Logical Partitioning.

**2010:** TRAI recommended that Internet telephony should be included as a part of the National Telecom Policy (NTP).

**2011:** DoT and TRAI go back and forth on whether VoIP should be a part of NTP.

---


¹⁷ Companies which provide services like tele-banking, tele-trading, e-commerce, call centres, and other IT Enabled Services (ITES), by using telecom resources provided by authorized telecom service providers have been classified by DoT as Other Service Providers (OSPs).
2012: Telecom commission approves allowing VoIP as part of unified license under NTP 2012.\(^\text{18}\)

2014: Unified License (UL) issued by the Government in January 2014 included the provisioning of unrestricted Internet Telephony through Access Service authorization.\(^\text{19}\)

**LEGAL FRAMEWORK – SURROUNDED BY CONTRACTUAL TERMS**

The setting up of telecommunication networks and provisioning of telecommunication services in India are basically governed by the Indian Telegraph Act, 1885 (“Telegraph Act”) and the Indian Telegraph Rules, 1951 (“Telegraph Rules”). Thus, Internet Telephony (transmission over public Internet) and VoIP (transmission over private network) services in India need to conform to the prescriptions laid down by the Telegraph Act and Telegraph Rules.

At this juncture, it is imperative to highlight that India still does not have a special statute for governing Internet Telephony and its various forms. The provisioning of these services still continues to be regulated by terms and conditions laid in the various license agreements signed between DoT and the service providers and in case of OSPs, the Revised Terms and Conditions, as amended from time to time, also form a part of the regulatory regime. The latest of such license agreement which governs the scope of VoIP in India is the New License Agreement as described above. Therefore, it is quite peculiar that the legal framework for VoIP in India is heavily governed by the terms of contracts between two parties (though one of such parties is the government) rather than usual mode of regulating through legislations.


VoIP for Businesses Vis-À-Vis Adherence to Conditions of the New License Agreement

In countries where it is permitted, VoIP can be seen assuming the form of a technological revolution. In addition to having become an integral part of communication for the common people, VoIP is also being increasingly adopted by businesses to meet their daily operational requirements. In fact, today VoIP solutions aimed at businesses have evolved into “unified communications” services that treat all communications—phone calls, faxes, voice mail, e-mail, Web conferences and more as discrete units that can all be delivered via any means and to any handset, including cell phones. The main reason for which businesses are so massively turning to VoIP technology is the cost savings and the flexibility that it provides in connecting to other devices. For the purpose of this chapter, we shall be discussing the mechanism of VoIP, particularly for companies engaged in IT/ITES sector, i.e. OSPs, and we shall also be specifically using the term “VoIP” as the IP Telephony services used by such OSPs for their operational purposes are transmitted over private networks via leased lines. Accordingly, we shall be elaborating upon how VoIP solutions can help OSPs and why it is being preferred over the conventional modes of communication while adhering to the conditions imposed by DoT by means of various agreements entered into between DoT and telecom service providers.

Logical Partitioning

As stated earlier, under the New License Agreement, telecom service providers in India have been allowed to provide VoIP services, but in a limited manner. The provisioning of VoIP services by telecom service providers has to be such that one can make VoIP calls only from (i) PC to PC within or outside India, (ii) PC/device/adapter in India to PSTN/PLMN outside India and (iii) device/


adapter connected to ISP node to a similar device within or outside India. Thus, even today, making PSTN to PSTN calls within India using VoIP is strictly prohibited. Further, the Telegraph Rules prohibit interconnection of a leased line to the public telecommunications network, such as PSTN, PLMN and Integrated Services Digital Network (ISDN). Thus, mixing of voice traffic between the PSTN and VoIP network for the purpose of toll bypass has been restricted in India. Previously, this required a user to have two phones to handle both PSTN and VoIP calls; an IP phone connected to the Electronic Private Automatic Branch Exchange (EPABX)\(^2\) for Intra-office and Inter-office VoIP calls and a separate phone connected to a PABX for PSTN calls. Due to this, OSPs had to incur double expenditure in setting up two different networks for facilitating the flow of voice and data traffic as well as managing them. Therefore, in order to enable such companies to merge their voice and data networks while still ensuring that there is no mixing of traffic between the PSTN and VoIP networks, thereby reducing the cost and complexities involved, TRAI allowed the principle of “Logical Partitioning” in India in 2008, which was also incorporated by DoT in the Revised Terms and Conditions of 2008.

**How Logical Partitioning works**

**Technical Aspect:** Logical Partitioning identifies where each phone is located using a “geolocation”, and routes all calls appropriately, depending on the calling phone location and the phone number being called. The geolocation information is in the IP packet, the same is used to select the proper policy to control communication between each pair of endpoints:

- A VoIP phone and a PSTN gateway
- A PSTN gateway and another PSTN gateway
- An Inter-cluster trunk (for example, Gatekeeper or SIP trunk) and a VoIP phone

• An Inter-cluster trunk (for example, Gatekeeper or SIP trunk) and a PSTN gateway

To meet regulatory requirements, Logical Partitioning defines which sets of VoIP devices are allowed to communicate with each other. Logical Partitioning also controls which mid-call features, such as conferencing and transfers, can be used on which types of calls. The Logical Partitioning feature specifies the capability of a telephony system to control calls and features on the basis of specific allowed or forbidden configurations. A common telephony system can provide access to VoIP and PSTN and configuration can control access.

Legal/Regulatory/Contractual Aspect: Today, an OSP is permitted to share the telecom bandwidth with other activities provided it ensures that there would be a logical separation between the Telecom Resources for OSP and the Telecom Resources for its other activities and that there shall be no voice/non-voice traffic flow between them. Further, a Domestic OSP is permitted to terminate PSTN/PLMN connection with outgoing facility on the same EPABX provided that such PSTN/PLMN lines shall be used for making calls through normal NLD network only and in no way directly or indirectly cause bypass of licensed National Long Distance Operator (NLDO) jurisdiction. Logical Partitioning is required to ensure the separation of these facilities so that there is no call flow between the PSTN lines and leased lines. The Revised Terms and Conditions, as amended from time to time, also mandate the OSPs

---

23 ibid.
25 Chapter I, Clause 1(d) of the Revised Terms and Conditions, as amended upto 2012: “Telecom Resource” means Telecom facilities used by the OSP including, but not limited to Public Switched Telecom Network (PSTN), Public Land Mobile Network (PLMN), Integrated Services Digital Network (ISDN) and/or the telecom bandwidth provided by authorized telecom service provider having valid licence under Indian Telegraph Act, 1885.
26 Revised Terms and Conditions, Chapter III, Clause 1(5), as amended upto 2012.
27 Revised Terms and Conditions, Chapter I, Clause 1(f), as amended upto 2012: “Domestic OSP” means the OSP providing the Application Services within national boundaries.
28 Revised Terms and Conditions, Chapter III, Clause 3(1), as amended upto 2012.
to submit a certificate from the vendors of the equipment that the software is capable of logically bifurcating the common infrastructure (EPABX) into two/three (as applicable) separate and independent environments for the Domestic OSP Centre, International OSP Centre and PSTN lines for office use. An OSP has to ensure the complete logical separation between the activities of the domestic and International applications. No voice traffic shall flow between the Domestic OSP, International OSP\(^{30}\) Centres and PSTN lines for office use and there is no bypass of the network of the authorized telecom service providers.

Thus, Logical Partitioning enables companies to combine PSTN and VoIP calls, while ensuring that there is no spilling of VoIP calls over the PSTN amounting to toll bypass. This simplifies the call making process by eliminating the need for having two separate lines, thereby further making system management easier and reducing calling and infrastructure costs.

**How VoIP Works for a Business**

For companies engaged in the IT/ITES sector, i.e., those falling in the category of OSPs, Internet protocol (IP) is not only a way to transport data but also a tool that simplifies and streamlines a wide range of business applications, telephony being the most obvious example. VoIP is also the foundation for more Advanced Unified Communications Applications—including Web and video conferencing—that can transform the way organizations do business. The benefits include:

- VoIP is not only a cheaper, dynamic and unified tool of communication, but it also provides more features while being less resource intensive. Companies can significantly benefit from the fact that the initial investment and setup cost for VoIP is quite less. VoIP allows significant cost-saving as companies have to manage only one network instead of two.

---

29 Revised Terms and Conditions, Chapter IV, Clause 4(B), as amended upto 2012.
30 Revised Terms and Conditions, Chapter I, Clause 1(g), as amended upto 2012: “International OSP” means the OSP providing the Application Services beyond national boundaries.
• One of the most significant benefits of VoIP is Portability. Since every IP phone can be identified by its IP address, a user can be reached at the same number regardless of where he plugs the phone in. An increase in mobility assists users who are always on the move, especially corporate employees who are required to travel. This makes the VoIP tool portable and flexible.

• VoIP networks are very scalable, meaning they can be expanded with relative ease given they use standard interfaces. It is also much easier to introduce new services over IP networks because of the way the protocols are structured. Also, from a maintenance and operational perspective, IP networks are much easier to handle. Moreover, in order to scale a traditional circuit-switched network, additional lines would have to be added, but VoIP rules out the need for any such investment.

• VoIP is also a very reliable technology. In a PSTN network, if a line is down, it is completely cut off and calls cannot be made from or to telephones in that line. However, in the case of VoIP, multiple routes can be established to reach a node, and hence downtime is negligible or nil.

• VoIP can also be integrated with other applications such as voice mail, three-way Conferencing, Speed Dialing, Call Forwarding, Simultaneous Ring, Call Waiting, Caller ID, Call return, Caller ID block, Anonymous call Rejection, ‘Do Not Disturb’ feature, last number redial and more. Employees can collaborate using each technology individually or all of them simultaneously, and from a single, easy-to-use interface.31

• Since VoIP is based on the Internet Protocol, it also handles other media types than voice such as transferring images, video and text. It is possible to share files or even communicate with the use of a Web cam.32

• Usually, VoIP service providers provide their customers with a “User Control Interface”, thereby enabling them to change features, options and services dynamically.

32 ibid.
CONCLUSION

The main force behind making VoIP initially popular with common people was its cost-effectiveness. Subsequently, as companies, irrespective of their size, opened their doors for business from abroad, they started seeing it as a cheaper alternative to using the traditional telephone network (PSTN) for making calls, especially long distance calls and audio conferences. Today, over a decade after the introduction of VoIP in India in 2002, a lot of water has flown under the bridge. Apart from the cost advantage associated with it, greater penetration of broadband internet service, increased adoption of smartphones, tablets, PCs, and availability of 3G/4G networks have contributed significantly towards making VoIP popular among common people. From business point of view, internet has become much more than just a means of communication, as numerous companies are foraying into E-commerce, Tele-banking, Tele-trading, etc. It is in these circumstances that the concept of VoIP has become much more relevant and significant. At this juncture, it will not be incorrect to state that the popularity of VoIP could have assumed even greater proportions had DoT not refused to allow unlimited VoIP when TRAI recommended for the same in 2008. What DoT allowed was the introduction and adoption of Logical Partitioning. Today, businesses have eliminated the need for having to set up and maintain two different networks for voice and data traffic by using Logical Partitioning between the PSTN and IP leased lines. In this way, on one hand voice and data networks are merged while on the other hand, Logical Partitioning ensures that there is no mixing of voice and data traffic between the PSTN and VoIP network. However, despite becoming increasingly popular with every passing day, even if in the limited form that is permissible in India, provisioning of VoIP continues to be Regulated only by the License agreements and other Terms and Conditions that are devised by DoT in consultation with TRAI, from time to time. In this regard, it may not be wrong to say that it is high time that India gets a Specialized Legislation for Regulation of VoIP so that common people as well as businesses can extract the most out of this technology, while ensuring that bigger concerns like National Security, Revenue Generation etc. are not compromised with.
ABSTRACT

With the advancement in technology and the introduction of various alternative reproductive technologies, surrogacy has become a sought after way for infertile or homosexual couples to have genetically related children. Surrogacy means the process of carrying and delivering a child for another person. This practice is not devoid of moral and legal issues. India is the most sought after destination for fertility tourism due to legalized nature of surrogacy, low medical costs, good quality medical care and most of all no Law to regulate surrogacy. Currently, the ICMR Guidelines and Supreme Court precedents are what govern the practice in the country. Although the Assisted Reproductive Technologies Bill, 2010 has been introduced, it is yet to be passed.

This unregulated nature of surrogacy creates a lot of problem. This article seeks to examine and analyse the present status of surrogacy in India, the problems faced by and in this industry and then suggest some reforms.

INTRODUCTION

It is the birth right of every women to conceive and cherish the feeling of motherhood. Infertility of a couple deprives them the opportunity of experiencing this pleasure. But new reproductive technologies like Artificial Insemination, Donor Egg Transplantation, and Surrogacy have given them hope to procreate. The word surrogacy has been derived from the Latin word *surrogatus*, which ‘means to be chosen in place of another’. Surrogacy is a “form of third party reproduction in which a woman agrees to create and/or maintain a pregnancy for another person or couple, typically for monetary

*Associate Professor of Law, National Law School of India University, Bengaluru.
**Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
compensation”. In other words, surrogacy is a practice in which a woman gives birth to a child for someone else.

Surrogacy has become a veritable ethical conundrum. It is being closely examined by feminists, anthropologists, sociologists and law makers alike. It is one of the ways for infertile parents to have children who are genetically related to them. It is very important to make sure that the surrogate is mentally and physically ready to deliver the child and go through this arduous journey. To ensure this, different legal measures have been adopted by different countries based on their own notions of public policy and its relation to surrogacy.

There are three types of parental roles in the case of surrogacy agreements. The first type are the intended parents who become the legal guardians of the child and are supposed to raise the child. They may sometimes also be referred to as social parents. The second type are the biological parents who, as the name suggests, are genetically related to the child. There can be only one biological father and one biological mother for every child. The surrogate mother may or may not be the biological mother of the child. The third type is the role of the surrogate mother who has the responsibility of giving birth to the child and is hence called the birth mother of the child. As per the contract, a surrogate mother is required to relinquish the child after birth to the intended parents.

There are basically two types of surrogacy contracts based on parental roles. One is called Traditional surrogacy and the other is called Gestational surrogacy. In traditional surrogacy, the surrogate mother is the biological mother of the child. From amongst the intended parents, only the intended father and not the intended mother, is genetically related to the child because the surrogate is artificially inseminated with his sperm. Before IVF techniques were introduced, this was the only available option for infertile parents to have genetically related children.

---

The other is a modern form of surrogacy, known as *gestational* surrogacy, in this the intended mother (and not the surrogate mother) is genetically related to the child. First, the egg of the intended mother and the sperm of the intended father are fertilized through IVF. Later, the embryo resulting from this is implanted in the uterus of the surrogate.

Another classification of surrogacy can be done on the basis of *financial compensation*. First to fall in this category is *commercial surrogacy*. As the name suggests, in commercial surrogacy, the surrogate mother is financially compensated over and above the gestation period. Now-a-days, many surrogacy agencies have come up which help arrange a surrogate mother for the couple who approach them and also help in the exchange of money between the two parties. Commercial surrogacy is sometimes referred to by the emotionally charged and potentially offensive terms “wombs for rent”, “outsourced pregnancies” or “baby farms”.  

Second type is *altruistic* surrogacy wherein no payment is made to the surrogate for her services although intended parents do tend to cover all the costs during pregnancy. Surrogacy is performed out of love and the surrogate is generally (but not always) from amongst the friends or family of the couple.

Thus, the important factor to consider in any surrogacy arrangement as commercial surrogacy contract is the ‘payment for the services’ rendered by the surrogate mother.

Giving up a child is not easy for a mother. That is where the role of contracts comes in. Like any other contract, surrogacy contracts bind both the parties with certain obligations, an important one being on the part of the surrogate to relinquish the child. There have been cases, especially in traditional surrogacy, where the surrogate suddenly refused to give up her child after birth due to emotional attachment. Contracts provide legal recourse to the intended parents in such cases.

---

2 *Baby Manji Yamada v Union of India (UOI) and Anr.* AIR 2009 SC 84.
3 DilLaway (n 1) 1435.
India presently tops the list of the most harbourered places for fertility tourism which means travelling abroad to take advantage of assisted reproductive technologies. This is mainly because in India, surrogacy is legal and there is provision for high quality health care and well-trained doctors at very minimum rates compared to other western countries where surrogacy is legal. Also, the fact that there does not exist any law to regulate the surrogacy arrangement in India is an added advantage. It is this absence which makes it imperative to examine and analyse various dimensions of surrogacy industry in India.

**What is Public Policy?**

Public policy plays an important role in shaping our lives in general and behavior in particular on a daily basis, whether we are aware of it or not. We may be consciously aware of large-scale policy decisions like the recent re-criminalisation of homosexuality by the Supreme Court or the Criminal Amendment Act of 2013 for the protection of women but many people, inspite of knowing, fail to realize that television content is also an example of public policy. The ethical and legal questions of surrogacy involve the issue of public policy. Especially now that surrogacy is regulated under contract law, Section 23 of Indian Contract Act, 1872 gains importance as it states that any contract against public policy is void. For this we first need to have an understanding of what public policy means.

Public policy is a ‘course of action adopted and pursued by the Government.’ It may be seen in various forms including Laws, Legal Ordinances, Judicial Decisions, Orders given by the executive, Governmental Rules so on and so forth. Public policy not only influences the public but is also influenced by it. The importance of public policy is such that it is at times considered to be the measure of the capacity to govern. The success or failure of governments

---

5 Sec. 23, Indian Contract Act, 1872.
is, many a times, determined by the success or failure of public policies.\textsuperscript{8} Paul Appleby, an eminent theorist of Public Administration, considers policy making as the essence of public administration. The use of policies is essential for planning a course of action.\textsuperscript{9} Policies constitute the standard guides, which help the managers to plan, to act according to the legal requirements as also to realize the desired objectives.

Figuring out the course of action in any field or providing a framework for reference for individual decisions is policy formulation. Given the above distinction, it should be noted that projects and programmes come under the purview of field administration and planning under that of technical organization.\textsuperscript{10} Policy formulation is a function of the “Highest echelons of the Government.”\textsuperscript{11} It is a commonly stated fact that the political executive is involved in laying down the policy while the permanent executive is involved in its implementation. It may be true in theory; but in practice, many a times bureaucrats, technocrats, administrators (permanent executive) do indulge in policy formulation at a higher level. Even the bills passed by the legislature are drafted by the Civil Servants, given the technical nature of the work.

\textbf{Judiciary’s take on Public Policy:}

Public policy is a ‘very unruly horse, and when once you get astride it you never know where it will carry you”\textsuperscript{12} but ‘with a good man in the saddle, the unruly horse can be kept in control. It can jump over obstacles.’\textsuperscript{13}

This statement basically summarizes the stance of the judiciary on the term public policy. Opinions on this term vary a lot. The Supreme Court in the

\begin{itemize}
\item \textsuperscript{8} Padmakar Dubhashi, \textit{Recent Trends in Public Administration} (95, Kaveri Books, 1996).
\item \textsuperscript{9} Amreshwar Awasthi and Shriram Maheshwari, \textit{Public Administration} (220, 26th edn, Lakshmi Narayan Agarwal, 2002).
\item \textsuperscript{10} ibid.
\item \textsuperscript{11} ibid.
\item \textsuperscript{12} Richardson v Mellish (1824) 2 Bing 229.
\item \textsuperscript{13} ibid.
\end{itemize}
case of *SESA Industries Ltd v Krishna H Bajaj & Ors*,\(^ {14}\) went on to say that this term is incapable of precise definition. The judges in this case based their views on the judgment in the case of *Central Inland Water Transportation Ltd & Anr v Brojo Nath Ganguly & Anr*,\(^ {15}\) which states as follows:

*Per Madon D.P.*, 

Public Policy is not the policy of a particular government. It connotes some matter which concerns the Public Good and the public interest. The concept of what is for the Public Good or in the Public Interest or what would be injurious or harmful to the public good or the Public Interest has varied from time to time. As new concepts take the place of old, transactions which were once considered against public policy are now being upheld by the courts and similarly where there has been a well-recognized head of public policy, the courts have not shirked from extending it to new transactions and changed circumstances and have at times not even flinched from inventing a new head of Public Policy.\(^ {16}\)

Public policy can be broadly divided into two schools of thought, namely, *narrow view* school and the *broad view* school. As the names indicate, narrow school does not accept new heads of public policy while the broad view school does. This means that “the latter accepts judicial law making in this area while the former” does not.\(^ {17}\) Sir Dinshah Mulla while talking about public policy adhered to the narrow view and said that no new heads of public policy could be developed than what already exists; that courts cannot new classes of public policy and that they should be careful while dealing with such cases.\(^ {18}\)

Adherence to the views of narrow school would have prevented the law in this area from evolving; which is not the case. Rather the principles of public policy can be expanded and modified according to the changing practices and

\(^ {14}\) AIR 2011 SC 1070.

\(^ {15}\) 1986 AIR 1571.

\(^ {16}\) ibid.

\(^ {17}\) ibid.

\(^ {18}\) ibid.
notions of public conscience keeping in mind the interests of the public.\(^{19}\) Moreover, in case of lack of any authority in deciding a case, the principles of the Constitution of India in the form of Preamble, Fundamental Rights, Directive Principles etc., can act as a ‘beacon of light’.\(^{20}\)

In *Venkatareddi v Venkatachalam*,\(^{21}\) public policy was again referred to as a difficult term to explain and was called a variable quantity, which varies with the ‘habits, capacities and opportunities of the public.’\(^{22}\) Public policy is uncertain and should be very cautiously used, as what may be true for public policy in one context may not be so in some other context. Whatever causes injustice, restraint of liberty or any right of an individual (be it natural or legal), is against public policy.

Connotation of the term ‘public policy’ is different from that of the expression ‘policy of law’. While ‘policy of law’ refers to object of legislation in making any law, the term ‘Public Policy’ involves judicial interpretation as to whether this policy is for the good of the people at large and as to whether it is opposed to the public interest. Public policy never remains static rather it witnesses inter-generational and even intra-generational variations. It is variable, being based on the current requirements of the community and thus depends upon what is seen as the welfare of the community in a particular period of time.\(^{23}\)

Further, in *Renusagar Power Co Ltd v General Electric Co*,\(^{24}\) the court made an attempt to explain ‘Public Policy’. The matter under consideration was Section 7 (1) of the Arbitration (Protocol and Convention) Act, 1937 which among other things provided a condition on the enforcement of foreign awards in India. According to this section, if a court in India is of the view that an award in consideration is opposed to public policy of India, then such award shall

\(^{19}\) ibid.
\(^{20}\) ibid.
\(^{21}\) AIR 1964 AP 465.
\(^{22}\) ibid.
\(^{23}\) *Basantha Nahata v State of Rajasthan*, 2001 (1) WLC (Raj) at pg 433.
\(^{24}\) 1994 Supp (1) SCC 644.
not be enforced in the country. For this purpose public policy was defined by the court to include ‘i. Fundamental policy of Indian Law; ii. the interests of India; and iii. justice or morality.’

Judicial activism reached its pinnacle in *Vishakha v State of Rajasthan*. In fact, this judgment was unprecedented on the following counts: (i) It was first authoritative decision on ‘sexual harassment’ in India by the Supreme Court, (ii) the Supreme Court drew upon international treaties which had, till then, not been made into municipal Law, and (iii) faced with a situation of statutory vacuum on the subject of sexual harassment, the Supreme Court used ingenuity and adopted the route of judicial legislation.

**Public Policy in Medical Law**

Like in any other branch of law, medical law is also driven by public policy decisions. Its importance is indicated by the fact that there has developed a discipline called ‘Clinical Ethics’ which takes into account all the ethical (or public policy) issues in the course of practicing medicine. Herein the discussions on involuntary treatment come into light. In this regard, a study was conducted with eight Swedish scientists recently. Question in hand was whether involuntary psychiatric treatment by practitioners is justifiable given the importance of patient autonomy in clinical ethics. Respondents answered that it depends from case to case based on the individual needs of the patient. Weighing of pros and cons of such a treatment to the patients is necessary. They said that involuntary treatment is justified in cases of psychotic patients, who cannot independently make decisions for themselves and do not understand the importance of such treatment. Even then, imposition of treatment is justified only if the benefit accruing out of it is more than the risk of harm to the patient.

25 ibid.
Not surprisingly, these views were quite in line with the Swedish law. This shows the overlapping nature of medical ethics and public policy. Whether it is always public policy that affects ethics or the other way round is not the question here. But it seems that both these areas aim at public welfare; in this case, welfare of the patient.

A similar overlapping example is legality of prenatal determination. While still legal in the USA, it has been illegal in India since the enactment of Pre-conception and Prenatal Diagnostic Techniques (PNDT) Act in 1994. Why this difference? Reason lies in the social practices. Son preference, rise in sex selective abortions, female foeticide and dwindling child sex ratio forced the government in India to pass such a legislation. Although some say that the Act has not been very effective in preventing female foeticide, but studies have shown that in the absence of this Act, sex ratio in India would have been lot worse than it is today.28

**SURROGACY AND PUBLIC POLICY:**

Surrogacy still remains an unregulated practice in India. The reason why the legality of surrogacy is questioned so much is that it is an issue of public policy. As highlighted before, public policy can be interpreted in a variety of manners depending upon the spatial and temporal differences.

*In re Baby M*29 case was the first ruling by an American court on the validity of surrogacy. Mr. and Mrs. Stern entered into a surrogacy arrangement with Mrs. Whitehead. It was agreed upon by them that the latter would be inseminated with Mr. Stern’s sperm and that she will bring pregnancy to term whereafter she would relinquish her parental rights, which would vest with Elizabeth Stern, William Stern’s wife. After the birth, however, Mrs. Whitehead had a change of heart and decided to keep the child. William and Elizabeth Stern then decided to sue Mrs. Whitehead and claimed the status of child’s legal parents.

---

The court decided that the surrogacy contract was not valid and that Mary Whitehead would be the child’s legal mother and directed the Family Court to decide as to whether Stern, as father or Whitehead, as mother should be given legal custody of the child. The court based its decision on the best interest of the child analysis. The court awarded custody to Mr. Stern and visitation rights to Mrs. Whitehead.

The legal significance of this case was that it demonstrated that the ‘possibilities of reproduction through third party brings forth certain new legal and social issues about the meaning of parenthood as also the possibilities of contracting on issues of pregnancy and childbirth. Another significant point to be noted is the time at which this case was decided. In 1988, surrogacy was relatively new especially commercial surrogacy. There was a lot of criticism on the ethical aspects of surrogacy including commodification of the child as well as the surrogate (now popularly known as womb renting), interference with the ways of nature, economic exploitation of women especially in developing countries. Sometimes, psychological considerations may create an impediment for a successful surrogacy contract. It created a lot of hue and cry in the public, thus influencing the Court’s decision to a large extent. Now with the passage of time and the development of new alternate reproductive technologies, the public has come to accept this practice in many places. Difference in public opinion is probably the main reason why there are varying surrogacy laws in various states of the United States.

Public policy is also based on religion many a times. Thus, religious values also influence policy decisions on surrogacy. Surrogacy is viewed differently by different religions. For example, Jews are allowed to practice only full gestational surrogacy; gametes of the intended parents should be used and implanted through in vitro fertilization method. Islam prohibits surrogacy. According to Catechism of Catholic Church, surrogacy is immoral as it dissociates the husband and wife as there is intrusion by a third person.

---

SURROGACY: INTERNATIONAL PRACTICES

Laws relating to surrogacy differ from country to country. In many countries like Sweden, Spain, France and Germany surrogacy arrangements have been made absolutely illegal, since it is against their public policy and in few other countries only altruistic surrogacy has been made legal.

United Kingdom: Surrogacy in United Kingdom is illegal. The surrogacy contracts are not enforceable even if the contract has been signed with the intended parents and they have paid for any expenses within the legal framework of UK. Under the UK Law, surrogate mothers are considered to be the legal mother of any child they carry unless they sign a parental order after they give birth transferring their rights to the intended parents.31

United States of America: In the USA the law on surrogacy varies from state to state. It ranges from banning surrogacy contracts to enforcing them.32 The Assisted Human Reproduction Act in Canada permits altruistic surrogacy. The enactment allows surrogate mother to be made good only the expenses she has incurred as a result of pregnancy.33 Also those who are found guilty of breaking the law is punished with a sentence of 10 years of jail and a fine upto $500,000.34

South Africa: In South Africa the Surrogacy agreement is governed by the South Africa Children’s Act of 2005. Under this Act, for the agreement to be valid, it is required to be confirmed by the High Court before fertilisation. This Act permits the commissioning parents to compensate a surrogate mother for the expenses that directly relates to the artificial fertilisation and pregnancy of the surrogate mother, the birth of the child and the confirmation of the surrogate

motherhood, loss of earnings suffered by the surrogate mother as a result of the surrogate motherhood agreement, or insurance to cover the surrogate mother for anything that may lead to death or disability brought about by the pregnancy.\(^{35}\)

**SURROGACY IN INDIA**

With an increase in the global market for surrogacy, the surrogacy industry of India has grown enormously. India’s commercial surrogacy industry accounts for about $2.5 billion.\(^{36}\) It is predicted that future market for surrogacy shall be concentrated in India, which provides access to contemporary technology, skilled doctors at very low rates compared to developed nations (those which have legalised surrogacy like United States of America).

As the market for commercial surrogacy is increasing, both the doctors and surrogate mothers are engaging in the profiteering activity. Newspapers have accounted few instances where the families have actually encouraged the surrogate mothers to take up surrogacy because that would help them build a better life for themselves and the family.\(^{37}\) Commercial surrogacy in India has raised many ethical and moral questions which require to be answered: whether it is morally correct for a women to give birth and sell the child for a sum?; whether it is ethically correct for married women to get into surrogacy in order fulfil her household needs?; will it lead to exploitation of women by her family members? Further surrogacy arrangements involve intricate health issues concerning the surrogate mother, and ethics of medical professions that need to be addressed.

Though the concept of surrogacy is considered as a new aspect of reproductive technologies, for India it is actually an old concept which has its mention in

---


the scripts of ancient Hindu mythology. Further, they also reveal that even during those days the practice of surrogacy was done in secrecy. Illustrations of surrogacy can be seen in the Bhagvat Purana, on hearing the prayers of Vasudev, appealing to Kansa not to kill all sons born to him, Vishnu transplanted the embryo from Devaki’s womb to the womb of Rohini, another wife of Vasudev, who later gave birth to Balaram, Krishna’s brother and raised him in secrecy while Vasudev and Devaki told Kansa that the child was born dead.

**LEGAL FRAMEWORK RELATING TO SURROGACY IN INDIA**

Since many countries ban surrogacy arrangements or have tough laws or the cost of the same is high, many people prefer India as their destination for surrogacy. This makes it necessary to examine the legal framework on surrogacy in India.

1. **Salient Features of the National Guidelines for Accreditation, Supervision and Regulation of ART Clinics in India:**

   The Indian Council for Medical Research (ICMR) along with National Academy of Medical Sciences in the year 2005 for the first time came out with Guidelines for Accreditation, Supervision and Regulation of Assisted Reproductive Technology Clinics in India. A brief reading of the guidelines provides that this was an attempt to ensure that the ART clinics are accredited, regulated and supervised in India, and to promise their patients that they would provide world-class services. Also to make sure that these ART clinics throughout the country follow a uniform code of conduct by prescribing the responsibilities of these clinics. The Guidelines provide criteria for screening of patients for choice of procedure to be used. The Guidelines further provide for the registration of the ART clinics and a Uniform Code of Practice for all the clinics. Code of Practice covers most of the features of the treatment given and research performed at the clinics. It prescribes that information and counseling must be provided to the patients who seek treatment.

   Relating to surrogacy, the Guidelines provide for the following:

   a. Children born out of surrogacy must be adopted by the genetic parents unless they cannot prove that they are the genetic parents.
b. Surrogacy should be adopted only where the patients are incapable of conceiving for complete term either physically or medically.

c. The Guidelines prohibit the ART centers to involve in any monetary aspect and advertising for surrogacy. Payment made to the surrogate mother should cover genuine expenses relating to pregnancy and documentary evidence of the financial arrangement should be made accessible.

d. The choice of finding a surrogate mother rests with the couple or a semen bank. A relative, known person or unknown person to the couple can act as a surrogate mother but if the chosen person is a relative then she has to belong to the same generation of intending mother.

e. The surrogate according to the guidelines should be less than 45 years of age. The surrogate should satisfy certain tests for HIV and should show that she is seronegative for this virus immediately before embryo transfer. She further has to provide certificate that – she has not taken drug through intravenous by a shared syringe or undergone blood transfusion or to the best of her knowledge she or her husband has not had any extra marital affair for the last six months. She has to further agree not to go for blood transfusion except through certified blood bank or take drug intravenously.

f. A woman cannot act as a surrogate for more than three times in her lifetime.

These Guidelines have been mainly criticised because they are non-binding in nature. Also these Guidelines fail to emphasise on the protection of human rights of the surrogate and the child.

2. Salient Features of the Assisted Reproductive Technology (Regulation) Bill, 2010

Considering the radical growth in the ART clinics being approached by infertile couples to procreate, the Indian Council of Medical Research came

---

38 Most surrogacy agencies around the world including Surrogacy UK, British Surrogacy Centre, Centre for Surrogate Parenting have set a mandatory requirement that a surrogate should have previously given birth to a live child before entering into a surrogacy agreement. Vangie Bergum, A Child on her Mind: The Experience of Becoming a Mother (Praeger 1997).
up with a Bill called the Assisted Reproductive Technology (Regulation) Bill, in the year 2010. Thus, in the interest of the public it was realised that a Law was imperative to ensure that services provided by these clinics were ethical and the socio-legal and medical rights concerned with this were protected. The Bill provides for the constitution of National and State Advisory Board for Assisted Reproductive Technology to regulate the permissible practices of the assisted reproductive technology, prescribe guidelines to the patients, to encourage and promote ART clinics training and research and also in the dissemination of information to the public with regard to ART clinics. It further makes provision for the establishment of Registration Authority for granting or rejecting to register ART clinics. The Bill also gives instructions as to who can apply for registration and procedure for registration of the ART clinics. The 2010 Bill defines the duties of the ART clinics so that the parties to the contract are provided with proper information to obtain their true informed consent. It states that the surrogate mother should give up all her parental rights over the child and the birth certificate should be registered in the name of the intended parents. Also the intended parents under the Bill are required to submit official documents that the child born in India is permitted to travel into the country to which the intended parents plan to take the child. But under the Bill the child born out of this arrangement is denied Indian citizenship despite taking birth in India.39 The Bill further prescribes penalty for committing the acts prohibited under the Bill and lastly provides for the maintenance of proper records, charts, forms, reports, and consent letters.

This Bill, unlike the Guidelines, would be binding on the ART clinics as well as on the parties to the surrogacy contract if it would become a law. But this Bill too fails to address some important ethical questions. Unlike abortion, the consent of the husband is mandatory if a married woman wants to get into surrogacy contract.

Appraisal of the ICMR Guidelines and the ART Bill, 2010

Authority of ICMR

The first question that is required to be answered is whether ICMR has the legal authority to issue guidelines to regulate ART clinics in India. ICMR in India is the apex body to formulate, coordinate and promote biomedical research. The very reason for setting up the ICMR is to promote research in the field of biomedical. Thus, this council has only the authority to regulate the institutes associated with biomedical research. The ART clinics in the name of research have actually attained the status of centres which are into business of surrogacy in India. Research Laboratories are laboratories for conducting research or investigations into science. These institutes are specifically established with the intention of advancement in the respective field. When these clinics attain the commercial status, they automatically lose the status of research centres. Hence, ICMR automatically loses its authority to regulate these centres.

Further, the guidelines issued by the ICMR declare that ART used by a woman without the consent of the husband amounts to adultery and can be a ground for divorce. Firstly, these are basically guidelines issued by ICMR, whose authority is still unclear with regard to ART clinics as such. Secondly, these are mainly guidelines which do not have binding effect on the ART clinics. Thirdly, in a country like India where there does not exist any secular law with regard to divorce or judicial separation, how can ICMR a research institute declare adultery as a ground for divorce? Further, unlike in cases of abortion, consent of the husband is mandatory if a married women wants to get into a surrogacy contract, if so, once again considering seriousness of both acts. How

42 Under Indian Law, Hindus are governed by Hindu Marriage Act, 1955. Section 13 of this Act provides for the ground for divorce and the concept of divorce for Muslims are covered under Muslim Law. Christian's marriages and grounds for divorce are governed under Indian Divorce Act, 1869.
43 Sec. 3(4)(b), Medical Termination of Pregnancy Act, 1971.
can only in cases of surrogacy, the non-obtaining of consent would amount of adultery? These are few important issues which ICMR fails to justify.

**Enforcement of the Commercial Surrogacy Contracts**

The next question that is required to be answered is whether commercial surrogacy must be recognised; if yes, then how can it be done. As discussed in the earlier section of the article, it can be seen that few countries recognise only altruistic surrogacy on the ground that commercial surrogacy is opposed to their public policy. In India, there is no specific law on surrogacy but it is not illegal either. The ICMR Guidelines and the ART Bill 2010 envisage that the courts in India shall enforce the surrogacy contract. The first difficulty of the party to the surrogacy contract, seeking enforcement of the contract, is whether the contract is opposed to public policy or not under Section 23 of the Indian Contract Act, 1872.

Prohibition against paid adoption and prostitution are the two most common public policies which the surrogacy contracts offend. But these reasons have not been so much convincing to ban commercial surrogacy in India. Few courts and legislatures consider that gestational surrogacy is distinct from ‘baby selling’ because the surrogate mother is not providing her genetic material. Also in the case of gestational surrogacy the surrogate mother does not accept compensation for her consent to give the child in adoption but for the services given by her (becoming pregnant, bearing the child in her womb for the full term, and giving birth) because as such in gestational surrogacy she does not have any right over the child. But also those who oppose this service oriented surrogacy contract often object to it by comparing it to prostitution which in reality does not stand as an analogy because the very objectives of the acts are different. Objective of prostitution unlike surrogacy is physical pleasure, which

---

44 Section 23 of the Indian Contract Act, 1872 reads as follows: The consideration or object of an agreement is lawful, unless— it is forbidden by Law; or is of such nature that, if permitted, it would defeat the provisions of any Law; or is fraudulent; or involves or implies injury to the person or property of another or; the Court regards it as immoral, or opposed to public policy. In each of these cases, the consideration or object of an agreement is said to be unlawful. Every agreement of which the object or consideration is unlawful is void.
is fundamentally different from surrogacy arrangements where the objective is giving birth to a new life.\textsuperscript{45}

Critics of surrogacy arrangements are unhappy with the mixing of economic element with the surrogacy arrangements because according to them it would belittle the dignity of women. But the underprivileged women actually are quite contended with the surrogacy arrangements because unlike prostitution it fulfils their economic needs in a dignified manner.\textsuperscript{46} They argue that surrogacy contracts are mainly service contracts which like other contracts involve certain amount of physical as well mental health risks and this alone cannot be the reason for the government to ban surrogacy. The main defence for legalising surrogacy arrangements is that it provides high economic benefit to the gestational mothers. In a country like India the amount earned out of this surrogacy contract in Indian currency would suffice a family for 15 years.\textsuperscript{47}

Now the next question that crops up for discussion is that if commercial surrogacy is legalised in India, then is India legally prepared to protect the rights of the women lending their wombs. There is actually no law as such to regulate surrogacy in India. But considering the predatory effect of the globalised open market of surrogacy on surrogate mothers, India should involve governmental paternalism so that these women are not marginalised in this process controlled by the intended parents. The best example that can be put forth to substantiate the argument that law is required to regulate the surrogacy market in India will be the Transplantation of Human Organs Act, 1994. This enactment was enacted with the objective to regulate the illegal trafficking of human organs and to protect interests of the parties involved in this dealing, especially that of the donor.\textsuperscript{48} In the same manner, the surrogacy market in India needs to

\textsuperscript{45} Rimm (n 50) 1450.


\textsuperscript{47} ibid.

be regulated and the rights of surrogate mothers are to be protected. Some of these rights have been discussed at length in the following selections.

1. Surrogate Mother’s Right to Self-Determination

Through a bare reading of the ICMR Guidelines and ART Bill, 2010 it can be understood that they actually do not address the issue of right to bodily autonomy of the surrogate mothers. Surrogacy is an activity which involves using a person’s body for the intended parents’ benefit. Surrogacy contracts should not render the surrogate mother to give up her right to determination with regard to her body. The law as well as the doctors should make sure that in surrogacy contracts the potential gestational mothers are not forced into termination of pregnancy or prohibited from doing so or for caesarean section or to bed-rest or to medical tests against her will which violate principles of bodily integrity. The law should make provisions which do not render the contract voidable because of the above mentioned reasons. Also the doctors have an obligation to make sure that in case the surrogate mother is required to terminate the pregnancy due to health reasons, she gets a compensation for the services already provided by her. The fact that she terminates her pregnancy does not negate physical and the mental challenges she would have gone through in the process of surrogacy. Hence, in the contracts of surrogacy it should be ensured that when the surrogate enters into the contract she does not give up her right of self-determination. Since most of the women who act as surrogates in India are uneducated, it must be obligated through law that the doctors who actually hire them as surrogates should make sure under the contract that they won’t give up right to self-determination of their body.

2. Problems of Middlemen

The guidelines issued by ICMR give rise to a series of problems rather than solving existing ones. Since the ART clinics, under the Guidelines and the Bill, are prohibited from advertising their surrogates, couples who want to hire a surrogate mother are forced to find them through their own sources, which in turn results in ‘middlemen’. Such middlemen give rise to ‘Motherhood for
Hire’ industry as termed by Jennifer Rimm and consume the share of the profit that actually belongs to the surrogate mother. The middlemen concept also results in hampering the wellbeing of the surrogate because their involvement takes shape of a profit making business and the surrogate mother turns out to be a commodity, solely for profit making. Also, due to the fact that intended parents and the surrogate do not have a direct connection, there are increased chances of such surrogates being forced into surrogacy contracts which in turn could lead to misrepresentation of the health of the surrogates.

3. Equal Status to the Surrogate and Commissioning Parents, and Guaranteed Informed Consent

Surrogacy contracts entered into in India mainly involve women from the lower strata who are uneducated unlike the commissioning parents who are educated and have a better understanding of the contractual implications. Also the fact that the parties arranged in the contract are actually paid by the commissioning parents, the commissioning parents have their interests protected and have a better say in the contract. But the surrogate mothers without separate and uninfluenced assistance are exposed to manipulation, and may end up in agreeing for an unfair price due to pressure or lack of understanding of the contractual terms of the contract.

Thus, under law we need to recognise the surrogate mother as an autonomous person who is given the exclusive right to decide whether or not to contract, thus, guaranteeing informed consent. Also, if the potential surrogate mother has a family, then the consent of her family must be made compulsory. The agencies must be provided with the task of protecting the rights of the surrogates in the contract negotiations.

4. Insurance Policy

The surrogacy contracts unlike in other countries do not make it mandatory to the commissioning parents, or to the clinics or to the middlemen to provide for

49 Rimm (n 5) 1456.
an insurance coverage for the health risks that surrogate mother might undergo in the process of surrogacy. India could incorporate into its legislation the minimum standard payment to be made to the surrogate mothers, mandatory insurance policy which applies even to post pregnancy care that is required to be taken and in case of permanent disabling injuries or death or medical expenses, compensation for the same can be made mandatory.

**Response of Indian Judiciary Towards Surrogacy**

The question of legal void on surrogacy first came up for consideration before the Indian Judiciary in the case of *Baby Manji Yamada v Union of India and Another*. In this case it was alleged that in the name of surrogacy a lot of irregularities were committed and a money market was being perpetuated and India should enforce stringent laws relating to surrogacy. Though during the time of this case, the Guidelines relating to surrogacy were laid down by ICMR but still there was no mention of it to support the Court’s presumption of legality of surrogacy. Baby Manji was born to biological parents, Dr. Yuki Yamada and Dr. Ikufumi Yamada, through surrogate mother at Anand in the year 2008. But, the biological parents developed marital problems and they were divorced by the time she was born. The child was rendered parentless and stateless. Government also found itself helpless in the absence of surrogacy laws in the country. So, Mr. Yamada sent his mother who claimed custody of the child. Later on, when she was under the care of her paternal grandmother, she was issued a birth certificate in the name of her genetic father who had gone back to Japan as his visa expired. Baby Manji was also breast fed by the Indian surrogate mother. The baby girl was issued a Certificate of Identification instead of a passport to make her transit out of India possible.

Subsequently a writ petition was filed before the Rajasthan High Court challenging the legality of surrogacy and criticising it as feeding an illegal industry. It stressed on the need for enactment of law on surrogacy. Consequently,

---

52 ibid at 521.
the High Court ordered for the production of the child before it, which was challenged by grandmother on behalf of Baby Manji on the ground that the writ petition was baseless as it was not proved in whose illegal custody the child was in the Supreme Court of India. But the Supreme Court of India setting aside the order of High Court asked the parties to seek redressal before National Commission for Protection of Child Rights setup under the Commissions for Protection of Child Rights Act, 2005. Thus the court’s stance in the instant case was pro-surrogacy as well as pro-contract. The Supreme Court as such did not take any stand on the issue of surrogacy in India when it had a great opportunity.\textsuperscript{53} The Supreme Court of India failed to discuss on the rights of the child born out of surrogacy or the citizenship issues that could occur if surrogacy is not recognised in the country where the intending parents plan to bring up the child.

In the case of \textit{Kalaiselvi v Chennai Port Trust},\textsuperscript{54} the Madras High Court held that a surrogate mother is entitled for leave under Rule 3-A of the Madras Port Trust (Leave) Regulations 1987 under which benefit to the adoptive parents are granted.

Recently the Kerala High Court in its judgement\textsuperscript{55} on 6 January 2015 coined a new term for surrogacy, ‘Split Motherhood.’ In this case the Honourable High Court held that women employees are eligible for maternity leave for raising their kids born out of surrogacy arrangements. Considering the importance of motherhood in a women’s life and the advancement in technology, it held that there cannot be made any discrimination on the grounds of whether the mother is a biological mother or a genetic mother, and she is entitled to all the benefits that accrue to an employee after the delivery as have been provided under the Maternity Benefits Act, 1961 or the staff rules (Kerala Livestock Development Board Limited Staff Rules & Regulations, 1993).

\textsuperscript{53} ibid at 523 & 524.
\textsuperscript{54} 2013 (2) KLT 567.
\textsuperscript{55} W.P(C)No.20680 of 2014H.
WHY REGULATE SURROGACY?

A recent earthquake in Nepal surprisingly brought into light the issue of surrogacy. The Israel government rescued 26 babies born out of surrogacy from Nepal but left the surrogates (mostly Indian women) behind. The government justified leaving behind the surrogates by saying that the surrogacy agreements did not have a natural disaster clause. These babies belonged to Israeli gay men who had to look for surrogates outside the country because their own country has not legalized the practice. Indian women were taken to Nepal because although commercial surrogacy is recognized in India but only for heterosexual couples and moving to Nepal is easy as no extra documents are required. In this case, had the surrogates returned to India and had the child been born here, the agreement would not have had any value and the surrogate would be forced to keep the child. This is a clear example of how important it is to regulate and not just out rightly ban practices like surrogacy. This incident is said to have some impact on the Israeli government and it is considering allowing Indian surrogates in the country for the purpose of childbirth.

As far as India is concerned, no specific law deals with the legality (much less regulation) of surrogacy in general (and commercial surrogacy in particular). It is the Indian Contract Act, 1872 that exercises jurisdiction over all the agreements and contracts related to surrogacy. Also it is the judiciary that has regulated surrogacy in the country through contractual and public policy interpretations. Surrogacy contracts have been validated by the courts on many account citing the presence of (supposed) consensus ad idem. Since the decision of the court in Baby Manji Yamada v Union of India, the court’s stance has been pro-surrogacy as well as pro-contract. The surrogate industry is flourishing in the country due to the rising demand in the international market and the ready availability of potential surrogates who are generally uneducated and/or are in need for money.

Then why do social activists ask for a blanket ban on this million dollar industry? In a study conducted by Centre for Social Research,\(^5\) it was claimed that the rights of surrogate mothers are seriously violated in this whole process. It was also pointed out in the study that majority of the surrogates especially in places like Delhi and Mumbai, are either married or divorced.

In such cases either the husband pressurizes the wife to undergo surrogacy thinking of it as an easy way to earn money or (as said by surrogates themselves in interviews) the mothers consider this to be fund raising for the education of their children. Many cases of excessive number of pregnancies have also been reported. For example, a woman was said to have undergone five pregnancies under surrogacy contracts and had four children of her own making it a total of nine deliveries, when the number of safe deliveries for any woman has been put at three.

Some other problems have also surfaced. In a case of gestational surrogacy in India by Australian commissioning parents, unexpectedly, twins were born. The intended parents took the girl child with them and left the boy saying they already had a boy and could not afford taking care of another kid.\(^5\) Currently, the child is stateless and his whereabouts are also unknown. In such cases, surrogates are reluctant to take care of the child due to additional expenses. Mostly uneducated and unaware, they are left with no redressal mechanism in case of Non-Performance of Contracts. Another similar yet infamous case was reported in Thailand wherein at the birth of twins, the intended parents (again from Australia), took with them only one child, leaving behind the other who was diagnosed with Down syndrome. As a result, surrogacy was banned in Thailand.\(^6\)

This brings into light the issue of right to abort in surrogacy arrangements. It has been proposed in the Assistive Reproductive Technologies (ART) Bill, 2010.

---


that surrogates should not be allowed to take the decision regarding abortion. Abortion is said to be a breach of contractual obligations in surrogacy contracts as the commissioning parents reasonably expect a child out of the contract. But who should actually be able to exercise this right? There is constitutional conflict on this issue. Intended parents are said to have the right to procreative freedom while the surrogate has the right to procreation both of which are offshoots of the right to life and personal liberty under Article 21. Here two situations can arise. On one hand, the commissioning parents may decide that they no longer want to have the baby due to any reason be it prenatal condition of the child or even personal conditions. The surrogate may treat this as a breach of contract. The court is also left in the dilemma whether to order an abortion on demand which would be forced on the surrogate. And if the court orders otherwise, it would mean forcing an unwanted parenthood on the commissioning parents. On the other hand, if a surrogate decides against the pregnancy and is consequently sued for specific performance, would the decision of the court in favour of commissioning parents lead to undue physical hardship and exploitation of the surrogate?

The ART Bill bans the right to abort by the surrogate by prohibiting her from harming the fetus in any manner. This would mean waiver of the surrogate’s right to abort through a contract. Any waiver of a right requires a fully informed consent. So is this waiver valid? Two points need to be noted- first, the Supreme Court in *Muthiah v CIT* 61 held that no fundamental right could be waived off through a contract; second, in *Baby M* 62 case, it was said that consent in a surrogacy contract can never be considered to be fully informed given the contractual and monetary considerations that too before childbirth. So, ideally it should not be valid given the precedence of the surrogate’s fundamental rights over any contract. These rights should be in line with the abortion Laws in India like the Medical Termination of Pregnancy (MTP) Act, 1971 (which allows termination of pregnancy on the consent of the woman). So if the surrogate decides to go in for abortion against the intended parents’ wishes, the latter

---

61 AIR 1956 SC 269.
62 537 A.2d 1227, 109 N.J. 396.
party should be absolved of the liabilities to make payment for the surrogate’s services. And if the parents want abortion and the surrogate does not, then (rather than forcing the abortion on her) again they should be absolved of the obligation to pay and the surrogate should be given full custody of the child and should be made to incur all the risks and expenses of the pregnancy and the child in a traditional manner. But practically, these rights are completely ignored. The intended parents refuse to pay the surrogate in case of abortion or even accidental miscarriage.

More recently, another important case, *Jan Balaz v Anand Municipality*, has been decided. In this case, a German couple entered into a contract with a surrogate in India. Twins were born. The couple found it difficult to take the child to Germany as it was not being given a passport. Germany refused to give the passport as surrogacy is not allowed in Germany while the Indian government is not allowing the children to go back as Indian citizens as they were born out of surrogacy. The latter also tried negotiating with the former for granting nationality to the children by treating this as a special case but to no avail. Finally, the Supreme Court found a way out. It ordered the Central Adoption Resource Agency to relax its rules and let the German couple adopt the twins from the surrogate mother. After two years of statelessness, the children finally got to go home. The Indian government agreed to give exit permit to the children. The Supreme Court also strongly recommended that the government should make laws to regulate the practice in the country. It said that no child should be made to go through this disturbing process. This case also brought forward the issue of citizenship yet again.

**Conclusion**

India, with its growth in medical tourism has been tagged to be the next leader in the ‘baby market’. With no legislative sanction or executive action, the sector of ‘surrogacy’ has become a viable commercial market for fertility clinics, across the country. It has been established that surrogacy in India is regulated

---

63 AIR 2009 Guj 21.
by contract law as well as public policy decisions as highlighted in judicial pronouncements. Surrogacy Laws in the country have emerged through judicial legislations. Initially, unprecedented situations and questions on surrogacy arise which are dealt by the judiciary. This is how the legal vacuum is filled. Even the USA followed the same path.

Considering the economic backwardness in India, surrogacy has actually come as a rescue to many poor families. The Indian women belonging to the poor strata actually consider it as a boon since it fetches them income that is equal to lifelong earnings without compromising on their integrity. Now, though morally surrogacy can be regarded as a blessing, the legal complications, and lifelong injuries that it might result in cannot be negated.

Thus, it is necessary that India adopts a framework where it provides for affordable surrogacy, along with protecting the rights of the surrogate mothers. The following could be incorporated in the legislation if India would come up with one:

(a) **Prior approval of the surrogacy contracts by the Judiciary:** The judicial approval of the surrogacy contract to be operational could be one such solution. This would result in balancing the interests of all the parties to the contract and would minimise the threat of marginalising the interests of surrogate mothers and the child. The courts should take into account the lack of bargaining power of the surrogates be it due to illiteracy or economic factors.

(b) **Unambiguous contract formation:** The contract thus formed should be very clear in its terms so as to prevent any future conflicts. For example, how to deal with the surrogate, and her rights and duties after birth of the child should be clearly defined in the contract so that in case the surrogate develops attachment with the baby, no problems may arise.

(c) **Addressing certain issues beforehand:** These include things like who will obtain guardianship for the child, in case the commissioning parent/parents die and the child was still a minor? Who would take care of the child if the intended parents get separated? (similar to what happened in Baby Manji Yamada case) What fees and expenses are to be paid by
the surrogate and the commissioning parents? What type/ amount of indemnification is to be given to the commissioning parents in case the surrogate mother is to be given custody of the child?

(d) **Mandating Psychological Counselling:** Since surrogacy affects the emotional and psychological health of the surrogates, it is necessary that they are provided with proper psychological counselling about the effects of being a surrogate to avoid any serious mental or emotional turbulence. This would also help the surrogate mothers in providing informed consent to surrogacy contract.

(e) **Insurance Policy:** The intended parents must be obligated to obtain an insurance policy for the surrogate mothers which covers the pre and post pregnancy costs incurred by the surrogate mother.

(f) **Non termination of the contract before the term of the contracts:** The Law should make provision which does not allow the intended parents to revoke or terminate the contract before the term of the contract ends because of termination of pregnancy or any other health issues that the surrogate may face as a result of surrogacy contract. It should be made sure that she is completely paid for the services provided by her till then and in case of lifelong injury, she is properly compensated.

(g) **Amendments to Maternity Benefits Act, 1961:** The Maternity Benefits Act, 1961 must be amended to accommodate Surrogacy Arrangements in India.

(h) **Recognition of Surrogacy under Employment Regulations:** The surrogacy arrangements must be provided recognition under employment regulations in India. Uniformity should be brought about amongst the various rules and regulations concerning maternity leave, where the surrogacy arrangements are recognised and they are treated on equal footing along with normal pregnancy.

(i) **Changes in the Citizenship Act, 1955:** Given that large number of surrogates dealing with foreign commissioning parents, provisions should be made for determining the citizenship of the babies and to prevent them from statelessness as happened in *Baby Manji* case and *Jan Balaz* case.
POWER PURCHASE AGREEMENTS

Dr. Sairam Bhat* & Robith Kamath**

ABSTRACT

The Indian power sector is one among those countries that have the lowest per-capita energy consumption. There have been emphatic developments in carrying out the activities of a power sector, viz. Generation, Transmission and Distribution, whereby from a closely-held government enterprise there has been a shift towards liberalisation by way of licensing, and the most recent trend being outsourcing of generation and distribution of activities. The need for these approaches was imperative, India therefore adopted a regulatory approach that is suitable to meet the vibrant and ever-requiring power sector. The Power Purchase Agreement is a structured technical document that deals with the procurement of power, thereby requires to be regulated by suitable and subsequent intervention by the Government Agency, so as to ensure a free, fair and equitable use and availability of electricity to the ultimate consumers.

INDIAN POWER SECTOR: A FOREWORD

Independence of India in 1947 brought forth the burden upon the Independent Government to balance the needs of both social and economic status of the economy. The Indian policy makers by and large had strong faith in the ideology of socialism, it was natural that “State” that played dominant role in procuring the socio-economic foundation for the country.¹ Prior to 1991, the Indian economy had a larger share of public sector and big monopoly capitalists as compared to presence of small private entities in the economy.² The Industrial Policy Resolutions of 1948 were adopted which later on led to Industrial Policy

---

² ibid.
Resolution of 1956. The effect was the creation of a centralized economy with strict licensing requirements and a large amount of public funding. The Resolution of 1956 altered the British regime of licensing and the production of electricity was reserved for public sector undertakings. This closed-economy approach of the government, in turn led to high tariff rates. Thus, economic activities and industries that required energy for their functioning incurred huge standing charges and overhead costs, while their output was still not satisfactory to meet the rising demands of households and businesses. The economic crisis was furthered by the Indo-China war of 1962 and Indo-Pak war of 1965 and thereon India was within extreme financial crisis of World Bank and International Monetary Fund.3 Similarly the droughts of 1965-67,4 posed a great threat and terrified the Indian stand on the world trade forum, which besides hitting lives had also been moving the country into huge budgetary crisis and slow industrial production. Hence, Indian monopolistic model was broken to introduce nationalization of banks in 1969 and Monopolies and Restrictive Trade Practices (MRTP) Act 1969.5

The Indian Power Sector has been under a regulatory framework from the start.6 Under the British regime, the power sector was developed by means of private participation.7 The basic framework was set-forth by the Electricity Act of 1910 (Hereinafter, Act of 1910). The Act of 1910 vested the power to grant multiple licenses for the supply of electricity, in the hands of the State Government, thereby bringing in more competition in the distribution of electricity. The Act provided for the sale of power to third parties, thus created

3 ibid, p- 2.
4 ibid.
5 The MRTP Act 1969 is now replaced by Competition Act 2002. It was a grim reminder of the ‘licence-quota- permit-raj’ of 1970’s & 1980’s. The Act had become redundant post July 1991 when the new economic policy was announced and Chapter III of the MRTP Act dealing with restrictions on M&A activities was made inoperative.
6 The Electricity Act 1887 regulated the use of electrical energy so as to protect the public. Under the later Electricity Act of 1903, the local governments were given the power to grant licenses for generation of electricity.
a framework of open access in distribution. The Act imposed a duty\(^8\) on the licensee to provide electricity to any person, on application, at a rate of charge without undue preference,\(^9\) that enabled the licensee to receive a reasonable return on capital expenditure and other standing charges incurred therein to meet the requisite demand. However, with the promulgation of the Electricity (Supply) Act 1948, three statutory bodies, namely: the Central Electricity Authority, the State Electricity Boards and the Regional Electricity Boards were established, and the power sector became a state monopoly with a few exceptions in the area of distribution of power.\(^10\) The first state to restructure its integrated SEB under a state level legislation was Odisha in 1995.\(^11\) Though power is a concurrent subject in the Constitution, the first major policy thrust from Central Government came only in 1998 when it enacted the Electricity Regulatory Commission Act, 1998 to pave way for formation of Central and State Electricity Regulatory Commissions and distancing of Government from tariff determination.

The monopolistic approach in the power sector was altered in 1991, whereby private participation was allowed in respect of the generation aspects of the power sector. In 1998, the policy framework was further revised to allow for private participation in the transmission of electricity and also sought to establish regulatory commissions for regulating the electricity sector.\(^12\) In the year 2003, there was a revamp of the entire legal framework relating to electricity that was brought forth by the Electricity Act 2003.\(^13\)

---

8 Section 22 of Indian Electricity Act 1910 (Act No. IX of 1910).
9 Section 23 of Indian Electricity Act, 1910 (Act No. IX of 1910).
10 Supra note 7, p-259.
11 Supported by the World Bank they started a) un-bundling the integrated utility into three separate sectors of generation, transmission and distribution, b) privatisation of generation and distribution companies, and c) to establish independent regulatory commissions to regulate these utilities. Soon afterwards, several other states like Haryana, Uttar Pradesh and Andhra Pradesh followed.
12 The Electricity Regulatory Commissions Act 1998 was enacted pursuant to the Common Minimum National Action Plan for Power (CMNPP).
13 Prior to the Electricity Act 2003, The Indian Electricity Act 1910, The Electricity (Supply) Act 1948 and The Electricity Regulatory Commissions Act 1998 were the three principal legislations that regulated the Power Sector.
The chief reason for seeking private participation in the development was to enable greater flow of capital for the establishment of infrastructure and provide for efficiency in the manner of provision of infrastructural facilities and related services. The changing power sector dynamics introduced issues to improve efficiency, reduce losses, reliable accessibility by smart system, segregating network assets and subsidizing electric tariffs to meet the demands of households, industries and agriculture. With the advent of liberalization, the government allowed private players to carry out heavy industries, mining, electricity, telecommunications etc with view to reform the economy. The government established various corporations viz. State Electricity Boards (SEB), National Thermal Power Corporation (NTPC), National Hydro-Electric Power Corporation (NHPC) and Power Grid Corporation Limited (PGCL) etc. to regulate the rising demand of energy and power in the country which constantly failed in supply as compared to demand. Finally, the government also invited, in addition to private firms, independent power producers and foreign companies to build power generation projects in India. However, it was agreed that all these projects would be regulated by Regulatory Commission established under the title of Central Electricity Regulation Commission (CERC) & State Electricity Regulation Commission (SERC); which would look into the matters of compliances, transmission & distribution among the consumers. Thereafter, in one of the most promising joint ventures between government and foreign collaboration, USA based Enron was invited to Indian economy to invest into clean and reliable source of energy generation through setting up Dabhol project in Maharashtra.

**LIBERALISATION OF INDIAN POWER SECTOR:**

**ORIGIN OF PPA IN INDIA**

Private participation in the power sector, may relate to either the Generation; Transmission or Distribution/Supply of Electricity and much recently to the

---

14 Supra note 7, p-85.


16 ibid.
Trading of Electricity. Although such participation existed since the British regime, a major shift lies in the manner such participation was dealt with. After the Electricity Act of 2003, there is a minimal regulatory compliance by the introduction of a uniform licensing requirement for either Generation; Transmission; or Distribution of Electricity. The chief aim of the changes that has been introduced is that in respect of Electricity Trading,\(^{17}\) a platform wherein electricity can be purchased for the purpose of resale. The respective commissions have been vested with the discretionary power\(^ {18}\) to fix, the trading margin, in respect of inter-state and intra-state trade of electricity. There are different schemes by which private participation can be generally categorised,\(^ {19}\) viz. Build Own Operate (BOO); Build Operate Transfer (BOT), a mechanism where the project company or operator generally obtains its revenues through a fee charged to the utility/government rather than tariffs charged to consumers; Build and Transfer (BT); \textit{et. c.} The heart and soul of a Power Project by way of Private Participation is the Power Purchase Agreements entered into between the State and the Private sector. This section would deal with few of the PPAs turned fowl.

Liberalization of the Indian economy in 1991 allowed for Multi-national Companies to invest in different sectors of Indian economy, including the energy sector. In 1991, Enron Corporation, a Houston based service provider for natural gas and one of the fast growing companies at international level, was invited by Government of Maharashtra to create an innovative and efficient mechanism for energy solutions and a better environment. The company through one of its subsidiaries Enron Development Corporation identified Dabhol district in Maharashtra (the only deep water port) to set up its 2015 MW power plant.\(^ {20}\) The Maharashtra State Electricity Board (MSEB) was

\(^{17}\) Section 53 of the Electricity Act, 2003.

\(^{18}\) Section 79(1)(j) and Section 86(1)(j) of the Electricity Act, 2003.


selected to aid the corporation in building and running the ambitious largest invested plant in India. The Dabhol project is one of those exposed corruption laid projects that showed the stiff resistance of Indian political parties against the issue of privatization and globalization. Even bureaucrats and technocrats failed to stand as whistle blowers to the impending damages that would harm the environment and safety of the people and stepped aside in the name of minor techno-economic clearance. The Enron funded Dabhol Power Project, was stalled owing to glitches that was found in the Contract. It was found by the Munde Committee that there was a lack of transparency and accountability and far less attribution to environmental concerns & issues and was marred by the absence of competitive bids. As a result, Enron decided to pull out its operations and slammed India at international level arbitration for violating the terms of contract and non-payment of its dues.21

Yet another tainted and controversial private venture in electricity sector is the Power Purchase Agreement (PPA) between Karnataka Electricity Board and Cogentrix for the generation of 1000 MW of electricity at Mangalore. This venture was furthered by the 1991 policy and like the Dabhol venture was covered by Sovereign Guarantee. The Cogentrix Project too, was marred by the absence of a competitive bidding process and the contract adopted a cost-plus approach in its place. The Agreement conferred numerous benefits, *inter alia*, immunity from the power of the Electricity Board to order for closure. By way of a Memorandum of Understanding, the State of Karnataka had decided to entrust implementation of the Project to Cogentrix for generation of power at Bangalore and Mangalore. The State had agreed to assist Cogentrix in implementation and approval, and to make available all reasonable requirements of permits, licences or other forms of approvals of the Government as may be found necessary from time to time for the development, construction and operation of the project. The Electricity Board of the State of Karnataka was to transfer to Cogentrix upon request, all permits, licences, consents and approvals previously obtained by the State, the Government of Karnataka and all its appurtenants, agencies, instrumentalities and departments with respect to the

21 *Infra* note 43.
Project. Upon completion of the envisaged activities, Cogentrix was to prepare a report covering financial structure and projections, project completion and operational schedule and the proposed tariff agreement. The MoU however, did not contemplate the execution of PPA with Cogentrix, yet there was a Power Purchase Agreement entered into that imposed power purchase obligations upon the State at the tariff rates specified under the PPA, thereby casting burden upon the end consumer.22

The Electricity Act 2003 provides for the following utilities, all of which may be carried out by private participation:

- Generating Companies: They are basically of two classes,23 based on the nature of power they generate, viz. Hydro-electric generating station and other than Hydro-electric generating station. The generating company is cast with a duty to establish, operate and maintain generating stations, tielines, sub-stations and dedicated transmission lines connected therewith in accordance to the Act.24 There is no requirement of licensing to carry out the activity of generation of electricity. Further, under the Act open access is granted to all generating companies for transmission or distribution of electricity upon application accordingly. A generating Company is authorised to sell electricity to any licensee(viz. a Transmission Licensee, a Distribution Licensee or an Electricity Trader.)

- Captive Generating Plants: The Act supports captive generation of electricity by mandating open access to every person who has constructed and maintains and operates a captive generating plant for the purposes of carrying electricity from its captive plant to the destination of its use.25

- Transmission: The Act allows for the grant of a license to enable a person to undertake transmission of electricity. Central Transmission Utility and State Transmission Utility assist in inter-state and intra-state transmission respectively.

22 Arun Kumar Agrawal And Another v State Of Karnataka, 1999 (1) KarLJ 603.
23 Section 8 and Section 7 of the Electricity Act, 2003.
Distribution: The Act creates a license regime so as to enable a person to undertake the distribution of electricity. Distribution is the activity that involves the process of provision of electricity to the ultimate consumers in the area of supply.

Trading in Electricity: The Act further introduces the concept of trading of electricity that allows a licensee to carry out the purchase and sale of electricity. This mechanism allows for the transfer of surplus electricity to the deficit areas and thereby attaining self-sufficiency and profitability.

**Power Purchase Agreements**

A Power Purchase Agreement (PPA) is a technical and industry-specific agreement that deals with the procurement or purchase of power/electricity. In today’s world, electricity generating assets need ample financing for adequate and efficient output. In India CERC is the regulatory authority for the regulation of PPAs that is built on similar lines to its American counter-part, Federal Energy Regulatory Commission (FERC). A PPA is a hybrid between Bulk Off-take Agreement and a Concession Agreement. The PPA would provide for the following clauses that deal with the role and responsibility of the parties, *inter alia*, as to Off-take obligation; Indemnity; Force Majeure; Insurance; Regulation of the facility, etc. The basic reason for a PPA may be said to be the need to have an industry-specific agreement that amply conveys, *inter-alia*, the technical obligations of the parties. A PPA can be characterised as a core document that facilitates the establishment of a framework that governs the implementation of the project in relation to the Power Sector. A typical PPA seeks to cover the following two core issues, *viz.* the framework for the construction, operation and maintenance of the power station; and the contractual obligation as to the sale and purchase of electricity. It may thus be said to be the bedrock of fundamental obligations on the basis of which the project is sought to be implemented.

---


27 *Supra* note 7, p-335.
The need for a PPA form of contractual framework for the implementation of the private participation in sale of Electricity is to counter-balance the lacunae that the law possesses. The law, however comprehensive it may be, cannot be exhaustive in itself due to the various implicative terms used in the provisions. By entering into specific contractual terms in the PPA that clearly and precisely enlist the obligations of the parties, there is a sense of security and certainty that can be achieved, which, but for the PPA, would depend upon the judicial foreplay at the time of interpretation of such transactions. However, there are manifold benefits that ensue upon entering into a PPA, which may be elucidated hereunder:

- **Financial Guarantee**: The projected revenues of the project would otherwise be uncertain and so some guarantee as to quantities purchased and price paid are required to make the project viable;

- **Protection from competition**: There is a possibility of competition from cheaper or subsidized domestic or international competition (e.g., where a neighbouring power plant is producing cheaper power) - the PPA provides some certainty of being protected from the same;

- **To legally facilitate an agreement**: A government utility may be purchasing the power generated by a power plant. The government will want to understand how much it will be paying for its power and that it has the first call on that power. A PPA will therefore substantiate such information.

**Pre-Operational Obligations:**

The parties to a PPA owe certain obligations to each other prior to the operation of the project. Obligations that arise during pre-operating times are mainly procedural. They intend to boost the project into action by clearing requisite policies. Such pre-operational obligations are determined either through a Letter of Intent or by means of the PPA itself. Depending on the nature of the project, various obligations arise under a PPA. The World Bank's PPP in Infrastructure
Resource Center for Contracts, Laws and Regulations some of the obligations that arise during the developmental stages have been enlisted below:

(a) Application for requisite clearances and consents:

It is the duty of the company to acquire and maintain all clearances and principal consents required by any Public Sector Entities that have jurisdiction over the Company in order to enable it to perform its obligations.

(b) Submission of Financial Documents:

A mandatory prerequisite for the private company is to submit essential and important documents to the grantor. These documents include Implementation Agreements, document of plans and specifications, copies of all Consents and other governmental authorizations etc.

(c) Due diligence:

Due diligence is an investigation of a business or person prior to signing a contract. The investigation is a pre-emptive measure in order to evaluate the credentials of the parties involved. The parties on a set date exchange various documents (E.g. Financial statements). The parties are therefore given a chance to verify each other’s financial conditions.

(d) Establishment of Operating Procedures:

The Company and grantor jointly develop written operating procedures for the Complex. Such operating procedures shall be based on the designs of the Complex and facilities inside it. These procedures are required to be consistent with the Minimum Functional Specifications.

In most cases, no liability arises from non-achievement of a obligation. That being said, if the obligation is critical and its breach would delay or terminate a project, a claim for this breach would arise.

Post-Operation Obligations

Post-operation Obligations arise once a project is operational for an extended period of time. They are intended to ensure the smooth flow of the project and also enable the parties to a few rights relating to the project. These rights are again to ensure the proper development and functioning. A few of the obligations given below have been derived from *The World Bank’s PPP in Infrastructure Resource Center for Contracts, Laws and Regulations*:

(a) **Energy Supply:**

Upon the Company’s request, the grantor (being the state) provides energy for construction, testing, Commissioning, Start-Ups and Emergencies etc in order to facilitate the functioning. The Company pays for such energy in accordance with the prevailing tariff rate for industrial facilities.

(b) **Inspection:**

Representatives of the grantor are given the right to observe the progress of the construction of the Complex and the testing and Commissioning of the Complex. The Company shall comply with all reasonable requests of Utility for, and assist in arranging, any such observation visits to the Complex.

(c) **Access to site:**

The Company is given reasonable access to any lands owned by Utility that are necessary for designing, financing, constructing, operating and maintaining the Complex. This right however is subject to conditions.

(d) **Agreements in respect of the complex:**

Various obligations arise with regards to the complex and are expressly mentioned. A few examples of are:

i. Designing, financing, constructing, owning, operating and maintaining the Complex in accordance with the Agreement and also the Minimum Functional Specifications by the company.
ii. Construction is to be done in a good and workman like manner. Only materials and equipment that are new, utility grade and suitable should be used.

iii. The Company is expected to maintain the site in a clean and presentable manner.

(e) **Record Keeping:**

The company maintains pertinent project accounts and records all project transactions. All grant proceeds are fully disclosed. The accounts and records are required to be maintained using an appropriate accounting system.

**Tariff Pricing**

The main obligation of the buyer under the PPA is to pay the agreed tariff when due. The PPAs have to base the tariff price on the basis of a competitive bidding process, as for the reason that it would bring about transparency and public confidence in the project. Further, the Electricity Act 2003 vests the power to determine tariff with the electricity regulatory commissions. The Generating companies and licensees are mandated to make an application to the relevant commissions for determination of tariff. Such an application is to be determined by way of a tariff order accepting the application with suitable modification as to the tariff value. Such an application may be rejected only if the same is not made in accordance with the provisions of the Act. However, no such application may be rejected unless the reasons for rejection are stated in writing.

**Dispute Settlement Process**

Prior to 2003, there was no effective dispute settlement mechanism. Consequential to the lack of an effective domestic mechanism was the failure of the resolution of the Cogentrix Project. The Dabhol Project due to the

---

30 See Section 62 of Electricity Act, 2003. However in accordance with Section 63, the Commission may also determine the tariff by means of transparent bidding process.

31 See Section 64 of the Electricity Act, 2003.
intervention of International Chamber of Commerce met its daylight, although causing international embarrassment to India.\textsuperscript{32} The Dabhol and the Cogentrix Projects have been tough lessons that taught India the need for an effective regulatory and compliance regime for the Electricity Sector, thus leading to the promulgation of the Electricity Act, 2003.

**Regulatory Commissions: as an Adjudicatory Body**

The Electricity Act 2003 has established Central Electricity Regulatory Commission (CERC) and the State Electricity Regulatory Commission (SERC) in each State. They are statutory bodies that have quasi-judicial powers to adjudicate upon disputes that relate to generation, transmission and distribution of electricity. The CERC has the power to adjudicate upon disputes involving generating companies or transmission licensees with regard to Regulation of Tariff and the sale of electricity in more than one State; Inter-state Transmission of Electricity; Determination of Tariff for Inter-state Transmission of Electricity and Issue of Licenses for transmission and trading of electricity for operation between states. The powers of the SERC are restricted to intra-state generation, supply, transmission, trade and wheeling of Electricity. Both the regulatory commissions have the power, \textit{inter alia}, to refer any dispute for arbitration.

**Avoidance of PPA**

Impossibility of performance, subsequent or supervening in nature, may arise due to changed circumstances or any occurrence of certain unforeseen events that would make the performance of the contractual obligation frustrated. In such a circumstance either of the party may seek to avoid the Contract. For instance, Impracticability is a recognized defense in California when fulfilment of the contractual obligations by a party may become too costly or challenging.\textsuperscript{33} However, mere increase in the costs and a heavier burden in performing the obligation do not always excuse a performance as impracticable.\textsuperscript{34} Such a

\textsuperscript{32} See, \textit{Infra} Note 43.
\textsuperscript{34} ibid.
relief is granted by the court when it finds that the basis of the contract was frustrated by the intrusion or occurrence of the unforeseen event or change in circumstances beyond the control of either party. Such avoidance or discharge is not available where the contract makes full and complete provision, so intended, for a given contingency. The occurrence of the impossibility must be of the kind that was not within the contemplation of the parties at the time of vetting of the contract.

In a matter before the CERC, where an application under Section 79 of the Electricity Act 2003 was made for the revision of the tariff price set-forth in the PPA between Adani Power and Gujarat Urja Vikas Nigam Limited, it was dealt in detail as to whether there would be a frustration of the PPA if the changed circumstances are induced by a change in law in Indonesia. Adani Power had agreed to supply electricity to Gujarat Nigam and certain State Utilities in Haryana. The former had made provisions for procurement of fuel, viz. Coal at reasonable price rate, from Indonesia due to issues in procuring fuel from domestic sources.

In 2010, the Indonesian Government issued a set of regulations stipulating that holders of mining permits in Indonesia would be permitted to sell coal only at benchmark prices accepted in the international markets and any sale of coal at a price less than the benchmark price would lead to the cancellation of the mining license. These Indonesian regulations had a significant impact on export prices of coal from Indonesia, which were higher than the contracted prices, due to which it became unviable for Adani Power to supply power at agreed prices to the state utilities in Gujarat and Haryana. Adani Power approached the CERC for a revision of the Tariff rates on account of changed circumstances; the performance of the obligations had become impracticable.

35 Satyabrata Ghosh v Mugneeram Bangur & Co. AIR 1954 SC 44.
and therefore the contract is to be held to be frustrated. However, the CERC refused to hold that the Contract was frustrated for the reason that a mere rise in price of a commodity does not result in impossibility of performance, and further held that the force majeure clause was not attracted on the basis that the ‘change in law’ as contemplated in the PPA referred to the change in the law regulating the PPA, viz. Indian Law. But however, the CERC allowed for the revision of tariff by providing for what it called a Compensatory Tariff, so as to counter balance the effect of increased price of coal imports. The CERC took this approach on the ground that if the parties were to resort to the process of competitive bidding it would bring uncertainty to the power sector and would be prone to misuse.

Avoidance of PPAs, by nature and Infrastructure Contract, would cause great hardship to the public, the premise on which the decision of CERC is commendable. Further, escalation of prices on account of Indonesian Regulation and non-availability of adequate fuel linkage from Domestic sources was correctly regarded as a temporary phenomenon that was likely to be stabilized over time. Therefore, the CERC ordered in the *Adani Case* that the Petitioner needs to be compensated for the intervening period. And as and when the hardship is removed or lessened, the compensatory tariff would be revised or withdrawn. It was observed by the Commission that the same was the most pragmatic way to make PPAs workable while ensuring supply of power to the consumers at competitive rates.

The matter is now pending before the Appellate Tribunal for Electricity, wherein the Supreme Court by an order dated 31st March 2015 has allowed Adani Power to raise the argument of change in International Law to defend the compensatory tariff allowed by CERC.38

*Arbitration in the Power Sector:*-

The decision to use arbitration to resolve infrastructure project disputes frequently is not an easy one, however. Infrastructure projects typically

involve several different types of contracts, and arbitration may not always be the preferred means of dispute resolution for each of those types of contract and therefore there are certain non-adjudicative processes that are preferred over arbitration. However, the potential advantage in Arbitration is that Infrastructure project disputes often involve technical subject matter that is more suitable for resolution by an arbitrator hand-picked by the parties for his or her specialized competence than by a national court judge or jury with little or no prior knowledge or experience in the field. The arbitrator’s specialized competence may enhance not only the quality of decision-making but also the efficiency with which the proceedings are conducted. Further, the confidentiality and relative informality of arbitral procedures (which may include site visits), as well as the flexibility arbitrators have in fashioning appropriate remedies in arbitration, may be better suited to preserve the long-term relationships established in connection with infrastructure projects.

In a Power Purchase Agreement between the Dabhol Power Corporation (DPC – owned by Enron, Bechtel, and General Electric) and the Maharashtra State Electricity Board (MSEB), the MSEB agreed to buy 90% of the power generated by the project regardless of market demand for electricity and at a cost well above that of other available energy sources. Public opposition to the Dabhol project was a major factor in the Maharashtra state election in 1995, which led to the election of a coalition government that was committed to the object of cancelling the project. The public outrage was due to the reasons, *inter alia*, that Enron’s proposal did not undergo a standard competitive bidding process in India. In response to the Government of Maharashtra’s step to cancel the project, Enron initiated arbitration in London under the dispute settlement clause of the PPA between the Dabhol Power Corporation (DPC) and the

---


MSEB, whereas the Indian Entity continued action in the domestic courts in India. The litigation ended when Enron and the Maharashtra Government agreed in 1995 to renegotiate the deal. The renegotiation led to modest changes in the size, tariffs, payment terms, environmental monitoring, and ownership of the project.42 Alleging a breach of the PPA by DPC, the Maharashtra Government ceased its payments to DPC, and the Indian Government, the counter-guarantor to MSEB also refused to make payments citing the existence of a contractual dispute. This led to a legal turmoil and battle between the parties to the PPA, as in first instance, the dispute under the PPA was referred by the DPC to arbitration in London (and by the MSEB to Indian courts). Secondly, Bechtel, a co-owner of the DPC, referred a claim under the DPC Shareholders Agreement to the International Chamber of Commerce (ICC) Arbitration in New York.43 There were in total four Arbitration matters that were filed in respect of the Dabhol Issue.

However, it is a matter of serious introspection that these Arbitration Tribunals did not purport to act as a forum of technical adjudicatory bodies, albeit, acted as a forum that enforced a broader review mechanism for policy choices of MSEB. The ICC assumed Jurisdiction for interpretation of the PPA, essentially an agreement between DPC and MSEB, neither of whom were parties to the Shareholders Agreement. In a claim against India, in respect of the Dabhol Project, India was required to pay about $110 million to Enron, Bechtel, General Electric, and Bank of America in risk insurance.44

The regulatory changes that have been brought forth by the Electricity Act 2003, whereby the respective commissions are given the power to regulate the tariff rates, and with the approach of the CERC in respect of Adani Power and

42 ibid.


*Tata Power,* it is quite commendable that the commission takes up the matter presented before it on the basis of commercial principles and not on the basis of economically or politically inspired objectives.

**CONCLUSION**

A PPA is a *sui generis* agreement that meets the requisite needs of the Power Sector. The interpretation of the same is of utmost importance as it can be seen from the DPC and other cases dealt herewith that the agreement involves within its ambit the policy and decision making of the government. Therefore it would be of pedestal importance that the scopes of *kompetenz-kompetenz*\(^{45}\) and Force Majeure, that are mostly inevitable, are drafted with close scrutiny so as to avoid sheer embarrassment and jeopardy. It is to be ensured that the pricing of procurement is to be determined by a Competitive Bidding Process, so as to avoid a yet another Dabhol or Cogentrix Fiasco. The adoption of a transparent process would not only yield in favour of the PPA, public confidence, but would also ensure that the burden of increased costs of power is not transferred indiscriminately unto the Consumer.

---

\(^{45}\) A Clause in a Contract that specifies as to which Forum shall be competent to adjudicate on disputes arising out of or in relation to the relevant contract.
CONTRACTUAL ASPECTS OF JOINT VENTURE AGREEMENTS

Surbhi Shah* and Aniruddha Majumdar**

ABSTRACT

Joint Venture agreements come under the ambit of multiple areas of law. This article brings to light the various aspects of Joint Ventures with the objective of making the concept more concrete and less vague. Joint Ventures have been defined with the help of analysis of case laws and statutes. A brief history of Joint Ventures in India has been given around the liberalisation period in India. JV’s have also been compared to Partnerships. The authors have elaborated on the types of Joint Venture agreements, the significance of shareholders’ agreements and the formation of Joint Ventures before amalgamations and mergers. The different clauses in JV’s have been studied along with the US, UK and Indian positions as found in judicial pronouncements. Lastly, case studies of Mahindra & Mahindra, LML & Piaggio, Kawasaki Bajaj, Hero Honda, Air Asia – Tata and the Joint Ventures in the insurance sector have been undertaken.

INTRODUCTION

In today’s continually evolving and fast-paced age of technology where traditional barriers are dissolved in the expansion of business endeavours, the need and importance of Joint Ventures has never been more pronounced. In an increasingly globalized world, corporate bodies feel the acute desire to achieve growth and progress that is at par with their competitors’ world-over. It is in such a scenario that Joint Ventures assume prominence in equipping Companies with opportunities to acquire access to greater resources and capital. Not only this, new capacities lead to higher economies of scale which subsequently facilitate cheaper and more productive methods of business - be it attaining goals, sharing of risks or reaching higher levels of efficiency.

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.

**Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
In this article, the authors have attempted to address certain vital questions within the vast arena of Joint Ventures. Firstly, the meaning, scope and need of Joint Ventures as a business model have been dealt with. The various rights and duties that parties possess with respect to each other have been addressed by highlighting relevant judicial pronouncements. Next, in light of the striking similarities which exist between the nature of a Joint Venture and a Partnership firm, certain subtle distinctions that exist between the two have been drawn. The authors have then delved into the various types of Joint Venture contracts that can be classified in multiple ways based on the objectives they intend to fulfil or on the forms they take while distributing rights and liabilities among the partners.

In order to lend specificity to their form, Joint Venture contracts contain various clauses that are usually drafted to suit the requirements and the objectives sought to be achieved. Invariably, however, there are certain fixed clauses that are present in every contract which have been described briefly. Further, the authors have analysed the various judicial pronouncements in Indian and foreign Courts that have addressed important contractual issues-such as the problem of non-compete clauses or the lifting of the “Corporate Veil”- that often arise between parties to a Joint Venture. Lastly, this research article elucidates case studies of various Joint Ventures in order to probe into the reasons for the success and failures of Joint Ventures.

**DEFINING JOINT VENTURES: RIGHTS AND DUTIES**

*New Horizons Ltd. v Union of India*¹ is considered to be the most authoritative judgment in India which laid down the requisites of Joint Ventures along with the rights and duties of parties to fill the void of legislations. The Supreme Courts took into account the US position and relied on Black’s Law Dictionary in order to define such ventures. Joint Ventures were thus held to be legal entities in the nature of Partnerships whose aim is mutual profit through a pool of

---

¹ *New Horizons Ltd. v Union of India*, (1995) 1 SCC 478 (Supreme Court of India). [“New Horizons”]
shared assets and liabilities including risk. Further, they must have community of interest in the subject-matter of the Joint Venture and a right to govern policies and methods of working enjoyed by both parties.

In addition to these, there are some other duties which have been ascertained in the United Kingdom and the US. One such duty is the duty to act in good faith at all times in the course of action relating to the venture. Such a duty might be expressly laid down in a contract or can be implied.²

A non-compete clause is one way in which the duty of good faith is enforced. A non-compete clause makes sure that parties do not undertake activities which lead to a conflict of interest between the individual and the venture.³ In cases of such conflict, the parties may direct their resources into the competing business which would be harmful for the Joint Venture and hence, would go against the duty of good faith. Such a clause can, however, be made flexible keeping in mind the nature of businesses of the Joint Venture and the competing firm so as not to hinder the interests of either.⁴ This could be done by specifying the period for which such non-compete clauses will be in force.

Apart from duties owed by members to other members, a Joint Venture, as an undertaking is responsible to third parties as well. Ventures may or may not result in the incorporation of firms and in the event of the latter the parties to such agreements might hold themselves liable only to each other under the terms of the agreement. However, it has been held that irrespective of incorporation, the agreement must include a clause which makes members jointly and severally liable for all transactions.⁵ Third parties who make transactions with Joint Ventures do so keeping in mind the joint entity and not individuals. Such a clause would protect the rights of third parties in case the terms of the contract only hold a single member liable for specific transactions.

---

³ Seth Dua and Associates, Joint Ventures and Mergers and Acquisitions in India: Legal and Tax Aspects (110, 1st edn., 2011).
⁴ ibid.
⁵ Asia Foundations & Constructions Ltd. v State of Gujarat, AIR 1986 Guj 185 (Gujarat High Court). ["Asia Foundations"].
HISTORY OF JOINT VENTURES

The history of Joint Venture agreements can be difficult to pinpoint. The reason behind this difficulty can be attributed to the variety of ways that such agreements are executed in. Pooling of resources, for instance, which is one of the most characteristic feature of Joint Ventures, is a strategy that merchants from time immemorial have put into use. Now, one can neither overlook these kinds of business agreements nor can one seek to trace them. On Indian soil, however, the term ‘Joint Ventures’ is popularly associated with collaborations between foreign companies and native ones. The most well-known is the Maruti Suzuki Joint Venture which is also one of the earliest of its kind. Entered into in 1982, it is among the most successful Joint Ventures in India’s corporate history.6

The 80’s was a period when up to 49% Foreign Investment was allowed in the automotive sector and foreign entrants were keen on cashing in on the opportunity. In a bid to enter the Indian market, they entered into Joint Venture agreements with local companies, the latter providing ready infrastructure for assembly and sales. This made the experiment in the Indian market much easier for the foreign entrants on one hand, and equipped the local companies with cutting edge technology at their doorstep. Soon, it became a trend to enter into Joint Ventures as an easy method of acquiring much-required capital, technology and market experience.

JOINT VENTURES VIS-À-VIS PARTNERSHIPS

One might notice the striking similarity between rights and duties of the members of a Joint Venture and those of partners in a Partnership firm. Rather, at first sight, there appears to be no distinction between the two. The Supreme Courts in New Horizons Ltd. v Union of India7 held Joint Ventures to be “in the nature of” Partnerships. Nevertheless, this must not be taken to mean that

---

there is no distinction between the two. In other cases, Courts have refused to treat them at par with each other describing Joint Ventures as a different breed of agreement and having been entered into with a view to earning profits without any express agreement on a Partnership.

The most significant difference between the two, the Gujarat High Court held in *Asia Foundations & Constructions Ltd. v State of Gujarat,*[^8] is that limited Partnerships are limited by liability and Joint Ventures are limited by scope and time. What must be observed is that the same opinion is countered right away by Section 8 of the Indian Partnership Act which defines “particular partnerships” and pertains to partnerships entered into for specific transactions.[^9] Therefore, partnerships can also be for specific and limited purposes, although such practices are not so common.

What, then, is the difference between a partnership and a Joint Venture? Is it perhaps the fact that partnerships can be entered into only by natural persons while both natural persons and legal persons can be parties to Joint Ventures? The Indian Partnership Act does not specify whether “person”, according to the Act, is a natural person or otherwise. This dilemma is solved by Section 3(42) of the General Clauses Act, 1897 which states that companies, associations and bodies of persons can come under the purview of “person” whether they have been incorporated or not.[^10] This definition is, nonetheless, subject to the condition that it must not be in contravention with anything contained in the legislation in question.[^11] The same was taken up in *Dulichand Laxminarayan v CIT*,[^12] which took into account the English position and held that a firm is merely a name under which several persons enter into agreements and make transactions. Therefore, for the purposes of partnerships, firms cannot be held to be “persons”. We thus come to at least one major difference between Joint

[^9]: Sec. 8, Indian Partnership Act, 1932.
[^10]: Section 3(42), General Clauses Act, 1897.
[^11]: Section 3, General Clauses Act, 1897.
[^12]: *Dulichand Laxminarayan v CIT*, AIR 1956 SC 354 (Supreme Court of India).
Ventures and partnership i.e., partnerships must be entered into only by natural persons while there is no such condition for Joint Ventures.  

Another argument is that partnerships, being backed by a full-fledged legislation, are largely governed by the statutes of law. On the other hand, the conditions, rights and duties of parties to a Joint Venture are decided by individual agreements and judicial pronouncements because of the absence of relevant legislation.

Both Partnerships as well as Joint Ventures have a connotation of mutual sharing of resources. Only when we look at trends in business do the differences come into light. For instance, a Partnership will usually involve the creation of a new firm which is meant to carry on business for a long term, if not indefinitely. Particular Partnerships are few in number. Joint Ventures, in contrast, are usually specific when it comes to their objectives. They may be for a single project, for technology sharing and have even been known to be used as ‘testing waters’ for foreign Companies looking for business opportunities.

**Types of Joint Venture Contracts**

It is acknowledged that there is a distinct variety in the motives for formation of Joint Venture contracts from financing projects, sharing of technology or lending brand name, to risk mitigation and expanding of marketing reach. In order to fulfil these diverse objectives, Joint Ventures have developed in various forms and can be broadly classified into incorporated and unincorporated Joint Ventures.

When parties to a Joint Venture make decisions to assign a separate identity and an independent legal existence to the Joint Venture, which is distinct from

---

13 A Limited Liability Partnership is an exception, as it is governed by the Limited Liability Partnership Act, 2008 and has been dealt with in later sections.

14 *Gupprel-Mee (J.V.) v Government of Andhra Pradesh*, 2005 (5) ALD 450 (Andhra Pradesh High Court).

the identities of the parties forming it, they may opt for the incorporated form of Joint Venture. Depending upon the requirement, it may be in the form of a public or a private limited company.\textsuperscript{16}

Parties may decide to constitute a company under the Companies Act, 1956 and hold the shares of such a company in a pre-decided proportion. This would be termed as a Corporate or an Equity Joint Venture. Instead of this arrangement, a partner in a Joint Venture could obtain the shares of the Company already existing, or transfer technology or business to the Company that has been newly incorporated in exchange for shares. Subsequent to this, the Memorandum of Understanding and the Articles of Association of the existing Company would be amended to incorporate the Joint Venture.\textsuperscript{17}

Acquiring of shares is usually a practice when the Joint Venture’s proposed activities are long-standing in nature—such as manufacturing goods, supplying raw materials and sharing of technology.\textsuperscript{18}

An unincorporated Joint Venture on the other hand, is suitable for partners who wish to further a common purpose or action for a profitable venture only for a fixed period or for a particular purpose. This type of Joint Venture may be in the form of a co-operation agreement that is purely contractual or a strategic alliance where parties are not shareholders in a Company, but independent contractors who collaborate by retaining ownership of their assets and liabilities. They agree to clearly demarcated rights and obligations.\textsuperscript{19} Contractual Joint Ventures provide companies an opportunity to establish a geographical presence that is \textit{de facto} in a new market and obtaining a greater market share. Examples of these would include technology transfer agreements, joint development of products, or distribution agreements. A consortium agreement that financing participants

\textsuperscript{16} Dua (n 3) 15.
\textsuperscript{19} Nishith (n 17).
enter into with a construction Company for obtaining an infrastructure project through a bidding process is also a contractual Joint Venture. 20

Often, in cases of contractual Joint Ventures, structuring concerns arise where parties fear that their actions do not result in being, in fact, a partnership. 21 In cases where parties intend to form partnerships, proceeds are shared in an agreed ratio and it is governed by the Indian Partnership Act, 1932. The liability of the partners in this case is unlimited and they are jointly as well as severally liable for the debts of the JV. 22

Unlimited liability, however, can be avoided by entering into a Limited Liability Partnership which was introduced in India by the Limited Liability Partnership Act, 2008. An LLP combines the benefits of a partnership as well as a company by limiting the liability of members and allowing them the opportunity of a flexible internal structuring, akin to a partnership agreement while simultaneously ensuring a separate legal entity capable of owning property and remaining unaffected by death, or a change in membership and thereby making it a stable organization. 23 An LLP not only maintains confidentiality but also ensures ease of registration. The LLP Act allows partnerships to not only individuals but also corporate bodies to enter into partnerships.

In spite of the LLP Act having mended several defects of the earlier partnership act, it is seen that parties are still reluctant to adopt a new legal form unless there is enough clarity and wide prevalence. Also, an LLP is not able to issue shares to the public as it would first have to be made into a company which might pose regulatory hurdles. 24

**Technical Joint Ventures**

With advances in technology taking place in leaps and bounds, a technical or tech-share Joint Venture allows parties to take advantage of the latest technical

---

20 Dua (n 3) 15.
21 Kothari (n 15).
22 Nishith (n 17).
24 ibid.
information available with each other. Parties to a Joint Venture of this nature mutually agree on rights, duties and obligations along with the duration of the contract, among themselves to form a contract that is binding on the parties, the breach of which will permit the other party to solicit legal recourse against the defaulter. Even though the agreement does not give birth to a corporate vehicle, parties are entitled, on a contractual basis to enforce claims pertaining to rights and liabilities because of their co-participants’ acts.25

Based upon the terms of the contract, shared technology could include technical and business knowledge, trade secrets, confidential information, product formula, designs, patterns or processes. When the venturers are involved in similar lines of business, technical Joint Ventures prove to be especially useful as parties are able to derive the benefits of synergy in an exchange of complementary knowledge, expertise and resources.26 Additionally, it is found that the high prohibitive costs and the risks involved in going solo is the most important reason prompting businesses to enter into technical partnerships.27

There are many ways in which parties who enter into a technical Joint Venture are significantly advantaged over those who choose technical licensing.

Unlike in the latter case, where the third party licenses the technology, parties to a Joint Venture find themselves in a position through which they can exercise a greater control at all times over proprietary, confidential information. In accordance with the terms of the Joint Venture, the parties are entitled to share benefits of the said technology, either by way of share in profits, or a fee or a royalty.28 However, a technology licensing agreement enables speedy entry into foreign markets and poses fewer legal and financial risks than being party to a Joint Venture does. Licensing also allows the overcoming of many of the tariff and non-tariff barriers that frequently hinder the export of products.29

25 Dua (n 3) 21.
27 Dua (n 3) 21.
28 ibid.
SHAREHOLDER’S AGREEMENT

Meaning

A shareholder’s agreement is a limited purpose agreement i.e. a contract, between the shareholders of a company which, among other things, describes the complex relationships between the shareholders themselves and between the shareholders and the company. It lays down the rights and duties that holding a specific proportion of shares in a company entail and describes the restrictions on the transferring of shares to third parties.30

Shareholders’ agreements have important, practical uses that are relevant while entering into Joint Ventures. The aspect relating to shareholders falls under the ambit of the joint venture agreement and no separate shareholders’ agreements needs to be executed. Thus, a shareholders’ agreement has a narrower scope than that of a Joint Venture agreement. Thus the thin line between shareholders’ agreement and the Joint Venture agreement is made evident. The two become substitutes for each other when there is typically no “Joint Venture” between the parties, but there is an arrangement between the parties to hold the shares of a company in an agreed proportion, and exercise the rights and obligations attached thereto in an agreed manner.31

In instances where parties do not want to participate in managing the affairs of the company, but are only interested in holding shares with profit as a motive, shareholders’ agreements may be entered into. This may also be done in cases of venture capital funding where the investor enter into shareholders’ agreements with other venture capitalists to invest start-up capital through the holding of shares in a specific manner and for a specific time with or without participation in the management of the company.32

30 Dua (n 3) 132.
31 Dua (n 3) 132.
Members of private companies are usually parties to shareholders’ agreements, since public companies have large memberships that render such agreements impractical. Additionally, shareholders of public companies have the freedom to transfer shares readily on the market- a benefit that members of private companies do not possess. Persons acquiring shares in a private company will be inclined to obtain special protections and rights to safeguard their position since they are not covered by the investor protection guidelines issued by SEBI like in the case of public companies.33

**Enforceability of Shareholders’ Agreements**

The enforceability of shareholders’ agreements raises a couple of important issues- firstly, whether shareholders’ agreements are enforceable as a means of regulation of the rights and obligations of shareholders among themselves and secondly, whether shareholders’ agreements are enforceable against the company.34

There have been significant variations in judicial decisions on the above questions. The Supreme Court in *V.B. Rangaraj v V.B. Gopalakrishnan*, also applicable to public companies, held that “a restriction which is not specified in the articles of association is not binding either on the Company or on the shareholders.”35 This decision of the courts is in direct contravention of the landmark English case of *Russel v Northern Bank Development Corp.*,36 that lays down the well-established principle of law that shareholders’ agreements (such as those determining who to give voting rights to) although unenforceable against the company, must be capable of being enforced among shareholders themselves. If breached, obligations must be imposed on the shareholders to either carry out specific performance or pay damages.

---

33 Graham Stedman and Janet Jones, *Shareholders’ Agreements* (3rd edn, 2001) 1; Dua (n 3) 132.
34 ibid 59.
35 AIR 1964 Ori 72.
The court was of the opinion that shareholders should be validly entitled to enter into agreements with respect to regulation of relationships among themselves with regard to the control and management of the Company and these agreements should be enforceable as personal agreements inter-se since in no way do they “fetter the Company in the exercise of its statutory powers”\(^{37}\). Lord Davey’s judgement in *Welton v Saffery*\(^{38}\) was relied upon to a large extent:

> “Of course, individual shareholders may deal with their own interests by contract in such way as they may think fit. But such contracts, whether made by all or only some of the shareholders, would create personal obligations, or an exceptio personalis against themselves only, and would not become a regulation of the Company, or be binding on the transferees of the parties to it, or upon any new or non-assenting shareholders.”

Although the Rangaraj judgement has been criticized as bringing havoc and confusion in the commercial world because loan agreements, bonds or stocks and other corporate financing documents often bring about restrictions on shareholders’ rights inspite of such a restriction being absent from the Articles,\(^{39}\) it remains the correct position of law. Justice P.B. Sawant, explicitly stated that if the Articles of Association are not amended to bring them in conformity with the said agreement, they would be binding on neither the shareholders nor the company.\(^{40}\)

However, the Supreme Courts in its 2003 judgement in the case of *M.S. Madhusoodhanan v Kerala Kaumudi Pvt. Ltd.*\(^{41}\) distinguished itself from what was pronounced in V.B. Rangaraj and held that restrictions “in relation to identified members on identified shares of a private Company did not amount to restriction of transferability of shares perse.”

---

\(^{37}\) ibid.

\(^{38}\) [1897] AC 324.


\(^{40}\) AIR 1964 Ori 72.

\(^{41}\) (2004) 9 SCC 204.
In *Western Maharashtra Development Corporation Ltd. v Bajaj Auto Ltd.*,\(^{42}\) it was held that clauses that restrict the free transferability of shares are in violation of Section 111A of the Companies Act, 1956 and hence, are not enforceable.

However, this judgement was overruled by the Division Bench of the Bombay High Court in *Messer Holdings Limited v Shyam Madanmohan Ruia and Ors*\(^{43}\) and it was held that private arrangements in relation to shares are not violative of Section 111A of the Act. The term “transferability” was interpreted liberally and Section 111A was held not to be a law that dealt with the rights of shareholders or expressly restricted the right of shareholders or deprived them of being able to enter into agreements that are consensual by way of a pledge or pre-emption or otherwise.

In *Rolta India Ltd. & Another v Venire Industries Ltd. & Others*,\(^{44}\) the Bombay High Court held that a shareholders’ agreement that curtailed directors’ rights if not mentioned in the Articles of Association would be unenforceable because directors’ fiduciary rights and duties cannot be infringed upon by shareholders. The directors too cannot contradict the Articles by agreeing among themselves. Amendment of the Articles of Association or removal of directors is the only way by which shareholders can dictate terms to directors.

Since it is the principles of contract law that govern shareholders’ agreements, if the company is not a party to the agreement, it cannot be bound by it. The freedom of the company would remain unfettered even if the company had acknowledged the agreement and acted upon it. On the contrary, if the company is party to the agreement, it would still not be bound by it (contravening the ordinary principles of contract law) as far as it puts “fetters on the management of the affairs of the company” and as far as those provisions have been incorporated into the articles of association.\(^{45}\)

\(^{42}\) (2010) 154 Company Cases 593 (Bom).
\(^{43}\) (2010) 98 CLA 325.
\(^{44}\) (2000) 100 CompCas 19 Bom.
Thus, a provision in an agreement entered into by a shareholder director and proscribed minimum number of directors not to be more than three, could not be enforced against the Company even though there was no violation of the articles because “The agreement cannot be used to supersede the statutory rights given to the Board of Directors to manage the Company.” Even under English law, this is an established rule- in *Walker v London Tramways Co*, the Courts discussed the rights of the Company to amend its constitution and held that:

“….the company is empowered by the statute to alter the regulations contained in its articles from time to time by special resolutions (Sections 50 and 51 [of the Companies Act 1862]); and any regulation or article purporting to deprive the company of this power is invalid on the ground that it is contrary to the statute”.

**Uses of Shareholders’ Agreements**

Inspite of the fact that most provisions shareholders deem necessary can be incorporated in either of the two- Shareholders’ Agreement or the Articles of Association, the former is useful in instances where the Articles of Association cannot be appropriately utilised to include terms that although may bind shareholders, cannot be made binding on the company.

Shareholders’ agreements enable the conferring of rights on shareholders that would otherwise be unenforceable as it would only be contained in the Articles of Association- such as personal rights conferred on shareholders, for example- the right to be a lifetime director, or to be appointed as a professional adviser to the company. Shareholders agreements assist in the regulation of certain special relationships between Joint Venture partners that are not connected with the administration of the company and protect minority rights conferred by the Articles by means of giving them significant veto power over alterations to the Articles.

46 (2000) 100 CompCas 19 Bom.
47 (1879) 12 Ch D 705.
48 Stedman and Jones (n 33) 59.
Shareholders’ agreements impose upon the parties to the agreement additional obligations, and also make it necessary for the company to recognise certain rights and duties it has with respect to the shareholders that it would otherwise not be required to do.50

Additionally, unlike the Articles of Association, the Shareholders’ agreement enables the preserving of confidentiality between the parties because, being a private document, it is not open for public inspection. Shareholders’ agreements also reasonably restrict the free transferability of shares and impose an obligation on the transferring party to give a pre-emptive right to the other Joint Venture partner(s) to purchase the offered shares.51

**JOINT VENTURES IN RELATION TO Mergers and Amalgamations**

Joint Ventures, being co-operation agreements as previously mentioned, are often known to fall within the purview of anti-competitive agreements as given in the Competition Act, 2002 that prohibits all agreements except those that “increase efficiency in production, supply, distribution, storage, acquisition or control of goods or provision of services.”52 This implies that Joint Ventures shall be exempted from being presumed to have an adverse effect on competition if they fulfil the above criteria. Sections 5 and 6 of the Competition Act prohibit combination as-

“No person or enterprise shall enter into a combination which causes or is likely to cause an appreciable adverse effect on competition within the relevant market in India and such a combination shall be void.”

As given in Section 5 of the same act, combinations include acquisitions and mergers or amalgamations. An acquisition or takeover is the purchase by one

50 Dua, (n 3) 136.
51 Dua, (n 3) 136.
52 The Competition Act, 2002, s 3(3).
company of controlling interest in the share capital, of all or substantially all of the assets and/or liabilities, of another company.\textsuperscript{53}

Joint Ventures on the other hand are substantially less risky than acquisitions because, firstly, they can be negotiated upon; secondly, they are co-operative and have greater flexibility and thirdly; they are easier to terminate. They bring two firms that have mutual interests and objectives but different strengths together in order to perform mutually beneficial work. Joint Ventures fall within the scope of Section 5 of the Act as although they may increase efficiency, they are also capable of creating perfect grounds for collusion between competitors and flushing out rivals in the market.\textsuperscript{54}

The term “merger” is not defined under The Companies Act, 1956, The Income Tax Act, 1961 or any other Indian law. A merger is similar to an amalgamation in that it achieves similar benefits such as the accumulation of assets and liabilities of the separate parties, acquiring of newer technology, economies of scale and foraying into newer markets. However, in a merger the assets and liabilities of the merging company are vested in the merged company.\textsuperscript{55}

Not only does the merging company lose its identity but also its shareholders, who become shareholders of the merged company. But in an amalgamation, two or more amalgamating companies lose their identity and emerge to form a new amalgamated company to whom the assets and liabilities as well as the shares are transferred. Unlike an amalgamation, there is no new combined entity that emerges and parties retain their individuality while competing against rivals as a combined business force.\textsuperscript{56}


\textsuperscript{55} ibid.

\textsuperscript{56} Accounting Standard 14.
The uncertainty surrounding the treatment of Joint Ventures under the Competition Act 2002 has proven to be problematic for both the business community as well as the Competition Commission of India. Since a broad set of agreements are included within the purview of Joint Ventures it brings into question which Joint Ventures should be treated as combinations under Sections 5 and 6 or which ones fall under Section 3 of the Act. Business interests have considerable preference for legal certainty and would want Joint Ventures to fall under Section 5 in order to avoid the continual risk of challenge should Section 3 potentially apply.57

**TYPES OF CLAUSES**

Contracts, being dynamic and ever-changing as they are, do not have a lot of specificity in their form. The contents and their order in an agreement are usually tailored to the requirements of that particular agreement and the parties involved. Nonetheless, there are some clauses which are invariably present in Joint Venture Agreements.

1. **Date and place of Agreement** – A document without a date is said to be worthless in the eyes of the law. As basic as it seems, the date along with the place of agreement is usually mentioned at the very outset of the agreement in order to facilitate future references.

2. **Parties to the contract** – It is in this clause that the various parties are enumerated and introduced in the contract. Affiliates of the parties to the contract, if any, as well as beneficiaries are named; how the parties will be referred to in the contract is also laid down. For instance, Ganga Housing Corporation might be called GHC, or by some other name, to simplify the text. It is important to note that as a common practice, the party’s name, unless repugnant to the context, is deemed to include its successors and permitted assignees as well.

3. **Definitions and Interpretations** – The terms used in the agreement that follows are defined and their manner of interpretation lain down. The definition and interpretation clause is an essential element of any

---

57 ibid 25.
contract and the better it is drafted, the lesser ambiguity there is and lesser are the chances of disputes arising in the future. A few typical definitions are enlisted below:

3.1 Articles – These refer to the Articles of Association of the Companies which are coming together.

3.2 Business – The scope of business is mentioned here in order to elucidate the activities and transactions which will come under the ambit of the term.

3.3 Call period and cooling off period – The duration of such periods as well as their purpose is dealt with.

3.4 Effective date – The date on which the Joint Venture Agreement will be executed.

3.5 Financial Year – The duration of the financial year for accounting purposes.

3.6 Accounting Principles to be followed

Other than these, basic terms such as “key personnel”, “persons”, “law”, etc. also find their meanings defined in this clause.

Interpretation clauses are just as fundamental as, if not more than, the definitions. They lay down the rules of interpretation to be followed while comprehending the agreement document such as the non-enforceability of the headings, effect of amendments (whether retrospective or prospective), etc.

4. Details of incorporation – This particular clause is present only in such Joint Venture Agreements where two or more parties collaborate to form a new entity. It contains affidavits by the parties regarding legality of the party Companies, their rightful titles, authority to conduct business, present liabilities, etc. It also declares that the Companies are neither sick nor have any reasonable expectation of any material and adverse action by the Government due to disapproval or non-approval of any sort. The clause might also contain statements by parties regarding any pending law suit, arbitration, etc. against or involving them which might materially affect the course of business of the entity to be formed. Not only this, the conditions to be fulfilled are also laid
down, for instance the required government approvals, other corporate approvals or outstanding debts, etc.

5. Purpose, scope and duration of business – The clause at hand defines the Joint Venture by delineating and demarcating the boundaries of the business. It lays down the nature of the business, the activities that will be undertaken as well as the duration of the agreement whether limited by time or performance.

6. Responsibilities – Duties of the parties - to act in good faith and with efficiency, to attend all meetings, to keep shareholders informed, special responsibilities of a Chairman and CEO (if any) among others - are enumerated. It might also mention the right of the parties to enter into Joint Venture agreements with other parties and their additional responsibilities in such cases.


8. Organisation of the Company -
   8.1 Appointment, removal and replacement of Directors and the qualifications required for appointment as director.
   8.2 Meetings of the board, their frequency, notice period, manner of meeting.
   8.3 Manner of passing resolutions, quorum of meetings.
   8.4 System of voting (whether simple majority or otherwise), special powers of directors in these matters, alteration of MoU or AoA, winding up or dissolution, acquisition (amalgamation, merger, etc.), suspension of business, change of name, borrowings, removal of key personnel, creation of mortgage, transactions with affiliates.

9. Financial Information – It mainly deals with the obligations to shareholders and the auditing Company to be engaged.

10. Events of default – It enumerates the activities which will be termed as default – death, disability, or other factors leading to inability. Other types of default may include default in payment of loans, change
in laws having adverse and unforeseeable effects on shareholders, material breach, misrepresentation, bankruptcy, annulment of the Joint Venture by the Courts and inability to meet Business Plan within stipulated time.

11. Indemnification – The clause of indemnification notifies the duties of the parties to be jointly and severally liable to indemnify, defend and hold the other parties harmless from and against any and all costs, claims, actions, arising out of any breach by the party unless it is caused by willful default or gross negligence.

12. Non-compete and confidentiality – Another clause which is seen in most Joint Venture agreements; it usually prohibits the parties from entering in any business which is a competitor of the Joint Venture formed through this agreement. The scope and nature of breach of confidentiality are also clearly laid down. Exceptions may be in the form of disclosure of information prior to confidentiality agreement or those required by Law or other authority.

13. Term of Joint Venture – A specific time in the future might be laid down or conditions may be specified (such as end of term in case a single shareholder becomes the sole shareholder). The term can be subject to extension by the parties.

14. Deadlock resolution – Such clauses state the mechanisms which can be resorted to in case of a deadlock between parties. The cooling off period (the period in which no dialogues may take place in order to ease tensions between parties after unfruitful negotiations) is specified, too. The cooling off period is usually not very long and usually ranges from two to three weeks.

15. Dispute resolution – Disagreements and altercations might arise even in the most well drafted contracts. In the event of such disputes, it is pertinent to provide for a mechanism before hand in order to ensure the speedy resolution of such disputes and to minimise the losses to the Joint Venture. Clauses under this head deal with the applicable laws, extra-legal mechanisms before formal proceedings, notice regarding place of meeting, etc.
In case arbitration is the means of dispute resolution resorted to, the terms of the proceedings are also laid down. For example, there may be three arbitrators appointed in total, one by each party and one nominated by both appointed arbitrators. Such appointments must adhere to the provisions of the International Chamber of Commerce or the relevant governing body.

16. Representations and warranties – This clause acts as another declaration by the parties where they vouch for their activities, current condition, pending suits, among other things.

17. Miscellaneous – The miscellaneous clause is one of the most underrated clauses perhaps because of its nomenclature and tends to be overlooked. It brings together all the aspects of an agreement which are not wide enough to form a subject by themselves but are significant enough to be mentioned.

**CONTRACTUAL ISSUES IDENTIFIED IN JUDICIAL PRONOUNCEMENTS**

There are several issues that can arise in a Joint Venture between two parties. In light of the fact that there are no special codified provisions for resolution of contractual Joint Venture disputes, an analysis and examination of cases- both Indian as well as foreign- becomes pertinent.

As has been previously mentioned, Joint Ventures usually have non-compete clauses or some variation of the same. Considering whether the Joint Venture and/or the co-venturers must be subjected to non-compete is often the most difficult and sensitive part of negotiating a Joint Venture agreement. There are countless English as well as American cases that deal with this issue and demand perusal in order to comprehend the jurisprudence employed to settle such disputes.

In a famous case in the American Supreme Court, two companies- Pennsalt Chemicals Corporation and Olin Mathieson Company- signed a Joint Venture agreement, each acquiring 50% of the newly formed Penn-Olin Chemical Company, which began producing sodium chlorate in South-Eastern United
The Government sought to dissolve the Joint Venture as being violative of the Clayton and the Sherman Acts- both anti-trust laws to prevent anti-competitive practices. The parties agree that they had the same line of commerce- i.e. sodium chlorate and the same relevant market.

The test of determining whether competition would be substantially lessened by a Joint Venture, is not only whether both parent companies would probably have entered the market, or whether one would probably have entered alone, but also whether the Joint Venture eliminated the potential competition of the company that might have stayed at the edge of the market, threatening to enter. If both the parties in a Joint Venture are engaged in commerce, and a new company is established to engage in commerce and to further the business interests of the parents irrespective of whether the new company is formed for a wholly new enterprise, it would be said to lessen competition between parties.

In determining the probability of substantial lessening of competition, the Courts might also take into account the following criteria: the power of the Joint Venturers, the competition existing between them, the reasons and necessities for its existence as a Joint Venture, its line of commerce, etc.

A similar issue arose in an English case in which a company in New York- The plaintiff Global containers (G) - entered into a Joint Venture with a subsidiary with the defendant- Bonyad Shipping (B) - of an Iranian Government Organisation. But the venture not being profitable was discontinued. Among the numerous contentions was the question of G’s entitlement to compete with the Joint Venture and whether G owed a fiduciary duty to B.

G complained that B had not paid its share of the losses and sued. A number of preliminary issues came up, amongst them being the question of whether G was entitled to compete with the Joint Venture and whether it owed any

---

58 United States v Penn-Olin Chemical Company, 378 U.S. 158 (1964) (Supreme Court of the United States). [“Penn Olin”].
61 Global Container Lines Ltd. v Bonyad Shipping Co., [1998] 1 Lloyd’s Rep 528. [“Global Container”]
fiduciary duty to B. The arguments centred on competitive business carried on by G on routes not involving the Persian Gulf and on the fact that G had used some vessels belonging to the Joint Venture to carry cargo.

The judgement was given in favour of G and it was held that under the terms of the agreement, G was allowed to continue its existing services for its own account, the Joint Venture agreement merely prohibiting G from carrying out competitive business to or from the Persian Gulf. Neither G nor B was entitled to compete against one another in the area of Joint Venture services. Mutual obligations in the nature of fiduciary duty arose in this area. Additionally, where G was permitted to compete it owed no fiduciary duty to B so as to limit the extent of that competition. Competition was limited only to the extent that a term was to be implied that the Joint Venture associates would act reasonably towards one another outside the area of the Joint Venture.62

In instances where foreign companies invest in India, the question of when the collaboration would be called a Joint Venture may also arise. In a case63 where a Government of India by a notification, ratified a scheme called Electronic Hardware Technology Park (EHTP) which permitted a foreign equity investment of up to 100%. Pursuant to this, the third respondent- the foreign company- filed an application for setting up of its subsidiary company for manufacture of its products in India.

This company would own the entire equity of the proposed Indian subsidiary and hence it was held that there was no element of Joint Venture involved in setting up of the subsidiary company. A Joint Venture would only come into existence when the resources of two different persons or entities are pooled together. Additionally, this wholly-owned subsidiary would undertake software development, engineering services, technical services including installation and maintenance, both hardware and software development and training on a world-wide basis including in India.64

63 U.K. Mehra v The Union of India, AIR 1994 Delhi 25 (High Court of Delhi). [“U.K. Mehra”]
In such an instance, “where a subsidiary is wholly owned by the Principal company which has a pervasive control over it and the former acts as the hand and voice of the latter, the subsidiary in that event would be nothing but an instrumentality, rather a part, of the principal company.” The two in that event would have to be treated as one concern.\(^{65}\)

Another important observation was made in the case of *Faqir Chand v Uppal Agencies*\(^{66}\) wherein the Supreme Court held that it is not enough for the parties to call their agreement a Joint Venture in order to qualify it as such. The requisites of a Joint Venture as decided in the New Horizons case must be fulfilled in order to treat such an agreement as a Joint Venture agreement. This is another significant holding when it comes to keeping in check avoidance of liabilities by parties by hiding beneath the “corporate veil”.

This pragmatic approach has been adopted by Courts in unveiling companies, especially subsidiary companies to reveal their real faces in the interests of justice.\(^{67}\)

This is because Companies may use the “corporate veil” to circumvent liabilities either related to tax or otherwise. In *Gammon India Limited v Commissioner of Customs, Mumbai*,\(^ {68}\) the question was whether the acts of parties to a Joint Venture in procuring materials for the purpose of the Joint Venture were committed by the Joint Venture in its name or in the individual capacity of the parties. It was ruled that the plaintiff had procured the materials in its own capacity because in no way did the transaction between it and the material supplier indicate that it was for the purpose of the Joint Venture. And hence it could not avoid the tax that it would otherwise not have to pay.

---

67 *Life Insurance Corporation of India v Escorts Ltd.*, AIR 1986 SC 1370 (Supreme Courts of India).
68 *Gammon India Limited v Commissioner of Customs, Mumbai*, (2011) 12 SCC 499 (Supreme Court of India).
This lifting of the corporate veil is permissible whenever a question of public interest arises. When the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud or defend crime, the law will regard the corporation as an association of persons.\(^69\)

**JOINT VENTURES: CASES AT A GLANCE**

**Mahindra and Mahindra**

Apart from other industries, Mahindra & Mahindra have entered into three major Joint Ventures in the automobile sector itself. The earliest was with Ford motors in 1995, followed by one with Renault and most recently with the American Company Navistar International Corp.

The deal with Navistar for Mahindra & Mahindra had the potential of becoming a major leap for the latter as it entered the Heavy Commercial Vehicle (HCV) sector of the automobile industry. Mahindra & Mahindra stood to gain immensely from Navistar’s technological prowess with its experience in manufacturing as well as its highly-equipped MaxxForce 7.2 diesel engine which was considered to be among the best in the market.\(^70\) Surprisingly enough, in December, 2012 Mahindra & Mahindra decided to exit the venture.\(^71\)

In an interview to Business Standard, Pawan Goenka, head of farm and automotive sector of Mahindra & Mahindra said - “there are challenges in a Joint Venture; when there are two decision makers, there are different approaches to do business”. The abstract statement did not actually reveal the course of events which led to the falling apart of the Joint Venture but did highlight an important aspect of such adventures in general.

---


71 ibid.
There was an initial capital of Rs. 1,080 crores in which Mahindra and Mahindra’s share was 520 crores and the rest belonged to Navistar. The initial stages saw great progress for the former with a considerable variety in its line-up. However, competition by veterans in the Indian market like Tata Motors and Ashok Leyland hit hard this short-lived high and Navistar’s prospects seemed to dwindle. The total market share was only about two per cent and loss of revenues led to an outstanding loan of Rs. 450 crores. This was aggravated by the fact that in order to deal with competition, the Joint Venture had to cut down on its prices as well.

In such circumstances, Navistar was forced to think of changes in tactics. “While the Indian market has not expanded as we had originally expected...but given Navistar’s 2013 priorities, our capital and focus needs to be allocated to other business opportunities in the near term,” Troy Clarke, the head of operations, Navistar, asserted.

Mahindra’s first Joint Venture was with Ford in 1995 which began with equal investments by both parties. Its purpose was the production of the Ford Escort, a passenger car. Ford later pumped in more capital, acquiring 72% stake in 1998 in the venture but Mahindra kept its investment low. The car did not reach its target sales over the years and Mahindra ultimately quit the Joint Venture in 2005. It next partnered with Renault for the Logan, a reasonably priced car for the sedan sector in a ratio of 51:49. Nevertheless, the failure of the Logan ultimately led to Mahindra pulling out of this Joint Venture prematurely, too.

73 ibid.
74 Kumar (n 72).
75 ibid.
76 ibid.
78 ibid.
Mahindra & Mahindra have, however, been optimistic about such Joint Ventures even with repeated failures.\(^{79}\) The Joint Venture with Ford taught the Indian Company about marketing strategies which it used effectively for its Scorpio, which was a huge success.\(^{80}\) Mahindra has constantly looked for development in the engine technologies through its ventures. The foreign Companies, in return, have learnt about the market conditions in India and have used these adventures as “stepping stones”.

**LML and Piaggio**

A Joint Venture was formed between Lohia Machines Private Company Ltd. that produced highly sophisticated machinery and processed synthetic yarn, and Piaggio- an Italian based Company that was among the leading producers of two-wheelers in the world. In 1984, the Company entered into an agreement that was in the form of a license for technical collaboration with Piaggio for producing Vespa- a brand of scooter that Piaggio had been manufacturing in Italy. In 1990, this licensing agreement, after having functioned successfully by introduction of new models of scooters through a sub-licensee, was transformed into a technical and financial Joint Venture in which Piaggio as well as the Indian promoters owned a stake of 23.6% each. Public and financial institutions held the remaining stakes.\(^{81}\)

Both the Companies, LML Ltd. and Piaggio, had distributed clearly defined responsibilities between themselves. While Singhania was in charge of finance, sales, management and external relations, Piaggio was responsible for transfer of technology and quality control. However, in that year itself, the Company faced severe crisis and its operations were adversely affected by foreign exchange crisis, political instability, and intense credit crunch.\(^{82}\)

---

79 Kumar (n 72).

80 Kumar (n 72).


82 ibid.
Additionally, when Piaggio announced certain restructurings in the Joint Venture, Singhania felt that the reorganisation would change the shareholding arrangement of “Piaggio & Co SPA” and would confer more power on that faction of Piaggio that was anti-Singhania. Getting wind of these developments, Mr. Singhania proclaimed his right to buy out Piaggio’s stake in LML. Simultaneously, Piaggio accused Singhania of mismanagement of the Joint Venture, of not divulging the details of the shareholding pattern of his Company and of buying the LML’s shares off the market so that he could increase his stake in their Company.

Finally, when the Joint Venture came to be terminated, although it extinguished the exclusive rights of Lodha, the non-exclusive rights to use Piaggio’s technology for vehicles other than Vespa, were retained by them. The termination did not prohibit Piaggio from setting up any competing businesses in India.

From the above case studies, it can be seen that for two Joint Venturers to work together in a business environment successfully, a high degree of mutual trust and respect is necessary. However, expecting venturers to have blind faith in each other is unreasonable, and hence parties must endeavour to agree to such terms and conditions that are clear and devoid of any shred of ambiguity while ensuring that all partners comprehend those terms and commitments, in a manner that is *consensus ad idem*.

A lack of goal-synchronization and compatibility between the partners in terms of corporate vision, financial strength and management style may prove to be fatal for any joint endeavour. Also, if the number of partners involved is too many and no one partner can be identified as the clear leader, it may lead to tussles and an eventual falling-out of the parties.

In cases such as those mentioned previously, where Indian businesses that are family-run enter into a Joint Venture with professionally managed foreign companies, a great many differences may arise between the parties. It has been

---

83 LML (n 81).
84 Dua (n 3) 204.
found that while the representatives of foreign companies usually prefer to work in a professional environment, the family run businesses function more autocratically, and hence both partners may not be able to adjust to each other’s differences. This is why companies should adequately address these issues and find ways of circumventing these problems keeping in mind the demands of the industry and the market conditions in the preliminary stages of the agreement itself.

**Kawasaki Bajaj**

Honda, Suzuki and Yamaha were all eager to enter the Indian two-wheeler market through the Joint Venture route. In furtherance of the same, they held talks with native Companies throughout the 1980’s. However, Bajaj had a strong foothold in the scooter market not only in terms of market share but also in terms of market share with its competitors far behind. Therefore, the foreign entrants avoided a confrontation with Bajaj by focusing on the motorbike sector which was much less fierce. At first, Honda wanted to collaborate with Bajaj and buy equity in the Company. However, Bajaj already being a strong player in the market, only wished to enter into technology sharing agreements. Talks between the two Companies broke down and they failed to reach any agreement.

Kawasaki was another reputed Company which, although smaller than Bajaj in terms of output, wastechnologically well-equipped. Bajaj found a suitable partner in Kawasaki and both entered into a technical Joint Venture with Kawasaki receiving royalties in exchange for its technology.

Their first product was the KB 100 which was based on Kawasaki’s stylish GPz500. Packed with various fancy features, it also had one of the most

85 Dua (n 3) 205.
87 ibid.
88 ibid.
89 ibid.
effective designs of its times and was among the cheapest in the market also.\textsuperscript{90} Success was easy to achieve, one would concur.

Surprisingly enough, despite Bajaj’s reputation in the market KB 100, fell flat in competition with models by TVS and Hero Honda.\textsuperscript{91} Unlike the trend with Joint Ventures, the Bajaj-Kawasaki technical agreement did not end with the failure of the KB 100. Instead, Bajaj realised that there were inherent flaws in its own marketing system as well as after sales services. Having total domination over the scooter sector, never earlier had Bajaj needed to market its products which meant that they had zero expertise in marketing.\textsuperscript{92} Moreover, they did not have to worry about customer satisfaction and their servicing circle was not equipped.

At this point, Bajaj started work on its marketing circle and reduced the specifications on its bike to provide for more utility-based features instead of going for style in order to adapt to the Indian consumer’s needs.\textsuperscript{93} It also introduced its 4-stroke engines which continue till date. Of course, Bajaj began developing its own technology later with its DTS-i and DTS-Si ranges which went to became huge successes but it learnt the tricks of the trade through its collaboration with Kawasaki.\textsuperscript{94} The success of its earlier ventures with Kawasaki are reflected in the talks about future Joint Ventures between the two and this is among the Joint Ventures which lasted even beyond their short term goals.

**Hero Honda**

Hero Cycles had been the largest bicycle manufacturer since 1975 before it decided to venture into the automotive sector.\textsuperscript{95} Initially, it got into talks with

\begin{itemize}
  \item \textsuperscript{90} ibid.
  \item \textsuperscript{91} ibid.
  \item \textsuperscript{92} ibid.
  \item \textsuperscript{93} ibid.
  \item \textsuperscript{94} Sandeep Belagajee, ‘Bajaj, Kawasaki working on “unique technology”’ \textless{}http://www.autocarpro.in/news-national/bajaj-kawasaki-unique-technology-2670\textgreater{} accessed on 7 June 2015.
\end{itemize}
Peugeot, a French moped Company, but when these failed, they released their own moped based on Peugeot’s model.96 However, Bajaj Auto Limited had been dominating the two-wheeler sector and in order to compete with them, Hero entered into a collaboration with the famous Japanese automobile company, Honda.

Hero Honda, thus formed, was a technical-cum-financial Joint Venture.97 It focused only on the motorcycle sector, leaving Bajaj to dominate the scooters. Despite this decision, Hero Honda’s reign was not such a cakewalk. Time and again, the Joint Venture was faced with predicaments. For instance, close on the heels of the signing of the contract, Indira Gandhi was assassinated, leading to violence across north India directed at the Sikh community.98 This put the production units of Hero in great jeopardy. Nevertheless, Hero Honda launched its first 100cc product in 1985 which turned out to be a great success.99

Another dilemma struck Hero Honda when the yen-rupee exchange began falling from 1985 and the company began to bear losses for every unit sold.100 Tensions arose when Honda insisted on using imported parts because of their lack of faith in the quality of local ones.101 However, with the bicycle division of Hero becoming the world’s largest, Hero got a ray of hope and the Joint Venture managed to survive. By the 1990’s, the exchange rate of the yen had stabilised and annual profits rose to $10 million.102

In the early 2000’s, Hero Honda rolled out a variety of products ranging from those for the lower classes to the style statement Karizma. The success of the Joint Venture made Hero aspire for even more – it wished to create its own

96 ibid.
98 ‘The Hero Re-born’ (n 11).
99 ibid.
100 ibid.
101 ibid.
102 ibid.
However, this proposal was unacceptable to Honda which felt that its technology was central to this Joint Venture. Moreover, reasons like export issues and possible conflict of interest because of Honda’s non-disclosure of plans eventually led to the parting of ways for the two in 2010. However, Honda extended gestures of gratitude even then, allowing Hero to use not only its earlier research and development but also some of its future research. This was a highly uncommon practice especially when compared to the trend in the US. Moreover, they sold their shares to Hero at half the market price as a gesture of appreciation for their continued support in making Honda a reputed name in India. Honda wanted to show that they would be ready to partner with Hero again. Thus, the Joint Venture successfully accomplished its objectives and led to genial relations between Hero and Honda even though they became competitors in the Indian two-wheeler market.

**Air Asia-Tata**

The Joint Venture between Air Asia, TATA Sons and Hindustan Aviation of the Bhatia’s was formed to implement Air Asia’s second investment proposal in the Indian aviation sector soon after the loosening of the government’s investment restrictions allowing foreign aircraft carriers to hold greater stakes in local airlines. TATA Sons currently holds 30 per cent stake in the Joint Venture with no operational role in the functioning of the airline. Air Asia holds a 49 per cent stake while Hindustan Aviation holds 21 per cent.

Given Air Asia’s reputed business model, TATA Sons believed that it could be a relevant and successful service provider in the domestic sector and promote further growth of India’s aviation market. Telestra Trade-Place is purely a

The Joint venture started with an initial investment of $14.5 million (about Rs 80 crore) and was fated to compete in the domestic passenger aviation space with Jet Airways, Spicejet, IndiGo, Go Air and state-run Air India. It is certain that the airline has a big cost advantage over other airlines including in terms of cost per passenger kilometre which is the lowest in the world at just $2 (excluding fuel). Not only will it compete with budget carriers but also the full-service carriers in the domestic market.\footnote{‘AirAsia incorporates Indian venture; files all papers with govt’ \textit{The Hindu} (New Delhi, 31 March, 2013) < http://www.thehindubusinessline.com/industry-and-economy/logistics/airasia-incorporates-indian-venture-files-all-papers-with-govt/article4566912. ece> accessed, 5 July 2015.}

However promising this Joint Venture did seem initially, there was subsequent fallout among the venturers due to a breach of trust. The Tata group’s entering into a Joint Venture with Singapore Airlines to set up a full-service carrier in India curried disfavour with the Bhatia’s who deemed it to be an “unethical” practice. This revealed a communication gap and a lack of confidence in the Joint Venture among the partners. The TATA’s partners in the Air Asia JV pointed out a very evident conflict of interest that would put their agreement in jeopardy. However, the TATAs upheld the position that the two airlines had different models- Air Asia was to be low-cost while Singapore was to be full-service, and hence there was no scope for a conflict of interest.\footnote{Devesh Agarwal, ‘What full-service carriers and low-cost airlines are offering to woo and retain frequent flyers’ \textit{The Economic Times} (14 August, 2014) < http://articles.economictimes.indiatimes.com/2014-08-24/news/53166706_1_jetkonnect-budget-carriers-airasia-india> accessed, 5 July 2015.}

However, it can be seen that in India there is no real distinction between low-cost and full-service airlines because almost all of them offer fares in a close price range. Therefore, the possible cannibalisation between the two competitors- AirAsia India and Singapore Airlines’ premium airline is a cause for concern.
particularly so in lieu of IATA’s (the International Air Transport Association) prediction that India’s passenger population would triple to 452 million by 2020 which would result in around 70 per cent of all air traffic in India being conducted by low-cost carriers.\textsuperscript{112} This would mean that all airlines would have to operate low-cost carriers as those would have the highest demand, reducing the need for premium carriers to a bare minimum.

Joint Ventures in the airline industry must therefore account for future demands and lay down strict clauses determining whether entering into agreements with rivals should be permitted. Being an industry where rivals engage in cut-throat competition, all parties to a venture must safeguard their own interests and provide for heavy penalties on breach of the agreement by either party.

\section*{Insurance Sector Joint Ventures}

Until this year, the insurance sector was a largely restricted sector in terms of the FDI cap. Ever since it opened up in the year 2000, foreign investment could only go up to a maximum of 26\%.\textsuperscript{113} The insurance sector did grow by leaps and bounds in 2008-09 but it soon came to a standstill after that and the need for further FDI was felt. Eventually, the cap was raised to 50\% in the new budget introduced in the year 2015.\textsuperscript{114}

A large number of Indian private Companies enter into Joint Ventures with their foreign counterparts in order to compete in the insurance sector. LIC, which has around 70 percent of the market share,\textsuperscript{115} has government backing for its finances. In order to compete with it, private Companies have to depend on foreign giants. The raise of cap on FDI is, therefore, a welcome step.


\textsuperscript{113} Shefali Anand ‘What lifting the cap on FDI in insurance really means’ \textless\url{http://blogs.wsj.com/indiarealtime/2015/03/13/what-lifting-the-cap-on-fdi-in-insurance-really-means/} \textgreater{} accessed on 24 June 2015.

\textsuperscript{114} ibid.

\textsuperscript{115} ibid.
An interesting observation is that the majority of Joint Ventures in insurance sectors have continued to operate unlike say, the automobile sector where the trend is the opposite. One possible reason is the presence of a regulatory body in the form of the IRDA in case of the insurance sector and the absence of the same in the automotive sector. However, at closer glance, first, the IRDA regulations hardly touch the aspect of Joint Ventures. More importantly, the success of a Joint Venture depends more on the understanding and compatibility between the two parties than on regulations.

One possible explanation could be the presence of the FDI cap on the insurance sector. The leading reason behind break up of Joint Ventures is conflict of interests caused by competition amongst the parties involved. For instance, in the automotive sector, Joint Ventures are usually entered into by foreign Companies as an entry strategy into new markets. Once the foreign entrant gets sufficiently acquainted with the market and becomes confident enough to enter the market on its own, it considers quitting the Joint Venture for obvious competition issues. This is possible in the automobile sector because of the 100% FDI cap. Such a situation has substantially lesser chances of arising in the insurance sector where the foreign participants do not have such an exit option.

**CONCLUSION**

At the outset of this article, Joint Ventures appeared to be the best kind of business entities with virtually no drawbacks. Individuals or firms entering into Joint Ventures do so in order to get the best of both worlds – lesser investment accompanied by smaller risks with virtually no limits on the benefits accrued.

As utopian as such a conception sounds, the stark reality is that Joint Ventures have, in many instances, been known to have premature ends. As was seen in the case of the Joint Ventures of Mahindra & Mahindra and that of LML & Piaggio, there is much more to Joint Venture agreements than meets the eye. They are, at the end of the day, a coming together of two distinct business entities which have different strategies and perspectives and bring along with themselves both their benefits and their shortcomings.
This aspect of Joint Ventures poses a unique kind of challenge – the need for reconciliation between two very distinct business policies which could even be poles apart. Such a contrast in strategies cannot exist in a single entity and the parties concerned must therefore either adopt (the other’s business model) or adapt (to a hybrid of both models). To what extent the parties collaborate with each other is perhaps the most pertinent question to ask with regard to the success of a Joint Venture.

The reconciliation between parties is facilitated by the flexibility that Joint Ventures as legal entities enjoy. Thanks to a dearth of legislation and prominent judicial decisions in the country, they are not strait-jacketed and can take on multiple roles according to the needs of parties. They are majorly governed by business trends and market conditions. Innovations in the drafting of agreements in the form of unique clauses or otherwise, act as trendsetters for such ventures all over the world and this is the reason why the contractual aspect deals with one of the most significant facets of the phenomenon of Joint Ventures.

THE CONFLICT BETWEEN WILLS AND FAMILY AGREEMENTS

Aditya Wakhlu* and Dhruv Jadhav**

ABSTRACT

The clash between wills and family agreements has received little attention. Both documents deal with the division of property. However, the former is a unilateral instrument which can only be enforced after the death of the testator. The latter, is a multi-party agreement which imposes rights and obligations. Consequently, a will can be changed suo moto by the testator; however any change in the terms of the family agreement has to be agreed by the members.

This article has been written in context of the dispute concerning Amarchand & Mangaldas & Suresh A Shroff & Co. It facilitated this discussion on the conflict between a family agreement and a will.

This article focuses on the legal arguments which can be made for both the instruments. Through this document, we show that the family agreement will prevail; due to the sanctity the judiciary has held it in and due to the application of the Rule of Estoppel.

INTRODUCTION

“A son could bear complacently the death of his father while the loss of his inheritance might drive him to despair.”

Since the advent of social life, matters of succession and property have been issues of great importance for man. This article concerns two instruments of forging and perpetuating such relationships, i.e., wills and family agreements. We intend to establish the supremacy of a family agreement vis-à-vis a will, in the event that the two instruments clash.

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
**Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
This article was written in light of the recent family dispute in Amarchand & Mangaldas & Suresh A Shroff & Co. In this particular case, the family framework agreement provided for equal division of the family property between the two sons, Cyril Shroff and Shardul Shroff keeping in mind “principles of inter and intra family equality”. However, before her death, Mrs. Bharti Shroff, the principal shareholder of the firm, bequeathed all her properties to her older son, Shardul Shroff by way of a codicil to her will. Her will had originally reflected the position of branch equality as espoused in the family agreement. The property in question was already accounted for in the family agreement. Hence the younger brother, Cyril Shroff disputed the applicability of the will.

This case was resolved through mediation by a three-member arbitral panel. Thus, a clash between a will and a family agreement was witnessed in this case, even though the judiciary did not decide on the issue. Past cases have generally dealt with the validity and nature of family agreements in isolation. A direct conflict with a will has been largely absent in case laws. In this context, we have analyzed the conflict between the two.

---


5 Please note that we have narrated the facts in a very simple manner, excluding complications peculiar to the Amarchand dispute. Only basic facts relevant to the issue at hand have been taken cognizance of.

Even though the function\(^7\) of a will and a family agreement is the same, i.e., division of the property within the family, the principles governing both and their ramifications are entirely different. In this article, we have gone into the definition of a will with reference to the freedom of testation. Further, we have looked into the nature and meaning of family agreements through judicial decisions. The conflict between the two is brought out and finally, the Rule of Estoppel is applied in order to come to the final conclusion.

**THE INTENT AND DESIRE OF THE TESTATOR**

“The power of making a will is an instrument entrusted to the hands of individuals to prevent private calamities.”\(^8\)

A man should have ultimate control over the disposal of his property. His natural instinct would be to leave it to the people closest to him in kinship and companionship. Of those who may potentially inherit his fortune, some may be deserving, others dependent and still others, who do not require any assistance due to their favorable position in life.\(^9\) The law neither knows these individuals or their needs or wants, nor is it for the law to decide who gets the property. It is the duty of the testator to know the circumstances of those who will inherit his fortune. Further, it is for him to decide whether this should even be part of the consideration. It is for him to ensure, if he so desires, that each gets his due according to his station in life in order to remedy the possible imperfection of the law.\(^10\)

Thus, the testator is in the best position to ascertain as to who should get what part of his property. Historically, the law has acknowledged this right. Common Law leaves the exercise of this right to the testator’s discretion, trusting individual judgment as opposed to “stereotyped and inflexible rules of a general

---

\(^7\) We seek to emphasize function or use (division of property) as opposed to objective (maintenance of harmony within the family).


\(^9\) *Banks v Goodfellow* [1870] LR 5 QB 549 (Lord Cockburn).

\(^10\) Bentham (n 8).
This clearly brings out the need to respect the intention of the testator in disposing his property.\textsuperscript{12}

In India, Section 2(h) of the Indian Succession Act, 1925 defines a will as “\textit{the legal declaration of the intention of a testator with respect to his property which he desires to be carried into effect after his death}”\textsuperscript{13} (emphasis supplied).

Here, too, the law recognizes the importance of the intent and desire of the testator in bequeathing his properties. This is further complemented by Section 87 of the same statute which decrees that the testator’s intention is to be “\textit{effectuated as far as possible}”,\textsuperscript{14} albeit in a slightly different context.

\textbf{FAMILY AGREEMENT TO ENSURE HARMONY AND HOMOGENITY IN THE FAMILY}

Man, being a social animal,\textsuperscript{15} has always placed emphasis on the importance of community. Man cannot survive alone and has to enter into relationships with fellow men in order to fulfill his basic needs. Hence, in order to achieve his own goals, he is dependent on the labour and skill of others.\textsuperscript{16} As humans transitioned from a nomadic life to a more settled one, the importance of acquiring and preserving land within one’s own social group became apparent.

Consolidation of one’s social group gave birth to the institution of family. This led to the rise of private property and the accompanying need to protect it. It had to be safeguarded not just for his needs, but also for the needs of his progeny. Thus, historically, ‘family’ has been an economic and a social unit as well as a system based on common interests and needs.

\begin{flushright}
\textsuperscript{11} \textit{Goodfellow} (n 9).
\textsuperscript{12} It must be noted, however, that even in England, due to the Inheritance (Family Provisions) Act, 1938, the courts can interfere and ensure there is some relief to relatives such as an infant son, unmarried daughter or a widow.
\textsuperscript{13} Indian Succession Act, 1925, s 2.
\textsuperscript{14} Indian Succession Act, 1925, s 87.
\textsuperscript{15} Aristotle, \textit{Politics} (2\textsuperscript{nd} revised edn., UCP 2013).
\end{flushright}
Ideally, a family should work together as one unit in order to achieve their common interests. However, disputes do arise when it comes to distribution of property, oft resulting in the destruction of family ties. To avoid such contingencies, members of a family can enter into an agreement so as to ensure harmony and goodwill in the family.

Family agreements, as such, have not been defined in Indian statutes and hence we must look to judicial pronouncements for the same. The Indian judiciary has borrowed the definition of family agreements as given by ‘Halsbury’s Laws of England’ and quoted in *Kale & Ors. v Deputy Director of Consolidation & Ors.*[^17] It defines a family agreement as:

> “An agreement between members of the same family, intended to be generally and reasonably for the benefit of the family either by compromising doubtful or disputed rights or by preserving the family property or the peace and security of the family by avoiding litigation or by saving its honor (emphasis supplied).”[^18]

Here, it is discernible that the basic objective of a family agreement is to ensure that the property is divided in an amicable manner and that the peace within the family is not disturbed. The overall benefit to the family is of paramount concern in such a definition of family agreements.

Further, Kerr, in his treatise ‘Kerr on Fraud and Mistake’,[^19] speaks of the special nature of a compromise between members of a family as opposed to an ‘ordinary compromise between strangers.’ He suggests that family arrangements are governed by a “*special equity peculiar to themselves.*” Equity, in this context has to be understood as a system which prevails over the rigorous application of the law.[^20] Therefore, equity emerged to fill the lacunae in the precedential common law system and to avoid the absurdity or injustice that sometimes

[^17]: AIR 1976 SC 807.
arose from its stringent implementation.\textsuperscript{21}

In the context of family arrangements, the application of principles of ‘equity’ itself implies that they are to be placed on a higher pedestal than agreements between strangers. The implication is that family agreements must be given primacy and should not be invalidated on the basis of mere technicalities.

Halsbury comes to a similar conclusion where he opines that family agreements should have a binding effect and “matters which would be fatal to the validity of similar transactions between strangers” would not limit the operation of family agreements.\textsuperscript{22} This clearly indicates the special status that they enjoy. Ordinary formalities of a contractual or a legal relationship do not apply in these cases.\textsuperscript{23}

Further, in Kale, the Court recognized that a family agreement is entered into in order to bring about “complete harmony and goodwill in the family”. Thus, the object of such agreements is to safeguard the family from long-drawn litigation or insfighting which disturbs “the unity and homogeneity of the family”.\textsuperscript{24}

This is the very basis for differentiating between family agreements and agreements between strangers. Equitable distribution of wealth underlies the creation of such agreements. They ensure that the interests of the various members of the family are protected vis-à-vis each other.

Reaffirming the principles given by Halsbury and Kerr, the Supreme Court held that mere “technical and trivial grounds” would not invalidate a family arrangement.\textsuperscript{25}

\textsuperscript{21} Lord Henry Home Kames and Ann Arbor (ed), Principles Of Equity (University of Michigan Library 2007) 15.

\textsuperscript{22} Halsbury (n 18).

\textsuperscript{23} However, as observed in Kale, this does not imply protection of a family agreement if it is induced by fraud, misrepresentation, coercion or undue influence.

\textsuperscript{24} Kale (n 17).

\textsuperscript{25} Kale (n 17). See also: Hansa Industries Pvt. Ltd. v Kidarsons Industries Pvt. Ltd., AIR 2007 SC 18.
Furthermore, in _Maturi Pullaiah & Anr. v Maturi Narsimham & Ors._, the court held that existence of conflicting legal claims was not necessary to ensure validity of a family settlement; rather maintenance of peace and harmony were sufficient grounds to ensure its validity. This implies that creation of a family agreement does not have stringent requirements or technical impediments.

In _Lala Khunni Lal v Kunwar Gobind Krishna Narain_, possibly the earliest case on family arrangements in India, the Privy Council had decided that it was the duty of the courts to give full effect to a family arrangement. Thus, from a very early stage, the judiciary has leaned towards upholding such agreements.

That a family agreement would lead to “amity and goodwill amongst persons bearing relationship to one another” was considered to be adequate consideration for the purpose in _Ram Charan Das v Girjanandini Devi & Ors._ A settlement which recognized the mutual rights of the parties, in presence of such consideration could not “be permitted to be impeached thereafter”. This indicates the inviolability of family agreements in ordinary circumstances.

Even one sided surrendering of rights is considered adequate; further no questions as to adequacy of consideration are entertained by the Courts in this regard. This was enunciated in _Sahu Madho Das & Ors. v Pandit Mukand Ram & Anr._

These examples clearly illustrate our earlier point that family agreements are not required to satisfy conditions which ordinary contracts need to fulfill. Thus a broad and liberal view should be taken of the validity of family agreements. The Supreme Court has taken this view in _S. Shanmugam Pillai & Ors. v K._

---

26 AIR 1966 SC 1836.
27 (1911) 13 BOMLR 427 (Privy Council).
28 AIR 1966 SC 323.
29 For the purposes of this paper, we have used the terms ‘family arrangement’, ‘family settlement’ and ‘family agreement’ interchangeably. In _Sahu Madho Das v Pandit Mukand Ram & Anr_, family settlements (post dispute) and family agreements (“which try to avoid future disputes, in anticipation”) were accorded the same sanctity by the apex court.
30 _Ram Charan Das_ (n 28).
31 1955 AIR 481 (Supreme Court of India).
Shanmugam Pillai & Ors.\textsuperscript{32} It held that courts should try to uphold family agreements as far as possible, and not as technical rules of evidence, keeping in mind that the ultimate aim of the law is the administration of justice. Thus a policy of non-interference should ideally be followed by the Courts when a matter has been settled by the consent of the parties, i.e. members of the family.\textsuperscript{33}

Further sealing the sanctity of family agreements, the Court in Hari Shankar Singhania & Ors. v Gaur Hari Singhania & Ors.\textsuperscript{34}, held that even technicalities like the law of limitation should not hinder the implementation of the family agreement. In this case the law of limitations was in relation to institution of arbitration proceedings. Here, the law limiting arbitration proceedings was considered too ‘trivial and technical’ to invalidate the terms of the family agreement, allowing the arbitration proceedings to be carried out.

Furthermore, in K.K. Modi v K.N. Modi and Ors.,\textsuperscript{35} it was reiterated that family agreements must be viewed “differently from ordinary contracts” and that their terms and internal dispute resolution mechanisms should not be disturbed. In this case, the agreement had provided for arbitration proceedings as the internal mechanism. The Court decided that its terms could not be vitiates.

\textit{The preceding discussion brings out the following points of law in India with reference to family agreements:}

\begin{itemize}
  \item [a] Upholding harmony and homogeneity in the family is supreme. Family agreements are, therefore, treated differently from ordinary contractual relationships.
  \item [b] Consequently, trivial or technical defects or frivolous grounds cannot invalidate or render ineffective a family agreement.
\end{itemize}

\begin{flushright}
\textsuperscript{32} 1972 AIR 2069 (Supreme Court of India).
\textsuperscript{33} Family should not be construed as being a narrow concept referring to people who have a possible claim or right of succession. "Near relations" must also be construed as being included. \textit{See: Krishna Bihari Lal v Gulabchand & Ors.}, 1971 AIR 1041 (Supreme Court of India); \textit{Ram Charan Das} (n 28).
\textsuperscript{34} 2006 (4) SCC 658 (Supreme Court of India).
\textsuperscript{35} [1998] 3 SCC 573 (Supreme Court of India).
\end{flushright}
Finally, the courts should follow a policy of non-interference in such matters while adopting a broad and liberal view with regards their validity.

These principles indicate the sanctity of family agreements in law. The courts have repeatedly given effect to family agreements overriding all legal objections.

THE CONFLICT

Both wills and family agreements deal with the disposition of property. At times, there may arise a conflict between the provisions of the two instruments. It must be noted that a will is a unilateral document made by an individual, whereas a family agreement is an arrangement between multiple parties having mutual rights and obligations. A conflict between a will and a family agreement is essentially a conflict between the intentions of the individual bequeathing his property and the interests and intentions of the members of the family, having jointly agreed to the family agreement.

The case of Mani Mani & Ors. v Mani Joshua is a peculiar one with reference to family settlements and wills. The testator had made a total of three wills and two settlements. He had, in the first two settlements and the two wills, bequeathed minimum properties to his elder son, the respondent because his elder son did not treat him well. However, in the last will he specifically revoked the previous wills and settlements and left considerable property for the eldest son. He declared the last will “final and operative” and decreed that the last will would be the only document that would govern the disposition of properties.

The wills which bestowed more property to the younger son were revoked. Further the property given to the older son in the settlement was given to the younger son. The older son wanted to claim both the properties given to him under the settlement as well as the property given to him in the last will.

---

36 Memorandums of Understanding and Gift Deeds have also been accepted as family agreements.
37 1969 AIR 1311 (Supreme Court of India).
It is of interest that the testator thought that he had the competency to invalidate the settlements via the last will. The intention of the testator was also given importance. The Court held that the older son in this had a choice between the settlement and the will. Essentially, he was allowed to take either the property given to him under the will or the property given by the settlement but not both.

It is arguable that this decision indicates that the intent of the testator in disposing his property holds immense importance in the eyes of law.

However, this case does not necessarily establish supremacy of the will vis-à-vis family agreements. Since a family agreement imposes certain obligations and in turn bestows certain rights on the members of the family, it can be shown that in ‘Mani Mani’, the intent of a family agreement was carried on through the will. The object of a family agreement is to ensure peace and harmony within the family. However, the elder son through his earlier actions disturbed the tranquility of the household by being a constant menace to his father. Hence in the earlier settlements he was given minimum property. In essence, since he did not undertake his obligations his rights were curtailed. As soon as he undertook the obligations towards his family, his father allowed him to have a substantial share in the family property.

Here it must be kept in mind that through a will, a testator has free license to distribute his property as he wishes. In this particular case, the object of the family agreement was achieved by means of the will. Therefore this case does not establish the absolute supremacy of a will over a family agreement because the principles of a family agreement were upheld albeit through a will.

**Applying the Rule of Estoppel**

The doctrine of promissory estoppel has been recognized in common law by Lord Denning in *Central Property Trust Limited v Highland Trees*.38 In the given case the rent rates were lowered during World War II and were subsequently raised after the war was over. However, he retrospectively wanted the tenants to

38 [1947] KB 130.
pay the higher rate from the time of reduced rent. The Court did not allow him to do so. It was stated by Lord Denning that if a person had given assurance that he would not strictly enforce his legal rights, the Court would not allow him to do so at a later date, if it affects the interests of others.

The principle also finds enunciation under Section 115 of the Indian Evidence Act, 1872.39

Further, in *Union of India v Godfrey Philips India Ltd.*,40 the Supreme Court clearly laid down the rule of promissory estoppel in India:

“The true principle of Promissory Estoppel is that where one party has by his word or conduct made to the other a clear and unequivocal promise or representation which is intended to create legal relations or affect a legal relationship to arise in the future, knowing or intending that it would be acted upon by the other party to whom the promise or representation is made and it is in fact so acted upon by the other party, the promise or representation would be binding on the party making it and he would not be entitled to go back upon it, if it would be inequitable to allow him to do so, having regard to the dealings which have taken place between the parties.”

Further, in the *M.P. Sugar Mills* case it was held that a detrimental effect on the promisee was not necessary to evoke Rule of Estoppel; rather “a change in position” is considered sufficient to invoke the doctrine.41 Thus, the doctrine was developed to prevent injustice and to prevent a person from going back on his promise if another person had placed reliance on such promise.42

---

39 Indian Evidence Act, 1872, s 115.

“Estoppel-When one person has, by his declaration, act or omission, intentionally caused or permitted another person to believe a thing to be true and to act upon such belief, neither he nor his representative shall be allowed, in any suit or proceeding between himself and such person or his representative, to deny the truth of that thing.”

40 1986 AIR 806 (Supreme Court of India).

41 *M/s Motilal Padampat Sugar Mills v State of Uttar Pradesh & Ors.*, 1979 AIR 621 (Supreme Court of India).

Even before formal enunciation of the doctrine, the Privy Council, in *Lala Kanhai Lal v Lala Brij Lal & Anr.* had stated that a person who has enjoyed a benefit at the expense of another’s detriment must be bound by it. Anyone agreeing to a compromise and inducing another to alter their position to his benefit cannot then forsake the compromise.

We shall use a few illustrations to show application of the above proposition. For example, in *Kale*, two unmarried daughters (respondents) and the son of the married daughter (appellant) were the disputing parties. Under the U.P. Tenancy Act 1939, the applicant was the sole heir of the property. The disputing parties entered into an oral family settlement and under the same certain *khata*s were given to the respondents. However, the Revenue Officer had committed an error while documenting the records. The records showed that the son was entitled to only one third of the share in the property. The daughters after being given the *khata*s as part of the family settlement, tried to take advantage of the discrepancy in the records. The Supreme Court, on the appeal of the appellant, applied the principle of estoppel to the case and prevented parties to the family agreement from going back on their compromise.

Applying the principle of estoppel to the concept of family agreements, it observed that “the rule of estoppel would be pressed into service and would be applied to shut out plea of the person who being a party to family arrangement sought to unsettle a settled agreement”. The courts disallow such a person from revoking terms of the agreement under which he himself has himself enjoyed some material benefits or acting upon which, the other party has suffered a loss. Even the presence of legal lacunae in the family agreement does not invalidate the same.

Thus, the Court combined the sanctity of a family agreement and the principle of estoppel to prohibit reopening of matters settled by family agreements on “frivolous or untenable grounds”. In this manner the Court has accepted the doctrine of estoppel to cement the position of family agreements.

---

43 (1918) 20 BOMLR 1048 (Privy Council).
44 *Kale* (n 17).
45 *Kale* (n 17).
Furthermore, in *Pillai*, the family property was bequeathed to the widows of the deceased. However, the plaintiff contended that the will was forged and that the control of the property should not be in the widows’ domain. The widows, in turn offered a compromise where the plaintiff would withdraw his plaint and in return would be given title to a part of the property. He accepted the bargain, knowing that he would be relinquishing his right to contest the validity of the will. In return, he was given instant access to the title of the promised properties. However, after assuming control of the property, he tried to challenge the validity of the will. The Supreme Court held that he was estopped from doing so as he had willingly entered into the compromise and settled his claim with the widows.\(^{46}\)

The judges in *Pillai*, reiterated the point from *T.VR. Subbu Chetty’s Family Charities v M. Raghava Mudaliar & Ors.*\(^{47}\) by holding that if a person having full knowledge of his right enters into a transaction which settles his claim as well as the claim of the opponents at the relevant time, he cannot be permitted to go back on that agreement at a later date. In this case, the ‘transaction which settles his claim’ is the family agreement.

In the *Modi Case*, there was infighting between members of the same family. In order to ensure equitable distribution, a memorandum of understanding\(^{48}\) was signed between them. Some of the members of the family had substantially acted upon the provisions of the Memorandum. However, others challenged its validity and enforceability. The Court held that “a family settlement which settles disputes within the family should not be lightly interfered with especially when the settlement has been already acted upon by some members of the family”.\(^{49}\) Thus the Rule of Estoppel comes into force in such scenarios in order to prevent injustice to different members of the family.

\(^{46}\) *Pillai* (n 32).

\(^{47}\) [1961] 3 S.C.R. 624 (Supreme Court of India).

\(^{48}\) Memorandums of Understanding have been accepted as valid family agreements in the *Modi Case*. See also: *Ramdev Food Products Pvt Ltd v Arvindbhai Rambhai Patel & Ors*, 2006 (8) SCC 726 (Supreme Court of India).

\(^{49}\) *Modi Case* (n 35).
Further, it is relevant to note that it is considered irrelevant whether the agreement is a voluntary promise or an imposed decision of an arbitrator; what is relevant are the actions of the parties thereupon. In the case of *Dhiyan Singh & Anr. v Jugal Kishore & Anr.*,\(^{50}\) the Court had held that even if an arbitral award is later found to be incorrect, if the parties adhere to it and act upon it, then the rule of estoppel would still apply and the parties would be estopped from challenging the validity of the award.

In this context, estoppel can arise in family arrangements even without any written document. In *Damodaran Kavirajan & Ors. v T.D. Rajappan*,\(^{51}\) it was held that even if a family agreement which required registration but was not registered, would operate as an estoppel against the parties who have taken advantage of the same. In the given case, the mother caved in to the continuous exhortations of her son requesting his share in the family property. His mother in order to maintain the peace of the household executed a gift deed in his favour on the condition that he would not stake a claim on her property thereafter. After the death of his mother, the son started a dispute against his siblings. His contention was that the gift deed was not binding on him as it was not registered as a family agreement. However the Kerala High Court held that the son was estopped from claiming a share in the family property as he had accepted the condition imposed by his mother during the execution the gift deed.

This case further goes on to illustrate our earlier proposition that courts generally take a broad and liberal view as to the validity of family agreements. Further, technical and trivial infirmities do not invalidate such agreements. The family agreement in question in *Kavirajan* clearly proves this. A mere gift deed accompanied by terms and conditions accepted by the son, was accepted as a binding family agreement. Consequently, the son was stopped from disputing property rights after the mother’s death in accordance with the terms agreed upon earlier.

---

\(^{50}\) 1952 AIR 145 (Supreme Court of India).

\(^{51}\) AIR 1992 Ker 397.
Estoppel can only be applied in a circumstance when a family agreement is entered into before the creation of the will. Here, the rights of multiple parties eclipse the intentions of the testator. In a reverse circumstance there is no question of application of estoppel. By entering into a subsequent family agreement, he automatically invalidates his will.

To sum up:

(a) The Rule of Estoppel ensures that a person does not go back on the terms of the family agreement, after others have acted on it.

(b) It does not matter if the people acting upon the agreement are negatively affected or benefited as long as there is a change in position of the party as a result of acting upon the other's assurance.

(c) That a family agreement is oral or unregistered does not preclude the application of the Rule of Estoppel in this regard.

THE EFFECTS OF REGISTRATION, OR THE LACK THEREOF

Family agreements arrived at orally are valid and protected under the law. In Ramgopal v Tulshi Ram & Anr,52 it was held that only if the terms of an oral agreement were reduced to writing, would it be necessary to register the same. Therefore, unless family agreements are written down, they need not be registered.53 The Supreme Court reaffirmed this position in Tek Bahadur Bhujil v Debi Singh Bhujil & Ors.54 Only if a family agreement is reduced to writing will it fall under Sections 17 (1) (a) or (b) of the Registration Act, 1908 which mandates that if there is a non-testamentary instrument which creates, declares, assigns, limits or extinguishes, whether in the present or the future, rights, title or interest in immovable property above the price of hundred rupees, then it

52 AIR 1928 All 641.

53 A memorandum or recital of facts intended to act merely as proof or record of the family agreement, but itself not creating rights relating to immovable property, need not be registered. See: Tek Bahadur Bhujil v Debi Singh Bhujil & Ors.; Ramgopal v Tulshi Ram & Anr. Further, documents conveying information of compromise or transfer of title to a court need not be registered. See: Bakhtawar v Sunder Lal & Ors., AIR 1926 All 173; Awadh Narain Singh & Ors. v Narain Mishra & Ors., AIR 1962 Pat 400.

54 AIR 1966 SC 292.
is compulsory to register such an instrument.\textsuperscript{55}

The registration of a will on the other hand, is optional.\textsuperscript{56}

In the context of a clash between the two, four possible situations emerge:

(a) Where the will is unregistered and the family agreement is registered

As per the Registration Act, if documents under Sections 17 (1) (a) to (d) and 18 (a) and (b), are registered, they will take effect against all other unregistered documents regardless of the fact whether the conflicting document is of the same nature or not.\textsuperscript{57} This applies to family agreements which will be covered either under Section 17 (a) or (b). Thus when a family agreement is registered and conflicts with an unregistered will, the family agreement will prevail. This is the only situation under which family agreements prevail by virtue of the Registration Act.

(b) Where the will is registered and the family agreement is oral and unregistered

(c) Where both the will and the family agreement are registered

(d) Where both the will and the family agreement are unregistered

These three situations operate in the absence of statutory guidance. The preceding discussion on nature of wills and family agreements and application of the rule of estoppel will resolve the conflict and family agreements will prevail in all three circumstances.

Further, courts, when dealing with family agreements, have not placed much stock on importance of registration. For example, in \textit{Kale}, the Deputy Director of Consolidation and the High Court, had both opined that if a family agreement which compulsory had to be registered, was not registered; it would be held invalid and unenforceable. Further, the Doctrine of Estoppel would become inapplicable. However, the Supreme Court had overturned both these situations.

\textsuperscript{55} Registration Act, 1908, s 17 (1) (a)-(b).
\textsuperscript{56} Registration Act, 1908, s 18 (e).
\textsuperscript{57} Registration Act, 1908, s 50.
positions taken by the High Court.\textsuperscript{58} Further, in \textit{Kavirajan}, the Kerala High Court too had applied estoppel despite non-registration of a compulsorily registrable document, i.e. the family agreement.\textsuperscript{59}

\section*{Conclusion}

The conflict between a will and a family agreement boils down to the clash between the freedom of testation on one hand and the sanctity of the family agreement on the other. Due to the historical importance of the institution of family, courts have repeatedly upheld agreements which seek to maintain peace and harmony within the family. A pragmatic argument for the supremacy of family agreements lies in the application of the principles of estoppel.

This, in our view is the right interpretation to take, because in a will the testator chooses his successors to bequeath property based on favoritism. The family agreement, on the other hand has a definite objective. It ensures that all the members adhere to the terms of the family agreement. The interests of the members who maintain peace and harmony and follow the terms laid down in the family agreement are safeguarded by the interpretation given by the courts.

An oral family agreement, or a written unregistered family agreement or even a Memorandum of Understanding between the members of the same family has been upheld by the courts as a valid family agreement. This shows that unlike in a will, where only the intention of the testator is considered relevant, in a family agreement the previous actions and promises of the various parties are taken into account and the family agreement is enforced, even if it suffers from some legal lacuna or if the intention of the family was to enter into an agreement but this was not categorically stated or registered as one.

Further, with the application of the Rule of Estoppel and the pedestal on which the judiciary has placed family agreements, it is quite apparent that in a clash between a family agreement and a will, the former will always be considered

\begin{footnotes}
\begin{enumerate}
\item[58] Kale (n 17).
\item[59] Kavirajan (n 51).
\end{enumerate}
\end{footnotes}
more sacrosanct and will be upheld by the courts.

Tying this back to the initial issue of the Amarchand & Mangaldas & Suresh A Shroff & Co dispute, the terms of the family agreement would supersede the will. Even though the will was registered, the rule of estoppel would act as a barrier against its application. As long as the terms of the family agreement were not vitiated, the division of property should be according to the family agreement. Moreover, as the agreement was written and registered, the case would have gone in favor of the family agreement.
UNFAIR TERMS IN INDIAN CONTRACTS AND THEIR REGULATION

Arijeet Shukla* and Prakhar Agarwal**

ABSTRACT

The standard form Contracts/unfair terms in a Contracts, with respect to consumers require greater protection than commercial Contracts. Such consumer Contracts can be held void as per Section 23 of the Indian Contracts Act, but the position of law related to this issue is a little ambiguous. Besides the Contracts. Act there are different legislations trying to govern such unfair and one-sided clauses in consumer Contracts, especially the Competition Act. The Competition Commission of India, with its Contracts amending and modifying powers is an effective regulatory body, besides various other regulatory bodies, been elaborately discussed here. But even with all these legislations and regulatory bodies, while governing such unfair terms, which have been dealt in the form of suggestions in the concluding part of this article.

INTRODUCTION

When mass production of standardized products take place, standardized printed forms of contracts occur, with blank spaces to be filled in by the customers because in today’s industrial world where large corporations enter into innumerable contracts with individuals, it is not possible to draft individual Contracts for each customer.1 These are known as “Standard Contracts”.

These standard contracts mostly operate in an authoritarian way. They introduce various wide exclusion terms which are most beneficial to themselves. People who bear the burden of such unfair clauses or standard form of contracts are not lift with any alternative that they can rely upon. This gives a great opportunity

---

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
** Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
1 Law Commission, Report on Unfair Terms in Contracts of India (Law Com No 103, 1984).
to the businessmen/corporates to abuse dominant position by imposing their own terms, which at times goes to the level of exempting the company from any kind of liability under the contracts.²

Cheshire’s Law on contracts defines standard form of contracts as:

“The process of mass production and distribution, which has largely supplemented if it has not supplanted individual effort, has introduced the mass contracts -- uniform documents which must be accepted by all who deal with large-scale organizations. Such documents are not in themselves novelties; the classical lawyer of the mid-Victorian years found himself struggling to adjust his simple conceptions of contracts to the demands of such powerful bodies as the railway companies. But in the present century many corporations, public and private, have found it useful to adopt, as the basis of their transactions, a series of standard forms with which their customers can do little but comply.”

Mentioning unfair terms in a contracts can be one of the arguments raised by the aggrieved side. Those terms which challenge the very structure of the contracts so entered or are in contradiction to the public policy³ are said to be the unfair terms of a contracts. This was very well laid down in the case of Lilly White v Mannu Swami, where the party was entitled to only 15% of the total cost of the cloth in case the laundry company loses/destroys the cloth. This particular clause by the laundry company was held to be unreasonable and was termed against the public interest.

Also, in the case of Seven Day Adventists v M.A Uneerikutty and anr.⁴ it was held by the court that if any particular clause or several clauses mentioned under a contract are unlawful and one sided then the contract is void and against public policy.

³ Indian Contract Act, 1872, s 23.
UNFAIR TERMS IN CONTRACTS

According to Section 20 of the Specific Relief Act,\(^5\) 1963, the court may not decree for specific performance if there is unfair advantage to one of the parties arising because of the contract.

“Unfair terms” in a contract has not been defined in any Central or State Legislation. Whatever notion of unfair terms in a contract is there is based on the various judicial decisions that have taken place in India. In the case of Life Insurance Corporation of India v Consumer Education and Research Centre and Ors.,\(^6\) the Hon’ble Supreme Court had held that:

“If a contract or a clause in a contract is found unreasonable or unfair or irrational one must look into the relative bargaining power of the contracting parties. In dotted line contracts there would be no occasion for a weaker party to bargain or to assume to have equal bargaining power. He has either to accept or leave the services or goods in terms of the dotted line contracts. His option would be either to accept the unreasonable or unfair terms or forego the service forever. With a view to have the services of the goods, the party enters into a contract with unreasonable or unfair terms contained therein and he would be left with no option but to sign the contract”.

In the first part of the article, the authors have tried to differentiate between consumer and commercial contracts. They have tried to show why consumer contracts require a higher degree of protection for the consumers as compared to commercial contracts.

In the second part, the authors have tried to show how the Indian law still remains ambiguous as to whether unfair terms can be brought under the ambit of Section 23 of the Indian Contract Act.

---

\(^5\) Specific Relief Act, 1963, s 20.

\(^6\) Life Insurance Corporation of India v Consumer Education and Research Centre and Ors., [1995] SC 1811(AIR).
In the third part, the authors have tried to show the role of regulatory authorities in attempting to regulate unfair contracts, especially authorities like TRAI and IRDA.

In the fourth part, the authors have tried to show how unfair terms are dealt under various legislations in India like the Consumer Protection Act, Competition Act, Specific Relief Act and the Sale of Goods Act focusing the large chunk on the Competition Act of 2002 and discussing in detail the Competition Commission of India, various case laws and important provisions of the same.

In the concluding part of the article, the authors have given their suggestions as to what can be done in order to curb the problem of unfair terms in contract and standard forms of contracts.

**CONSUMER CONTRACTS AND COMMERCIAL CONTRACTS**

Generally, a *commercial Contract* takes place between two businessman. It is generally assumed that merchants have more knowledge of economics and commerce than the average citizen, and may be more “business savvy” than consumers. Both the businessman are aware of the terms of the contract. Also the scales of bargaining power are not too heavily tilted towards either of the parties. Hence, the regulations are much more relaxed as compared to consumer contracts. 7

Consumer contracts are those that take place between a merchant and a consumer. Some of the characteristics of the consumer contracts are-

1.) Forms of Contracts- Standard forms of Contracts are the ones that are strictly regulated in consumer contracts, because they shift the bargaining power in the favour of one party.

2.) Contracts terms- Generally in commercial contracts, the parties are free to have their own terms in the contracts. In the case of *Phulchand*

---


*Exports Ltd. v O.O.O Patriot*, 8 the Supreme Court held that when commercial businessmen are involved in commercial contracts who are not of unequal bargaining power and have entered into a contract then the agreed terms between them cannot said to be unreasonable, unjust or unconscionable.

While in consumer contracts those terms are prohibited that may be unfair to the consumer.

3.) Price gouging- Price gouging happens where a trader exploits the market situation so as to charge extravagant costs. For eg, after a catastrophe, traders may raise the costs of filtered water or canned merchandise. However, the Supreme Court in the case of *Shivdas Loknathsing v Gayabai Shankar Surwase* 9 held that the degree of unfair advantage should be of such a nature so as to shock one’s conscience. Mere inadequacy of consideration in comparison with market price would not make the contract unconscionable. If this does not follow, the merchant does not have unfair advantage under Sec. 16 of the Indian Contract Act.

**UNFAIR TERMS: WHETHER AGAINST PUBLIC POLICY AS PER SECTION 23**

Section 23 of the Indian Contract Act demarcates as to what consideration and object are lawful in a contract and what are not.

“The consideration or object of an agreement is lawful, unless the consideration or object of an agreement is lawful, unless—” it is forbidden by law: or is of such a nature that, if permitted, it would defeat the provisions of any law; or is fraudulent; or involves or implies, injury to the person or property of another; or the Court regards it as immoral, or opposed to public policy. In each of these cases, the consideration or object of an agreement is said to be unlawful. Every agreement of which the object or consideration is unlawful is void.”10

---

10  *Indian Contract Act, 1972, s 23.*
'Unconscionability' is not a ground in this section. All those contracts whose object or consideration are against the law or are against public policy are termed to be void.

Does public policy include unconscionability? The 103rd Law Commission of India in its report\(^\text{11}\) had taken into consideration that there was a chance of bringing in an “unconscionable bargain” by depending upon “public policy” as per Section 23 of the Indian Contract Act, 1872. It also said that Section 23 was not able to facilitate in the required situation and as per the demands of that time. The Law Commission noticed that the courts have decided (as per the laws of 1984) that the heads of public policy cannot be stretched to a whole new ground in general, with various exceptions, and that the expressions of a contract excusing an entity from all sorts of liability was not against public policy in Section 23.\(^\text{12}\)

The Contract Act nowhere explains the term “public policy” or what is known to be “opposed to public policy”. Expressions such as “public policy”, “opposed to public policy” or “contrary to public policy” cannot be defined precisely because of their very nature. Section 23 gives the authority to the Court to repudiate the clauses that are against law or public policy and to declare them as void ab initio, unlike Section 16 which gives right to the party to avoid a contract.\(^\text{13}\)

Section 23 of the Indian Contract Act lays down certain provisions of what can be considered lawful. As per this section, unless a court terms the consideration or object of an agreement unethical and against public policy, an agreement shall stand enforceable by law. Courts have held that various interpretations of public policy cannot be taken to a whole new level in general, with various anomalies, and that the provision which frees a particular party from any sort of liability is in tandem with the public policy and therefore it is not of much use in dealing with present situations. However, Supreme Court in *Central Inland*
Water Transport Corporation Limited v Brojo Nath Ganguly\(^{14}\) decided that the terms were harsh and unconscionable due to the “inequity of bargaining power” between the parties as the employee had no option but to accept the terms. Hence the contract was held to be in violation of public policy under section 23. This shows that the Courts have displayed a significant readiness to prevent the printed form contracts which clearly shows that unequal bargaining power has been used in such contracts. It has always been held by the courts that they will try to protect the weaker section from “unconscionable, oppressive, unfair, unjust and unconstitutional obligations” in a standard form contract.

The apex court has held that where the parties had unequal bargaining power, the standard form of contracts can be declared to be void on the reasons of coercion. Except some attempts, the Contract Act lacks ability to stop the abuse of standard form of contracts\(^{15}\). Courts on their own have developed and put in application various procedures to secure the rights of the customers who suffer the wrath of standard form contracts or exemption clauses, for example adequate notice should be given, fundamental breach theory, *contra proferentem*\(^{16}\) of the contracts, tortuous liability etc.

The 103rd report of the Law Commission of India which was specifically established to analyse the complicated standard form contracts issue, examined various contentions surrounding the same and various provisions related to it and gave certain suggestions to the Indian Contract Act.

India does not have a specific act on the exclusion of contractual liability, like England does. Unconscionable bargains can be struck down either under Section 16 on the grounds of undue influence or as per Section 23 on the grounds of being against the public policy.

---


\(^{15}\) Nilima Bhadbhade, ‘The Indian Contracts and Specific Relief Acts’ in Pollock and Sir Dinshaw Fardunji Mulla (eds), *The Indian Contracts and Specific Relief Acts: with a commentary, critical and explanatory* (14th edn, Lexis Nexis Butterworths 2012).

\(^{16}\) *Contra proferentem* (“against the offeror”), The Contra Proferentum rule states that if there is any confusion regarding the meaning of a Contracts, the Contracts should be construed in a manner which goes against the person who drafted the Contracts.
In *M/s Pawan Alloys & Casting Pvt. Ltd. Meerut v U.P.S.E.B.* it was held that where unreasonable terms are being imposed by the state (State defined under Article 12 of the Constitution), the court could apply either Article 14 of the Constitution, 18 or Section 23 of the Contract Act. The only meaningful development was that the Courts were not restricted to existing heads of public policy. Although in various situations it was seen that Article 14 cannot be put in application to commercial contracts which were entered by parties that were a ‘state’ within Article 12 of the Constitution, in some cases Section 23 was put up against these parties to award compensation. A range of decisions delivered by the Court would show that the abovementioned action was chosen because the court did not have a general power provided to them by a statute to repeal ‘unreasonable clauses’.

**STANDARD FORM CONTRACTS—ROLE OF THE REGULATORY AUTHORITIES**

Various regulatory authorities in India regulate the contracts between the companies and the consumers, so that the companies do not gain an unfair advantage over the consumers. Authorities like Insurance Regulatory Development Authority (IRDA), Telecom Regulatory Authority of India (TRAI), have various clauses in their statutes to prevent unfair advantage to the insurance or the telecom companies.

**Insurance Regulatory Development Authority**

IRDA wants the insurance companies to offer a fair deal and the terms and conditions of their offer must be transparent. There should not be any hidden agenda. The insurance companies should not take recourse to any “ticketing contracts”.

---

19 *Bharat Petroleum Corporation Ltd v Chembur Service Station*, [2011] 3 SC 710 (SCC).
Section 14(2)(i) of the Insurance Regulatory and Development Authority\textsuperscript{20} of India says “control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under section 64U of the Insurance Act, 1938 (4 of 1938)”

The High Courts have investigated the terms of the agreement in connection with the bargaining powers of the parties involved and have meddled in situations where the bargaining powers of the parties were not equivalent. In \textit{Life Insurance Corporation of India v Consumer Education and Research Centre}\textsuperscript{21} and others the Hon’ble Supreme Court held that-

“If a contract or a clause in a contract is found unreasonable or unfair or irrational one must look to the relative bargaining power of the contracting parties. In dotted line contracts there would be no occasion for a weaker party to bargain or to assume to have equal bargaining power. He has either to accept or leave the services or goods in terms of the dotted line contracts. His option would be either to accept the unreasonable or unfair terms or forego the service forever. With a view to have the services of the goods, the party enters into a contract with unreasonable or unfair terms contained therein and he would be left with no option but to sign the contract.”

In the case of \textit{United India Insurance Co. Ltd. v Manubhai Dharmasinbhai Gajera},\textsuperscript{22} the appellant approached the respondent for the renewal of his mediclaim policy, which was refused by the respondent on the reasoning of a “high claim ratio”. Later, the insurance company agreed to renew the policy, but only with the exclusion cause that excluded the disease suffered by the plaintiff. The Supreme Court held that since the renewal of the policy was based on mutual consent, it did not mean automatic renewal of the policy. Also, since the terms of the revised product required the approval of the IRDA, they are fair and

\textsuperscript{20} Insurance Regulatory & Development Authority Act, 1999, s 14.
\textsuperscript{21} Supra note 6.
\textsuperscript{22} United India Insurance Co. Ltd. v Manubhai Dharmasinbhai Gajera, [2008] 10 SC 404(SCC).
reasonable. Hence the petition of the appellants was dismissed.

**Telecom Regulatory Authority of India**

TRAI makes sure that it regulates the contracts between the broadcasters and the service providers. The broadcasters are required to furnish each and every detail about the interconnect agreements with the service providers containing standard form of contracts/MOU to TRAI.\(^{23}\)

According to Section 11(2) of the TRAI Act,\(^ {24}\) “the authority from time to time, by order, notify in the official gazette the rates at which the telecommunication services within India and outside shall be provided under this Act including the rates at which messages shall be transmitted to any country outside India.”

In the case of *SET Discovery Private Limited Interface v Telecom Regulatory Authority of India*,\(^ {25}\) TRAI issued a notification according to which the broadcasters get 45% share in the revenue with Multi System Operators and the Local Cable Operators get the balance 55%. Further a standard interconnect agreement was provided for, which was to operate if the parties failed to arrive at an agreement, according to which TRAI had prescribed maximum retail price of Rs 5 per channel per month per subscriber. The appellants argued that such notification of TRAI was outside its jurisdiction. Also the rate of Rs. 5 per month was unfair and arbitrary. The Delhi arbitration tribunal noticed that after introduction of the CAS system, the consumers had to pay for channels *on a-la-carte* basis. Hence in order to be fair to the consumers it was necessary to have a maximum retail price per channel. So the notification passed by TRAI tries to balance the interests of the broadcasters, service providers and the consumers.

In the case of *Hotel and Restaurant Assn. v Star India Ltd.*,\(^ {26}\) the appellants were

---

\(^ {23}\) Telecom Regulatory Authority of India Act, 1997, s 13.

\(^ {24}\) Telecom Regulatory Authority of India Act, 1997, s 14.

\(^ {25}\) *SET Discovery Private Limited Interface v Telecom Regulatory Authority of India*, CW 16913-14/2006 (Supreme Court of India).

\(^ {26}\) *Hotel and Restaurant Assn. v Star India Ltd*, [2007] SC 1168(AIR).
members of the Hotel Association of India. They provided television services to their guests. The respondents were distributors or broadcasters. In view of an arbitrary increase in the chargers of services to the hotels, the appellant hotel association sought for intervention of TRAI. Later the case went to the court where it was decided that the term consumers in the Telecommunication (Broadcasting and Cable Services) Interconnection Regulation, 2004 would include “commercial consumers” as well. Hence, the broadcasters were held liable for the increase in prices and it was held that the prices could not be increased arbitrarily.

**Competition Commission of India**

The Competition Commission of India draws its powers and authority from the Competition Act of 2002. It’s prominent function includes the complete execution, compliance of the Competition Act of 2002 (amended in 2007) and administration of the same. The act was however passed in 2002; the CCI was established in October 2003 and became completely functional only in May 2009. 27

CCI attempts to guarantee maximum customer satisfaction with proper functioning of market players.

CCI is also assigned with the task of creating awareness/conducting training sessions and taking up of competition advocacy under Section 49 of the Act.

It also has the power to inquire, investigate, regulate, and adjudicate and also to advise. As per the powers conferred to CCI under Section 64 (Power to make regulations) of the Competition Act, it has enacted regulations called “The Competition Commission of India (General) Regulations, 2009”.

Basically, there are 3 elements which are dealt with under this Act, specifically with the help of sections 3, 4 and 6 read along with sections 19, 26, 27, 28 and 29 of the Act. The three elements are-

---

27 Competition Act 2002 (IND).
1.) Anti-competitive agreements.

2.) Abuse of dominant position.

3.) Regulation of combinations which are likely to have an appreciable adverse effect on competition.

The Competition Act, 2002, has overriding powers and provides for having jurisdiction in addition to and not in derogation of any other law (section 60-62). Strong powers are given to the Competition Commission in terms of enhanced authority, penalizing provisions (Sec. 42-48), and a committed appellate authority (Sec. 53A; introduced through 2007 amendment Act). Sec 49 of this Act provides the Commission with advisory powers to the Central and State governments on policy formation.

Regulatory bodies are institutionalized for independent regulation of the sector. The Supreme Court has recently penned down the important role of a regulator while considering the powers of the Telecom Regulatory Authority of India.

However, several Courts are not able to appreciate the role of regulators, particularly CCI, which was set up in 2009. Its jurisdiction is still questioned by the high courts which are brisk in stalling investigations initiated by them.²⁸ Even in the famous DLF case as discussed later, the court stayed the order of the Commission modifying the unfair clauses of the agreement.

We need the courts to appreciate the working of such regulatory authorities, because the failure of such authorities would hamper the process of regulating the unfair terms in Indian contracts.

Next, the authors have tried to juxtapose the working of CCI with the courts with respect to one sided contracts. One way in which the Competition Commission has been doing so is in relation to builder-developer agreements.


Builder-developer agreements

Today the increase in the demand of the residential and commercial property has given birth to a number of builders and developers who offer or promise special features to attract prospective allottees. The same has also developed a long ending fight between the allottees and the builders with respect to the unfair practices and terms of contracts used by the builders and the delay in handling over the possession the allottees in which case the ultimate sufferer is the allottee who suffers mentally as well as financially.

Builders these days charge exorbitant prices from the customers by having unfair terms in the contracts and indulging in unfair trade practices. In this business power is concentrated in the hands of a few big builders. So they enter into standard contracts that have unequal bargaining power.

In the case of *DLF Universal Limited v Ekta Seth and Anr.*, the builder demanded an extra amount of Rs. 16,37,448 because of cost escalation, increase in area, external electrification, fire-fighting system and standby generators. The terms of the contracts stated that there could be an escalation in price. Clause (4) of the agreement stated that “decision of the company in this regard would be final and binding on the apartment allottee”. Later when the appellant failed to pay the amount, the builder cancelled the allotment. The court, however in exercise of its power under Article 142 of the Constitution of India, held that the contract was unjust and compensation should be provided to the appellants.

In one of the recent cases of *Amit Chawla v Parsvath Developer Ltd*, in Greater Noida, one of the clauses of the agreement stated that the builder could charge interest at the rate of 24%, in case of a default. Such agreement had to be performed even in cases of delay of construction by the builders. The National Consumer Council held that such terms of contracts were unfair in nature and the appellants were justified in receiving compensation in cases of delay.

---


in construction by the builders.

Following is the analyses on a landmark judgment based on a builder-developer agreement which was decided by the Appellate Tribunal of the Competition Commission of India, which clearly shows us the extent of powers and the authority exercised by the CCI in amending, severing and modifying clauses in a contract. The Competition Commission taking up such one-sided contracts has been very effective since it has exercised its power to amend and modify the contracts in an elaborative sense to make it fair and conscionable in nature. This holds the guilty party to its promise rather than providing compensation to the allottees.

**Belaire Owners’ Association v DLF Limited**

It is interesting to note that how unfair terms in such landlord tenancy agreements are being governed by the Competition Commission of India, as was observed in the recent case of *Belaire Owners’ Association v DLF Limited, Huda & Ors.* In this case, the Competition Commission of India adjudged that DLF builders had abused there dominant position. This clearly violates Section 4(1) of the Act which states that “No enterprise or group shall abuse its dominant position.” The Competition Commission identified 16 clauses in the agreement which proved that DLF had abused its dominant position in the contract. These clauses were therefore unfair and unconscionable in nature and had to be suitably modified. Thus under Section 27 of the Act, the Competition Commission modified these clauses between DLF and the allottees of the Belaire Society.

The unfair and one-sided clauses are listed below-

1.) Unilateral changes can be made by the builder without the buyers’ consent. The allottees have no right in this regard. This clause gives unequal bargaining power to DLF.

2.) DLF has given itself the right to change the layout plan without buyer’s consent.

---

3.) The builder in this project, DLF can unilaterally change *inter se* areas for different uses like residential and commercial without informing any of the allottees.

4.) Preferential location charges are paid for upfront, but there is no guarantee that you will get your preferred location. In that case you get refund without any interest, and that too at the payment of the last instalment.

5.) The builder enjoys one-sided right to increase or decrease the proportion of land on which apartment of the allottee is situated at his sole discretion without consulting allottees, who are bound to pay supplementary amount or accept a reduction in the area.

6.) The builder has the right to change the super area of the buildings *per se*.

7.) The builder continues to enjoy complete and sole rights on the sporting and recreational activities, community buildings, sites with the allottees having no rights in the said regard.

8.) Builder has sole discretion to link the Belaire project with any other of its developmental projects. This may have impact on the standard of living than promised under the Belaire project, but the allottees will have no right with respect to it.

9.) You are liable to pay external development charges which are based on a variable cost. So DLF has the discretion to enhance the costs at any time without these being disclosed in advance.

10.) The builder has sole discretion regarding the plan for power supply and the rate for it. This gives it the power to arbitrarily increase or decrease the price.

11.) There is arbitrary forfeiture of the earnest amount paid by the allottee in many situations. DLF cites the reason that it is to make the allottees fulfill their payment commitments, but allottees should have the right to change their choice if they want to, which in this case almost becomes impossible.

12.) Allottees have no way out except when developer flounders to give the ownership within the stipulated time, yet even for this situation
they get refunds without any interest, and that too strictly when the flat is sold.

13.) The builder’s exit clause gives it full discretion to terminate the given agreement. No penalty is prescribed in the agreement for such a termination. Only refunds are awarded that too with a simple interest.

14.) The builder has the sole authority to make any alterations to the building and such altered portions would be sole property of the builder. The allottees would have no say in this matter, even if the alteration is detrimental to their interests.

15.) Third party rights can be created without your consent, in cases where DLF wants to raise loans from financial institutions. So if DLF flounders in the payment of the loans, then allottees rights may be negatively affected. Also, there is no provision of payment of penalty to allottees in such a scenario.

16.) There are huge penalty provisions for any delays in payment by the allottee. It may go up to 15% for the initial 90 days of the delay and an additional 3% after that. While no such penalty provisions are prescribed for any default by DLF.

The Commission wanted to annul these clauses and replace them with some of the modified clauses which are listed below-

1) Most of the modified clauses included indemnifying the buyer out of any loss to the allottees arising because of the legal agreements entered into by DLF with third parties.

2) The layout plan could not be changed at the will of DLF. It could only be done at the direction of DTCP\(^{32}\) and such a change had to be notified to the allottees in writing.

3) The agreement was a proof that the allottees had fully understood their rights and obligations.

4) The allottees understood all the laws and regulations relevant for the agreement and were entering into it willingly.

\(^{32}\) Directorate of Town and Country Planning.
5) The exact amount of land that DLF held on Phase V of the project was decided at 6.67 acres. Earlier the agreement did not contain the exact amount of land DLF owned on Phase V.

The Commission believed that these modified clauses would remove the abuse of dominant position of DLF, making the terms of the contracts fair and conscionable at the same time.

HOW UNFAIR TERMS ARE DEALT UNDER VARIOUS LEGISLATIONS

In India there are various legislations which strive to protect the rights of the people whether from unfair terms in a contract or unfair trade practices.

Although, unfair terms are not explicitly defined in any of the legislations, unfair trade practices, however, find place in a lot of consumer friendly laws, such as, Consumer Protection Act, 1986, Competition Act, 2002, Specific Relief Act, 1963, Monopolies and Restrictive Trade Practices Act, 1969 etc. In order to analyse how unfair terms are dealt within these legislations we need to draw an analogy between unfair trade practices and unfair terms of a contracts. 

We can certainly say that unfair terms of a contract and unfair trade practices bring about same repercussions because both of them are opposed to public policy and therefore would render a contract void under Section 23 of the Contract Act. Various corporations employ unfair trade practices by the means of introducing unfair terms in the contracts that they undertake. Also, if in a business transaction a contract contains unfair terms it would amount to an unfair trade practice.33

We will now move on to explaining some legislations briefly which talks about unfair trade practices.

Consumer Protection Act, 1986

When consumer friendly legislations like the Consumer Protection Act, 1986 was not in existence the principle of caveat emptor (let the buyer beware) was

33 Supra note 5.
in general use in the market. With the advent of globalisation, removal of trade barriers and coming up of international players in the market, which not only increases the competition and quality of products benefitting the consumers, but also increases the risk of consumer exploitation.\(^{34}\) Now the general principle of *caveat venditor* (sellers beware) prevails in the market. Even though there was a presence of various legislations giving security to the consumers like the Civil Procedure Code, 1908, Indian Contract Act 1872, Sale of Goods Act, 1930 etc. nothing substantial could be gained in the field of consumer protection. Although the Monopolies and Restrictive Trade Practices Act, 1969 made available various remedies, still it became imperative to protect customers from unfair treatment, abuse and to also protect them from degraded, low quality goods and unfair business practices and deficiency in services. And therefore in order to provide solutions to the consumer’s problems from unfair and unreasonable business practices of the manufacturers, the Consumer Protection Act, 1986 was enacted. It came into force in the year 1987 and was suitably amended as and when needed. The preamble of the legislation says that it is “an Act to provide for better protection of the interest of consumers and for that purpose, to make provision for establishment of consumer councils and other authorities for the settlement of consumer disputes and for matters connected therewith.” Initially, when the Consumer Protection Act was passed in 1986 it did not have the definition of “unfair trade practice”. The notion of unfair trade practice was explained as per the definition under the MRTP Act, 1969. However, in 1993, through an amendment to the Consumer Protection Act section 2(1)(r) was added which provided a comprehensive explanation of what could be an ‘unfair trade practice’ as was provided in not so exhaustive manner under 36A of MRTP Act.

**Specific Relief Act, 1963**

According to Section 20 of this Act, it is the discretion of the Court to grant specific performance. Just because it is lawful to grant specific relief, does not

\(^{34}\) Law Commission, *Report on Quality, Control and Inspection of Consumer Goods* (Law Com No105, 1984)
make it mandatory for the court to do so. Moreover, discretion does not mean arbitrariness; this decision should be sound and reasonable and should be based on judicial principles. An illustration of use of discretionary power by the Court not to grant can be seen in Section 20(2) (a) to (c), wherein denial of such specific performance can be based on unjust enrichment to one party or where the situation becomes inequitable due to hardship.

**Sale of Goods Act, 1930**

The Sale of Goods Act, 1930 provides with a wide range of rights, obligations and liabilities. Some of which comprises the warranties and guarantees given by the legislation. However, Section 62 of that legislation allows non-inclusion of these rights, obligations or liabilities by express clause or on account of the course of transactions between the entities, or by usage, if the usage is binding the entities to the contract. Section 62 of the Sale of Goods Act says- “Exclusion of implied terms and conditions: Where any right, duty or liability would arise under a contract of sale by implication of law, it may be negatived or varied by express agreement or by the course of dealing between the parties or by usage, if the usage is such as to bind both parties to the contract.” The legislations in UK and other nations do not allow an entity to not include certain rights, obligations or liabilities of one or other entities under contracts, specifically with respect to sale of goods. Also the terms entailed during a transaction will be subject to Section 9. This act which normally can be applied to most of the contracts which relates to product sold or given to customers allows one party to not perform its obligations and liabilities or not include the rights of the customers that are present in that legislation. Such terms are deemed to be naturally unpleasant, as long as there is ample justification for the same.

**Competition Act, 2002**

Caveat emptor is no longer applicable to the present scenario. Now importance is given to the best interests of the consumer. In furtherance of such interest, two substantially overlapping yet distinct legislations can be found in India, viz., MRTP Act, 1969 and Consumer (Protection) Act, 1986. They are different on many grounds including jurisdiction, who may seek relief, what kind of relief
may be sought, what procedure is to be followed and so on. Also, a consumer is provided with a choice as to which body he/she wants to approach to seek relief.

But these legislations were insufficient to cover anti-competitive practices under their ambit. Therefore, in furtherance of the rights of consumers and the report of the Raghavan Committee on Competition Law, 2000 (wherein the importance of free and fair competition was highlighted), the Competition Act, 2002 was enacted, thus repealing the MRTP Act, 1969.

If we talk about the Competition Act, the word unfair trade practices or unfair terms do not find a place in the Act but that nowhere means that it is implicit or the Act does not cover it. It is present in the Act but is now classified under various heads like False Offer, Representation, Price Scheme, Non-Compliance of prescribed standard, Hoarding etc. The preamble of the legislation says that “it is an Act to provide, keeping in view of the economic development of the country, for the establishment of a Commission to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other participants in markets, in India, and for matters connected therewith or incidental thereto”.

The extent and jurisdiction of Competition Act, is justly broad. Section 3(1) of the legislation, forbids anti-competitive agreements based on production, supply, distribution, storage, acquisition or control of goods or provision of services, which results in high unfavourable repercussions on the competition in India. Any agreement which is signed in violation of the terms in Section 3 (1) shall stand void. Competition Act revokes the Monopolistic and Restrictive Trade Practices Act, 1969. As per the provisions of the Act, it is necessary for the Competition Commission of India to knock out such practices that have a negative impact on competition in India, and to ensure healthy and fair competition with fair terms between the parties. The CCI has the authority to give an interim injunction, prohibiting any entity from indulging in any of the above mentioned activities. CCI also has the authority to provide with adequate compensation to the aggrieved party who has suffered losses as a result of any violation of the provisions under chapter II of the Act.
UNFAIR TERMS IN CONTRACTS - SOME SUGGESTIONS

In this part of the chapter, the authors provide some suggestions relating to “unfair terms in Contracts.”

First, one of the things that the authors have found is that various legislations have clauses regulating unfair contracts in their specific field. Some of them are-

1) Section 3 of the Usurious Bank Loan Act, 1918\(^{35}\) says that if the interests are excessive [clause (a)] or the transaction is of an unfair nature [clause (b)], then,
   a. The transaction can be reopened and the debtor be relieved of the excessive interest or the contracts can be set aside.
   b. The contracts can be set aside either wholly or in part or alter any security given or agreement made in respect of any loan, and if the creditor has parted with the security, order him to indemnify the debtor in such manner and to such extent as it may deem just.

2) The Rent Control Act creates such provisions as-
   a. Fixations of ‘fair’ or ‘standard’ rent.
   b. Protection to tenants against indiscriminate eviction by unscrupulous landlords.

In the case of *DLF Universal Limited v Ekta Seth and Anr.*, when the courts found no way of regulating builder-developer agreements under any legislation, it resorted to Article 142 of the Indian Constitution which deals with the Supreme Court exercising jurisdiction to pass order as may be necessary for doing complete justice in any matter before it.

Thus from the above analysis it becomes quite clear that we need a law regulating unfair terms of Contracts in general, like the UK’s unfair Contract Terms Act, 1977. Also it would save the time and the pain of providing various clauses to regulate unfair terms under different legislations, all dealing with their own fields.

\(^{35}\) Usurious Bank Loan Act 1918, s 13.
Second, standard form contracts can be used as an important commercial tool provided the general people read the contracts thoroughly prior to signing one. The main reason for the trouble is the long and tedious terms and conditions, that may comprise of exemption clause, and which generally people avoid reading.

Third, any deed in the shape of a standard form contract should have a precise summary at the starting of the particular Contracts, so that the people can understand the contracts prior to entering into one. This particular summary must contain the exemption clause, in order to make general public know about it.

Fourth, it is highly unlikely that the abovementioned recommendations given will be followed religiously in every standard form contract which is made, therefore it is imperative to make suitable changes in the Indian Contract Act, 1872 and a clause for obligatory following of it should be added to the Indian Contract Act’s provision so as to serve the interest of the general public.

**Conclusion**

Although one of the most established and aged legislation of India, the Indian Contract Act’s importance has developed in a multifarious nature in the present business framework with notable growth in the number of agreement being entered upon by different parties and the various contentions arising thereof. It is therefore quite necessary to bring suitable changes into the Indian Contracts Act so as to make it dynamic and in synchronization with the evolving business situations.

The Indian Contracts Act is an important and exhaustive bit of legislation. The ideas under the law of Contracts somewhat works in tandem with the laws of the UK. Yet, the law has various clauses that differ from the UK’s. Contract laws in India do not have a legislation managing unreasonable terms of an agreement. It is important to make changes accordingly to the general standards directing unreasonableness in contracts. This will have broad repercussions on
a wide ambit of contracts including lending agreements, builder-developer agreements, debt instruments, landlord-tenant agreements, government contracts, arbitration agreements etc.

Most of the progressing countries have brought in suitable changes with the requirement of the time to counter and curb unfairness in Contracts, and figure out the likelihood of “procedural” and “substantive” unfairness. Courts should be given the authority to bring up a matter of unfairness regardless of the fact that the parties involved raise it or not. Even the Law Commission has prescribed that a different law should be passed in order to protect people from such unjustifiable terms. Many concur that The Indian Contract Act is very systematic and lucid enactment, yet various changes would facilitate it to keep it dynamic and in sync with the changing times, requirements and with contemporary global entrepreneurial practices. This will provide more belief to outside players who desire to work and establish in India.
DOCTRINE OF ECONOMIC DURESS

Pragya Kaushik* and Ritika Bansal**

ABSTRACT

Duress is normally understood as the force used by a person to make another person act or not act in a certain way, which the other person ordinarily may or may not perform. Several contracts are made to be signed under duress and all such contracts are by law, 'voidable'. Originated from Common Law, the present features defining this principle have been derived from several landmark cases. Some of these features are the 'but for' test (i.e. the refusal of a person to perform an act but for the threat by the coercive party), absence of a reasonable alternative to the coerced party, protest by the coerced party etc. This article will describe the elements of ‘economic duress’ using the landmark cases and then an additional perspective will be outlined using the American position on this principle. Then the authors will elaborate upon the Indian position. Important principles and terms like ‘Take it or leave it’ and ‘illegitimate pressure’ will be explained.

INTRODUCTION

Duress, as a layman would understand, is the pressure exerted on a person so as to coerce him to perform an act or abstain from doing so, which he may or may not perform, ordinarily. A contract induced by duress is voidable.

The increasingly complex nature of the various complicated transactions has coughed up the concept of economic duress as a separate doctrine. The rationale is that illegal pressure can be exerted without threatening with physical harm. In modern times, this pressure exerted during duress is called ‘illegitimate pressure’.¹ This concept calls for a clear demarcation between legitimate, and

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
** Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
unacceptable and illegitimate pressure. Law usually does not take legitimate pressure into account as it is expected to be normally healthy for competition. Law does not allow any party to conform to illegitimate pressure without having remedy. Illegitimate pressure is when one party threatens to breach the law or statutory duty using, crime, tort or breach of contract. The coerced party may set aside the contract in such cases. Context becomes important as there can be situations in which even though the pressure is lawful, it is considered illegitimate. Duress is not held in cases where the threat is legal in nature, for example the termination of a contract lawfully. However, it could be held to be duress if certain demands are made on the basis of these threats.

Earlier, there was a misleading interpretation that coerced person’s entry into the contract induced by duress was not a voluntary act. The rationale applied is that the coerced person is completely aware of the terms and conditions of the contract induced by duress. It is not his will that is defective; it is his freedom to choose to contract that is violated.2

Duress has always been differentiated on the basis of threat. Initially, the only forms of duress recognized were duress to the person, but now threats of economic injury and threats to property have also gained prominence. These types of duress have illegitimate pressure in common but are differentiated on various basis like the rules of causation.

It is necessary to show that there is a causal connection between duress and contract. Where there is duress to a person, it needs to be shown that duress was one of the causes of the contract, whereas in economic duress, the duress has to be the most significant cause of the contract.

The provisions for the doctrine of economic duress tend to be ambiguous due to the subjectivity in determining the nature of this “illegitimate threat”. This doctrine finds its origin in the Common Law, which was developed primarily through case laws and their judgements. Though, the American Law tends to provide a more specific outline for the determination of economic duress in

2 ibid 351.
these cases, the element of subjectivity cannot be entirely removed. Similarly, in India, the position on economic duress is not very clear, with reliance being on provisions of the Common Law and case laws for the application of the doctrine.

In this article, attempts have been made to understand this doctrine of economic duress through analysing its origin in the common law, and the various cases which first introduced it. Moreover, the authors provided an alternative position in the American context to present several commonly identified features in the application of this doctrine. The Indian position is then elaborated in this article to understand the provisions of the Indian Contract Act and the Competition Law under which economic duress has been applied in cases. Analysing the overlaps and interface between these two laws would help gauge a better understanding of the Indian position on economic duress, and provide an insight into its loopholes. Lastly, this article aims to identify the problems faced in the application of this doctrine. Thereby, the authors suggest a few measures which could be taken to solve these problems, and promote efficient use of this doctrine in judgement of cases.

**Elements of Economic Duress**

The doctrine of economic duress finds its origin under Common Law. It was developed as a remedy for contracts which are made under the influence of a threat made other than to person or goods. Economic duress, as a doctrine, has been defined mostly due to the judgments in three cases and a Privy Council appeal. These judgements helped outline some of the elements of economic duress, thus providing the guidelines under which this remedy can be granted.

First in the case of *Occidental Worldwide Investment Corporation v Skibs A/V Avanti* the defendant had chartered two ships from the plaintiff. The charterers asked for a lower rate of hire than that had been previously contracted. They incorrectly claimed that if the price was not lowered, they would go bankrupt.

---


The owners would then get no payment whatsoever. The owners agreed to reduce the price as this was considered to be the ‘lesser of the two evils’. In this case, the judge granted that there was fraud by the charterers. However, no relief for economic duress was given as it was claimed to be normal commercial pressure due to an apparent choice with the owner to reduce the price. This judgment was questioned later, accepting that economic duress would also be a ground for relief in this case as a threat of economic loss had been issued to the owner due the fraudulent claims of the charterers. Though, the relief for economic duress is immaterial in this case as the relief for fraud had already been provided, this helped develop the concept of an illegitimate threat to the economic profits of a plaintiff as a ground for relief under economic duress.

In the case of North Ocean Shipping Co. Ltd. v Hyundai Construction Co. Ltd., the plaintiff had contracted with the defendant for building a ship. The payment for this contract was supposed to be made in five instalments. After the first instalment was paid, the US dollar devalued. The defendants threatened to discontinue building the ship unless the plaintiff agreed to raise the price of the ship. The plaintiff had a valuable charter already lined up for the ship with Shell, and so hesitatingly agreed to the increased price. It was held that this was a case of economic duress, and the plaintiff could have refused to the payment of increased prices. However, the delay in filing this case in the court, long before which the plaintiff had already made the payment and accepted the delivery of the ship, would waive off their right to file under economic duress. This delay would be taken as the acceptance of the plaintiff to the price variation under the contract.

In the case of Pao On v Lau Yiu Long, the claimant had threatened to leave the main contract for the purchase of shares incomplete unless the defendant had agreed to a few subsidiary agreements. These subsidiary agreements included a guarantee and an indemnity. This contract for acquisition of shares between the two parties had been made public, and so it was important for the reputation

---

5 Chitty (n 3) 678.
6 [1979] QB 705 (HC).
7 [1979] 3 All ER 65 (PC).
of the defendant Company, and their share prices, that this contract took place. The defendant, therefore, agreed to the demands of the claimant. The defendant could have sued the claimant for the specific performance of the contract, however, it refused to do so as this would have resulted in a delay in the matter and would have also damaged the reputation of the Company. The defendant had taken legal advice before agreeing to the subsidiary agreements. It was held that there was no economic duress in this case. Lord Scarman further outlined four main factors to consider the presence of economic duress in a case. He said it was material to inquire: whether the person claiming to have been coerced, protested or not; whether there was an alternative legal remedy present to the coerced person; whether the coerced party was independently advised; whether the coerced party took steps to avoid the contract after entering into it. It was later held through American cases that merely having an alternate legal remedy would not rescind the right of the coerced person to file for economic duress, but having a practical alternative legal remedy would.

In the case of Universe Tankships of Monrovia v International Transports Workers Federation, the defendants had blacked a ship belonging to the plaintiff at the port. They refused to release the ship unless the plaintiff agreed to certain pay and work conditions, along with paying a certain sum to the Seafarers International Welfare Fund. The plaintiff agreed to this in order to get the ship released from the port. They later sued for economic duress to recover the payment made to the welfare fund. It was held that economic duress did apply in this case. Also, the House of Lords held that as the plaintiff had no other choice but to submit to the demands of the defendants, it could be held that there had been “coercion of the will” and so the plaintiff had not consented to it. Two elements of economic duress were identified through this case. These were the absence of choice to the coerced party and the illegitimacy of the demands of the defendants.

8 Pao (n 7).
9 Chitty (n 3) 679.
10 [1982] 2 All ER 67 (HL).
The doctrine of economic duress was first accepted in the English courts in the case of *Dinskal Shipping Co Ltd v ITWF*, where the threat to strike by the defendants qualified as illegitimate pressure, thus constituting duress. Economic duress was also applied in the case of *B & S Contracts Design v Victor Green Publications Ltd.* In this case, the defendants indicated that its workers would go on a strike, which would result in the incompletion of the stands being set up for the plaintiff’s exhibition, unless a higher payment was made. The plaintiff agreed to the increased payment as the tickets for the exhibition had already been sold. It was held that there was a “veiled” threat in this case as the plaintiff had no other practical option but to pay the higher payment, thus economic duress was held to be present. The element of ‘good faith’ was discussed in this case, which brought about the finding that even if the party seeking to renegotiate a contract was not at fault for the difficulty arisen in the completion of the contract, economic duress can still be held to be present in the case.

Therefore, these cases helped to outline the main elements of the doctrine of economic duress. These have been used as a guide by subsequent judges to determine whether economic duress can be held to be present in a case. These elements have been outlined below.

One of the important elements happens to be *Causation* or the ‘*But For*’ Test which suggests the presence of economic duress if the plaintiff would not have agreed to the new demands of the defendants “but for” the threat made by the defendant. If there is held to be voluntary submission on part of the plaintiff, which means they did not mind paying the extra amount anyway, economic duress cannot be claimed in the courts. It was held that the plaintiff failed the “but for” test in the *Pao on* case, which resulted in the refusal of the courts to accept economic duress in the case. In cases of duress, courts hold that if the

---

11 [1991]4 All ER 871 (CA).
12 [1984] ICR 419 (CA).
14 Chitty (n 3) 684.
15 *Pao* (n 7).
threat to a person or good is merely 'a' cause for the agreement of the coerced party, duress can be claimed. However, in cases of economic duress, it is important that the threat is a significant cause of the agreement to the contract.  

Another important element is ‘Reasonable Alternative’. In duress to goods, having a reasonable alternative would not bar the remedy given under duress. For example, an alternative remedy of a suit under tort for wrong interference would help in providing damages to the party, however it does not provide the right to recover the goods from the defendant. Therefore, in such cases, the presence of an alternative can still result in a successful claim under duress. On the other hand, in economic duress, having a reasonable alternative would rescind the right to claim economic duress in a contract.

“Economic duress can only provide a basis for avoiding the contract if there was no real alternative.” The presence of a reasonable alternative to agreeing to the demands of the party renegotiating would show that the coerced party voluntarily agreed to the new terms and not due to some external pressure. This would, therefore, waive off the right of the “coerced” party to claim economic duress. Furthermore, whether there was a reasonable alternative present or not at the time of renegotiation would be determined from the perspective of a “reasonable” man. If a reasonable man found there to be an alternative, even if the coerced party’s did not think of this, the plea of economic duress would fail.

‘Gravity of the Threat’ is another important element to be considered. Minor threats, even if they are unlawful, are not seen as a ground for redress under economic duress. This is because minor threats could easily have reasonable alternatives, which the party should have adopted rather than agreeing to the threats. While determining the seriousness of a threat, the mental and physical conditions of the “coerced party” are also taken into consideration. Factors

16 Anson (n 13) 354.
17 ibid 355.
18 Chitty (n 3) 686.
19 ibid (n 3) 686.
20 ibid.
such as weak intellect or fear are often considered by the judges to determine whether the threat was serious enough to constitute economic duress.\textsuperscript{21} The presence of reasonable alternatives would again determine whether a threat was serious enough.

Whether the coerced party protested or not would help the court determine whether the payment was made voluntarily or not. *Hence ‘protest’ becomes an important element.* If a party voluntarily agreed to the terms in order to help the other party or because the originally contracted prices were really low, and so the party did not mind paying more, then the claim of economic duress would not be entertained by the courts later. For example, in the case of *Universe Tankships*,\textsuperscript{22} the plaintiff had protested while making the payment in order to get their ship released from the defendant. This shows that the payment was not voluntarily made, and so the claim of economic duress was entertained by the court. However, if a party did not “protest” while making the payment, it does not necessarily mean that the payment was voluntarily made.\textsuperscript{23}

The decision of the coerced party to seek independent advice would show whether they attempted to find reasonable alternatives. *This constitutes the element of ‘Independent Advice’.* It is, however, not an essential condition to have approached legal advice previously to be able to claim economic duress later.\textsuperscript{24} For example, in the case of *Pao on*,\textsuperscript{25} it was held that it is a material fact to inquire whether the coerced party had independent advice. This would help determine the presence of alternatives, which in effect would determine whether the case has sufficient grounds for a claim under economic duress.

The element *‘Illegitimacy of Demand’*, outlined mostly by American cases, suggests that if the threat made had a legitimate basis, the plea of economic duress would not be entertained. The demand might be considered legitimate

\textsuperscript{21} ibid.
\textsuperscript{22} *Universe Tankships* (n 10).
\textsuperscript{23} Chitty (n 3) 687.
\textsuperscript{24} ibid 687.
\textsuperscript{25} *Pao on* (n 7).
due to unforeseen commercial difficulties which would make the performance of the contract impractical, or if the renegotiating party acts in “good faith” that they deserve more payment making the demand ‘fair’.26

Stating the inevitable in a contract would be regarded as a fact and not a threat. For example, if the party truthfully states that it would not be possible to complete the contract without increased payment, it would be taken as a matter of fact and not treated as a threat. Even if the contract may not be “impossible” to perform, if it results in severe hardships for the party completing it, it would not be treated as a threat.27 In the case of Williams v Roffey Bros & Nicholls (contractors) Ltd,28 it was held that there had been no threat from the claimants as they had asked for an increased rate due to a miscalculation of their costs to complete the contract, to which the defendant had initially agreed, to help to finish the contract. The subsequent refusal of the defendants to pay the sum left the claimant without enough money to complete the contract. The refusal of the claimant to complete the contract unless the additional payment was made was not held to be a threat, and therefore it was not seen as a ground to grant economic duress.

The fairness of demand would also determine whether economic duress can be claimed. If the party is seeking renegotiation due to an imbalance in the original contract, for example unreasonably low prices charged, then this demand could be said to be fair. However, such a demand would be considered fair only if the coerced party had agreed to the new terms to help out the other party, and not under influence of the threat.29 If the threat is the main influence behind the contract, then economic duress can still be claimed. In the case of Atlas Express Ltd v Kafco (Importers and Distributors) Ltd.,30 the defendants had miscalculated the number of cargo so had offered very low prices. This became unfeasible with the actual number of cargo to be transported. They threatened

26  Chitty (n 3) 689.
27  Chitty (n 3) 690.
28  [1990] 2 WLR 1153 (CA).
29  Chitty (n 3) 691.
the non-performance of the contract unless the prices were raised. The plaintiff
had agreed to the increased prices in this case only due to the threat of non-
performance, and did not voluntarily wish to do the same. Economic duress
was granted in this case as the demand was no longer “fair”.

Therefore, all these elements are taken into consideration by the courts in
deciding whether there are sufficient grounds for claiming economic duress
in a contract. The main elements out of these are the causation (the “but for”
test), reasonable alternative and illegitimacy of demand.31

INTERNATIONAL INPUTS: AMERICAN POSITION

The take on economic duress is differentiated between the states in America,
however the doctrine mostly does find a place in the American laws of contracts,
even if it does not enjoy a prominent position.32 This article focuses on the
general themes identified in these laws and the position on economic duress
taken under the uniform commercial code (UCC). A few of the elements of
the doctrine as identified through American case laws are as follows.

‘Wrongful conduct’ – being first one of such elements - takes a meaning beyond
what is merely illegal under the criminal law. It extends to acts done under
“bad faith”, even if not necessarily illegal. Wrongful conduct, as described by
Corbin, would mean “breach of good faith and fair dealing”.33 According to
the Burton’s theory of good faith performance, when a person contracts upon
certain terms, such as the price of the contract, he bargains away his opportunity
to set other terms.34 A party to a contract does have the right to approach the
other party to modify the terms of the contract, however, this should not be to
restore the opportunity lost while contracting originally. Any such modifications

31 Chitty (n 3) 692.
hugheshubbard.com/ArticleDocuments/Economic%20Distress.pdf> accessed, 13 May
2015.
33 ibid 2.
34 Randy E. Barnett, The Oxford Introduction to U.S. Law: Contracts, (Oxford University
would be acting in “bad faith”. Any modifications suggested due to a change in circumstances, which hinder the performance at original terms, would be termed as acting under “good faith”. It can be said that good faith and bad faith can be differentiated through investigating the motive behind the modifications as suggested by the party seeking changes.

The UCC imposes an obligation of good faith in the performance and enforcement of contracts under section 1-304. Furthermore, the concept of using bad faith to escape contracts has been highlighted under the official comment to Sections 2-209.

“*The effective use of bad faith to escape performance on the original contract terms is barred, and the extortion of a modification without legitimate commercial reason is ineffective as a violation of the duty of good faith.*”

This comment demonstrates that wrongful conduct, or acting under “bad faith” to “extort” modifications from the other party would violate Section 1-304, which imposes an obligation of good faith in the performance and enforcement of contracts.

On the other hand, several courts have refused to broaden the definition of wrongful conduct to an extent that it covers merely “immoral” acts. This was seen in the case of *Dunes Hospitality L.L.C. v Country Kitchen Int’l, Inc.* In this case, Dunes had contracted with CKI to manage a restaurant in South Dakota. Upon complaints of mismanagement, the members of Dunes decided to consider the various options they had under the management agreement, including firing CKI, running the restaurant by themselves or filing a suit.

---

35 ibid.


37 “Every Contract or duty within the Uniform Commercial Code imposes an obligation of good faith in its performance and enforcement.” UCC 1952, 1-304.

38 It is part of the general comment to UCC 1952, 2-209.

39 623 N.W.2d (SC).
They, however, decided to negotiate with CKI, and reached a settlement agreement, which they were initially against. Later that year, Dunes terminated the management agreement, and filed a suit claiming that the settlement agreement was extorted by CKI under fraud and economic duress. It was held, that economic duress would not be given as Dunes did have reasonable alternatives under the original contract, and they need not have signed the settlement agreement. Taking advantage of the superior bargaining power may be immoral, however, it would not necessarily constitute economic duress. Therefore, broadening the scope of “wrongful conduct” would raise many frivolous cases claiming economic duress, which do not meet its essential criteria.

Another element of economic duress is ‘Financial Distress’. It has to be shown that severe financial distress has been caused by the coercing party to the other party. This may include bankruptcy or irreparable business injury. Such a causation is often shown by displaying that the parties under the contract had pre-contractual relations, which may demonstrate why such a severe situation arose. Inferior bargaining position would not bring claims of economic duress, as was seen through the Dunes case.

Another element – ‘Reasonable Alternative’ - follows closely to that as under Common Law. If the coerced party had other practical options it could have adopted rather than agreeing to the terms as suggested by the other party, then a plea of economic duress would fail. This would include not only commercial alternatives, such as obtaining the contracted goods from another supplier, but also legal alternatives. For example, a suit for damages, restitution or specific performance might have provided an adequate remedy for the coerced party rather than agreeing to the terms of the coercing party.

This was seen in the case of Austin Instrument v Loral Corp. In this case, the supplier of the goods threatened to not complete the performance of the

40 Sullivan (n 32) 3.  
41 Dunes (n 39).  
42 Sullivan (n 32) 3.  
43 272 N.E.2d 533 (CA).
contract, unless the plaintiffs agreed to a higher payment. As the plaintiffs could not find any other source of the goods, and had no other reasonable alternatives, they agreed to the higher payment. Later, upon bringing a suit claiming economic duress, the court awarded it due to the lack of reasonable alternatives with the plaintiffs.  

Another important element, protest, has been discussed in the American position. To show that the coerced party agreed to the new terms under economic duress, it is vital to demonstrate that they did not voluntarily agree to such terms. Protest can be shown through protests to the terms originally made while signing the contract, through attempts to reinforce the terms as originally contracted, and through promises to sue for breach of the contracted terms. Section 1-308 of the UCC shows that a party may sign a contract and preserve its rights saying that such a contract is signed under protest.

“A party that with explicit reservation of rights performs or promises performance or assents to performance in a manner demanded or offered by the other party does not thereby prejudice the rights reserved. Such words as “without prejudice,” “under protest,” or the like are sufficient.”

The element of protest was seen in the case of United States v Progressive Enterprises. In this case, a contractor had placed a bid with the Government based on the rates quotes by the supplier. The supplier, subsequently, asked for increased rates due to unforeseen higher costs. The contractor had agreed to the higher rates without protest. Later, the contractor brought upon a suit of economic duress against the supplier. It was held that economic duress would not be given in this case as it could be seen that the contractor did not “mind” making the extra payment due to the absence of protest from him.

---

44 Barnett (n 34) 225.
45 Sullivan (n 32) 4.
46 UCC 1952, 1-308 (a).
48 Barnett (n 34) 225.
Other factors such as the presence of legal advice also bears an importance in determining whether sufficient grounds for economic duress are present in a case. However, like Indian courts, American courts are normally hesitant in granting economic duress in cases. This is due to immense subjectivity of the doctrine.\textsuperscript{49} Ambiguity arises as the doctrine is claimed to be too vast a topic. To increase its application by courts, it needs to be better defined under the statutes. However, as can be seen from the various case laws, this doctrine is too vast to be defined; an attempt to define it might leave out many cases where it would acquire “fair” use.

**Position in India**

The above elements had been outlined under the Common Law and the American Laws through several cases. The presence of these elements in a contract would stand as a ground for economic duress, thus would vitiate such a contract. The Indian Contract Act, 1872, on the other hand, makes no mention of the doctrine of economic duress under its sections.\textsuperscript{50} Duress to goods is covered under section 15 of the Indian Contract Act which deals with “coercion”.

“Coercion’ is … or the unlawful detaining, or threatening to detain, any property, to the prejudice of any person whatever, with the intention of causing any person to enter into an agreement.”\textsuperscript{51}

Section 15 covers duress to goods by making provision for contracts which are entered into due to a threat made to the “property” of the person. This, however, does not cover agreements which are entered into due to the threat to the contract. However, section 72 of the Indian Contract Act, can be said to better provide for economic duress.

\textsuperscript{49} Sullivan (n 32) 4.

\textsuperscript{50} Nilima Bhadbade, *Contract Law in India*, (Kluwer Law International 2010) 129.

\textsuperscript{51} Indian Contract Act, 1872, section 15.
“A person to whom money has been paid, or anything delivered, by mistake or under coercion, must repay or return it.”

This section deals with unjust enrichment under a contract, which would cover the use of illegitimate pressure used to enter into a contract. This can be said to cover contracts of economic duress. However, when this section is read in accordance to section 15, it can be said that this remedy is provided only for mistake or coercion as defined under section 15, which does not cover threat to contracts.

In the case of Kanhiya Lal v National Bank of India, it was held that the term “coercion” in section 72 is not controlled by the definition provided for it under section 15, and instead requires “general use” and that by “common sense”. This would suggest that economic duress can be seen as “coercion” and so would be provided for under section 72 of the Indian Contract Act, 1872. The elements of economic duress discussed in the previous section stand as grounds for determining the coercion even in the Indian context.

Courts in India are still hesitant in holding economic duress in contracts due to the subjective nature of the doctrine. Subjectivity arises in the determination of the “fairness” of the demand and the gravity of threat. This could be due to the unclear definition under section 72 which makes a reference to coercion and does not clearly define economic duress. An amendment to introduce a provision for economic duress under the Indian Contract Act might help to reduce this ambiguity of the doctrine and increase its application in the Indian courts. One more interesting aspect of the whole scenario is that economic duress can also be studied under competition law and this is because economic

---

52 Indian Contract Act, 1872, section 72.
54 (1910) 12 BOMLR 430 (HC).
55 ‘The doctrine of economic duress’ (n 53).
56 ‘The doctrine of economic duress’ (n 53).
duress was mostly visible in commercial contracts up till now. For example, many landmark Indian cases of economic duress have situations in which disputes regarding a commercial contract were brought in front of an arbitrator who declared them void or valid depending on presence or absence of economic duress. When the decision of the arbitrator was challenged in courts, it was either upheld or declared void by the court depending on the presence or absence of economic duress.

Several other decisions of Indian courts have provided multiple criteria for determining economic duress, one of them being real or perceived threat. Another one is that to prove economic duress, the coerced party should have had no ‘reasonable’ alternative to turn to because if there was such alternative available then it could not take the defence of a ‘no choice’ situation. A person threatened in such a manner can have the contract deemed unenforceable due to operative duress and he can also claim a separate action for tort.

Commonwealth jurisdictions apply this doctrine a lot in cases of commercial contracts. Civil law countries, on the other hand, are a bit more wary about its application as their main concern is the role that duress would play in destroying the contractual terms.

The courts in India have applied this doctrine, but not in liberal amounts. Mostly this doctrine has been seen in commercial contracts. The courts in India have applied this doctrine mostly in cases on employee related contracts and in some similarly restrictive agreements. This can be attributed to the liberalized business and legal environment in India. The courts find it difficult to define

---


59 ibid.

60 ibid.
inequality in holistic, unequivocal terms.\textsuperscript{61} The presence of multiple angles restricts the attempt to give an unbiased definition of inequality in the Indian context. Indian courts exercise their discretion very carefully. For example, a cross-border contract is riddled primarily with problems of jurisdiction and dispute-resolution and often the clauses which are imposed are due to the sheer power of the stronger country. The question then arises whether the weaker country can challenge such international contracts later on grounds on economic duress. It can be safely predicted, based on the old and newly emerging patterns of Indian judiciary that the courts, to provide stability, will not entertain this plea and will seek to enforce these contracts and rather than setting them aside.\textsuperscript{62}

**ECONOMIC DURESS IN INDIA THROUGH CASE LAWS**

Economic duress is the threat of extremely serious economic consequences in that the threatened party is cornered and has no other option but to enter into the contract. There can also be a situation where the coercive party threatens to break an existing contract unless new terms and conditions are renegotiated in its favour and the other party accepts the new contract, fearing severe financial consequences.

An example of this situation is the *Dai-ichi Karkaria v ONGC* \textsuperscript{63} case. This was also one of the first landmark cases which clearly defined and identified economic duress in the history of contract law in India. In this case, the plaintiff was a small Company which supplied goods to the ONGC, the first defendant, the second being the national bank. The plaintiff used to import raw materials for the goods to be manufactured for ONGC and used to pay a large customs duty on those goods. The plaintiff and ONGC entered into an agreement in which the plaintiff agreed to supply a certain amount of goods approximately worth Rs. 1.5 crore to ONGC. The price of the goods included the market

\textsuperscript{61} ibid.

\textsuperscript{62} ibid.

\textsuperscript{63} AIR 1992 Bom 309 (Bombay HC).
value (about Rs. 10 per unit) of the goods plus the export price (about Rs. 30 per unit) paid on them by the plaintiff.

Before the execution of this agreement the parties had contemplated, based on a notification issued by the Central Government which said that certain goods will be exempted from customs duty, that the customs duty may be refunded to the plaintiff by the Central government. A bank guarantee was also furnished in favour of ONGC, according to which the plaintiff agreed to return the amount of customs duty, refunded by the central government, to ONGC within 10 days of date of receipt of the customs duty or within 6 months of the date of the guarantee, whichever was earlier. The first time goods were supplied to ONGC was in October, 1983 and they were sold at the price decided under the agreement, which was inclusive of the customs duty.

Similarly, the second time goods were supplied to ONGC, they were sold at the decided price. Thus, ONGC had induced the plaintiff to believe that the same price was acceptable to them for the previous transactions and for future transactions. Soon after this transaction, the plaintiff spent crores of rupees in booking and buying further raw material, for which he paid customs duty, for a further supply of goods to ONGC.

The third time ONGC asked for a fresh supply of goods, they argued to pay only the market price for it and not full amount as decided under the agreement. This was protested by the plaintiff who sent a letter to the ONGC explaining that based on their assurances, further raw material was being continuously imported and customs duty was being paid on it and that the backing out of the agreement by ONGC put the plaintiff in a severe economic crisis. ONGC denied any commitment being made to buy the goods at the decided price. It pressurized the plaintiff to renegotiate the terms of the contract and coerced the plaintiff to agree to the new ones. The plaintiff participated in the negotiations under economic duress as it had employed a huge amount of its resources to securing future procurement of raw materials for ONGC and thus had no resources to fall back on. The court found it impractical to call the difference between the agreed price and the export duty as ‘advance payment’ (as specified in the agreement and the bank guarantee).
According to the renegotiations, it was decided that the export duty would be treated as the new agreed price. From January to March, 1984, several consignments of the goods were delivered to ONGC under the new agreed price. Meanwhile, the Indian Government refused to consider the raw material for refund of customs duty. It appeared that the plaintiff had furnished a bank guarantee in favour of 1st defendant (as described above), under coercion, in which it was decided that the plaintiff would have to refund the ad hoc amount irrespective of whether he received the refund from the government or not. Plaintiff’s suggestion of reducing the bank guarantee in case of non-refund of bank guarantee was rejected. Since Rs. 1.5 crore of the plaintiff were blocked which the defendants were not willing to release unless he furnished the bank guarantee, he agreed under duress.

Essentially, an unfair bank guarantee was procured from the plaintiff by taking advantage of the economic crisis he was placed under by the defendants when they threatened to breach the contract by refusing to pay the legally payable price of about Rs. 40 per unit.

The plaintiff did not raise any objection to the refund of the customs duty, if and when, by the Indian government. The issue raised pertained to the invocation of the bank guarantee even at the non-receipt of the customs duty from the government no matter how much he tried to get it refunded.

When the customs duty was not refunded, the plaintiff extended the guarantee multiple times. Also, the defendant did not invoke the bank guarantee for several years. The plaintiff pleaded fraud, economic duress, and exceptional circumstances to seek judicial intervention for interim relief.

It was held that economic duress and fraud took place when the plaintiff was forced to agree to the stipulation in the bank guarantee that it can invoked irrespective of whether the Indian Government has refunded the customs duty or not.
In the case of *Sara International Limited v Rizhao Steel Holding Group*, the Delhi High Court specified the necessary ingredients on the basis of which a contract can be avoided on the grounds of economic duress:

1.) Illegitimate pressure

2.) The pressure should be a significant cause which induces the coerced party to enter the contract

3.) The practical effect of the pressure should be the compulsion on the coerced party to enter the contract, or a lack of reasonable alternative or practical choice for that party.

Apart from laying down these ingredients, the Delhi HC also specified that while deciding the case of economic duress, courts should find out whether the coerced person protested before or soon after the impugned contract and if he/she has the benefit of independent legal advice.

In *National Insurance Co. Ltd. v Opera Clothing*, the court held that the Indian Contract Act is not exhaustive. It is false to say that the principles of law on economic duress as elucidated in various English, American and Australian positions are not relevant to Indian cases. They are relevant to the interpretation of the law of coercion given in Section 15 of the ICA. It also depends on the facts of the situation. So the coerced party is entitled to rely on ICA as well as various international positions. This case highlighted several important issues which may arise in the future. It talked about a future scenario where not the entire transaction but only a particular term/stipulation is vitiated by economic duress. It was held that whenever economic duress ends up in a varied contract then the coerced can refuse to abide by the new term which introduced the variation. It was also held that in specific situations, the coerced party can seek an injunction to restrain the enforcement of the impugned term (imposed on him by economic duress) without setting aside the whole transaction and the court can, after proper analysis, grant such an injunction. This judgement emphasized on the need to clearly distinguish between permissible commercial pressure

---

64 In the High Court of Delhi, CS(OS) 1586 of 2009.
65 In Bombay High Court on 13th March, 2015.
and economic duress because the dividing line between the two is very thin.

In *Democratic Builders v Union of India*, it was held, inter alia, that money paid under duress is not necessarily limited to duress to goods and that if necessary facts are proved, compulsion may turn into ‘economic duress’. Threat to breach a contract may come under ‘economic duress’. If any such form of duress results in a contract for consideration then it is a voidable contract and the excess money paid under it is liable to be recovered. It was also held that a plea for duress must be specifically pleaded and clear, convincing evidence to prove duress should be given in such regard. Mere assertion of a particular position would not be considered proof.

In the case of *Hitesh Anilkumar Jaju v The Vyasya Bank Ltd.*, illegitimate, legitimate, lawful yet illegitimate pressures were discussed. It was held that it is not duress to threaten to do something which one has a legal right to do. Hence, the threat to prosecute or let a litigation continue legally would not constitute illegitimate pressure. It was held that effect of coercion should be the direct result of cause.

In *National Insurance Co. Ltd. v M/S Boghara Polyfab Pvt. Ltd.*, it was held that discharge coupon which is given under threat or coercion amounting to economic duress, is not valid or binding.

In the *M/S Unikol Bottlers Ltd. v M/S Dhillon Kool Drinks* case, the court identified 3 elements – involuntary acceptance of the coerced party, absence of a reasonable, practical alternative, causal effect of the coercive acts – common to all forms of duress. The court held that to prove economic duress or business compulsion, a person has to go beyond proving a reluctance to accept or a situation of financial crisis. He/she has to necessarily show that the acts committed by the coercive party led to the involuntary acceptance or the

---

66 In Delhi High Court on 29th February, 1996.
67 In Bombay High Court on 12th March, 2015.
68 In Supreme Court of India on 18th September, 2008.
69 In Delhi High Court on 7th February, 1994.
financial crisis. It has to necessarily be proved that the economic duress was due to the conduct of the defendant and not due to the plaintiff’s necessities. The court gave the ‘real test’ to determine whether the consent was vitiated by duress – first, it has to be proved that illegitimate means were used and second, it has to be proved that the illegitimate means were a reason (not necessarily the main one) for the consent. The court had also emphasized on the validity of a contract being dependent on the factors of free will and consent of the parties.

In Superintending Engineer v Progressive Engineering Co., the court held that the refusal to extend time period despite the presence of valid reasons, unless the contractor agreed to work at old, lower rates might constitute economic duress, especially if the employer is in a dominant position and the terms of the contract are of his choice.

The Sara International case and the Dai-Ichi Karkaria case are examples of direct threat under economic duress. There are no known landmark cases in India about indirect threats being considered under economic duress. If such a situation arises then the case B & S Contracts and Design Ltd. v Victor Green Publications Ltd. will be referred to.

Difference between practical and legal choice has to be kept in mind. If the coerced person proves that he had no practical choice (not legal choice) but to enter into the contract, then the contract will be voidable. Even in Indian cases, the elements seen in Common Law, such as wrongful threat, are treated as important factors to determine economic duress in a case.

70 1997 (2) ALT 701 (Andhra HC).
71 In the High Court of Delhi, CS(OS) 1586 of 2009.
72 AIR 1992 Bom 309 (Bombay HC).
74 A party indicated that it would allow its workers to strike unless the opposite party made additional payments. This was held to be a veiled threat and hence economic duress as the victim had no option left but to agree to the demands.
Here we describe a very important provision – ‘Take It or Leave It’ provision. One of the most common problems in the economic duress scenario is that the coercive party threatens to or actually breaches the contract and usually the coerced party needs the performance of the contract, in order to maintain his reputation or protect against losses, one example being *Dai-ichi Karkaria* case.\(^76\) The coerced person is thus cornered in such a way that no other reasonable alternative is available to him and he is forced to either accept the contract or suffer serious losses. Also, the terms of such contract are more favourable to the coercive party and ensure heavy (usually irrecoverable) losses to the other party. This twisted situation is called ‘take it or leave’ contract.

The most famous landmark case in the scenario of ‘take it or leave it’ provision is the *Belaire Owners’ Association v DLF Limited, Huda and Others*,\(^77\) where the purchasers of the flats were left with no option but to agree to the renewed and unfair terms and conditions of the contract which DLF had introduced in its own favour after defaulting on the terms and conditions of the original contract.

Another example of this case would be the *M/S Unikol Bottlers Ltd. v M/S Dhillon Kool Drinks*\(^78\) case.

There is a difference between economic duress and the ordinary ‘rough and tumble’ in the commercial world and contracts.\(^79\) It was held that situations where lawful acts are also unethical are some extreme situations in which such acts can amount to economic duress. Illegitimate pressure takes into account factors like whether the coercive party acted in bad faith, or if a reasonable, practical alternative was available to the coerced party, whether the coerced party protested at the time or whether he/she affirmed the contract. Causation is about the ‘but for test’- ‘but for’ the illegitimate pressure, the coerced party would have never contracted with the coercive party. Also it was stated that illegitimacy does not have to always mean illegal or criminal act.

\(^76\) AIR 1992 Bom 309 (Bombay HC); “Take it or Leave it” and Economic Duress (n 57).
\(^77\) In Competition Commission of India on 3\(^{\text{rd}}\) January, 2013.
\(^78\) In Delhi High Court on 7\(^{\text{th}}\) February, 1994.
\(^79\) *The doctrine of Economic Duress* (n 58).
This section deals with situations where legal acts were deemed to be illegitimate pressure.

In the case of *CTN, Cash and Carry v Gallaher*, a threat to refuse to enter into any future contracts with the opposite party. This threat was held to be legitimate because of many reasons. Firstly, the defendant was not under an obligation to form any future contracts. Secondly, it was the defendant’s *bona fide* belief that he was truly entitled to the amount claimed. Thirdly, both the parties shared a purely commercial relationship. It was held that focus should be on whether the conduct was ‘morally or socially acceptable’ and not whether it was ‘lawful’. A lawful act amounting to economic duress in a commercial relationship is a rare occurrence.

In *Progress Bulk Carriers v Tube City IMS LLC*, the respondent made a take it or leave it offer to the claimant, where the only options available were of no discount or a little discount dependent on waiver of all claims for loss or damages. The claimant had to choose the second option, under protest. The take it or leave it offer was completely legal and the parties were in a purely commercial relationship, but because the defendant had acted in bad faith, the pressure was illegitimate.

Another interesting proposition which came up in *Borrelli v Ting* was that a past illegality which impacts or brings about the subsequent pressure, can make the pressure illegitimate. This decision brought to the fore the fact that any claim for economic duress depends on the facts of the case. There has been an addition to this proposition that whenever any unjustified past illegality or breach of contract impacts or results in pressure, any following unconscionable conduct of the defendant that enhances the pressure will be enough to add to

---

81 *Lawful acts can constitute economic duress* (n 75).
83 *Lawful acts can constitute economic duress* (n 75).
the illegitimacy of the pressure. 85

Hence, it can be safely said that a party’s unethical, yet lawful actions, subsequent to a breach of the contract, can constitute economic duress, in certain situations. 86 Facts of each case play one of the most significant roles in determining economic duress in such situations. It is extremely difficult to determine whether aggressive negotiations are economic duress or just a part of the world of competition. This is becoming increasingly difficult when we take into account the massive global commercial agreements and negotiations. The courts have to be careful about determining what falls on the right side of the ‘tough and fair’ competition in the corporate world, and what does not.

CONCLUSION

The doctrine of economic duress developed from the traditional concept of duress. This doctrine finds its origin in the Common Law wherein it was developed primarily through judgements. These cases outlined a few elements which must be present in a contract for it to be declared void under the claims of economic duress. These commonly identified features include the causation or “but for” test which talks about the otherwise refusal of the coerced party to do the act “but for” the threat by the other party. Moreover, there should not be a reasonable alternative with the coerced party, and there should be protest from his side to agree to the terms of the other party. Furthermore, the threat should have some gravity which would accrue in some losses for the coerced party. A few cases also held that the coerced party should not have means to independent legal advice, in which case he could have had the reasonable alternative to sue the other party rather than agreeing to his terms. Lastly, there should be an illegitimate demand made by the other party, if there is a fair basis to it, such a claim will not be treated under the claims of economic duress.

The position in United States of America varies according to the laws of each state, however, certain general trends can be picked up from different cases

86 Lawful acts can constitute economic duress (n 75).
and laws under the state laws and the uniform commercial code. While, certain elements such as the requirement of protest and the absence of a reasonable alternative remains, a few more factors have been identified in the American position. Wrongful conduct on the part of the coercing party is one such example. This deals with the acts which are committed through *mala fide* intentions, however, it has been argued that this may be too broad a test and would attract several frivolous claims. There should be a match of other requirements as well. Furthermore, under the American position, through the conduct of the coercing party, the coerced party should have suffered financial distress.

From this article, it has been understood that economic duress is a highly specialised branch of duress. Economic duress can not be understood by only applying section 15 or section 72 of the Indian Contract Act. For this the evolution of economic duress was traced. Economic duress is getting increasingly recognised as something apart from the common duress, especially in the corporate world and other kinds of commercial contracts. The concepts of legitimate or illegitimate pressure and lawful and unlawful threats have been elaborated. The necessary ingredients which constitute duress – illegitimate pressure, the illegitimate pressure being a significant cause of the coerced party being induced to enter into an unfair contract, lack of reasonable, practical alternative were outlined. These three are common to all forms of duress, but for economic duress it has to be necessarily proved that acts of the coercive party resulted in involuntary acceptance or the economic instability of the coerced one. The coerced party should prove that economic duress was due to the coercive party’s conduct and not due to its own necessities. The entire contract need not be set aside when only the faulty or the impugned term can be vitiated by economic duress (doctrine of severability). Plea of economic duress should be clear and specific with convincing and concrete evidence. The significance of ‘take it or leave it’ provision in deciding economic duress has been discussed.

The authors have observed that in case laws, the terms ‘illegitimate/legitimate pressure’ and ‘lawful/unlawful threats’ are used. The authors feel that this
terminology is inappropriate because ‘pressure’ is too broad a term and is sometimes, even inappropriate. Also Section 15 of the Indian Contract act, uses the phrases “threatening to commit…” and not “pressuring to commit…” The use of the phrases ‘illegitimate/legitimate pressure’ has become customary, but it does not exactly convey the essence of the arguments. The use of the word ‘pressure’ should be replaced with ‘threat’. ‘Pressure’ can also include the healthy pressure which comes along with the competition always present in the commercial, corporate or business world. ‘Threat’, on the other hand, always has a negative connotation attached. Threat is a negative manifestation of pressure; when the coercive party goes out of the way to force the other party into doing something they will voluntarily and ordinarily not do and to not leave any other option open for the other party. Hence, the authors feel that it is more prudent and appropriate to replace the term ‘pressure’ with ‘threat’.

The one concrete remedy that the authors would like to suggest is to introduce a new section in the Indian Contract Act, as Section 15(A) which will consist of the necessary elements of economic duress as identified in various jurisdictions across the world, namely the U.K., U.S. and India. These elements are:

i.) ‘Illegitimate’ threat
ii.) ‘But for’ test
iii.) ‘Take it or leave it’ provision
iv.) Absence of a reasonable, practical alternative.
v.) ‘Grave’ nature of the threat
vi.) Actual or possible financial distress
vii.) Protest by the coerced party.

The courts need to keep in mind that all these elements are extremely subjective and blind reliance should not be placed on the landmark cases or any other previous case laws of any jurisdiction. The courts should treat each case in a different manner by looking into the facts of the situation.
THE LAW ON HYPOTHECATIO

Sanjana M* and Sharvari Kothawade**

ABSTRACT

This article seeks to examine hypothecation in India. The concept of hypothecation has been distinguished between pledge, mortgage and trust. Due to a lack of complete codification, a lot of its aspects such as the rights of the parties, approach to the Court, sovereign debts etc. are open to judicial interpretation and these have been analysed in this article to determine the current stance on various issues. The Securitisation and reconstruction of financial assets and enforcement of Security Interest Act 2002 (SARFAESI) lays down the guidelines for the creditor with regard to enforcement of the securities. The act has been analysed with particular focus on section 13 which allows for enforcement of secured assets by the creditor.

INTRODUCTION

A hypothecation Contract is a contract between two parties for gaining of credit by providing security, just like a pledge or a mortgage. It is usually employed in the context of vehicle loans and is generally considered a more convenient form of securing credit because banks no longer need to make the effort to secure and maintain the property hypothecated. It is also beneficial to the hypothecator who can now put the good to use even during the tenure of its hypothecation.

Hypothecation, mortgage and pledge are three prominent forms of securing credit, differing mainly on possession and the rights of the creditor on the security provided. Some authors have gone so far as to call to hypothecation a hybrid of pledge.

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
**Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
However, unlike in a pledge, the lack of possession of assets by the creditor and the continued usage of the same by the debtor puts into question the interest the parties have in the assets hypothecated. It is this question that the authors seek to answer.

The Indian Contract Act, makes no mention of, nor has there been an attempt to include hypothecation contracts within its ambit. This is a curious omission considering that hypothecation agreements and judgments on the same can be dated back even to the pre-independence period. It is only recently that the SARFAESI act has codified certain aspects of hypothecation. There is also a serious lack of literature on the legal aspects of hypothecation in India which remains a prominent transaction in banking worldwide. It is this lacuna that the authors of this article seek to fill.

The lack of codification means that there has been heavy reliance on judicial pronouncements to define the rights of parties in a contract of hypothecation.

Through the course of this article, Indian case law has been analysed to determine the interest, rights and duties of the parties to hypothecation contracts. The SARFAESI Act has also been analysed with special focus on sections related to enforcement of security assets by the creditor in case of default by the debtor.

**Origin**

Hypothecation has a long standing history that can be traced back as far as the ancient Greeks who were the first to use hypothecation as a credit securing concept. Possession of the property was not parted with and an undertaking was taken up by the borrower to pay the loan within a stipulated time. In order to avoid fraud, a notice was fixed to the hypothecated property which stated the amount of loan and the value of the property.

This concept was later borrowed by Roman Civil Law in the 15th Century and was used for the issuance of bottom bonds. Merchants mainly entered into
these agreements to obtain necessities for their troubled ships. It is referred to as hypothec and was largely prevalent only in maritime law. There were no specific legislations and the main conflict was whether common law Courts could exercise jurisdiction or the admiralty Courts. Hypothec was commonly referred to as a maritime lien at the time. The merchant would secure a loan and hypothecate his ship through an agreement called respondentia and the lender could get his money back only if the ship successfully completed its voyage. Because of this clause, high interest rates were exacted and it was outside the purview of the prevailing usury laws. Just like modern day hypothecation, it transfers neither possession nor title. A preferential right for acquisition upon default was created.

Hypothecation’s association with the shipping industry continued even into the 18th and 19th century with prominent cases such as Johnson v Shippin featuring in the early 18th century England.

**STATUTORY REFERENCE IN INDIA**

Hypothecation, pledge and mortgage are closely related concepts with variations mainly in the rights the lender has over the secured assets. Hypothecation is often referred to as a hybrid pledge.

Unlike pledge, it does not find a mention in the Indian Contract Act. However, the Securitisation and reconstruction of financial assets and enforcement of Security Interest Act, 2002 herein after referred to as the SARFAESI Act provides a definition of hypothecation under section 2(1)(n)-

“Hypothecation” means a charge in or upon any movable property, existing or future, created by a borrower in favour of a secured creditor without delivery of possession of the movable property

---

2. 91 E.R. 37.
to such creditor, as a security for financial assistance and includes floating charge and crystallisation of such charge into fixed charge on movable property;”

**HYPOTHECATION VIS-À-VIS PLEDGE AND MORTGAGE**

A pledge is a kind of bailment of goods for securing a loan and is usually done in the case of gold or other jewellery loans and advances against stocks and goods. Hypothecation is a variant of a pledge where the possession of the security extended for the loan remains with the hypothecator. The most common example of hypothecation is in the case of vehicle loans and loans against stocks. Considering the closeness of the concept of pledge, mortgage and hypothecation, there is a need for clarification on the nature and distinctions among the three.

Pledge finds a definition within section 172 of the Indian Contract act. The crucial difference between hypothecation and pledge is that pledge is a form of bailment as defined within the section itself, whereas in the case of hypothecation, the borrower retains possession of the property. As a result there is a difference in the rights of the parties to the security as well.

The rights of the parties in case of a pledge are similar to the rights of a bailor and bailee, while it is not so in hypothecation as there is no transfer of the assets.

Mortgage is regulated by the Transfer of Property Act. Section 58 of the act provides a definition of mortgage as-

> “A mortgage is the transfer of an interest in specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to a pecuniary liability.”

The crucial difference between the two is that hypothecation is usually done for moveable property such as vehicles, whereas mortgage is restricted to immovable property.
A single judge bench of the Andhra Pradesh High Court in the case of *State Bank of India v S.B. Shah Ali*, noted that hypothecation becomes a pledge when there is bailment of goods actual or constructive while the title of the good remains with the pawnor. Hypothecation was described as a mortgage of movables which unlike a mortgage or a pledge only creates a charge that creates an equitable interest in the property. Also, it must be noted, that unlike mortgage, there is no transfer of interest in the property. Only an equitable charge can be created.

It was held by the Calcutta High Court in the case of *Netai Das Poddar v Bank of Baroda*, that non-codification of the principles of hypothecation does not make it non-permissible. It can be considered as a mortgage on movables whilst creating an equitable charge on them. It cannot be treated as a mortgage entirely because it allows the hypothecator to file a suit for the debt and in the same suit pray for the sale of the goods.

**HYPOTHECATION IN INDIA**

The principles of hypothecation has not, unlike in the case of pledge, been fully laid out in a statute. While the sarfaesi act, does deal with the enforcement of security interest by the creditor in case of default, the rights and duties of the two parties are mainly laid out in common law.

The hypothecator is usually, according to the terms of the Contract, required not to assign, sell, charge, underlet, pledge or otherwise encumber or part with the possession, custody or beneficial interest of the hypothecated good without the written consent of the hypothecatee. The breach of these obligations results in a right of the hypothecatee to move to the Court or seize the goods as per the stipulated terms. Usually the hypothecatee has the right to take possession of the property if the hypothecator fails to pay a fixed number of instalments and the interest or if any of the undertakings given by the hypothecator is proven to

---

5 (1991) 1 CHN 152.
6 *Indian Oil Corporation v NEPC India Ltd* (2006) 6 SCC 376.
be false. The hypothecator is obligated to take permission of the hypothecatee for anything he/she might chose to do which may potentially harm the rights of the hypothecatee with regard to the good.

If at any point the bank feels that the borrower has cheated the bank by not keeping the required stock of goods, the bank may take over possession of the goods and convert the hypothecation to a pledge by keeping the goods under the possession and control of the bank. The hypothecator continues to hold possessory and proprietary rights over the hypothecated goods until default, when the hypothecatee will convert the assets into his possession.

In a recent 2006 Supreme Court judgement, it was clearly enunciated that the hypothecator only has the right to enforce the charge in a manner that has been specified in the Contract. A hypothecatee’s rights cannot be equated to a beneficial interest of a beneficiary in a property held in trust that is, entrustment. It is frequently argued in Court that the hypothecator is in fact only holding the goods in trust for the hypothecatee. There has been a change in the stance of Indian Courts on the issue of hypothecation creating a trust in favour of the creditor or the hypothecatee.

Initially, as was seen in the 1938 judgment by the Judicial Commissioner in the case of Gobindram C. Motwani v Emperor the position was that in the interest of creating an equitable charge over the hypothecated good, the hypothecatee must have entrusted the goods to the hypothecator and can expect the hypothecator to comply with the terms of the Contract. In the case of Bank of Maharashtra v Official Liquidator, the Mysore High Court also favoured the interpretation of hypothecation creating a trust.

This view was however, discarded later in the late 1990s. In the case of Central

---

8 Indian (n 6).
9 Indian (n 6).
10 (1938) 39 Cr.L.J. 509.
11 Bank of Maharashtra v Official Liquidator, 1970 40 CompCas 674 Kar.
Bureau of Investigation, New Delhi v Duncans Agro Industries Ltd.\textsuperscript{12} where it was clearly held that a beneficial interest in the favour of the hypothecatee is not created unless the hypothecatee takes possession of the goods upon default of the hypothecator. The Supreme Court, in the landmark case of Indian Oil Corporation Ltd. \textit{v} NEPC Ltd.\textsuperscript{13} also reiterated this view and clarified the position in the Duncan Agro case by stating that a hypothecated good is not an entrustment to the hypothecator.

In the case, a hypothecation deed for aircrafts was created in favour of IOC. During the course of the hypothecation, NEPC was in fear of default and the IOC, fearing loss of the hypothecated goods sought an injunction over the shifting of the aircrafts from a particular city. When the injunction failed and the aircrafts were shifted, IOC claimed a criminal breach of trust by NEPC Ltd. under Sec.405 of the Indian Penal code. The Court referring to the judgment in Duncan Agro, held that no “entrustment of the property” or “dominion over the property” is created in a deed of hypothecation. For a criminal breach of trust, three ingredients must be met- entrustment of property, dishonest appropriation of property and misappropriation of the property in any manner which is in contravention of the law on trust or the legal Contract. The Supreme Court, in this case conclusively held that a hypothecated good is not an entrustment. Hence, no trust is created between the creditor and the debtor unless the creditor takes possession of the goods as an exercise of his rights under the deed.

In the case of Lloyd Bank, Limited \textit{v} Bank of America National Trust and Savings Association,\textsuperscript{14} before the Court of appeals, the plaintiffs had loaned money to a company upon a hypothecation agreement. The company had constituted themselves as trustees for the plaintiff. However, the company pledged away the hypothecated property to the defendants. The plaintiff sued the defendant for return of the documents or the payment of damages. The Court took a view different from that of the Indian Courts and held that the plaintiffs were

\begin{itemize}
\item \textsuperscript{12} (1996) 5 SCC 591.
\item \textsuperscript{13} Indian (n 6).
\item \textsuperscript{14} [1938] 2 K.B. 147
\end{itemize}
in fact the owners of the property and the company, the mercantile agent. It therefore held that the pledge of documents to the defendant was valid. Therefore, a different stance was taken from the Indian Courts by allowing the hypothecated good to be treated as an entrustment.

**RIGHT TO PRIVATE SALE AND THE SARFAESI ACT**

While dealing with issues of possession of the goods and the hypothecatee’s rights over goods, the question of the rights of a third party to the same goods has repeatedly come before the Courts.

In the case of *Bank of Maharashtra v Official Liquidator*, the company in question sought to shut down. Pursuant to this, the official liquidator proceeded to take over possession of the assets and properties of the company. However, he was unable to take possession of immovable property, machinery and some other property belonging to the company as the possession of the same had been taken over by the Bank of Maharashtra in exercise of its power as mortgagee and charge holder of the property of the company. The liquidator filed the suit in order to obtain possession of the goods from the bank. The Mysore High Court decided upon the question of the movable property that was hypothecated to the Bank by looking at the Contract. The hypothecation Contract clearly stated that the bank would have the right to take possession of the goods if the company decided to wind up. The Court in this case reaffirmed the right of the hypothecatee to take over possession of the goods without the intervention of the Court. The Court recognised the right of the bank to exercise the right to private sale. On the nature of hypothecation, the Court remarked that hypothecation is only an extended idea of pledge in which the creditor permits the debtor to retain the goods on his behalf or in trust for himself.

The case of *Eureka Forbes Limited v Allahabad Bank and others* also clarified the stance that physical dominion over hypothecated goods is dispensable for

---

15  *Bank (n 6).*

16  2010 (6) SCC 193.
the bank to enforce its rights. The appellant is obligated to deal with the goods only upon permission from the bank. This is essential considering it would directly impact the bank’s rights with regard to the goods.

One of the contentious issues in the context of hypothecation is with regard to hypothecatee’s course of action upon default by the hypothecator. In the early case of *Nagpur Judicial Commissioner’s Court v Chimna*, the Court had held that the rights of the hypothecatee are entirely determined by the terms of the Contract. On default of payment of debt, the hypothecatee may compel delivery of property or obtain a decree for the sale of the property if the same has been stipulated in the Contract. If the property has simply been hypothecated without any specifications for recovery, then the only remedy open to the creditor is to obtain a money decree declaring his lien on the property and his right to sell.

This position on the rights of the hypothecatee upon default by the hypothecator has been crystallized with the passing of the SARFAESI Act. This act largely displaced the Recovery of Debts due to Banks and Financial Institutions Act, 1993. Prior to the enactment of the Debts due to Banks and Financial Institutions Act, banks had to take recourse to Courts to recover loans from defaulters. The legal process through Courts however, took a long time to resolve these issues and was hence inconvenient. The new 1993 Act sought to introduce a remedy by introducing Debt Recovery tribunals. Suits could now be resolved in about a year’s time, which is considerably less than the 5-7 years an average civil lawsuit took. The Act provided for the limits, duties and responsibilities of the tribunals. The modes of recovery that the tribunal could chose according to the Act are-attachment and sale of the property (immovable or movable) of the defendant, arrest and detention in prison of the defendant, or appointing a receiver for the management of the property.

While the Act was successful initially, the tribunals soon got overburdened with cases. The parliament then passed the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act in June 2002 in

---

17 (1911) 10 Ind Cas 869.
order to control the growing number of non-performing Assets of Indian banks. The biggest reform introduced by the Act was that it allowed banks to recover non-performing assets without the intervention of Courts or the tribunal. The Act has been considered a landmark legislation with an overall reduction of non-performing assets from 14% in 1999-2000 to 9.4% in 2002-2003 after its enactment.

Section 13(1) of the act makes a departure from earlier practice by allowing secured creditors to recover any security interest without the intervention of the Court. Section 13(4) provides the mechanism for the creditor to secure his debt in case of the borrower failing to discharge his liability. It provides the creditor with four recourses.

The creditor may take over the management of the business of the borrower or his secured assets, including the right to transfer through Lease, Assignment or Sale. They may also require by providing a notice in writing, that any person who has acquired the secured assets from the borrower and who is or may become liable to pay some dues to the borrower, to first pay them the sum required to discharge the borrower’s dues.

The creditor is also provided with the option of appointing a manager to manage the secured assets whose possession the creditor has taken over.

The constitutionality of the SARFAESI Act was questioned in the case of *Mardia Chemicals v Union of India*.18 The petitioners in this case argued that the Act endowed vast and arbitrary powers to lenders without any proper guidelines to exercise these powers. The Act also has a lack of provisions for borrowers to challenge the actions of the lender both in the civil Court and in the tribunals. The petitioners argued that there was no need for a new legislation considering that there was already a special legislation, namely, the Recovery of Debts due to Banks and Financial Institutions Act.

There is a lack of adjudicatory mechanism for the borrowers in case of a violation or lapse on the part of the lender. Section 34 of the Act in fact bars

18 AIR 2004 SC 360.
the jurisdiction of civil courts in respect of any matter which a debt recovery tribunal is empowered to entertain. It further provides that no injunction will be granted against any other authority with respect to any action taken under this Act or the 1993 Act.

The remedy under section 17, that allows appeals by the borrower to the debt recovery tribunal, was termed illusory as it allows complaints only 45 days after the creditor has taken action under section 13(4). The section at the time also mandated that the borrower, while filing the complaint, deposit an amount that is 75% of the amount claimed, unless the tribunal says otherwise. This limits the remedy available to the borrower significantly.

The respondents argued on the necessity of the act considering the growing number of NPAs in the Indian banking sector despite the enactment of the 1993 act. The need was therefore felt for a new law with radical reforms. In response to the argument that the borrower had no recourse, the respondents put forward that the borrower could always respond to the notice issued by the creditor under section 13(2). It was argued that the same was a contractual relationship that did not require adjudication.

The Supreme Court largely favoured the arguments made by the respondents. The bench emphasised on the need for a legislation of this nature, considering the need to reduce NPAs to maintain the financial health of the economy.

It was held that the borrower was not without remedies as she still had the option of filing a case before the tribunal under section 17 after action had been taken under section 13(4), before the sale was concluded. It also held that the jurisdiction of civil Courts still existed within the narrow scope of the cases in the nature of an English mortgage.

Despite finding in favour of the respondents on most grounds, the Court ruled that section 17 was unconstitutional to the extent that it required the complainant to deposit a sum of 75% of the amount demanded. The same was found to be unreasonable and a deterrent to complainants especially considering that the tribunal would be exercising original and not appellate jurisdiction. The court also held that the lenders must be required to respond to borrowers
with reasons for non-acceptance of their objections, if the borrowers reply to the notice issued by the lender.

It was following this judgment that the government, in 2004, issued an ordinance-the Enforcement of Security Interest and Recovery of Debt Laws (Amendment) Ordinance, 2004.

The ordinance, which was subsequently turned into an act of parliament, amended section 13 by introducing a clause-13A, which makes it mandatory for the creditor to respond to the borrower’s objections, communicating the reasons for non-acceptance, within a week of receiving the borrower’s response. This clause was further amended in 2013 to extend this time period to 15 days.

The Security Interest Enforcement (Amendment) Rules, 2007 also introduced rule 13 under the Security Interest (Enforcement) Rules, 2002 that provides details of the Court fees to be paid. The Mardia case was instrumental in drawing attention to the oppressive nature of the SARFAESI Act. While the Court did strike down section 17 as unconstitutional, it did not entertain arguments regarding the limited right to recourse available to a borrower. The borrower may approach a DRT only after 45 days after action under section 13(4) has been taken during which time it may be too late to reverse a sale that is entered into by the lender. Considering that the jurisdiction of civil courts in the matter is also severely restricted to cases of fraud, the right to remedy of the borrower is adversely affected.

Under the SARFAESI Act 2002, there are no other provisions in relation to creation of security of hypothecation, rights and obligations of hypothecator and hypothecatee and the rules of priority in regard to various claims on the hypothecated property. The Act categorises hypothecation deeds as a financial asset under S.2(1)(l) and mainly deals with the securitisation and asset reconstruction for non-performing assets with a company. The Reserve Bank of India issues several guidelines in this regard, some of which include regulations on sale of financial assets to securitisation company/reconstruction company by the bank, classification of assets, purchase/sale of non-performing assets etc. These are revised every year in order to ensure efficiency and avoid malpractice.
SOVEREIGN POWER OF THE STATE

The sovereign power of the state often takes precedence over the claim of the lender on the security asset. This question came up in the case of Union of India and another v CT Shentilanathan and another.\textsuperscript{19}

In this case the first defendant was the Union of India, represented by the finance department dealing with income tax matters. The third defendant was the hypothecator whose camera (which was hypothecated to the plaintiff) was seized by the first defendant. The plaintiff, who is the hypothecatee filed a suit claiming possession of the camera. The contention of the first defendant was that the rights created under the hypothecation bond are not equitable to the rights of a mortgager under a mortgage of moveables as no interest has passed to the plaintiff. The second contention was that considering that the debt due to the tax office is a public debt unlike the one due to the plaintiff which is a private debt, the public debt will take priority in the absence of any secure right that the plaintiff could project. The plaintiff on the other hand argued that this being a mortgage of moveables, the first and second defendant cannot be classified as bona fide transferees without notice of the plaintiff (hypothecatee). Alternatively it was also pleaded that the state cannot claim any priority on the right of sale of the camera. A clause in the Contract also existed in which the hypothecator had agreed not to deal with the security in any way that might prejudice the plaintiff. The Court in this case contended that there was no real transfer of title or interest in favor of the hypothecatee. It also concluded that the state did in fact have priority in this case as the debt of the state was a public debt which had priority over the private debt owed to the plaintiff. A similar conclusion was arrived at in the case of Manickam Chettiar v Income Tax Officer\textsuperscript{20} where a full bench of the Madras High Court ruled that income tax debts, being public debts, have priority over private debts.

The principle of crown debt is a Common Law doctrine that continues to remain in force in India owing to Article 372 of the Constitution. It stipulates that a borrower is required to pay her statutory dues before paying off creditors.

\textsuperscript{19} Union of India v C T ShentilaNathan (1977) 2 MLJ 499.
\textsuperscript{20} (1938) 1 MLJ 351.
In the case of *Builder Supply Corporation v Union of India*, the Supreme Court remarked that- “It is essential that as a sovereign, the state should be able to discharge its primary governmental functions and in order to be able to discharge such functions efficiently, it must be in possession of necessary funds, and this consideration emphasises the necessity and the wisdom of conceding to the State the right to claim priority in respect of its tax dues.”

In the case of *Collector of Aurangabad and Another v Central Bank of India* and another, the Supreme Court held that the doctrine of priority of crown debts may be considered as “law in force” and by virtue of Article 372(1) it continues to be applicable in India. A similar opinion was held by the Madras High Court in the case of *Kaka Mohamed Ghouse Sahib and Co. v United commercial syndicate*.

In the case of *Dena Bank v Bhikhabhai Prabhudas Parekh & Co.*, however, the Court held a differing view in that a welfare state cannot claim precedence over a secured private debt for every commercial contract it enters into because it does not directly impede upon the revenues it gains from taxation.

However, it can be inferred that the Courts are largely of the view that the doctrine of priority of crown debt is still applicable in India, giving the state the power to acquire assets even if they have been hypothecated to a secured creditor.

**CONTEMPORARY USAGE**

**Hypothecation of Stocks**

Hypothecation has been a topic of major business transactions for securing loans and this practice has become prevalent in the capital market and stocks have become a subject of hypothecation lately. Hypothecation of stocks has

21 AIR 1965 SC 1061.
22 AIR 1967 SC 1831.
23 (1963) 49 ITR 824.
24 2000(5) SCC 694.
the capacity to work as a working capital for development of business. Securing the rights of the parties is contingent on various factors in these cases and standardisation of these contracts is imperative in order to avoid inequality which will be discovered only later. A hypothecation of stocks has to consider a variety of factors in order to create an equitable charge. Apart from the basics of the deed, a few addendums to this contract can be a decision on limits of the credit availed based on the turnover sales or the projected sales of the stocks which will be assessed by specialized agents working with the bank or any other institution. Moreover, another factor that can be added to this Contract is a collateral security to the tune of 80% and 90% in order to protect the interests of the bank from the vagaries of the stock market.

Contractual determination is again a main factor of these kinds of contracts because the question of guarantors, insurance, evaluation, disposing of stocks and amount of discretion with regard to them granted to the hypothecator are fairly new contractual issues and as of now, are governed only by primary contractual obligations. Hence, hypothecation of stocks would envisage the hypothecator to have a certain amount of control over his stocks with consent form the hypothecatee with regard to buying, selling or any other activity. These contracts have a high futuristic value taking into consideration the increase in the size of the stock markets and the modern contract of hypothecation.

**CONCLUSION**

Hypothecation, a practice widely prevalent in banking has various legal encumbrances associated with it and one of the major issues that have arisen before the courts have been in relation to the rights of the parties of the contract because both the possessory and proprietary rights lie with the hypothecator while the hypothecatee’s right upon the goods manifests itself only upon default of the terms of the contract by the hypothecator.

A few broad conclusions that may be drawn are as follows-

- Hypothecation does not bestow any rights on the hypothecatee other than an equitable charge on the goods which acts as security for the credit extended.
• The Hypothecator has discretion to use the hypothecated goods in the contractual confines and has to obtain prior permission of the hypothecatee for deviation from the terms which may affect his interest in the asset.

• The recourse available to the creditor is provided in the SARFAESI Act, under which the creditor may enforce his security interest without the intervention of the courts.

• Public debts take priority over the private debts according to the doctrine of priority of crown debts. Therefore, in this case, the government may take control of the hypothecated property even if the hypothecatee has a legal claim to the goods.

The principles of hypothecation being largely uncodified, has led to a certain degree of uncertainty that is seen in the often contradictory nature of judgments. While the SARFAESI Act has been instrumental in this regard, codifying the recourse available to the creditor, it remains a onesided legislation, giving wide powers of enforcement to the creditor and reduced remedies to the borrower.

Hence, complete codification of hypothecation transactions, like in the case of pledge in the Indian Contract Act could lead to enhanced regulation and standardisation. It is long overdue considering the prevalence and the long history of these transactions.
EMPLOYMENT BONDS

Amol Mehta* and Mohnish Mathew**

ABSTRACT

In this article, the authors have analysed the legality as well as enforceability of employment bonds. Employment bonds present a tantalising paradox given that there is a lack of consensus on the validity of such clauses in an employment agreement, but at the same time these are ubiquitous in modern day employment contracts. This paradox is further complicated by the fact that there is little or no scholarship on the legality of such clauses vis-à-vis Section 27 of the Indian Contract Act, and that there is a lack of substantial judicial decisions on the same. The authors of this article have therefore analysed the validity of such bonds against provisions of the Indian Contract Act and Common Law as well as by looking at judicial decisions on the same.

INTRODUCTION

Employment Service Bonds form a part of multitudes of employer-employee relationships today. Such bonds operate to bind the services of an employee with the employer for a certain time period specified in the agreement. In the modern business environment where complexity and dynamism are ubiquitous, the importance of training employees and personnel in the latest methods and technologies is essential for any business to thrive. Therefore, quite often, employers incur great expenditure on sending their key employees to institutes of higher learning or to train them in the newest technologies being employed in that particular trade. Keeping in mind the great expenditure incurred by employers in such training of their employees, employment agreements today have indemnity clauses. These clauses require the employee to serve the employer for a specified period, and if they leave before the completion

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
**Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
of that period they are required to indemnify or make good to their employer the expenditure incurred in their training. The argument to justify a clause requiring an employee to serve for a specified period is that, the employer incurs expenditure on training an employee so that he can gain from the employee’s increased productive capacity. Therefore, the employee must serve with the employer for a certain minimum period so as to enable his or her employer to proportionally benefit from his investment.

The frequency of usage of such bonds has, in recent times, increased to such a volume that they usually form a part of a majority of standard form employment contracts. The inclusion of such clauses in a contract raises various legal concerns and affects various contractual edifices that govern the law of contracts in India. Further, significant lack of jurisprudence puts these clauses in a grey area of law and thus, it is important to develop legal insights with respect to the legality and justiciability of such bonds.

It is important to note here the lack of specific legal provisions that also manifests itself as lack of specific jurisprudence with respect to such clauses in employment bonds. To the best of the knowledge of the authors, there is one case that delves deep enough into the legality of one of the kinds of such employment service bonds and that too in a specific and limited context.\(^1\) However, there are various established provisions in the Indian Contract Act, 1872 and doctrines in common law that deal with ancillary and closely related issues and those could be extrapolated to gain an in-depth understanding of the legality of such bonds.

Through the course of this article, the authors undertake to achieve an understanding of the legitimacy of the aforesaid bonds from a legal perspective and in the aforementioned fashion. They would then advance to extrapolating and using well-established ancillary legal doctrines to gain insights with respect to the validity of these clauses.

---

\(^1\) Dr. P.N.V.S.V. Prasad v Union of India, 1994 SCC OnLine AP 286. (Hyderabad High Court)
Understanding Contexts and Types of Clauses

Employment Bonds appear in the form of specific clauses in employment contracts. The manner in which such clauses are drafted – whether there is an escape proviso that follows the clause, whether the clause unfairly favours one party, etc. – is extremely important whilst determining their legality. In order to understand the legality of the clauses that bind the employee to the employer in such cases, it is imperative to distinguish the circumstances that beget the inclusion of such clauses. Whilst furthering the same, two broad paradigms are visible from a bird’s-eye view:

a.) Where the employer has explicitly incurred some expenses on training the employee: Every company functions in a distinct manner; every trader has a distinct business plan. It thus becomes necessary for the employer to invest in training the employee to make him a specialist in errands that he is supposed to undertake through the course of his employment. In such cases, in almost every parable, the law of indemnity could be understood as an underlying justification for the inclusion of these impugned clauses as here, a certain cost is incurred whilst training the employee and this invests a right to be indemnified in the employer.

b.) Where the employer has not incurred any expenses with respect to the employee’s training or otherwise: Not all employers, however, need to specifically train their employees. Thus, if an Employment Bond clause is included in the contract of employment in such cases, it becomes difficult to account for the legitimacy of such clauses as these are hit by Section 27 of the Indian Contract Act, 1872 and the common law doctrine of Restraint of Trade. However, these provisions and doctrines have, over time, become contextual and pigeon-holed. In order to apply these to the impugned clauses, the established notions need to be extrapolated accordingly.

In Situations where the Employer Invests upon the Employee

An employment agreement today, in cases where the employer incurs expenditure on the training and development of the employees, contains an
indemnity clause. These have traditionally taken two forms. The first requires the employee to serve with the employer for a specified period and if the employee desires to leave the employment of the employer, he then has to indemnify the employer for the expenses incurred in training the employee. Another type of clause is one where the employer realises the costs of training the employee in instalments from the emoluments of the employee. These clauses, in either of the above form, are very common in any employment agreement today. The authors shall now proceed to analyse how well this purpose is served by an indemnity clause and whether such a clause is legally valid in a court of equity. We shall now proceed to a discussion on how well the law on indemnity in India covers such arrangements.

The law of indemnity in India is primarily governed by the provisions of the Indian Contract Act of 1872. Sec. 124 & 125 of the Act deal with indemnity agreements. As per 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 called a contract of indemnity”. In our situation, in an indemnity agreement, the employee receiving the training will be the promisor and the employer the promisee. Therefore, in light of the above definition, an employee will by an indemnity clause make good to his employer, the loss caused to him or her, by the employee’s act of leaving the employer’s services prematurely. For a valid contract of indemnity, based on the provisions of the Indian Contract Act and judicial decisions on the same, there are certain essentials. These are:

- There must be a promise by the indemnifier to make good to the indemnity holder loss arising from the acts of any person, including the promisor himself.

2 *Jet Airways (I) Ltd. v Mr. Jan Peter Ravi Karnik*, 2000 (4) Bom CR 487 (Bombay High Court).

3 The law of indemnity in English common law also governs certain aspects of indemnity. See, Pollock and Mulla on the commencement of liability in an indemnity agreement for how common law interpretations of the law on indemnity are applicable in India

There must be an actual loss that has been incurred.\(^5\)

The presence of the clause in the agreement itself satisfies the first requirement. The second requirement, of there being an actual loss which has occurred, is a contentious one. In most cases surrounding a contract of indemnity, the point of conflict is around whether or not any loss has arisen so as to justify the enforcing of the right of the indemnity holder. It has been held by the Supreme Court in *State Bank of India v Mula Sahakari Sakkar Karkhana*\(^6\) that a loss must arise before one can claim indemnity. In our scenario, this loss must be therefore established. As stated earlier, every employer engages in the activity of training their employees at their own cost so as to benefit from their increased productivity. Therefore when after receiving the training, the employee is working for the employer, there is a recovery of the employer’s investment. Thus, in the event the said employee leaves the employer prematurely, the recovery of the employer’s investment is jeopardised and as a result there arises a loss to the employer or indemnity holder by the acts of the employee, that is the promisor.

Therefore an indemnity clause, in an employment agreement where the employer is incurring costs in the training of the employee, would be a valid one as it satisfies the requirements of the law on indemnity. Such a clause would not attract the provisions of Sec. 27 of the Indian Contract Act as the employee is under no obligation to necessarily work with the employer for a specified period, and is at liberty to leave prematurely. However, in the event of such a departure it is imperative as per the principles of equity, for the employee to compensate the employer for the expenditure incurred for his or her training, especially given the fact that the employee has himself benefitted immensely from this training. By virtue of possessing such training, the productivity and value of the employee has increased manifold. The employee may even choose to leave the employer to join a competitor. It is only just, equitable and fair for

---

5 *State Bank of India v Mula Sahakari Sakkar Karkhana Ltd.*, 2006 (3) SCCD 1662 (Supreme Court).

6 2006 (3) SCCD 1662 (Supreme Court).
the employer to be indemnified for the losses he will necessarily incur as a result of the concerned employee’s departure. Therefore, the validity of such a clause cannot be impeached on the grounds of it being against Sec. 27, as the object is not to restrain the employee from carrying out any lawful trade or profession, but to prevent the interests of the employer from being adversely affected as a result of the employee’s conduct. Therefore in the event of a breach of such an agreement, the relief sought would not be the restoration of the services of the employee but instead only the indemnification of the employer under the indemnity clause for the losses incurred as a result of the employee’s conduct.

This view was upheld in a decision of the Hyderabad High Court in the case of Ledalla Ravichander v Satyam Computer Services Limited.7 In this case, the court upheld the obligation imposed on the employee as a result of a two year employment bond, however, as the employee had already served a period of one year, the amount of compensation the plaintiff company was entitled to was held to be only Rs. 100000 as opposed to the Rs. 200000 stipulated for in the bond. Therefore while the court did not, in this case, deal with the legality of such clauses, the upholding of obligations imposed under such a clause in a bond shows that it was considered legally valid by the court.

Another case which merits our consideration is the case of Sicpa India Ltd v Manas Pratim Deb.8 In this case, the respondent had signed two bonds with the appellant as he received training on two separate occasions. The first one was for a period of 5 years, and the second as per the terms of the employment contract could be for a maximum of three years. The judge has made some interesting observations in deciding this particular case. Though the bonds were justified by the appellant on the grounds that they had incurred significant expenditure in training the employee, it was found by the court that there was no proof that any such training actually took place and in fact it was alleged by the respondent that the trips were made to meet foreign customers of the company and not to receive any actual training. The fact that the second

7 2011 SCC OnLine AP 76 (Supreme Court).
8 2011 SCC OnLine Del 4805 (Delhi High Court).
bond was again for a period of five years hence violating the appellants own employment contract, and no proof of training having been provided could be produced, the court held that these particular bonds were unconscionable and not employment bonds en bloc.\textsuperscript{9} The judges in this case then went on to consider the reasonability of the compensation being demanded by the appellant. In the submissions of the appellant it had been stated that a sum of money was owed to the respondent. After ascertaining the amount spent on the second trip of the respondent by the appellant, and dividing the total expenditure by three years, and the respondent having worked for a period of two years out of the three, the court had arrived at a figure which would be payable by the respondent to the appellant for their expenditure. However, the court found that it would be in the interest of equity and fairness to treat the two amounts as reconciled and denied the appeal. Therefore, in balancing the interests of both parties, the court has in principle upheld the validity of reasonable obligations imposed under an employment bond and the various points on which the bonds were assailed in this case were strictly specific to this particular context and not employment bonds en bloc.

Indemnity clauses, as we have pointed out earlier, are quite common in modern employment agreements. However, it is the view of the authors that the purpose sought to be accomplished would be better served if instead of inserting an indemnity clause, a more efficient alternative is used. That is, by having a contract of guarantee. A contract of guarantee, as per Sec.126\textsuperscript{10} is, “\textit{a contract to perform the promise, or discharge the liability of a third person in case of his default.}” It also goes on to define the parties to the contract, namely “\textit{The person who gives the guarantee is called the surety; the person in respect of whose default the guarantee is given is called the principal debtor and the person to whom the guarantee is given is called the creditor.}” Therefore what is being proposed is that in a scenario as described above, the employer asks the employee to provide a guarantee stating he will serve for a certain amount of period, in default of

\textsuperscript{9} ibid Para 6 “I have no hesitation in coming to the conclusion that \textit{these} bonds were terrorem, unconscionable and extravagant” [emphasis supplied].

\textsuperscript{10} Sec. 126, Indian Contract Act,1872.
which the surety will be called on to pay the employer. Therefore the employer here would be the creditor, the employee the principal debtor and a third surety provided by the employee. This practice is being followed already by a number of employers with whom the authors had a chance to interact.

There are a number of reasons as to why a contract of guarantee would be a superior choice in this situation, however before we get into these reasons, it is necessary to understand a little about the nature of a contract of guarantee. A contract of guarantee is essentially an auxiliary or accessory contract. By this what is meant is that an agreement will not be of the nature of a guarantee unless there is an antecedent obligation, and to this pre-existing obligation the guarantee is only an ancillary obligation. At the same time, what is to be noted is that a guarantee is a separate contract in itself, distinct from the original contract creating obligations.

In the context of an employment agreement therefore, a contract of guarantee would apply by making the surety answerable for the default of the employee or principal debtor. Thus in a case, where the employee is required by the employment agreement to work with the employer for a period of 2 years after the completion of his training, and the employee then leaves the employer before the completion of the two year period, then in this case the surety would be made answerable for the costs of training the employee and will be liable to pay the same to the employer. It would now be fruitful to discuss some of the benefits of choosing a contract of guarantee over an indemnity clause.

In an indemnity agreement, what is necessary to prove is that a loss has been suffered before any claim for indemnity can be made. In most cases of indemnity, the contentious issue is around whether or not there has arisen any loss to be indemnified. Therefore, while an indemnity clause in such a contract will eventually be upheld in a court of law if challenged, it will nevertheless on multiple occasions still be challenged. As a result of this, the employer may not

---

11 Pollock & Mulla, *The Indian Contract And Specific Relief Acts*, 1353, (Edited by N.Bhadbhade, 14th edn.).

12 *State Bank of India v Mula Sahakari Sakkar Karkhana Ltd.*, 2006 (3) SCCD 1662 (Supreme Court).
receive the amount he is entitled to or will get it after a protracted legal battle. This kind of delay in the modern business environment could be highly injurious to the functioning of the company. This is where a contract of guarantee is superior, as the employer can make a claim to the surety when the contract is breached by the employee and seek the amount spent on his or her training, and the surety will be obligated to pay.\textsuperscript{13} The question of quantification of loss or existence of loss itself will be dealt with after the employer has received the amount from the surety, in the event it is challenged.

The second benefit of a guarantee is that the employee may or may not be able to make good to the employer, the immense expenditure that would have been incurred for his or her training. Therefore in such a case an indemnity clause would not be of much benefit. Rather, if a guarantee is used, then the surety is made liable for the amount and so the ability of the employee to pay the company for the expenditure incurred would not be of relevance to the employer as the surety would answer for his debt. Since the ultimate objective of these clauses and agreements is to protect the interests of the employer from being adversely effected by the departure of a trained employee, we believe that a contract of guarantee between the employer and employee would better accomplish this goal.

\textbf{IN SITUATIONS WHERE THE EMPLOYER DOES NOT INVEST UPON THE EMPLOYEE}

In this section of the article, we would be dealing with circumstances patently different from what has been dealt with in the previous section. In the previous section, the Employment Bond clauses were justified based on law of indemnity as these were circumstances where the employer had invested predominantly on the employee expecting returns.

The condition, however, becomes different in cases where no expenses have been incurred by the employer in training the employee. In such cases, determining whether or not a ‘loss’ has been caused to the employer becomes difficult. Also

\begin{footnote}
\textsuperscript{13} \textit{Carter v White}, (1883) 25 Ch D 666 (House of Lords).
\end{footnote}
in such cases the contract, in the opinion of the authors begets invoking Section 27 of the Indian Contract Act, 1872; infused with the reasonableness enquiry of the common law doctrine of Restraint of Trade. Before proceeding, it is important to refute the prevailing notions that exclude a Section 27 inquiry into the interpretation of such clauses.

Falsifying Prevailing Notions

Two peculiar cases often misguide scholarly opinion with respect to employment bonds. However, the context in these cases is either very different from what their meanings are construed to be or is very case-specific, thereby impeding the generalisation of such cases.

Firstly, in the case of V.N. Deshpande v Arvind Mills Co. Ltd., a weaving-master who had an employment bond for three years coupled with a non-compete and non-disclosure clause was held to be bound by it. However, the reason why such a case cannot be held as a blanket validation for employment bonds is because the validation that was granted was contextual and restricted to the part of the covenant that prevented working elsewhere during the course of employment and not to the covenant that held the employee bound by the employer. Further, the validity of the employment bond was never questioned in the first place, which is clear from Justice Kania’s observation to that end:

“…it must be pointed out that no issue had been raised in the trial Court to cover the contention that the agreement was void, as it was in restraint of trade… it was only contended that the clauses in question were hard, inequitable and penal…”

Secondly, in Lalbhai Dalpatbhai and Company v Chittaranjan Chandulal Pandya, a fresh engineering graduate was made to enter into a three year employment bond with the appellant partnership firm which was held to be

---

14 A.I.R. 1946 Bom. 423 (Bombay High Court).
15 Justice Kania in para 13 of V.N. Deshpande opined that “agreements of service, containing a negative covenant preventing the employee from working elsewhere during the term covered by the agreement” are valid (emphasis supplied).
16 VN Deshpande (n 12), para 13.
17 AIR 1966 GUJ 189 (Gujarat High Court).
valid. Here, Justice Bhagwati whilst concurring with Farran C.J., observed that such a clause does not beget a section 27 inquiry as:

“If it did, all agreements for personal service for a fixed period would be void. An agreement to serve exclusively for a week, a day, or even for an hour, necessarily prevents the person so agreeing to serve from exercising his calling during that period for anyone else than the person with whom he so agrees.”18 [emphasis supplied]

Also, another reason for not delving deep into this issue was the fact that no ground was suggested on the behalf of the defendant that would invalidate the clause.

It is important to note, thus, that the observation relied on by this case necessarily deals with contracts of personal service, and that not all contracts of employment are contracts of personal service. This is primarily because the skill sets which were a scarcity once, such as those of an engineer, are no longer scarce in the current scenario and thus, a prima facie connotation of all employment contracts as contracts of personal service fails in the current paradigm. The authors shall recuse themselves from delving further into the essentials of a contract of personal service and showing how all contracts of employment are not those of personal service, in light of it being not only out of the scope of this article, but also a rather undisputed notion in contemporary contract law.

**Understanding Section 27 and Doctrine of Restraint of Trade**

Section 27 of the Indian Contract Act posits that an agreement that is in restraint of lawful profession, business or trade is to that extent, void with an exception of cases where goodwill has been sold. This Section is a point of departure from the common law doctrine of Restraint of trade by the Indian Contract Act, 1872.

The common law doctrine of Restraint of Trade is based on the freedom of trade as being a general principal of the common law.19 With respect to Employment

---

18 ibid Para 2.
contracts in particular, the doctrine distinguishes the impugned covenants in contracts, based on the extent of their operation, into two broad categories – a.) in-service covenants; and b.) post-service covenants.

With respect to in-service covenants, the position of law is rather liberal and the aforesaid doctrine in most cases recuses itself from being applied to such cases, unless such clauses have an effect of sterilising and not absorbing the employees’ capacity for work.20 However, with respect to post-service covenants, the doctrine attempts a rather different stance wherein it mandatorily identifies the extent of restraint being imposed and delves into a reasonableness inquiry with respect to the same.21 For example, a covenant is usually held to be reasonable if it is necessary to protect the proprietary interests of the employer in trade connections and trade secrets as against the objections to the usage of such skill sets by the employee as were gained by him/her in the course of employment.22

The position of law in India, however, is different vis-à-vis restraint of trade covenants. The locus classicus here would be the landmark case of Niranjan Shankar Golikari v Century Spinning and Manufacturing Company23 wherein a narrow interpretation of Section 27 was promulgated and it was held, again making a distinction between in-service and post-service negative covenants, that all in-service covenants are usually not hit by Section 27 and are therefore not in restraint of trade. Further in Superintendence Co. v Krishan Murgai,24 Justice Sen in his concurring judgement interpreted Section 27 in an even narrower way that excluded the reasonableness enquiry whilst discussing the legality of a covenant in restraint of trade, thereby meaning that every covenant in restraint of trade is void, whether unreasonable or not. This new rule has, inter alia, been applied to negative covenants in restraint of trade in vertical

20 HSG Halsbury, (n 15) 43.
22 Herbert Morris Ltd. v Saxelby [1917] All ER Rep 305 (House of Lords).
23 AIR 1967 SC 1098 (Supreme Court).
24 AIR 1980 SC 1717 (Supreme Court).
franchise agreements, agency contracts, etc.

With respect to employment contracts, the position of law by way of applying the rules of interpretation laid down in the aforementioned cases was set in *V.F.S. Global Services Ltd. v Mr. Suprit Roy*, where a ‘garden leave’ clause was invalidated since – a.) It was *prima facie* in restraint of trade and following the interpretation laid down in *Krishan Murgai*, the court never delved into the ‘reasonableness’ enquiry; and b.) Since it was a post-service covenant, the clause did not enjoy the assumption of validity as laid down in *Niranjan Shankar Golikari*.

**Point of Departure – Interpretation of Bonds**

The common law doctrine of Restraint of Trade, as it has developed over the years has majorly seen its application in cases where the impugned clauses are by way of non-disclosure, non-compete, etc. This is the reason behind its classification of impugned covenants on the basis of their extent of operation – the classification elucidated in the previous sub-part of the article that places a sort of liberal application of the doctrine over in-service negative covenants.

Employment Bonds are also included by way of negative covenants on the employee in employment contracts and these covenants are by way of clauses that operate during the persistence of employment. However, according to the authors, these clauses purport to seek an end that has not been so far accounted for in the jurisprudence with respect to common law doctrine of Restraint of Trade and are thus, qualified to be called a *hybrid* of prevailing clauses. These clauses, by way of imposing a time-limit over the contract, seek to *abrogate the right of the employee to terminate his employment*. Such an abrogation prevents the employee from turning in his resignation in the first place and thus, holds the

---

25 *Gujarat Bottling Co. Ltd. v Coca Cola Co.*, AIR 1995 SC 2372 (Supreme Court).
27 2008 (2) BomCR 446 (Bombay High Court).
28 AIR 1980 SC 1717 (Supreme Court).
29 AIR 1967 SC 1098 (Supreme Court). Supra n 23
employee beyond the limit of his/her intention to associate himself/herself with the employer. This implication leads to a position where the employee is often bound to the employer against his/her will. Hence, the authors believe, that the juridical interpretation of this begets a novel approach, if not to all covenants that operate during the course of employment, then at least to Employment Bond clauses. They believe that despite the persistence of such clauses during the course of employment of an employee, the juridical interpretation of these must invoke the ‘reasonableness’ enquiry per the common law doctrine of Restraint of Trade that is usually not applied in Indian jurisprudence. This is because such clauses essentially prevent the basis of classification (termination of employment) from occurring, thereby making such clauses a unique hybrid of in-service and post-service clauses.

Hence, should a question of legal validation of such employment ‘bonds’ arise before a court, it must consider the hybridity of these bonds and consequently invoke the doctrine of Restraint of Trade, thereby subjecting these clauses to a strict test of reasonability.

**Conclusion**

Employment bond clauses are an accepted inclusion in almost every standard form employment contract. The legality of such clauses, however, is something that has not been ventured into explicitly by courts of law in India. The resulting lack of jurisprudence upon the same necessitates a legal inquiry into the same and this is exactly what the authors have sought to achieve by way of this article.

In order to develop a legal insight into Employment Bond clauses, there is a necessity to define contexts in which such agreements are entered into. Two such contexts appear on a prima facie enquiry within the paradigm of employment contracts – one, where the employer has invested upon the employee by way of imparting training or otherwise, and; second, where the employer has not invested upon the employee.

In the first context, where the employer has invested upon the employee by way of training or otherwise, it would be correct to attribute to such clauses – a
character of indemnity clauses as the reason behind inclusion of such clauses appears to be holding harmless, the employer who has incurred expenses in such furtherance. Hence, the legality of such clauses, if contended, should be validated by courts upon the grounds that such clauses essentially seek to indemnify the employer should he incur a loss by way of an employee’s leaving the company before the value added by him to the employer reaches the cost incurred in his/her training. Also, in order to undermine losses to an employer by way of procedural delay or the employee’s inability to account for the damages sought to be claimed by the employer in cases he decides to leave his employment, the authors also suggest requiring the employee to furnish a guarantee instead of holding him for a fixed period of time by way of an indemnity agreement.

In the second context, however, it is essential to note that since no investment has been made by the employer upon the employee; no prima facie right is invested in the employer by way of which he can hold the employee for a fixed term and that his/her leaving would affect the reasonableness inquiry. Further, these clauses beget an application of the common law doctrine of ‘Restraint of Trade’ and are hit by Section 27 of the Indian Contract Act, 1872. The form of application required is the standard of post-service negative covenants despite the fact that the Employment Bond Clauses only operate during the course of employment. Hence, should such clauses be challenged, the courts must decide on a case to case basis, applying the aforesaid common law doctrine’s test of reasonableness, the validity of such clauses.
PRE-NUPHTIAL AGREEMENTS

Vani Sharma*

ABSTRACT

With a rise in divorce rates and a shift in the attitudes towards marriage, pre-nuptial agreements are slowly gaining traction in India. The lack of legislation or judicial precedent, however, leaves the question of their enforceability open to interpretation.

Attempts at answering this question have largely focused on the question of whether and how a pre-nuptial agreement is invalidated by the personal laws of the parties. The nature of a pre-nuptial agreement as conceived of in the West, and how it might potentially differ from the kind of agreements popular in India is rarely considered.

In this article, the author attempts a more comprehensive examination of the issues affecting the enforceability of pre-nuptial agreements, beginning with defining pre-nuptial agreements and addressing the question of whether such agreements are contracts at all. The possible grounds for invalidating pre-nuptial agreements i.e. the lack of a lawful and valid object and unconscionability are then considered. Finally, the author evaluates the possible impact of pre-nuptial agreements on maintenance, property and succession rights of the spouses.

INTRODUCTION

A future separation is usually the last thing that would occur to a couple contemplating marriage. However, the possibility of divorce is unfortunately too real to be ignored, and the event can have significant ramifications for both parties to the marriage. It is to mitigate the financial consequences for one or both of the parties that the pre-nuptial agreement evolved in the West.

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.

1 Synonymous terms include ‘ante-nuptial’ or ‘pre-marital’; wherever the sources used by the author have cited either of these terms, they have been replaced by the term ‘pre-nuptial’ to bring about a consistency in style.
The pre-nuptial agreement is made before marriage is solemnized, and usually contains provisions for property disposal in the event of a divorce or separation.\(^2\) In addition, in some jurisdictions, pre-nuptial agreements can be used to affirm or waive a marital right or obligation for the duration of the marriage, or when it is terminated by death or separation, or the occurrence of any other event.\(^3\)

As the popular perception of marriage evolves from an eternal commitment to a more impermanent entity,\(^4\) pre-nuptial agreements – once taboo in Indian society\(^5\) – are gradually gaining more acceptability.\(^6\) The major problem arising from the increasing use of pre-nuptial agreements in India is that the legal validity of pre-nuptial agreements is still unclear. Varying opinions have been offered; while some analysts believe they have validity under contract law but not personal marriage laws,\(^7\) practicing lawyers hold vastly different views based on their success or failure in persuading the courts to accept their clients’ pre-nuptial agreements as binding.\(^8\)

This article is an attempt to clarify the legal position on pre-nuptial agreements by examining some of the provisions of law relevant to the question of pre-nuptial agreements. The author will examine the questions that would impact the validity of pre-nuptial agreements, such as the question of consideration, the provisions under Section 23 and Section 26, and the extent to which certain rights can be granted or waived away by a pre-nuptial agreement.

---

3 Uniform Pre-Marital and Marital Agreements Act 2012, s 2(5).
5 ibid.
6 ibid.
8 ibid.
DEFINITION, PURPOSE AND FORM

Definition and Purpose

Broadly speaking, a pre-nuptial agreement is ‘an agreement that is made between a couple before marriage with provisions for property disposal should they separate or divorce.’ Catherine Fairbairn submits that a pre-nuptial agreement is ‘an agreement made by a couple before they marry or enter into a civil partnership which sets out how they wish their assets to be divided if they should divorce or have their civil partnership dissolved.’ An accepted legal definition of pre-nuptial agreements in the United States is given under the Uniform Pre-marital and Marital Agreements Act:

[A]n agreement between individuals who intend to marry which affirms, modifies, or waives a marital right or obligation during the marriage or at separation, marital dissolution, death of one of the spouses, or the occurrence or nonoccurrence of any other event. The term includes an amendment, signed before the individuals marry, of a premarital agreement.

A cursory examination of these definitions indicates the purpose of a pre-nuptial agreement. A common intent behind a pre-nuptial agreement is to modify the community of property regime after marriage. A pre-nuptial agreement is thus commonly used in cases where the parties own significant assets, or have married earlier. The United States jurisdiction takes a broader view of the purpose of pre-nuptial agreements, as is evident from the definition. The modification or waiver of a ‘marital right or obligation’ appears not to be restricted to property alone. It has been upheld by American courts that pre-nuptial agreements can

9 cf n 3.
10 Home Affairs Section, Pre-nuptial Agreements (Cm SN/HA/3752, 2014).
11 cf n 3.
also account for the legal consequences upon the death of one party.\textsuperscript{14}

\textbf{LEGAL POSITION AND FORM OF PRE-NUPHTIAL AGREEMENTS}

There is a sharp divergence in the legal position on pre-nuptial agreements in the United Kingdom and the United States. Until recently, pre-nuptial agreements were not enforceable in the United Kingdom on grounds of being perceived to be against public policy.\textsuperscript{15} Moreover, unlike counterpart jurisdictions in Europe,\textsuperscript{16} the United Kingdom relied on judicial discretion to determine the property consequences in the event of a divorce.\textsuperscript{17}

\textit{Position in the United Kingdom}

In \textit{Katrin Radmacher v Nicholas Granatino},\textsuperscript{18} the value of pre-nuptial agreements for protecting the rights of former divorcees was recognized,\textsuperscript{19} and it was declared that ‘a carefully fashioned contract should be available as an alternative to the stress, anxieties and expense of a submission to the width of the judicial discretion’.\textsuperscript{20} A valid pre-nuptial agreement, however, would be subject to three conditions. First, it must not void the jurisdiction of any courts, though such a provision would be severable. Second, the general principles of the law of contract must be upheld. Third, a judge will retain the power to review the agreement if it is grossly unfair to one of the contracting parties.\textsuperscript{21}

\begin{itemize}
\item \textsuperscript{14} \textit{Re Garbade} 633 NYS 2d 878 which deals with the proprietary rights of a widow.
\item \textsuperscript{15} “The Ecclesiastical Courts looked upon agreements to live separate and apart as contrary to public policy and void but the common law courts would enforce them.” \textit{MacLeod v MacLeod} [2008] UKPC 64, [2009] All ER (D) 32 (Jan).
\item \textsuperscript{16} \textit{Katrin Radmacher v Nicholas Granatino} [2010] UKSC 42, [2011] 1 AC 534.
\item \textsuperscript{17} ibid.
\item \textsuperscript{18} ibid.
\item \textsuperscript{19} “There is a view that the fact that pre-nuptial agreements are not currently binding may deter people from marrying or entering into civil partnerships in some cases. The issue may be of particular importance to those who have experienced divorce and wish to protect their assets, however extensive, from a future claim for ancillary relief. It may also be crucial for couples who have entered into marital property agreements in jurisdictions in which such agreements are enforceable.” \textit{Katrin Radmacher v Nicholas Granatino} [2010] UKSC 42, [2011] 1 AC 534.
\item \textsuperscript{20} cf n 16.
\item \textsuperscript{21} cf n 16.
\end{itemize}
Pre-nuptial agreements in the United States were legalized much earlier, in 1972. In *Posner v Posner*, even a provision that left the wife with an inadequate and disproportionate share of assets was upheld on the grounds of freedom of contract. The two cases underline the difference in the way pre-nuptial agreements are treated in United States and United Kingdom jurisdictions. *Radmacher* places greater importance on the need to protect the rights of contracting parties, and the conditions listed above act as safeguards for the same. *Posner*, on the other hand, places the onus on the parties to determine what is right for them. It explicitly declares that “[f]reedom to contract includes the right to make a bad bargain.” The only limits it places on this freedom is that the contract be executed ‘under terms of fairness and candor’, terms that are subjective and open to interpretation.

The discussion above presents an idea of the purpose and form of pre-nuptial agreements that differs sharply from the kind of agreements that have been negotiated in India. Indian agreements have generally dealt with the waiver or modification of rights and obligations. For instance, early cases dealt with a minor husband forfeiting the right to move out from his in-laws’ house or persuading his wife to accompany him, and the right of a wife to move away from her husband following an agreement between them. Though there have been more recent cases dealing with the transfer of property, the emphasis on marital rights and obligations remains. Agreements have increasingly been sought to prevent any one spouse from pressurizing the other to convert in an

---

22 257 So 2d 530 (Supreme Court of Florida).
23 ibid.
24 ibid 534-35.
25 ibid 535.
26 ibid.
27 Tekait Mon Mohini Jamadai v Basanta Kumar Singh (1901) ILR 28 Cal 751.
28 Krishna Aiyar v Balammal (1911) ILR 34 Mad 398.
interfaith wedding,\textsuperscript{30} to allow wives to maintain their parents after marriage,\textsuperscript{31} to prevent wives from seeking alimony in case of a mutually agreed upon separation\textsuperscript{32} and even to accommodate changes in their lifestyles post the solemnization of the marriage.\textsuperscript{33}

**IS A PRE-NUPPTIAL AGREEMENT A CONTRACT?**

For an agreement to be considered a contract under in law, it is necessary to have an offer, an acceptance, and some form of consideration for enforcing the contract.\textsuperscript{34} While offer and acceptance can easily be divined in a pre-nuptial agreement, the question of consideration needs to be examined, particularly because proving a lack of consideration could serve as grounds for either party to avoid performing their obligations under the agreement.\textsuperscript{35} This section will focus on how the question of consideration is dealt with in the United States and see if such a position might be acceptable under Indian law. It will also examine whether it could possibly fall under a contract made on the basis of ‘love and affection’ under Section 25(1).

**CONSIDERATION IN THE AMERICAN CONTEXT**

Consideration is as sacred to the principles of American contract law as it is to Indian and common-law contracts.\textsuperscript{36} American law has two distinct approaches to the question of consideration in pre-nuptial agreements. The first and predominant approach is that a pre-nuptial agreement does not require

\begin{itemize}
  \item \textsuperscript{30} cf n 7.
  \item \textsuperscript{31} ibid.
  \item \textsuperscript{32} ibid.
  \item \textsuperscript{34} Indian Contract Act, 1872, ss 2(e), 3 and 10.
  \item \textsuperscript{35} Indian Contract Act, 1872, s 25.
\end{itemize}
consideration for it to be enforceable under American law. However, in certain cases, the courts have been willing to consider marriage as consideration for the pre-nuptial agreement.

For instance, Maryland courts consider marriage to be ‘valuable consideration’ and it is possible to use marriage as specific consideration to enforce an agreement transferring real estate. For instance, in *Braecklein v McNamara* the sufficiency of marriage as consideration to support a pre-nuptial conveyance of property was upheld, and the wife was granted proprietary rights in spite of the fact that the property in question was disputed. In *Watson v Watson*, there was a dispute between a man and his first wife over her interest in a part of his estate. Noting that the woman had agreed to marry the man based on his promise, the court allowed her to hold an equitable interest in the property. The observations of *Levy v Sherman* sum up the position of law in this regard:

An antenuptial settlement or agreement to the extent that it is executory must be supported by consideration, but marriage itself is consideration for such a settlement or agreement, and indeed, it is said to be perhaps the most valuable and highly respected consideration of the law in this as well as other cases.

**CONSIDERATION IN THE INDIAN CONTEXT**

*The Definition of Consideration*

Consideration under Indian law is not purely monetary. It can refer to an act done (or an act with one party has abstained from doing); or the promise of performing an act or abstaining from an act. The crucial element is that the

---


39 *Dugan v Gittings* 3 Gill 138 (1845).

40 147 Md 17 (Md 1925).

41 304 Md 48 (1985).

42 185 Md 63 (Md 1945), 6767.
act or abstention must be at the desire of the other party. An agreement can be formed through a set of mutual promises, with each promise being viewed as consideration for the other.

A promise without any consideration is generally void under the Indian Contract Act. Section 25, however, provides for three exceptions where the requirement of consideration can be done away with – a written, registered agreement made on account of natural love and affection, a promise to compensate the other party for a voluntarily done act, an a promise to repay a limitation-barred debt. Interestingly, inadequacy of consideration does not automatically void a contract, though it could serve as an indicator that consent may not have been freely given.

Can Marriage Serve as Consideration?

Does marriage meet the definition of consideration under the Indian Contract Act? A literal reading of Section 2(d) would appear to support the proposition. Marriage could be seen as a positive act done, or a harm suffered by one party. It could also be construed as being performed ‘at the desire of the promisor’, if one of the parties is identified as the promisor. Moreover, the courts have certainly accepted the possibility that marriage could be good consideration for a contract, though its adequacy cannot be determined.

In PJP Thomas v Commissioner of Tax, a man transferred certain shares he held to his fiancée, with the agreement stating that the transfer was in consideration of their forthcoming marriage. The woman in question married him soon

---

43 Indian Contract Act, 1872, s 2(d).
44 Indian Contract Act, 1872, ss 2(e) and (f).
46 Indian Contract Act, 1872, s 25(1).
47 Indian Contract Act, 1872, s 25(2).
48 Indian Contract Act, 1872, s 25(3).
49 Indian Contract Act, 1872, s 25 explanation 2.
50 1962 44 ITR 897 Cal.
51 ibid.
after the offer.\textsuperscript{52} The court took into account that this would have been the woman's second marriage\textsuperscript{53} and she would have desired a means to guarantee her financial security,\textsuperscript{54} and decided that marriage could certainly be good consideration beyond natural love and affection.\textsuperscript{55} The adequacy of marriage as consideration, however, was indeterminable for the purposes of taxation law.\textsuperscript{56}

The decision in \textit{PJP Thomas} has been echoed in other taxation law cases. In \textit{Maharao Raja Kamlekar Singh v Commissioner of Income Tax, Uttar Pradesh},\textsuperscript{57} a man transferred certain quarries to his wife on a lease in perpetuity, claiming that it was in consideration of a pre-nuptial agreement between them. Though the existence of the pre-nuptial agreement was never proved, the Court echoed the views on marriage as consideration in \textit{PJP Thomas}, observing that the Supreme Court has remained silent on the issue.\textsuperscript{58}

The position of law was further elaborated upon in \textit{AP Jaiswal v Gift-Tax Officer},\textsuperscript{59} where a pre-nuptial agreement was presented to prove that a transfer of shares to a wife was in consideration of their marriage. The Tribunal reiterated the position that marriage may be good consideration, but not necessarily adequate consideration.\textsuperscript{60} It also made some rather interesting observations. For one, it says that:

\begin{quote}
A mere promise to marry, though it may be good consideration to support the validity of a contract, cannot, therefore, be regarded as one for adequate consideration. Simply because the shares were transferred having regard to the obligations of the assessee under the pre-nuptial agreement, it is not possible for us to take the view that the said shares were transferred for adequate consideration as
\end{quote}

\begin{footnotes}
\item[52] ibid.
\item[53] ibid.
\item[54] ibid.
\item[55] ibid.
\item[56] ibid.
\item[57] 1968 67 ITR 351 All.
\item[58] ibid.
\item[59] 1985 11 ITD 703 Delhi.
\item[60] ibid.
\end{footnotes}
understood in law.\(^{61}\)

Here, the Tribunal supports the validity of a contract based on a promise to marry. It also appears to take the view that obligations arise from the pre-nuptial agreement. The Tribunal also directly addresses the question of pre-nuptial agreements:

An ante-nuptial agreement or settlement made in consideration of marriage may be enforceable at law on the ground that marriage is a sufficient consideration for the settlement.\(^ {62}\)

If a pre-nuptial agreement were contested for lack of consideration, it would therefore be possible to argue that the marriage itself serves as consideration for the agreement. However, as the Supreme Court has remained silent on the issue,\(^ {63}\) it would be wise to also explore the issue of whether a pre-nuptial agreement would fall under the definition of Section 25(1), thus vitiating the need for consideration at all.

**CONTRACTS UNDER SECTION 25(1)**

A plain reading of Section 25(1) provides for the following conditions for a contract made on the basis of love and affection to be enforceable: (a) it must be expressed in writing (b) it must be registered (c) it must be made on account of love and affection (d) the parties must be standing in near relation to each other.\(^ {64}\) This section will examine the last two conditions and see if they are fulfilled by a pre-nuptial agreement.

While husband and wife stand in near relation to each other, a pre-nuptial agreement is concluded between prospective spouses. The question of whether they stand in near relation to each other is therefore open to wide interpretation. Traditionally, the term has been applied to near relatives.\(^ {65}\) However, in *Nisar Ahmad Khan v Rahmat Begam* AIR 1927 Oudh 146.

---

\(^{61}\) ibid (emphasis added).

\(^{62}\) ibid.

\(^{63}\) cf n 51.

\(^{64}\) Indian Contract Act, 1872, s 25(1).

\(^{65}\) *Nisar Ahmad Khan v Rahmat Begam* AIR 1927 Oudh 146.
Ahmad Khan v Rahmat Begam, the Allahabad High Court has attempted to widen the definition of the term ‘in near relation’:

When the meaning of this proviso has been under discussion in previous cases there appears to have been a tendency to interpret the words ‘parties standing in a near relation’ as though they mean ‘near relatives’. We are of opinion that the meaning of the words should not be narrowed down in this way. There are many instances in which persons, who are not relatives or relations within the meaning of the law, nevertheless stand in a near relation to one another.66

The Allahabad High Court used this reasoning to extend the meaning of the term to include the parents-in-law of a Muslim man.67 It, however, did not provide a basis for determining whether two parties stood in near relation to each other. Though it could be argued that a prospective husband and a prospective wife stand in near relation to each other, it is uncertain that this would be accepted by the court.

The condition that the agreement is made on the basis of love and affection is an even more subjective one. It would largely depend on the facts and circumstances of each case, and does not necessarily stem from the nearness of relation of the parties.68 In Rajlukhy Debee v Bhootnath Mookerjee, for instance, a contract between husband and wife exhorting him to pay for her separate residence and maintenance was not held to be on account of mutual love and affection because it was the outcome of previous disagreements between the parties.69 In Appa Pillai v Ranga Pillai, the court took into account that there was no express declaration that the agreement was made on account of love and affection, and construed that the agreement was actually made based on the pragmatic consideration that the other party would be more capable of managing the estate.70

66 ibid.
67 ibid.
68 Appa Pillai v Ranga Pillai 1882 Indlaw Mad 15; Rajlukhy Debee v Bhootnath Mookerjee, (1900) 4 Cal WN 488
69 (1900) 4 Cal WN 48.
70 1882 Indlaw Mad 15.
In the instance of a pre-nuptial agreement, the parties are contemplating the consequences of a future separation. It could be said that, on account of mutual love and affection for each other, the parties are attempting to reach an agreement that would make the consequences of such a separation less harrowing. This is similar to the reasoning applied by the courts in *Manali Singhal v Ravi Singhal*, where the court held that the consideration for the family agreement under discussion was love and affection because the underlying idea was to put an end to discord and acrimony. However, if the precedent in *Appa Pillai* is followed, a pre-nuptial agreement made under Section 25(1) might require an express declaration that the consideration for the agreement is mutual love and affection.

**POSITION UNDER MUSLIM PERSONAL LAW**

The discussion so far has focused on whether or not marriage can serve as consideration for a pre-nuptial contract. It is important to note that the cases listed in the section above dealt with the question of Hindu marriages. The outcome of the discussion would not apply to marriages conducted under Muslim personal law because of the difference in which such marriages are viewed.

In opposition to Hindu law, which sees marriage as a sacrament, Muslim personal law views marriage purely as a contract. The elements of a civil contract have to be satisfied – the free consent of the parties to the marriage is required, the parties must be competent to contract under the terms of the Indian Contract Act, and consideration in the form of mahr or dower is

---

71 AIR 1999 Delhi 156 [20].
72 Provided that the courts accept the argument that prospective husband and wife stand in near relation to each other.
73 *Tekait Mon Mohini Jamadai v Basanta Kumar Singh* (1901) ILR 28 Cal 751.
76 Muslim Personal Law (Shariat) Application Act 1937, s 3(1)(2).
essential. Violating the terms and conditions set out, such as the concealment of a pregnancy, would have the same effect on the marriage as a breach of contract would in civil law. In fact, even the rescission of a Muslim marriage would be governed by the Indian Contract Act. In *Mahmad Usaf Abashabai Bidiwale v Hurbanu Mansur Atar*, the High Court of Bombay has declared: ‘It is well-settled that marriage under the Mahomedan law is a civil contract. Hence it should attract all the incidents of contract as any other contract.’

Consequently, the questions raised about marriage as consideration for a pre-nuptial agreement have no application to Muslim marriages.

**THE QUESTION OF A LAWFUL AND VALID OBJECT**

Pre-nuptial agreements have not always been acceptable even in Western jurisdictions. In an article on pre-nuptial agreements, Alison Marston briefly discusses the reasons that American courts relied on in invalidating pre-nuptial agreements before *Posner v Posner*. This included the agreement being “contrary to the concept of marriage”, causing marriage to “lose its dignity and sacredness”, and encouraging abandonment, along with other reasons that broadly fall under the head of public policy. The United Kingdom was more explicit in outlawing pre-nuptial agreements on grounds of public policy.

77 *Mahmad Usaf Abashabai Bidiwale v Hurbanu Mansur Atar*, (1979) 81 Bom LR 102 where the issue was the return of the gifts given as consideration for the marriage upon its termination.

78 *Amina v Hassan Koya* (2003) 6 SCC 93 where it is pleaded that the marriage is void because the wife concealed her pregnancy at the time of marriage. The Supreme Court does not deny that this would be grounds to render the marriage void. Rather, it relies on the fact that the pregnancy was in an advanced stage and impossible to conceal to compel the groom to pay *mahr*.

79 *Bidiwale* (n 76) 104.

80 Marston (n 36) 897.

81 “Leaving aside the usual contractual reasons, such as misrepresentation or undue influence, the only other such reason might be the old rule that agreements providing for a future separation are contrary to public policy. But the reasons given for that rule were founded on the enforceable duty of husband and wife to live together. This meant that there should be no inducement to either of them to live apart: see, for example, *H v W* (1857) 3 K & J 382, 386. There is no longer an enforceable duty upon husband and wife to live together.” *MacLeod v MacLeod* [2008] UKPC 64, [2009] All ER (D) 32 (Jan).
For a pre-nuptial agreement to be valid in India, it will have to necessarily have a lawful object and consideration, i.e. they must not be ruled out under the provisions of Section 23. It must not be forbidden by law, defeat the provisions of any law, or be immoral or opposed to public policy. This section will examine whether the idea of a pre-nuptial agreement would, by its very nature, be against public policy under Section 23. It will also briefly examine whether it could serve as a contract in restraint of marriage under Section 26.

**Illegality Arising out of Personal Laws**

The object of a pre-nuptial agreement is chiefly to alter the terms of a marriage to suit the convenience of the parties. Few such cases have come up before the courts. Pre-nuptial agreements82 that have been sought to be enforced have not been favorably regarded by courts.

The earliest cases dealing with pre-nuptial agreements were largely decided on the basis of the personal law of the parties. In *Tekait Mon Mohini Jemadai v Basanti Kumar Singh*,83 there was a pre-nuptial agreement between the parents of minors to the effect that after marriage the husband would live in his wife’s parent’s house. The husband’s parents also waived away right to take him back. When, following a disagreement, the husband wanted his wife to come live at his parent’s place, she refused, citing the agreement.

The agreement was void on two counts – it was a violation of Hindu personal law84 and it was in violation of public policy.85 The court inferred a duty imposed upon a wife under Hindu law to reside wherever her husband wishes to take up residence, and held the agreement void on grounds that it allowed the wife to escape this responsibility.86 Ghose, J. also remarked that the very nature of Hindu marriage, which was primarily a sacrament, prevented the variance of

82 That is, pre-nuptial agreements where both the parties were Hindu.
83 (1901) ILR 28 Cal 751.
84 ibid.
85 ibid.
86 ibid.
contractual duties:

This brings us to the consideration of the question what is the Hindu Law upon this subject. It may be premised that though marriage under the Hindu Law is a contract, it is also a sacrament, it is more religious than secular in character; the union is indissoluble, for it is a ‘union of flesh with flesh, bone with bone.’

*Krishna Aiyar v Balammal*87 was decided soon after *Tekait Mon Mohini*, in 1910. The case dealt with an agreement providing a woman the right to live away from her husband and obtain an allowance from him. The husband filed a case for the restitution of conjugal rights.88 In deciding the matter, the court took into account their personal law and held that an agreement between a husband and a wife to live apart would probably be deemed forbidden by Hindu law.89

The position laid down in *Krishna Aiyar* and in *Tekait Mon Mohini* was further discussed in *A.E. Thirumal Naidu v Rajammal*.90 There was a pre-nuptial agreement in this instance for the husband and wife to live separately, which was challenged by the wife in a decree for the restitution of conjugal rights.91 Although the final decision was based on the notion of public policy, the court does appear to rely on the insight of Banerjee, J. on Hindu marriage:

> The Hindu law upon this subject still retains its archaic character. Marriage in that law is not merely a contract but also a sacrament, and the rights and duties of the married parties are determined solely by the law, and are incapable of being varied by their agreement.92

While any pre-nuptial agreement would obviously have to comply with the provisions of statutes governing Hindu marriages, this conception of Hindu marriage as a sacrament provides an additional challenge to the legal validity

87 (1911) ILR 34 Mad 398.
88 ibid.
89 ibid.
90 (1967) 2 MLJ 484 (High Court of Madras).
91 ibid.
92 ibid.
of pre-nuptial agreements. It asserts that the marriage itself is above variance; that any attempt to alter the structure of marriage would be a nullification of the marriage itself.

However, the sacramental nature of marriage as established in these cases rests on the indissolubility of the union, which lends sanctity to the rights of the parties to each other’s society, and the duty of a Hindu wife to reside with her husband. The indissolubility of the union has been substantially altered by the Marriage Laws (Amendment) Act, 1976. The amendment provided for the recognition of divorce by mutual consent under Hindu law. In effect, the new provision allows the parties to vary the terms of their marriage by agreement. Hindu marriages have thus become more contractual, which has diminished their sacramental character as outlined in Tekait Mon Mohini, Krishna Aiyar and A.E. Thirumal Naidu. It would be interesting to note that the legalization of pre-nuptial agreements in other jurisdictions has been associated with the introduction of no-fault divorce, similar to the provision under 13B of the Hindu Marriage Act.

**PUBLIC POLICY**

The challenges to pre-nuptial agreements under Section 23 are not restricted to illegality. As has been noted above, public policy has been a ground to deny the enforcement of pre-nuptial agreement even in other jurisdictions. The central argument for classifying pre-nuptial agreements as being against public policy was that they would facilitate divorce.

It would therefore be pertinent to look at whether there would be any grounds for holding a pre-nuptial agreement to be against public policy other than that it violates the personal laws of the parties.

---

93 The Hindu Marriage Act, 1955, s 13B.
95 Marston (n 36).
In *AE Thirumal Naidu*, the court outlines its position on contracts that would be opposed to public policy:

‘There is a fundamental difference between a case where an agreement for separate living for a time is entered into during the continuance of marriage and an agreement before or at the time of marriage controlling the rights of the parties which the law confers upon them after the marriage and which, if enforced, might make the marriage itself nugatory, or infructuous. Such an agreement would seem to be opposed to public policy. The agreement with which we are concerned is an agreement of that latter character... I am of opinion that the agreement is opposed to public policy.’

The remarks offered by Alagiriswami, J. point to the existence of two conditions that would render a pre-nuptial agreement against public policy. First, the marital rights of the parties must be impacted. Second, the enforcement of the agreement – that is, the denial of the altered marital rights – would make the marriage infructuous.

This emphasis on the importance of maintaining the marriage appears to be what the courts consider in the interest of public policy. The effect of an agreement on marriage appears to have been the basis for deciding whether or not it was against public policy in several other cases. In *Vemuru Venkata Krishnayya v Vemuru Lakhsamma*, a compromise decree that allowed a wife to walk away from her husband if he refused to maintain her was held to be executable. The court believed that the provisions of the decree had prompted the wife to accept a compromise and give her husband another opportunity. Not only was such an agreement not against public policy, it was also held to be in the interests of family life.

Interestingly, the court distinguished the present agreement from the one in *Krishna Aiyar* on the basis of the fact that the objective of the older agreement was to allow the marriage to be terminated more easily: ‘It is not surprising

---

97 (A Alagiriswami, J); *A E Thirumal Naidu v Rajammal* (1967) 2 MLJ 484.
98 (1943) 56 LW 536 (High Court of Madras).
99 ibid.
that such a contract was held to be contrary to public policy, in that it enabled a marriage to be broken up for no proper cause. 100 The view in Vemuru Venkata was echoed in a case with very similar facts, Gogineni Subbaya v Goggineni Govindaamma. 101 A compromise decree involving a clause for future separation was not seen as being against public policy because its purpose was for the reconciliation of the parties. 102 The idea of marriage as a sacrament proposed in Tekait Mon Mohini appears to have found a secular form in these cases. Though they scarcely discuss the personal law of the parties, the basic principle remains the same – the marriage is an institution that must be guarded and maintained.

It must be noted, however, that the cases discussed so far have mostly been decided before the High Court of Madras. Though these decisions have persuasive in courts outside of Tamil Nadu, they are not binding, and it is possible for courts to adopt alternate points of view. The High Court of Mysore, for instance, adopted a radically different view of the relationship of marriage to public policy in Sudha v Sankappa Rai. 103 The court deals with a petition against the Madras Aliyasthana Act, 1949, which is essentially the codification of a matrilineal customary practice followed in parts of Karnataka. The main grievance lay in the ease with which marriages could be dissolved under this Act: it could be done by either party without undergoing any formal procedure or even assigning a reason. 104 Though the validity of the act was upheld based on the plenary power of the legislature, 105 the court also expressed a view on public policy and marriage that subtly differs from the prevailing view:

It is true that it is not desirable that matrimonial ties should be broken at the caprice of one of the parties to the marriage. It is equally true that neither society nor the parties to the marriage will be benefited by yoking together two persons who pull in opposite

100 Emphasis added.
101 (1944) 57 LW 485 (High Court of Madras).
102 ibid.
103 ILR 1963 Mys 121.
104 ibid.
105 ibid.
The court has made the important acknowledgement that the continuance of a marriage might not always be in the interest of public policy or to the benefit of society. While this was accepted in a very limited sense by allowing divorce under the Hindu Marriage Act, the conditions under which a divorce could be obtained before the 1976 Amendment were very limited.\(^{107}\)

Also of relevance to us is the part of the holding of the court that bars a legislative measure from being struck down on the grounds that it is opposed to public policy.\(^{108}\) The court’s emphasis on the power of the legislature to determine public morality would allow for pre-nuptial agreements to be given formal legal recognition provided the laws were to be enacted by a competent legislature and did not contradict Constitutional principles.\(^{109}\) In the absence of any such legislation, however, it is important to consider whether pre-nuptial agreements as conceived of in foreign jurisdictions would be viewed as a violation of public policy.

Pre-nuptial agreements in the United States have generally been held void on the grounds that they facilitate divorce. A pre-nuptial agreement barring the wife from seeking alimony was held void in *Re Marriage of Gudenkauf* on the grounds that such a provision could induce dissolution of marriage, and this possibility operated to void any pre-nuptial agreement ab initio.\(^{110}\) The reasoning is made explicit in *Duncan v Duncan*, where it was discussed that limiting alimony would make divorce a more attractive option for the wealthier spouse, and agreements limiting attorney’s fees were held to be part of alimony and against public policy.\(^{111}\) *Mulford v Mulford* holds that agreements in which the spouse loses the rights to the other party’s property also promotes divorce,

\(^{106}\) (Hedge, J); *Sudha v Sankappa Rai* ILR 1963 Mys 121, 124 (emphasis added).
\(^{107}\) Hindu Marriage Act 1955, s 13.
\(^{108}\) *Sankappa Rai* (n 102) 125.
\(^{109}\) ibid.
\(^{110}\) 204 NW 2d 586 (1973) (Supreme Court of Iowa).
\(^{111}\) 652 SW 2d 913 (1983) (Court of Appeals of Tennessee, Eastern Section).
especially in cases where the spouses have different incomes.\textsuperscript{112}

This position of law had been altered in the United States to accommodate changing social attitudes.\textsuperscript{113} The contemporary trends of marriage and divorce altered the position of pre-nuptial agreements so much so that the Supreme Court of Ohio felt that ‘It may be reasonably concluded that these types of agreements tend to promote or facilitate marriage, rather than encourage divorce.’\textsuperscript{114} The condition of a contract facilitating divorce has now been reduced to evaluating whether the terms promote or encourage divorce or profiteering by divorce. An attempt at explaining this new terminology and to distinguish it from the earlier principle has been made by means of a hypothetical example in \textit{Gross v Gross}:

A hypothetical example of the type of situation which condition three seeks to avoid is where the parties enter into an antenuptial agreement which provides a significant sum either by way of property settlement or alimony at the time of a divorce, and after the lapse of an undue short period of time one of the parties abandons the marriage or otherwise disregards the marriage vows.\textsuperscript{115}

Based on the cases examined in this section, it would be reasonable to conclude that the narrow definition of contracts that promote divorce proposed in \textit{Gross v Gross} would not be acceptable in India. The judgment itself clearly states that the shift in the Ohio position of law stems from a larger sociological shift in the attitude towards marriage and divorce. Although the attitude towards divorce and pre-nuptial agreements in India is slowly changing, it is a phenomenon restricted to certain sections of society, and is not pervasive enough to merit the \textit{Gross} argument for reading down the concept of a ‘contract facilitating divorce’.

\textsuperscript{112} 320 NW 2d 470 (1982) (Supreme Court of Nebraska).
\textsuperscript{113} 464 NE 2d 500 (Ohio 1984).
\textsuperscript{114} (Holmes, J); \textit{Gross v Gross} 464 NE 2d 500 (Ohio 1984).
\textsuperscript{115} ibid.
UNCONSCIONABILITY IN PRE-NUPITAL AGREEMENTS

Unconscionability

The possibility of an unconscionable agreement being entered into is especially important when pre-nuptial agreements are being considered. Legal author Judith Younger points out that the parties involved in a pre-nuptial agreement are likely to not have equal bargaining power at the time of drafting the contract, and are in a confidential relationship when they are less than rational. These conditions make them especially prone to making bad decisions about giving up their rights. It is usually women who end up with the worse end of the bargain because of social and economic inequalities. In addition, they are generally motivated to ensure the marriage takes place, and any effect of a pre-nuptial agreement on their fiancé’s decision to marry may impact their own decision.

In American jurisdictions, because of the immense power given to vary state-prescribed terms for the end of the marriage there is a danger that the terms of the contract may be rendered unfair by the time they need to be enforced. This makes pre-nuptial agreements inherently unstable, and necessitates different rules for their enforcement. Often the circumstances surrounding the execution of the contract are looked into before allowing for their enforcement.

Both procedural and substantive fairness are considered when determining the

117 Mackay (n 94).
119 Younger (n 115) 699.
120 ibid.
conscionability of an agreement.\textsuperscript{121} Procedural fairness generally requires that the contract is voluntarily entered into,\textsuperscript{122} that there is full disclosure between parties,\textsuperscript{123} and that each party is adequately represented by independent counsel.\textsuperscript{124} It also treats the parties as being in a fiduciary relationship.\textsuperscript{125} The concept of substantive fairness is more commonly open to judicial interpretation, and standards can vary widely across courts.\textsuperscript{126} Some parameters that are nevertheless useful in determining the substantive fairness of an agreement are their financial situation and needs, their contribution to the marriage, their physical and mental conditions, and their other family obligations.\textsuperscript{127} The goal of the court is often to ensure the parties do not have to endure any financial hardship due to unforeseen circumstances.\textsuperscript{128}

The relative role of substantive fairness can vary widely depending on the court. An extreme contrast is represented by \textit{McKee-Johnson v Johnson}\textsuperscript{129} and \textit{Simeone v Simeone}.\textsuperscript{130} In the former case, though the husband had meticulously fulfilled the criteria to establish procedural fairness, the court insisted on sending the case back to review to a lower court to determine if the criteria for substantial fairness were met.\textsuperscript{131} In \textit{Simeone}, however, the High Court of Pennsylvania was more stringent in holding parties responsible for the content of their agreements, even if it were arguably a bad bargain.\textsuperscript{132} It is interesting to note the difference in circumstances in which the two agreements were signed. The \textit{McKee-Johnson}

\begin{itemize}
\item \textsuperscript{121} Younger (n 115) 699; Marston (n 36) 898.
\item \textsuperscript{122} Younger (n 115) 700; Marston (n 36) 898.
\item \textsuperscript{123} Marston (n 36) 898.
\item \textsuperscript{124} Younger (n 115) 700; Norris v Norris 419 A 2d 982, 985 (DC 1980).
\item \textsuperscript{125} Marston (n 36) 898.
\item \textsuperscript{126} McKee-Johnson v Johnson 444 NW 2d 259 (Supreme Court of Minnesota); Simeone v Simeone 581 A 2d 162 (Pa 1990).
\item \textsuperscript{127} Marston (n 36) 898.
\item \textsuperscript{128} Younger (n 115) 701.
\item \textsuperscript{129} 444 NW 2d 259 (Supreme Court of Minnesota).
\item \textsuperscript{130} 581 A 2d 162 (Pa 1990).
\item \textsuperscript{131} McKee-Johnson (n 128).
\item \textsuperscript{132} Simeone (n 129).
\end{itemize}
case saw that the woman herself waived her right to an independent counsel, in spite of her husband’s repeated insistence that she seek legal advice.\textsuperscript{133} The \textit{Simeone} case saw a husband present a pre-nuptial agreement on the eve of their wedding, and she signed the agreement without receiving counsel about the legal rights she was surrendering.\textsuperscript{134}

The Uniform Pre-Marital and Marital Agreements Act stipulates that a court need not enforce a term in a pre-nuptial agreement if the term were unconscionable either at the time of signing, or if enforcing the said term would cause substantial hardship to one of the parties.\textsuperscript{135} Unconscionability is not defined under the Act, and is to be determined by the court “as a matter of law”.\textsuperscript{136}

The question of unconscionability in Indian law was traditionally subsumed under the question of undue influence. The Privy Council in \textit{Raghunath Prasad v Sarju Prasad} required that it be adequately proved that one party was in the position to dominate the will of the other, and unconscionable terms were secondary to this.\textsuperscript{137}

Unconscionable agreements were distinguished from agreements vitiated by undue influence in \textit{Central Inland Water Transport v Brojo Nath Ganguly}.\textsuperscript{138} The Supreme Court pointed out that unconscionable agreements were usually characterized by an inequality in bargaining power, usually on economic grounds.\textsuperscript{139} Though they did not clearly meet the requirements of “undue influence” under Section 16\textsuperscript{140} nor were they illegal,\textsuperscript{141} they were still void under Section 23 because the terms were extremely unfair and unreasonable so as to

\begin{flushleft}
\begin{itemize}
  \item \textsuperscript{133} \textit{McKee-Johnson} (n 128).
  \item \textsuperscript{134} \textit{Simeone} (n 129).
  \item \textsuperscript{135} Uniform Pre-Marital and Marital Agreements Act 2012, s 9(f).
  \item \textsuperscript{136} Uniform Pre-Marital and Marital Agreements Act 2012, s 9(g).
  \item \textsuperscript{137} (1923-24) 51 IA 101, 105-106 (Privy Council).
  \item \textsuperscript{138} (1986) 3 SCC 156.
  \item \textsuperscript{139} ibid 217.
  \item \textsuperscript{140} ibid.
  \item \textsuperscript{141} ibid 219.
\end{itemize}
\end{flushleft}
“shock the conscience of the court”. Unequal bargaining powers appears to be the key test; where there is equality of bargaining powers, the courts have set aside claims of unconscionability. The position on unconscionability was summed up by the Supreme Court in *Pomal Kanji Govindji v Vrajlal Karsandas Purohit*: “Freedom of contract is permissible as long as it does not lead to taking advantage of oppressed or depressed people.”

**WAIVER OR MODIFICATION OF MAINTENANCE RIGHTS BY AGREEMENT**

Maintenance rights are the common subject of pre-nuptial agreements in the United States, with a party often limiting or forfeiting their right to claim alimony after divorce.

The position under Indian law appears to leave little scope for the variance of maintenance rights by agreement. In *Hirabai Bharucha v Pirojshah Bharucha*, the court relied heavily on English case law to declare that maintenance rights, being a statutory provision, form a matter of public policy, and cannot be bargained away. A contract to give away maintenance rights would be *void ab initio* similar to a contract with a minor. The decision was upheld by the Bombay High Court in *Geeta Satish Gokarna v Satish Shankar Rao Gokarna*, which said that the section providing for maintenance was itself based on public policy.

---

142 ibid.
143 *Phulchand Exports Ltd v OOO Patriot* (2011) 10 SCC 300, 315.
144 (1989) 1 SCC 458.
145 ibid 476.
147 AIR 1945 Bom 537.
148 In the given case, it was a consent decree under s. 40 of the Parsi Marriage and Divorce Act, 1936.
149 *Hirabai Bharucha* (n 146).
150 AIR 2004 Bom 345.
policy. Further, it held that permanent alimony and maintenance formed part of the right to life, and any clause in a contract that waived such rights would be against public policy. A pre-nuptial agreement that thus attempts to waive alimony would probably be successfully challenged on grounds of being against public policy.

There is case law to support the proposition that a wife relinquishing her right to maintenance on payment of a lump sum might not be against public policy. In *Muniammal v Raja* the Madras High Court, recognized that a decree or agreement for fixing maintenance was no bar to a wife claiming an increase in maintenance due to a change in her pecuniary circumstances. However, in case she agreed to an amount while not relinquishing her subsisting right, it would be necessary to look into the circumstances to see whether her claim for increased maintenance is justified. It would be pertinent to note, however, that the agreement under consideration in this case was concluded and the arrears for maintenance were claimed before the Hindu Marriage Act came into force in 1956, and it is very likely the decision can be distinguished on that ground.

Interestingly, some courts have held that a maintenance agreement by itself would not be in violation of public policy, and might even be permitted under s 25 of the Hindu Adoptions and Maintenance Act. The Delhi High Court pointed out that the section contains the phrase ‘or by agreement’ which implies that the maintenance amount can be fixed by the parties themselves. The maintenance amount, however, remains alterable if there is a change in circumstances. Moreover, the agreement to fix the maintenance was allowed in the context of a family agreement whose aim was to bring about peace and

---

151 ibid 349.
152 (1977) 90 LW 666 (High Court of Madras).
153 ibid 670.
154 ibid 671.
155 ibid 668.
156 *Manali Singhal v Ravi Singhal* AIR 1999 Delhi 156 [19].
157 Hindu Adoptions and Maintenance Act 1956, s 25.
harmony, and it is unclear whether courts would accord similar importance to an agreement between husband and wife that is drawn up before marriage.

**Pre-nuptial Agreements and Their Impact on Property and Succession Rights**

Property and succession rights in the event of divorce or death are the two subjects most popularly dealt with by pre-nuptial agreements in the United States. The agreements commonly provide for a scheme of distributing assets on death or divorce that differs from the marital property regime laid out by the state. The default marital property regime followed by most states aims to protect spouses by pre-determining property division, which may be equal, equitable, or per title, depending on the laws of the concerned states. Alterations to this regime are usually contracted in order to protect family property or business.

The legality of pre-nuptial agreements dealing with these subjects has been upheld by statute and by the courts. Forty-three out of fifty states have express statutory provisions legalizing pre-nuptial agreements dealing with the disposal of property in the event of divorce or death. Of the remaining seven states, Oklahoma and Vermont do recognize the right to alter the marital property regime, although not by statute. Courts have upheld the waiver of a wife’s marital rights upon the intestate death of her husband, the waiver of claims

---

158 Manali Singhal (n 156).
160 Marston (n 36).
161 Younger (n 96).
162 Younger (n 115).
163 Marston (n 36).
164 Nasheri (n 155).
165 ibid.
166 Rowland v Rowland 599 NE 2d 315 (Ohio Ct App 1991); Gentry v Gentry 798 SW 2d 928.
to the property of the other spouse, and the exclusion of property titled to any one party from the scope of ‘marital property’ as being examples of valid alterations to the state-provided marital property regime.

The discussion on the usage of pre-nuptial agreements in India demonstrated that very few of the agreements dealt with alterations to the property regime. In this section, I will first examine India’s existing marital property regime with respect to property rights and succession rights. I will then look at the scope for pre-nuptial agreements to alter the property regime and finally look at whether such pre-nuptial agreements are hit by public policy under Section 23 of the Indian Contract Act.

**Outlining the Marital Property Regime in India**

India’s regime to deal with property ownership after marriage is largely based on the ‘separate property regime’ which was popular in England of the nineteenth century. Property is deemed to belong to the person who owns title to it, regardless of when it was acquired and the contribution of the other spouse. Such a situation is understood in opposition to a ‘community of goods’ regime under which spouses become co-owners of their property by the mere fact of marriage. Naturally, the dominance of the doctrine of separate property has been identified as the reason why Indian personal laws lack a clear position on the division of property post divorce, beyond the concepts of stridhan and joint marital property.

Property that jointly belongs to both spouses is dealt with in a limited sense under Section 27 of the Hindu Marriage Act, 1955. A plain reading of the

---

167 Re Marriage of Rahn 914 P 2d 463 (Colo Ct App 1995).
168 Critchell v Critchell 746 A 2d 282 (DC 2000); Gentry v Gentry, 798 SW 2d 928.
171 ibid.
172 Sen (n 169) 134.
section provides us two conditions that need to be satisfied before it is brought into force: the property must have been presented ‘at or about the time of marriage’ and the property must jointly belong to both husband and wife. The dominant interpretation of the section tells us that Indian law exclusively deals with jointly owned property and gifts made exclusively to any one party are not covered by s 27. A separate suit would need to be instituted to gain control of, or an interest in property whose title rests with a single spouse. A slightly more flexible interpretation is that the property may have been received individually by the spouses, but must be used jointly by them to be covered by the scope of s 27. The third interpretation is that the court may have jurisdiction over property solely belonging to either husband or wife ‘to ensure the making of … equitable adjustments’, which is the object of s 27. The Family Court also has additional powers conferred on it that enable it to consider property separately owned by the parties that was not earlier considered under s 27. The notion of joint property, however, is limited to property that was presented in close temporal proximity to the marriage, and property that is presented to the couple or acquired subsequent to the marriage is excluded. Assets that have been created as a result of partnership between the spouses do not gain recognition as such under s 27, especially if title to such property is exclusively held by one of the spouses.

Stridhan is a customary practice of transferring property to a woman that has been granted legal recognition. Courts have variously recognized that

---

173 Hindu Marriage Act 1955, s 27.
175 MD Krishna v MC Padma AIR 1968 Kant 226; Sen (n 169).
176 Mariamma Ninan v KK Ninan I (1997) DMC 570.
177 Nandini Sanjiv Ahuja v Sanjiv Birsen Ahuja AIR 1988 Bom 239.
178 Kamta Prasad v Om Wati AIR 1972 All 153 [3].
179 Family Courts Act 1984, s 7(1) explanation (c).
180 Sangeeta B Kadam v Balkrishna Ramchandra Kadam AIR 2005 Bom 262 [17] [18].
181 Nandinia Sanjiv Ahuja (n 173).
182 MD Krishna (n 171) [18].
183 Sen (n 169).
184 ibid 136.
stridhan, once conferred upon the woman, becomes her absolute property.\textsuperscript{185} It falls outside the s 27 definition of joint property,\textsuperscript{186} and if the property is misappropriated by the husband or his relatives, the wife has a right to recover it under s 406 of the Indian Penal Code.\textsuperscript{187} It must be noted, however, that stridhan typically consists of jewelry, clothing, or money,\textsuperscript{188} and its function as a security for a divorcing wife is dubious.

\textbf{PRE-NUPHTIAL AGREEMENTS: A SAFEGUARD FOR WOMEN’S RIGHTS?}

The marital property regime as described above is patently unfavorable to women. A significant number of divorcing women have no reported income and become economically dependent on their natal family.\textsuperscript{189} Women are often discouraged from, and much less likely to, continue working after their marriage.\textsuperscript{190} The situation is compounded by the absence of a joint marital property regime and the fact that ownership of assets usually rests with the man.\textsuperscript{191} Domestic affairs are usually almost exclusively handled by women, yet the law does not assign any economic value to such work.\textsuperscript{192}

Pre-nuptial agreements, if enforced by the courts, could theoretically be used to

\textsuperscript{185} Pratibha Rani v Suraj Kumar 1985 SCR (3) 191; Rashmi Kumar v Mahesh Kumar Bhada (1997) 2 SCC 397.
\textsuperscript{186} ibid.
\textsuperscript{187} ibid.
\textsuperscript{188} Sen (n 169).
\textsuperscript{190} ibid.
circumvent this regime, and have been recommended for this purpose.\textsuperscript{193} For instance, an agreement could stipulate a fair division of property and financial assets after marriage\textsuperscript{194} which would more adequately value a non-working woman’s financial contribution to the marriage. A pre-nuptial agreement altering the community of property regime is not unprecedented in India: the Uniform Civil Code in Goa allows couples to determine which property regime (absolute community, absolute separation, or separation of assets acquired before marriage) would govern their assets.\textsuperscript{195} It could be argued that such an agreement could even be protected as falling under public policy, as its objective would be to safeguard the rights of women post-divorce.

The courts, however, have demonstrated a reluctance to interfere with the personal law of the parties, even when they contradict constitutional principles. While the Delhi High Court has refused to interpret Article 21 in a way that would ‘have the effect of weakening the marriage bond’,\textsuperscript{196} the Supreme Court has also indicated that the Fundamental Rights do not affect personal law.\textsuperscript{197} Given that most personal laws – indeed, even the Special Marriage Act – do not make a provision for the equal distribution of property,\textsuperscript{198} it is possible that a challenge to a pre-nuptial agreement on the grounds that violates the personal laws of the parties would be successful. Moreover, receiving a share in the husbands’ assets to which they would not otherwise have been entitled might be viewed as incentivizing divorce and thus challenged on grounds of violating public policy.

\begin{footnotesize}
\begin{enumerate}
\item[193] Sen (n 169).
\item[195] Sen (n 169) 149.
\item[196] Kaur v Chaudhry AIR 1984 Del 66.
\item[197] Krishna Singh v Mathura Ahir AIR1980 SC 707.
\item[198] Sen (169) 141-42.
\end{enumerate}
\end{footnotesize}
PRE-NUPITAL AGREEMENTS AS AN INSTRUMENT TO ALTER SUCCESSION RIGHTS

Although pre-nuptial agreements are commonly used abroad to alter the succession rights of the surviving spouse, this usage is uncommon in India. For one, the succession rights of the surviving spouse would only attain relevance if the husband or wife died intestate. The rules of succession are clearly laid down in case the wife survives her husband: she is a Class I heir under the Hindu Succession Act and is given priority over other heirs to the property.199

The widow has an absolute share in the property.200 Because she attains full ownership of the property vested with her, she cannot be divested of it even upon her remarriage.201 Interestingly, it has been held that the wife remains an heir to the property even if the husband dies during divorce proceedings.202 A pre-nuptial agreement, if upheld, could possibly protect the husband’s estate from devolving to a spouse he has fallen out with in such an event.

There are grounds to believe that the relinquishment of succession rights is not necessarily always against public policy. The courts have often upheld family agreements in which one or more parties relinquish certain rights as being legally binding.203 In Maturi Pullaiah v Maturi Narasimham, for instance, the Supreme Court took into account the objective of family agreements in resolving anticipated disputes, and allowed for an arrangement where one set of members relinquished their rights to property in favour of only one member.204 However, establishing a similar motive – that of conflict resolution – would be more challenging for a pre-nuptial agreement, particularly because it is signed before the marriage is solemnized.

199 Hindu Succession Act 1956, s 8 sch, ss 9 and 10.
200 Hindu Succession Act 1956, s 14.
202 Thankam v Rajan AIR 1999 Ker 62; Cherotte Sugathan v Cherotte Bharathi AIR 2008 SC 1467.
203 Ram Charan Das v Girjanandini Devi 1965 SCR (3) 841; Maturi Pullaiah v Maturi Narasimham AIR 1966 SC 1836.
204 AIR 1966 SC 1836.
CONCLUSION

This article looked at the validity of a pre-nuptial agreement by examining the potential grounds for contesting its enforceability. Such grounds broadly included the form and content of a pre-nuptial agreement. In terms of form, a pre-nuptial agreement can be said to meet the barest legal definition of a contract. The question of consideration can be addressed either by viewing marriage as consideration for the contract, or by attempting to bring the agreement under Section 25(1) of the Indian Contract Act. Although both arguments may be contested, the argument for viewing marriage as consideration for a pre-nuptial agreement has a stronger basis than an argument for seeing the agreement as an outcome of love and affection.

In terms of its content, the change in personal law in divorce might make it more difficult for the courts to dismiss a pre-nuptial agreement on the grounds that it violates personal laws. However, a pre-nuptial agreement might still be held void against public policy if the court sees it as facilitating divorce. As the social and economic conditions in India have not yet altered to the degree required to bring about a shift in legal thinking, the public policy argument is the strongest argument against the enforceability of a pre-nuptial agreement.

In addition, the most common clauses of a pre-nuptial agreement – dealing with maintenance and property and succession rights – can also be challenged. Unconscionability is a general grounds that can be used to overturn specific terms. Maintenance rights are protected by statute, and even though some interpretations of the Hindu Adoptions and Maintenance Act allow the parties to vary the maintenance amount by contract, such agreements can easily be set aside by courts if there is a change of circumstances that justifies the act.

Pre-nuptial agreements have immense scope for benefitting both parties and equalizing the post-marital distribution of property. However, because they provide a stronger incentive for women to divorce their husbands, such agreements could possibly be against public policy in the eyes of the court. Similarly, allowing alterations in the succession regime could benefit husbands,
but courts would be unlikely to allow parties to contract out of statutory rights that embody the spirit of the right to equality.

It would therefore be inadvisable to attempt to enforce a pre-nuptial agreement in a court of law. As long as the court adopts a conventional stand and continues to see contracts facilitating divorce as being against public policy, pre-nuptial agreements shall remain unenforceable in India.
AN ANALYSIS OF ARBITRATION CLAUSES IN INDIAN CONTRACT LAW

Aniruddh Nigam* and Siddharth S. Aatreya**

ABSTRACT

Arbitration has gained the status of the preferred mode of dispute resolution over the past few years around the world. The benefits that accrue to parties from this process range from confidentiality of proceedings, to binding awards and to speedy resolution of disputes. However, the realization of these benefits requires that the parties be free to arbitrate without any judicial intervention.

Unfortunately, Indian courts have adopted a highly paternalistic approach to arbitration, increasing the probability of such judicial intervention. Specifically, these courts have exhibited a propensity to intervene right at the beginning of the process, penalizing the parties for poorly drafted arbitral clauses.

This article highlights problematic positions of law in India with respect to commonly accepted arbitral principles such as severability, and demonstrates the need to exercise abundant caution when drafting arbitral clauses. It then attempts to provide a guide of practices that can be followed as a matter of general practice to ensure that the unfavourable approach Indian courts have taken to arbitration does not result in an erosion of the efficacy of arbitration as a form of dispute resolution in the Indian context.

INTRODUCTION

With rapid growth in trade and commerce, both domestically and transnationally, arbitration has become the preferred mode of dispute resolution in almost all commercial transactions in India today.¹ As a convenient alternative

---


---
to traditional systems of justice dispensation (courts), arbitration has allowed parties involved in such commercial transactions to tailor-make adjudicatory mechanisms to ensure that disputes are resolved in a fast and efficient manner.

The rising popularity of arbitration in commercial transactions has not been without good reason. Adjudication of commercial disputes before courts, especially in the Indian context, has resulted in long delays and gross inefficiencies in conflict resolution. Furthermore, arbitration gives parties the freedom to choose an adjudicator who is both neutral and experienced in the subject, hastening the process and increasing its efficiency, while also allowing them to choose the law applicable etc. in international matters. Benefits have accrued to the economy on the whole too, since arbitration does away with the possibility of court delays stalling commercial transactions and therefore hampering economic growth.

The realisation of all these benefits, however, is predicated on the parties being free to arbitrate without any judicial intervention. Such intervention in arbitration could come about at different stages of the process – right from the commencement of proceedings (through a challenge to the arbitration agreement) to the enforcement of an award rendered by the tribunal. In all these situations, the primary benefit of arbitration - freedom from the limitations of traditional courts - does not accrue to the parties. This renders the motive behind choosing to arbitrate in the first place moot. Prevention of judicial intervention, therefore, is a matter of primary importance in ensuring that the arbitral process has tangible benefits to the parties involved.

In light of the above, this article analyses the interplay between contracts and arbitration from the point of view of judicial intervention in the Indian context. The most common basis for preliminary judicial challenges to arbitration is the validity of the arbitration agreement, which is a contractual issue. Therefore,

---

2 ibid.
5 ibid.
this article will to highlight the most common challenges to such arbitration clauses, and provide suggestions with respect to the manner in which these clauses should be drafted to reduce the probability of such intervention.

It will begin by analysing the relationship between arbitration and contract law. Specifically, in the Indian context, it will look to provisions of the Indian Contract Act, 1872, and present it as the primary source of statutory authority for all arbitral agreements in India.

It will then go on to look into two problematic areas of law in the intersection between contract and arbitration law in India. It will begin by addressing the issue of severability. This is a universally accepted doctrine, which posits that arbitration clauses must be viewed separately from the original contract between the parties.\(^6\) This would normally imply that invalidation of the original contract would not affect the validity of the arbitration agreement, but has received a muddled interpretation in Indian jurisprudence.

Additionally, this article will deal with pathological clauses in a general sense. These have been defined as arbitration clauses which have defect(s). These defects are potentially wide-ranging and stem solely from a lack of clarity due to the use of bad phraseology in drafting these clauses. Simple solutions to the most common reasons for pathological clauses being drafted in India will then be highlighted, followed by an analysis of the different ways in which the Indian judiciary has interpreted these. Furthermore, methods of prevention will be highlighted.

**INTERFACE BETWEEN CONTRACT LAW AND ARBITRATION LAW**

The arbitration process has often been called a ‘creature of consent’.\(^7\) The implication of this representation is that the use of arbitration as an adjudicatory mechanism is solely based on the consent of the parties to it. Furthermore, the process is extremely malleable, and can be tailor-made to suit the needs of the parties, based again on their consent to these characteristics.

---

\(^6\) UNCITRAL Model Law on International Commercial Arbitration, Art 7(1).

The consent of the parties to the arbitral process is embodied in the arbitral agreement between the parties. In this manner, contract law (which governs the entering into and provisions of the arbitral agreement) and arbitration law are inextricably tied together. This is evident from the provisions of the Indian Contract Act, 1872. Sec. 28 of the Act holds that any agreement in restraint of legal proceedings is, to that extent, void. However, the first proviso to Sec. 28 makes a clear exception for arbitration agreements, and states that such agreements would not fall within the ambit of Sec. 28. In this manner, Sec. 28 provides the earliest statutory legitimacy to arbitration as a form of dispute resolution between parties. Subsequent statutory sources of legitimacy of arbitration as a substitute to using traditional courts for dispute resolution (such as Sec. 8 of the Arbitration and Conciliation Act, 1996) can be traced back to this.

This relationship has wide implications on the kind of challenges arbitration has faced from the judiciary. As an *a priori* source of legitimacy to any arbitration proceeding, the arbitration agreement has come under close scrutiny of Indian courts in the past. The import of this statutory provision is that the rules for interpreting the arbitral provision are the same as the rules for the interpretation of any contractual clause.

This is because by virtue of being mentioned and legitimised in Sec. 28 of the ICA, the arbitral clauses and their construction must be read in conjunction with the rules surrounding the Indian Contract Act as well. This provides for the interface between contracts and arbitration and presents the environment within which the problem of bad drafting must be observed.

The subsequent sections of this article will highlight some of the more common issues commonly faced in this area in India.

---

8 Indian Contract Act, 1872, s 28.
9 Arbitration and Conciliation Act, 1996, s 8, delineates the course of action to be followed when a party approaches a court of law arising out of a dispute falling within the ambit of a pre-existing arbitration agreement between the parties. It states that, in such situations, the court is bound to direct the parties to refer the dispute to an arbitral tribunal and is barred from adjudicating upon the dispute. This serves as an additional source of statutory legitimacy of arbitration as a form of dispute resolution.
SEVERABILITY

Arbitration is a consensual activity, hinging on the principle that no party must be compelled to submit a dispute to arbitration without having agreed to it previously. In this light, the arbitral agreement, and its evaluation thereof, gains immense importance, as it is the source of the authority and jurisdiction of the arbitrators.10

Article 7(1) of the UNCITRAL Model Law states that

“[a]n arbitration agreement may be in the form of an arbitration clause in the contract or in the form of a separate agreement”11

The arbitral clause therefore, essentially is a contractual clause between the parties and this freedom to draft it is liberally exercised by most parties. However, most agreements in customary practice today are a part of the underlying commercial agreement.12

Chapter II of the Indian Arbitration and Conciliation Act, 1996 also recognizes this freedom, and the provisions relating to arbitration agreements in the statute borrow from the UNCITRAL Model Law on International Commercial Arbitration 1985.13

It has to be understood that arbitration is an alternative mechanism to settle disputes, specifically for the business community that wishes to avoid pitfalls like lengthy procedures, delay in evaluation of cases and court expenses in India. The logical conclusion of this understanding is that judicial intervention in the

11 UNCITRAL Model Law on International Commercial Arbitration, art 7(1).
arbitral process must be minimal. In this regard, the principle of Competence-Competence is extremely important.\textsuperscript{14}

The power of the arbitral tribunal to decide on its own jurisdiction is a crucial power,\textsuperscript{15} and most international instruments that govern arbitration incorporate this principle.\textsuperscript{16}

This power is intricately tied to the principle of severability of the arbitral clause, which holds that the “validity of an arbitration clause must be determined independently from the validity of the basic commercial contract in which it is contained”.\textsuperscript{17} However, both these principles have seen a muddled approach from Indian jurisprudence in the past, which has led to a confused understanding of these principles.

The principle of severability (or separability) evolves from the concept that arbitration agreements are distinct, apart and separate from the main contract within which they are situated.\textsuperscript{18}

\begin{itemize}
\item \textsuperscript{14} ibid.
\item \textsuperscript{16} UNCITRAL Arbitration Rules 2010, art 21(1) reads: “The arbitral tribunal shall have the power to rule on its own jurisdiction, including any objections with respect to the existence or validity of the arbitration agreement. For that purpose, an arbitration clause that forms part of a contract shall be treated as an agreement independent of the other terms of the contract”; ICC Arbitration Rules 1998 art 6 reads as follows: “Unless otherwise agreed, the Arbitral Tribunal shall not cease to have jurisdiction by reason of any claim that the contract is null and void or allegation that it is non-existent, provided that the Arbitral Tribunal upholds the validity of the arbitration agreement. The Arbitral Tribunal shall continue to have jurisdiction to determine the respective rights of the parties and to adjudicate their claims and pleas even though the contract itself may be non-existent or null and void.”
\item \textsuperscript{17} Tushar Biswas, ‘The doctrine of competence-competence from an Indian perspective’, (2010), 13(2), Int. A.L.R, 42.
\item \textsuperscript{18} Emmanuel Gaillard and Savage, ‘Fouchard Gaillard Goldman on International Commercial Arbitration’ (1999), 197: “However, it should be emphasized at the outset that the term ‘autonomy’ has a dual meaning. It is sometimes used in its traditional sense, which is to refer to the autonomy or separability of the arbitration agreement from the main contract to which it relates. Sometimes though, the courts, especially in France, refer to the autonomy of the arbitration agreement from ‘all national laws,’ which is an entirely different concept, related to the issue of the selection of the rules on the basis of which the existence and validity of an arbitration agreement must be assessed.” This article examines only the first form of autonomy.
\end{itemize}
Prior to this, arbitration agreements were thought of as accessories to the underlying contracts, and that invalidity of the underlying contract automatically rendered the arbitration agreement invalid. Therefore, if one of the parties to the contract raised a challenge to the validity of the contract, the arbitration agreement would be attacked as well and the arbitral tribunal would no longer hold jurisdiction.19

However, this position changed when arbitral clauses started being conceived of as “procedural contracts in a broader agreement, so that the law applying to such clauses were procedural ones of the arbitral forum, and not the substantial ones applying to the rest of the main agreement”.20 This interpretation leads to the idea that parties to a contract enter into two distinct agreements, one regulating the underlying commercial relationship, and the second procedural contract regulating dispute resolution.

This position gained legal eminence following the Harbour Assurance21 case in the United Kingdom, where the Court held that even if the plea that the contract is illegal is taken, the arbitration clause would survive so as to allow the arbitrator to determine the issue of its validity. The Indian Arbitration and Conciliation Act of 1996 also provides for this principle under Section 16(1)(b), which states that:

“for the purpose of ruling on its own jurisdiction, the arbitral tribunal shall (i) treat an arbitration clause which forms part of a contract, as an agreement independent of the other terms of the contract, and (ii) a decision of the arbitral tribunal that the substantive contract is null and void shall not, ipso jure, invalidate the arbitration clause”.22

---

22 Arbitration and Conciliation Act, 1996, s 16(1).
The survival of this clause, even when the underlying contract is held to be null and void, is a legal fiction crucial for the efficient working of the arbitral process. It would be extremely inconvenient if a breach of contract, or a claim that the contract was voidable would be able to terminate the arbitration clause as well. Severability ensures that if, for example, one party claims that there has been a total breach of contract by the other, the contract is not destroyed for all purposes.

This, therefore, provides a legal basis for the appointment of an arbitral tribunal. If the tribunal is to decide on its own jurisdiction, as has been statutorily provided for, it must first assume that jurisdiction. This practical advantage is necessary for the efficient working of arbitration as a practice, and therefore must be upheld at all costs.

**Indian Approach To The Principle**

Prior to the 1996 Act, the Indian jurisprudence on this issue was contrary to global practice. The Indian Courts displayed a paternalistic attitude towards the process of arbitration, and mitigated its authority. While these precedents have been rendered redundant by the 1996 Act, the Indian approach still prevails and jurisprudence on the issue still reflects a hostile attitude towards the practice of arbitration in general, and the principle of severability in specific.

The decision of the Supreme Court in *Jawaharlal Barman*, is a useful point of reference for this discussion. In this case, the Court held that a challenge to the existence or validity of one [the underlying contract] would mean challenge to the existence or validity of the other [the arbitration agreement].

Following this, a Constitutional bench in *Khardah Co* held that if a contract is illegal and void, the arbitration clause contained in it must also perish along

---

25 Arbitration and Conciliation Act, 1996, s 16(1).
26 *Jawaharlal Barman v Union of India*, AIR 1962 SC 378.
27 *Khardah Co Ltd v Raymon India*, AIR 1962 SC 1810.
with it and the dispute relating to the legality and validity of a contract is not within the jurisdiction of the arbitrator. The same Court in *Waverly Jute Mills*\(^{28}\) reiterated this principle stating that “a dispute to the validity of a contract could be the subject matter of an agreement of arbitration in the same manner as a dispute relating to a claim made under the contract, but such an agreement would be effective and operative only when it is separate and independent of the contract”. The position of law prior to the 1996 Act therefore, can be summed up as was by Tulzapurkar J in *Renusagar Power*\(^{29}\) where he said that “the arbitration clause must fall along with the underlying commercial contract”.

In 1996, the Indian Arbitration and Conciliation Act incorporated the principle of severability and competence-competence. However, even after this, the Supreme Court continued to uphold its supervisory role in the arbitral process.

In the case of *Wellington Associates Ltd*\(^{30}\), the Court observed that in interpreting Section 16 of the Act, the proposition that the ‘tribunal can decide about the existence of the arbitration clause’ is not acceptable. The primary reasoning of the Court behind this decision was the use of the word “may” in Section 16, which implies an option for the tribunal to do so, if enabled to exercise this power by the municipal courts. This principle was upheld later in subsequent judgments as well.\(^{31}\)

In 2002, the Supreme Court finally recognized the global trend of arbitral practice, and in an effort to make India an arbitration friendly jurisdiction, upheld the principle of severability. In the case of *Konkan Railway Corp*,\(^{32}\) a Constitutional Bench observed that “objections relating to the existence or validity of the arbitration agreement could be raised before the tribunal itself”. This judgment was relied upon by a Constitutional Bench in *Food Corp of India*,\(^{33}\)

---

\(^{28}\) *Waverly Jute Mills v Raymon India*, AIR 1963 SC 90.


\(^{31}\) *Grid Corp of Orissa v AES Corp*, 2002 7 SCC 736.

\(^{32}\) *Konkan Railway Corp v Rani Construction*, 2002 1 Arb LR 326.

\(^{33}\) *Food Corp of India v Indian Council of Arbitration*, AIR 2003 SC 3011.
where the Court laid down the rule that “questions relating to the improper constitution of the arbitral tribunal or its want of jurisdiction are matters which should be canvassed before the arbitral tribunal itself, which has been specifically empowered to rule on such issues and on its own jurisdiction”.

The Court also observed that questions relating to scope, meaning and effect of the arbitration clause are matters which are related to the jurisdiction of the arbitral tribunal, as the tribunal derives its jurisdiction from such agreement. Therefore, logically in line with the statutory provisions, this question should be evaluated by the arbitral tribunal.

However, this pro-arbitration position was overruled by a 7 member bench of the Supreme Court in the Patel Engineering case. In this case, the Court interpreted Section 16 to mean that “if and when issues regarding the jurisdiction of the tribunal appear before the arbitral tribunal, then it can rule on those issues.” This can happen when the parties have gone to the arbitral tribunal without recourse to Section 8 or 11 of the Act. However, where jurisdictional issues are raised under these sections before a reference is made, Section 16 cannot be held to empower the arbitral tribunal to decide on its jurisdiction, and the order of the municipal Court will prevail.

This case represents the current position of law in India. It serves as a reflection of traditional Indian jurisprudential attitudes towards the process of arbitration. The implications of this position of law for arbitration in India and drafting of contracts in India are manifold.

**Suggestions**

The current position of law in India, in the opinion of the authors, is a faulty position that inhibits arbitral practice in India and makes India an anti-arbitration environment. This has immense implications for international
trade and commerce, which has successfully globalised using arbitration as an instrumentality of dispute resolution.

Normatively, a return needs to be made to recognition of the principle of severability. Four arguments are advanced in support of this claim.

First, when two parties enter into a contract providing for arbitration, they usually use the phrase “and dispute arising out of or relating to the agreement”. The implication of this fact is that they intend to require arbitration of disputes arising out of the contract, which includes disputes over the validity of the contract.\textsuperscript{36} The use of this specific phrase denotes the will of the parties to arbitrate over any dispute that emanates from this agreement, including disputes regarding the existence of the agreement as well. Once this express intention takes the form of a concluded agreement, the will of the parties should be given effect to.

Second, if a party is given the option of denying arbitration to the other party simply by alleging that the agreement lacked initial or continuing validity, and if through such an allegation, deny the arbitral tribunal the right to decide on its jurisdiction, it would always be open to a party to vitiate its arbitral obligations by simply declaring the agreement void.\textsuperscript{37} The intention of both the parties, as well as the requirement of effective arbitration therefore both reflect a need for the doctrine of severability.

Third, as a matter of legal presumption and negotiation, parties to an agreement conclude not one, but two agreements. While they initially conclude the substantive portion of the contract, which is the commercial contract, they also conclude an additional agreement which provides for arbitration of disputes arising out of the principal agreement.\textsuperscript{38} Therefore, even if it is argued that the principal agreement is invalid, voided, nullified or suspended, nevertheless the arbitral agreement is separable and so separated, survives to furnish a viable

\textsuperscript{36} Supra note 8.


basis for the arbitration tribunal to rule upon such arguments. Therefore, when parties to an agreement enter into that agreement, they conclude not one, but two agreements, the arbitral twin survives any birth defect or acquired disability of the principal agreement.

_Fourth_, if the principle of severability were not the rule, the Courts, when they evaluate the jurisdictional threshold, would be drawn into passing upon the substance of the dispute to be submitted to arbitration.

Therefore, the return to the doctrine of severability must be encouraged in Indian jurisprudence. Not only is this in line with international global practice, and helps make India an arbitration friendly environment, but it also gives effect to the will and intention of the parties.

The same position was enumerated by the dissenting C.K. Thakker J. in the _Patel Engineering_ case, who appreciating the requirements of the globalised business community, and reading into the intent of the Parliament in framing the Arbitration Act 1996, which provided for Section 16, upheld the principle. _A priori_, once the tribunal concludes that it has jurisdiction, it may proceed to substantively decide the issue and make an award. Challenge to this award is always permitted under Section 34. The provision therefore, is an enabling provision. In the opinion of Thakker J., the parties, by virtue of their choice of arbitration, have expressed a positive selection of an alternative dispute resolution system. The parties, in doing so, have expressly rejected municipal jurisdiction. In light of this decision, the Courts should take a back seat, as is the will of the parties.

Descriptively however, contracting parties must recognize this trend of Indian jurisprudence and frame their contracts accordingly. The current position of law in India highly encourages dilatory tactics by non-cooperating parties who can stall and delay the arbitration process, therefore making arbitration infructuous as an institution. In order to avoid these dilatory tactics, parties must take special steps in the drafting of their contracts to actualize the benefits of the arbitral process.

These steps include, but are in no way limited to the following:

(i) Encapsulate the arbitration agreement in a separate contract.
   a. Admittedly, this is contrary to global practice and business efficiency. However, as a stop-gap measure, this move can prevent the arbitral agreement from being invalidated by virtue of some impropriety in the underlying contract.
   b. The benefits of this measure are manifold, virtually making the arbitral agreement immune from any other contractual objections, and ensuring that the will of the parties is realised and the matter proceeds to arbitration.
   c. The harms of this measure however manifest themselves in real world business practice, where parties now have to negotiate and arrive at two separate contracts, increasing articlework, making transactions bulky and contrary to global practice.

(ii) Expressly mention the principle of competence-competence in the arbitral agreement.
   a. An express provision within the arbitral agreement to the extent of “the arbitral tribunal shall be the only body to decide on its jurisdiction” would circumvent the rule laid down in Patel Engineering.\(^{40}\)
   b. The parties expressly authorize the arbitral tribunal to evaluate questions of its own jurisdiction under this paradigm. However, whether such a move passes the stringent “public policy” test is a question that will have to be evaluated.

**Pathological Arbitration Clauses**

Pathological arbitration clauses have been a huge source of dispute and controversy in the field of arbitration. These clauses are often open to differing interpretations, and these interpretive clauses often open up the gates for judicial intervention in arbitral disputes. These clauses are essentially a part of

\(^{40}\) *SBP and Co v Patel Engineering*, 2005 6 SCC 618.
the contract between the parties, and therefore there is a need to interpret these clauses in the same manner as ordinary contractual terms.

**Pathological Clauses**

The phrase ‘pathological arbitration clause’ refers to arbitration clauses which contain defect(s). These clauses are interpretive in nature, and their differing interpretations may often take away from the intention and will of the parties. The ramifications of a pathological clause are immense, as they can impact not only the enforcement of an award, but can also stop the dispute from being presented before an arbitral tribunal at all. Indian Courts have very often intervened in the arbitral process to evaluate the validity and existence of the arbitral clause in these cases of pathological clauses.41

Section 7 of the Arbitration and Conciliation Act 1996 holds arbitration agreements to mean:

“an agreement by the parties to submit to arbitration all or certain disputes which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not”.

The section further lays down some statutory requirements, such as the stipulation that the agreement must be in writing, contained in either a document signed by the parties, or in an exchange of correspondence.43

In addition to these statutory requirements, Indian Courts have stipulated some other requirements that must be fulfilled by an arbitral clause in order to qualify itself as an arbitration agreement. Pathological clauses arise when some of these requirements have not been fulfilled. A source of these problems is haphazard or careless drafting, which can lead to a plethora of issues with the clause. These issues can range from the clause being optional and not mandatory; the clause


43 ibid.
bearing unexercised options; the clause not deciding on essential terms. These clauses therefore open the way for judicial interpretation in the arbitral process.

**Instances of Pathological Clauses**

**Failure in deciding essential terms**

An arbitral clause should normatively specify essential terms of the arbitration agreement. The failure to do so leads to a failure in invoking the ‘essential terms’ test which may solve the pathology in the clause or resolve disputes with regards to intention.44 These essential terms include designation of the arbitral institute, the rules of arbitration or the personhood and number of arbitrators. Failure to specify these essential terms often renders an arbitral clause pathological.

In the case of *CM Karanji*, the clause referred to a ‘local Chamber of Commerce’. However, there existed a large number of ‘local chambers of commerce’ which satisfy this description. The arbitral clause in this agreement, therefore, was held to be uncertain. Similarly, in the case of *Altos India*, the clause specified the arbitrators name, however his personhood or any detail signifying who this person was had been omitted. In these circumstances, the Court upheld the argument that this clause could refer to any person with the same name, and therefore, was a pathological clause.

The failure in deciding essential terms also extends to blank clauses without a dispute resolution mechanism. An illustration of the same can be gleaned from a comparative analysis of the cases of *Janki Prasad Agarwal* and *ITC Classic Finance*.48

---

44 *Loftus v Roberts*, 18 TLR 532.
46 *Altos India v Goyal Gases*, 1 ARB LR 454 1996 (Delhi).
47 *Union of India v Janki Prasad Agarwal*, AIR 1986 All 15.
48 *ITC Classic Finance v Grapco Mining*, AIR 1997 Cal 397.
In *Janki Prasad Agarwal*, the clause stipulated that a potential dispute would be referred to a sole arbitrator, whose name was not decided in the contract. It was also agreed by the parties that if they were unable to agree on the name of the arbitrator, they could approach the Court which would assist them in appointment of the arbitrator, under the 1940 Act. This clause was held to be valid by the Courts.

However, in the case of *ITC Classic Finance*, the clause was somewhat similar but lacked one essential condition. The clause provided for the appointment of a sole arbitrator in the case of a dispute without specifying the identity of this arbitrator. However, it lacked the provision that enabled the Court to assist in the appointment of this arbitrator. The Court held this clause to be vague and uncertain. Since this clause did not meet the certainty of essential terms test, it was held to be pathological.

Therefore, we see that the failure to decide on essential terms of the arbitral process may open up the gates for judicial intervention, insofar as the Court is now empowered to apply its own interpretation of these clauses and delay the proceedings.

**Option-provision clauses**

Arbitral clauses, owing to vague drafting may often provide options to the parties in the case of a dispute. In the construction of these clauses, there have been different methods of construing the importance of these options and their exercise thereof.

In the case of *Seth Kerorimal Adwani*, the clause referred to “Chief Engineer/Additional Chief Engineer willing to act as arbitrator”. This was incorporated from a standard form contract. The Court, upon review of this clause, held

49 *Union of India v Janki Prasad Agarwal*, AIR 1986 All 15.
50 The Arbitration Act 1940, s 8.
51 *ITC Classic Finance v Grapco Mining*, AIR 1997 Cal 397.
52 *Seth Kerorimal Adwani v Union of India*, AIR 1959 Cal 430.
that since the parties had failed to eliminate one of the options and thus created an uncertainty on the question of would be the arbitrator, the clause was pathological and invalid. This principle was borrowed from the case of Luxmi Chand Bajinath,\(^53\) where it was held that a “failure to choose between equal alternatives vitiates the entire clause”.

The same problem however, has seen two different kinds of treatments by the Courts, which don’t suffer from an anti-arbitration bias and are enabling judgments.

In the case of Ashoka Construction,\(^54\) the Court held that the mere presence of an unexercised option would not lead to the entire clause suffering from vagueness. The clause in this case presented an option as to the identity of the arbitrator. The Court held that the agreement should be evaluated to mean that no arbitrator was named, and the Court should step in to appoint an arbitrator.

The alternative approach was propounded in the case of Dwarkadas and Co.\(^55\) In this case, the clause stipulated that “the dispute was to be referred to the Bengal or Indian Chamber of Commerce”. In evaluation of this clause, the Court held that the word “or” could mean that if the Bengal Chamber of Commerce failed to arbitrate, the Indian Chamber of Commerce would be enabled to do so. Therefore, the use of the word “or” was interpreted to mean a preference evincing provision, which enables different bodies.

The case of Sankar Sealing Systems\(^56\) provides an interesting factual matrix which could see application of two differing rules of interpretations to the same problem. In this case, there were two clauses simultaneously in the contract, one of which provided for arbitration of a dispute, and the other provided the Courts of Chennai with exclusive jurisdiction in the event of any legal proceedings.

\(^{53}\) Luxmi Chand Baijnath v Kishanlal Sohonlal, AIR 1955 Cal 588.
\(^{54}\) Ashoka Construction v Union of India, AIR 1969 Tri 19.
\(^{55}\) Dwarkadas and Co v Daluram Goganmull, AIR 1951 Cal 10.
\(^{56}\) Sankar Sealing Systems v Jain Motor Trading Co, AIR 2004 Mad 127.
The first school of interpretation, which borrows from the case of *Shree Bhowani Cotton Mills*, provides for harmonious construction of such clauses. The principle laid down in this case stipulated that in the presence of these two ostensibly contradictory clauses, the intention of the parties was that they should have recourse to a municipal court of law for disputes which do not fall under the ambit of the arbitration clause.

However, the Court in *Sankar Sealing Systems* followed the second school of interpretation, laid down in *Wellington Associates*. According to this principle, the Court held the provision related to arbitration to be an enabling provision, which would require fresh consent of the parties at the time of the origin of a dispute. If the parties consent to arbitration, the arbitral tribunal has jurisdiction. Otherwise, the municipal courts obtain this jurisdiction. The presence of two clauses therefore, does not render the contract vague, but takes on the form of an “enabling provision”.

**Non-Compulsory Phrasing**

Pathology in arbitral clauses also arises when they use non-mandatory words. In the situation that a party does not wish to proceed to arbitration, or wishes to engage in dilatory tactics, they may resort to using this non-mandatory language to render the arbitral clause uncertain and unworkable.

The case of *KK Modi* laid down the rule that a clause is an “arbitration agreement” only if the agreement to refer disputes to arbitration is expressly spelt out from the clause. The rule of interpretation followed by the Court in this case was that the intention of the parties has to be gathered from the terms of the agreement. Therefore, in situations where there is a mere possibility of the parties agreeing to arbitrate in the future, contrasted with an obligation to refer disputes to arbitration, the agreement would not be valid and binding.

---

60 *KK Modi v KN Modi*, AIR 1998 SC 1297.
This principle was followed by the Indian Courts in several other cases.61

Building on this rule of interpretation, the Court in *Jagdish Chander*62 laid down three guidelines with regards to the evaluation of the arbitral clause

a) “Where the clause contained words which specifically exclude any of the attributes of an arbitration agreement, or contains anything that detracts from an arbitration agreement, it will not be an arbitration agreement.

b) If the clause requires fresh consent of the parties at the stage of dispute settlement, it is not an arbitration agreement.

c) Clauses which merely indicate a desire or hope to have the dispute settled by arbitration are not valid and binding arbitral clauses.”

The Courts, in the evaluation of arbitral clauses, have been hyper technical in their approach, with the decision hinging on the use of the words “may”, “can” and “shall have” in some instances.

In *Wellington Associates*63 and *Jyoti Brothers*,64 the Courts held that if the arbitral clause uses the word “may”, it denotes that arbitration is a mere possibility at the time of dispute resolution. The Courts held that usage of this word denotes that it is not the intention of the parties that arbitration be the sole remedy.

In *Castrol India*,65 the Court held that the words “shall have the right” are merely optional in nature. The Court decided that no specific or definite intention of the parties can be gleaned from the usage of these words. Therefore, the clause was not an arbitral clause to be mandatorily referred to arbitration under the New York Convention.66

---

61 Bharat Bhushan Bansal v UP Small Industries Corpn Ltd, 1999 2 SCC 166; Bihar State Mineral Development Corp v Encon Builders, 2005 7 SCC 418.


64 Jyoti Bros v Shree Durga Mining Co, AIR 1956 Cal 280.

65 Castrol India v Apex Tooling Solutions, 2014 2 ARB LR 481 (Madras).

This sort of technical intervention by the Indian judiciary poses problems when juxtaposed with the obligation under the New York Convention\(^{67}\) to mandatorily refer all arbitral disputes to arbitration, an obligation encapsulated in the Indian Arbitration Act\(^{68}\) as well.

The rule of contractual interpretation followed by the Courts therefore gains primary importance in these scenarios, and can heavily influence the result of the judicial process. The rule of interpretation followed by the Courts has huge impacts on the sort of environment created in India and the efficacy of arbitration as a process.

**Rules of Interpretation**

In the situations of the pathologies mentioned above, the rules of interpretation adopted by the Courts assume major importance. Since arbitral clauses, or arbitration agreements are essentially contracts, the rules of interpretation are based on general contractual principles. Various acceptable rules of contractual interpretation and how they actualize in the evaluation of arbitral clauses are examined below.

**The Intention Test**

Arbitration is a consensual activity, hinging on the common intention of the parties to select an alternative dispute resolution mechanism. Therefore, the Courts often consider the issue of whether the parties were *ad idem* in the context of referral of disputes to arbitration.\(^{69}\) In this pursuit, the Courts often attempt to ascertain the parties’ common intention. Therefore, the Courts must look to the substance of the arbitration clause, at the expense of the form of the arbitration clause.\(^{70}\)

\(^{67}\) ibid.

\(^{68}\) Arbitration and Conciliation Act, 1996, s 8.

\(^{69}\) *Bihar State Mineral Development Corp v Encon Builders*, 2003 7 SCC 418.

This test has often been adopted by the Indian Courts. While the primary approach is to gather the intention from the words of the arbitral clause,\(^71\) Indian Courts have also looked at the conduct of the parties, their attitudes and their correspondence before, after and at the time of entering into the agreement.\(^72\)

This test was adopted in the case of *Ramji Dayawala*,\(^73\) where the respondent failed to reply to a letter from the appellant which objected to arbitration in Yugoslavia. The Court ascertained that the respondents’ failure to reply signalled his acquiescence or tacit compliance, and the intention of the parties was deemed to be intention to delete the arbitration clause.

The intention test therefore, spreads not only to the words of the contract, but also to the conduct of the parties. If the Courts can reasonably ascertain that the conduct of the parties signifies intention to arbitrate the disputes, the clause is treated as an arbitration agreement.

**Effective Interpretation**

A well-known rule of contractual interpretation is the rule of effective interpretation, i.e., if required to decide between two different meanings, the Court should prefer the meaning which supports the contract rather than the one which invalidates it. The Latin maxim of "*verba ita sunt intelligenda ut res magis valeat quam pereat*", which means that "*words are to be so understood that the subject matter may be preserved rather than destroyed*" is followed by the Courts.\(^74\) Therefore, the interpretation preferred by the Courts is one that gives effect to the clause, over the interpretation that invalidates it.

In *Dwarkadas and Co*,\(^75\) the Courts had to decide between two differing interpretations. The first interpretation evaluated the word “or” in the context of two different forums to mean an alternative with regards to the choice of

\(^{71}\) *Veer Construction Technocrats v Saraswati Enclave CGH Society*, AIR 1996 Del 12.

\(^{72}\) *Shree Bhowani Cotton Mills v Union Textile Traders*, AIR 1966 Cal 588.

\(^{73}\) *Ramji Dayawalla and Sons v Invest Import*, AIR 1981 SC 2085.

\(^{74}\) *Adamastos Shipping Co v Anglo Saxon Petroleum Co Ltd*, 1976 2 WLR 925.

\(^{75}\) *Dwarkadas and Co v Daluram Goganmull*, AIR 1951 Cal 10.
forum. The second interpretation evaluated this clause to mean that there was no ad idem and therefore, there was no intention on the part of the parties. The agreement that gave effect to the contract was followed by the Courts.

The same principle was upheld in Bhagwati Prosad Harlalka, where the Court said that “a clause referring disputes to arbitration must be upheld if there exists sufficient cause for upholding it.”

**Scope of construction**

A dichotomy faced by Courts in the issue of construction and interpretation of arbitral clauses is whether the construction should be strict or narrow. Therefore, the question before the Courts is whether the clause should be widely construed, so as to fit the situation before the Courts, or the clause should be narrowly construed, and the situation must fit within this construction. The discussion for this contention must be traced historically, starting from the initial view that these clauses must be strictly constructed.

In the case of Ganpatrai Gupta, the Court stated that “Arbitration agreements should be strictly construed. Clear language should be introduced into any contract which is to have the effect of ousting the jurisdiction of the Courts and compelling the parties to have recourse to arbitration for decision of disputes.” The same view was affirmed in the MV Baltic Confidence case as well.

However, lately the trend has shifted. The principle laid down in Ram Lal Jagan Math was adopted by the Supreme Court in DN Revri, where the Court stated “It would not be right while interpreting a contract, entered into between two lay parties, to apply strict rules of construction which are ordinarily applicable...”

---

76 Bhagwati Prosad Harlalka v Kamala Mills Ltd, AIR 1959 Cal 687.
78 State Trading Corp of India v Owners and Parties interested in the Vessel MV Baltic Confidence, 2 Arb LR 327 (1999) Cal.
79 Union of India v Janki Prasad Agarwal, AIR 1986 (All.) 15; Ram Lal Jagan Nath v Punjab State through Collector, AIR. 1966 P&H 436.
80 Union of India v DN Revri, AIR 1976 SC 2257.
to a conveyance and other formal documents. The meaning of such a contract must be gathered by adopting a commonsense approach and it must not be allowed to be thwarted by a narrow pedantic and legalistic interpretation”. The same principle was upheld in the Corn Products\textsuperscript{81} and the MP Housing Board\textsuperscript{82} cases.

**Suggestions**

The current situation therefore, is incredibly perilous to parties that draft their contracts haphazardly or negligently. This position of law often takes away from the will of the parties and renders the arbitration agreement infructuous, leading to lengthy and expensive disputes.

In light of this, it is clear that there is a need to ensure that, by abundant caution, no material factor related to the arbitration process is left out from the terms of the agreement.

While most parties opting for institutional arbitration usually adopt the model clause recommended by that particular institute, the freedom to decide terms of arbitration often leads parties away from these model clauses. Further, issues relating to pathological clauses are witnessed mostly in ad-hoc arbitral proceedings.

In these cases, it is necessary to provide a framework within which parties can substitute their own rules and desires. The specific suggestion forwarded by the authors in this regard is, therefore, the adoption of the framework of the LCIA Model Clause which prescribes the specific caveats to ensure a lack of vagueness in the terms of the agreement.

The LCIA recommends the following clause:

“Any dispute arising out of or in connection with this contract, including any question regarding its existence, validity or termination, shall be referred to and

---

\textsuperscript{81} Corn Products v Ayaz Ghadiya, AIR 1997 Bom 331.
\textsuperscript{82} MP Housing Board v Satish Kumar Raizada, 2 Arb LR 553 (2003) MP.
finally resolved by arbitration under the [rules of arbitration], which Rules are deemed to be incorporated by reference into this clause.

The number of arbitrators shall be [one/three].

The seat, or legal place, of arbitration shall be [City and/or Country].

The language to be used in the arbitral proceedings shall be [ ],

The governing law of the contract shall be the substantive law of [ ].”83

This clause, in the opinion of the authors, is extremely suitable and adaptable. This clause not only expressly tackles any challenge to severability and jurisdiction of the arbitral tribunal, but also covers further contingencies which arise in the arbitral process, thereby ensuring that these conditions such as the number of arbitrators, the seat of arbitration or the law of the contract are not subject to challenge in the municipal Courts.

However, it must be stated that this does not create an obligation for parties to use LCIA rules when choosing to arbitrate. The same terms can be substituted to a situation involving ad-hoc arbitration, where the name and identity of the arbitrators, specific rules to be followed etc. must be explicitly mentioned in place of the LCIA rules in the above clause.

CONCLUSION

This article has been an attempt at analysing the largest barrier to the efficacy of arbitration as a form of dispute resolution in the modern Indian paradigm - judicial intervention. It dealt specifically with how faulty drafting of and unfair provisions in arbitration clauses could lead to such judicial intervention in arbitration.

It began with an analysis of the interface between arbitration and contract law and highlighted the fact that Indian contract law, in fact, provides the most cogent statutory legitimacy to arbitration as a form of dispute resolution in the country.

It then went on to look at the doctrine of severability and the interpretation it has received in Indian jurisprudence. As highlighted earlier, severability implies that the original arbitral clause is viewed separately from the subsisting contract between the parties. However, the current position of law in Indian jurisprudence looks at these clauses as part of the original contract, thereby not allowing the tribunal to determine the same. This approach was strongly criticised, and suggestions (such as signing a completely separate arbitration agreement) were given to combat challenges to arbitration that may arise out of this position of law.

Additionally, this article analysed pathological clauses. It noted that simple poor phraseology could lead to uncertainty creeping into the clause. The manner in which the Indian judiciary has looked at a variety of such clauses was discussed, and the apathy of the judiciary towards even minor errors in such clauses was highlighted. In light of this, various model clauses of arbitration were presented, and their potential shortcomings presented. The analysis ended with the authors suggesting that the LCIA model arbitral clause is the most comprehensive, and therefore the least prone to judicial intervention.

The end goal of the adoption of such practices is to ensure that India becomes a more arbitration-friendly legal environment. The rather restrictive and paternalistic approach the Indian judiciary has taken to arbitration has necessitated the exercise of abundant caution in drafting arbitration clauses to ensure that justifications for intervention are minimised. The adoption of such measures as a matter of general practice could ensure that the biased judicial approach to arbitration taken by the Indian judiciary does not result in the shortcomings generally associated with Indian courts being transplanted to arbitration in the country too.
Arbitration And Standard Form of Contracts

Bhavna Mishra

Abstract

This article seeks to analyze arbitration within the purview of standard form of contract. With an exponential growth in the use of standard form contracts with the rise of mass-serving industries (for instance the software industry), arbitration provisions in such contracts impact individuals on a daily basis. Since these individuals do not play a role in drafting the standard form contract, this raises some significant issues when it comes to arbitration like whether veritable consent to arbitrate was present or not, and whether arbitration clauses in such contracts are unconscionable. These issues have been taken up in the course of this article. Another area of focus is arbitration incorporation by reference to a standard form contract, the validity of which is hugely contested in different jurisdictions across the globe.

Introduction

With the advent of globalization and the increasingly important role that international trade plays in the lives and economies of every nation, it has come as no surprise that the variety of situations where courts are not a favourable option anymore are increasing. In India too, the trend of globalization has caught on and as a result, the number of commercial disputes has inevitably increased. In such a scenario where going to court would be detrimental to both the parties’ interests, alternate dispute resolution mechanisms like the age-old institution of arbitration have been revamped and reintroduced into our daily lives.

Also, with increase in the industries that serve the masses, contracts of a standard form are increasingly being utilized for the sake of efficiency, for saving operational time, predictability and for ease of transaction. Standard

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
Contracts, Agreements and Public Policy in India

form contract is a one-size-fits-all kind of contract and different parties finding themselves in similar situations usually utilize them. It needs to be kept in mind that standard form of contract is of the ‘take it or leave it’ type and the non-drafting party has almost no negotiating power. Most standard form contracts incorporate their provisions in fine print, which in most cases does not give the non-drafting party enough notice or opportunity to realize what binding obligations they are undertaking.

In the above scenario, when the standard form contract contains default arbitration clause, the party signing the contract might not even be aware of the presence of this clause. Whether valid consent to the arbitration clause was present here or not is a contentious issue which has been analyzed in the course of this article. Another issue which arises in standard form contracts is that of unconscionability. Certain default arbitration clauses are drafted in a manner which exploits the non-drafting party; for instance ‘carve-outs’ are present in arbitration clauses which allow the drafting party to avail judicial intervention at any point in the course of the arbitration procedure, but restrict the opposite party only to arbitral forums which might not suit their needs. Such unconscionable agreements have been discussed in this article.

In some scenarios, contracts incorporate arbitration provisions by reference to a standard form of contract. The method of reference in such cases, whether direct or indirect, goes a long way in determining the validity of such provisions. It is surprising that even though a large number of contracts incorporate various default clauses like the arbitration clause by reference, there is no uniformity in how different jurisdictions regard arbitration incorporation by reference. An attempt has been made to address this issue by undertaking a comparative analysis between various European nations and India.

TRACING THE EVOLUTION OF ARBITRATION IN INDIA

In India, arbitration as a civilized mode of dispute resolution has been widely prevalent since ancient times. The awards, decided by the panchayats at that time, were binding in nature. Even during the British times, the abrogation of
the *panchayat* system did not take place.¹ The pioneers of modern arbitration law in India were the Bengal Regulations of 1772, 1780 and 1781; which encouraged arbitration.² In the Bengal Regulation of 1781, an interesting provision about arbitration was present, which said that an arbitrator's award cannot be set aside unless it is fully proved by two credible witnesses that the arbitrators were guilty of partial or gross corruption in the cause in which they made the award.³

Later, the very first attempt at Indian codification began in 1859 with the passing of the first Civil Procedure Code⁴ in which section 312 to 325 dealt with arbitration. The Indian Contract Act, 1872 also made certain references to arbitration agreements, for instance, under Section 28. Then the second Code of Civil Procedure was enacted in 1882, which again iterated the provisions of the previous Code about arbitration. Section 506 to 526 of the Civil Procedure Code, 1882 provided for, *inter alia*, referring of disputes after they had arisen for arbitration, and that any agreement about referring future disputes that may arise for arbitration would be void.⁵ In 1899, the Arbitration Act was passed along the lines of the English Arbitration Act of 1889.

**THE CIVIL PROCEDURE CODE, 1908**

Section 89 of this Code, which came into existence after the CPC (Amendment) Act, 1999,⁶ recognizing the pertinent need for alternate dispute resolution, refers to the settlement of disputes outside of court. Clause 1 of this section states that if the court opines that a matter can be settled outside of court, it can formulate the terms of settlement of the dispute through arbitration,

---

conciliation, mediation or judicial settlement. Clause 2 of the section defines the above four modes of dispute resolution. Thus, after a suit is presented in a court, the parties involved can adjust, compromise or settle it with an agreement.\(^7\) The objective is to reduce the backlog of the judiciary, avoid multiplicity of litigation, and allow parties to amicably come to an agreement that is voluntary for both the parties, lawful and in writing.\(^8\) The general principle that has been laid out is that any matter that can be adjudicated in a civil court can also be settled by an agreement.\(^9\)

Hence, Section 89 of the Civil Procedure Code has a sound objective behind it, which is to reduce the multiplicity of litigation, save money, time and expenses in order to help facilitate a binding, amicable and voluntary decision that satisfies both the parties to the dispute.\(^10\) However, there are certain practical problems pertaining to the drafting of Section 89. For instance in the landmark case of Afcons Infrastructure Ltd. v Cherian Varkey Construction Co, the Supreme Court observed that the understanding and interpretation of this provision is a ‘trial judge’s nightmare’.\(^11\) The first discrepancy arises with sub-section (1) of section 89 which says that the courts “shall formulate the terms of settlement” and present it to the parties. However, if this matter then goes for arbitration, then the ‘terms of settlement’ drafted by the courts would be of no consequence.

The Supreme Court has tried resolving this discrepancy in the case of Salem Advocate Bar Association v Union of India by stating that ‘terms of settlement’ refers to only a summary of disputes.\(^12\)

The Supreme Court then decided on the issue of how section 89 was to be interpreted. It opined that this section is to be read with Rule 1-A of Order 10 of the Civil Procedure Code, according to which the court will direct the parties

---

\(^7\) (1968) 3 SCR 158.

\(^8\) AIR 1997 P H 155.

\(^9\) (1973) 1 SCC 761.


\(^11\) 2010 (7) SC 616.

\(^12\) AIR 2005 SC 3353.
to out of court settlements with their consent, and no terms of settlement on
the court’s behalf would be mandatorily needed.\textsuperscript{13}

The third issue was the obvious drafting error in sub-section 2 of the section. Clause 2 has mixed up the definitions of ‘mediation’ and ‘judicial settlement’ under clause (c) and (d). Clause (c) says that for ‘judicial settlement’, the court shall refer the same to a suitable institution or person who shall be deemed to be a Lok Adalat. Clause (d) provides that where the reference is to ‘mediation’, the court shall arrange a compromise between the parties by following such procedure as may be prescribed. These definitions contradict universally accepted meanings in common parlance and have consequentially led to a lot of complication and confusion at the implementation stage.\textsuperscript{14} Resultantly, in the \textit{Afcons Infrastructure Ltd. v Cherian Varkey Construction Co.} case, the Supreme Court declared that these clauses would be read interchangeably until legislative changes occur.\textsuperscript{15} Unfortunately, no such change has occurred till date.

\textbf{STANDARD FORM OF CONTRACTS}

With the rise of some industries which served the masses, for the sake of predictability and mutual benefit of both the contracting parties, standard form of contracts came into being. Such contracts seek to increase efficiency, reduce operational cost and save time and effort.\textsuperscript{16} According to a French theory, standard form of contract was born from centuries old multinational contracts. When some nations wanted to join existing treaties which they had not drafted, they opted to “adhere” to the original terms.\textsuperscript{17} This is similar to the ‘take it or leave it’ nature of modern day standard contracts.

\textsuperscript{13} Law Commission, \textit{Amendment of Section 89 of the Code of Civil Procedure, 1908 and Allied Provisions} (Law Com No 238, 2011).

\textsuperscript{14} (2007) 4 SCC (Jour).

\textsuperscript{15} ibid 11.

\textsuperscript{16} 80 Chi-Kent L. Rev. 487.

It has been estimated that standard form contracts (also called boilerplate contracts) comprise of 90 percent of the contracts formed nowadays.\(^\text{18}\) Let us now define what a standard form contract is. According to the California Court of Appeals, it is a contract which is “imposed and drafted by the party of superior bargaining strength, and relegates to the subscribing party only the opportunity to adhere to the contract or reject it.”\(^\text{19}\) Example of such contracts would be insurance contracts, tickets to sports matches, medical contracts, Facebook user agreements etc. With the burden of litigation in today’s world, arbitration was sought in such cases.\(^\text{20}\) Now, the decision to include arbitration clause in standard form contracts for resolving disputes gives rise to some pertinent issues that threaten the basic fabric of contract law (like consent and conscionability) and impact the everyday life of the non-drafting party in various ways.

**CONSENT**

The basis of arbitration is the valid consent of both the parties. However, in some scenarios, even though there is a written contract with an expressly mentioned arbitration clause which has been signed by both the parties, some doubt remains whether one party actually consented to the arbitration clause or not. Here, the lack of consent does not refer to someone forcing a party to sign a contract using a gun or physical force. Duress is usually absent and arbitration is not mandatory or involuntary. This is not an issue. The issue in the case of standard form contracts is that they can be heavily one-sided and the non-drafting contracting party has no bargaining power. Here comes into play the issue of consent and the arbitration clause in such a contract would be ‘unconscionable’ when consent of one party is absent.

According to Sternlight, standard form contracts where arbitration clauses are not ostensibly placed are adhesion contracts and the adhering party may not

---


323
even know that an arbitration clause exists in the contract it is entering into.\textsuperscript{21} In some cases the arbitration clause in a standard ‘take it or leave it contract’ is confusing, or the arbitration clause is “buried”. Here, the consumers may not have completely understood what they were getting themselves into at the time of entering into the contract. Even though there is no strict legislation mandating institutions to highlight arbitration clauses, if this is done in the contract, and if the parties are made aware of the repercussions of such clauses such as no jury trial, no right to approach a court and limited rights of appeal and review; it would be to the betterment of both the parties, would ensure that the consent obtained was valid and that the contract was not unconscionable.\textsuperscript{22}

There are a few instances where the consent to the arbitration clause in a contract is considered valid, for instance when there has been a long standing relationship between the contracting parties and in all the previous instances they have consented to one particular arbitration clause. In such a scenario, the parties need not concern themselves about formalizing the same arbitration clause on every new occasion. There is an implicit consent in this scenario. However, such is not the case if in the past the parties have on some occasions opted for a particular arbitration clause and on some other occasions have chosen not to opt for this particular clause regarding arbitration and chosen, say, the state jurisdiction. The Paris Court of Appeal in the case of \textit{G.I.E Acadi v Thomas-Answare} opines that this is a waiver of an implied arbitration agreement.\textsuperscript{23}

\textbf{Consent in Software License Agreements}

One of the significant standard form contracts prevails in the case of a software license agreement, which is an End User License Agreement (EULA). Here, the user or the purchaser is supposed to adhere to a standard form contract just by opening a packet containing the software disk.

In such cases, when determining whether consent is present or not, what needs to be examined is whether the text of the agreement, containing the arbitration

\textsuperscript{21} Jean R. Sternlight, ‘\textit{Panacea or Corporate Tool?: Debunking the Supreme Court’s Preference for Binding Arbitration}’, (1996) 74 WASH. U. L.Q. 637.
\textsuperscript{22} Steven C. Bennett, \textit{Arbitration: Essential Concepts} (ALM Media, LLC, 2002).
clause, is accessible prior to opening the license agreement or not. The question is not whether he/she had knowledge of the terms of the agreement or not; the question is whether his/her consent can be deduced from the mere opening of the packaging or not. In such scenarios, the norm is that if after opening the packaging, if query/complaint have been filed regarding the arbitration clause, then the contract is not concluded. If however, a person failed to familiarize himself/herself with the terms of the contract before opening the packaging, but did not file a complaint or send a query, then he/she is bound by the contract.\footnote{Vera Van Houtte, ‘Consent to arbitration through agreement to printed contracts: The continental experience’ (2000) 16(1) Arbitration International, 1.}

This could be problematic in some cases, and the legislature needs to provide a standard test for gauging whether consent is present in such cases or not.

**UNCONSCIONABILITY**

The doctrine of unconscionability to protect parties from exploitation is a common law principle which is applicable to all contracts. Most of the parties utilize this very argument to render some standard contracts unenforceable. Unconscionability also exists in standard form contracts just like normal contracts on the basis of fraud, duress, consent, notice etc.\footnote{Melissa Briggs Hutchens, ‘At What Cost?: When consumers cannot afford the costs of arbitration in Alabama’ (2002) 53. Ala. L. Rev 599.}

Now, drawing a distinction between an arbitration agreement which is unequal but still valid, and one which is so one-sided that any court will deem it unconscionable (and hence void) is a tough task. One factor that renders a contract unconscionable is inclusion of excessive “carve-outs”. Let us understand what a carve-out is. One sided exceptions to arbitration clauses are called carve outs, which limit the application of the arbitration agreements. For instance, in such contracts the drafter is exempted from the obligation of arbitration but the non-drafting party is restricted to arbitrate. This is unconscionable because the party may find arbitration an expensive method and by being barred from approaching the courts, has no method of dispute resolution at all. An
illustrative case in this regard would be \textit{Ferguson v Countrywide Credit Industries, Inc.}, where there was present an arbitration clause in a standard employment contract which expressly contained remedies that an employee would seek like discrimination, harassment and breach of contract, etc and hence bound the non-drafting party to arbitrate only. But it exempted from the obligation to arbitrate the remedies that the employer might seek like unfair competition, relief for disclosure of trade secrets, IP violations etcetera. The Ninth Circuit held that this agreement was extremely one-sided and substantively unconscionable.\footnote{(2002) 298 F. 3d 778, 784-85 (9th Cir).}

For unconscionability, it needs to be shown that a contract is both procedurally and substantively unconscionable. Hence, there must be lack of any meaningful choice for the non-drafting party and contractual terms extremely favorable to the drafting party, respectively. For the procedural element, any court will analyze the process of contract formation to see if one party had any choice regarding entering the contract or not. This would be done by looking into the setting of the transaction, education/experience of the non-drafting party, whether the drafting party used high pressure tactics, whether the contract had fine print, lack of bargaining power, etcetera.\footnote{Gary B. Born, \textit{International Arbitration: Cases and Materials} (2nd edn, Aspen Publishers, 2015).}

For the substantive element, it needs to be shown that the contract terms unusually favor the drafting party. Although to prove unconscionability, both substantive and procedural elements need to be present, however, since standard form contracts mostly contain procedural elements, hence more stress is laid on the substantive elements.\footnote{ibid 27.} An example of this would be seen in \textit{Matter of Teleserve Systems}, where excessive fees incurred under the ICC procedure was a ground for finding the arbitration clause unenforceable on the grounds of commercial unreasonability and unconscionability.\footnote{(1997) 659 N.Y.S.2d 659.}

Another issue would be regarding e-commerce contracts which are mostly standard form. Courts recognize that a risk-protecting standard form contract is

\footnotesize{\textsuperscript{26} (2002) 298 F. 3d 778, 784-85 (9th Cir).}  
\footnotesize{\textsuperscript{27} Gary B. Born, \textit{International Arbitration: Cases and Materials} (2nd edn, Aspen Publishers, 2015).}  
\footnotesize{\textsuperscript{28} ibid 27.}  
\footnotesize{\textsuperscript{29} (1997) 659 N.Y.S.2d 659.}
necessary in the arena of e-commerce. However, some sellers take advantage of their consumers using standard form contracts. A recent illustrative case would be *Bragg v Linden Research*, where the plaintiff owned some virtual property on an internet site. His account was seized and his virtual property (which he had purchased) was removed. The defendant contended that this dispute should be referred to arbitration. However, it was held that the arbitration clause would not be enforceable due to procedural and substantive unconscionability: the lack of mutuality, high arbitration costs, choice of forum.³⁰

The author feels that unconscionable claims should be prevented and in order to do so, the drafting parties need to highlight the arbitration clause in a more prominent manner. In case of e-contracts, a separate ‘I Agree’ option could be present for the dispute resolution provisions.

**Arbitration through Incorporation by Reference: A Comparative Analysis**

Another dimension of the interface between arbitration and a standard form of contract presents itself when dealing with the controversial issue of arbitration clause incorporated by reference in a contract. First, let us understand what the above term exactly means. Often in real-life scenarios, for instance in case of a bill of lading or construction contracts, the parties to a contract agree on specific trade terms in the main contract and on generic terms by referring to a separate document, usually a standard form of contract. The document referred to contains the arbitration clause, among other clauses.

The debate is whether such a reference can be deemed as validly concluding an arbitration agreement between parties. Article II of the New York Convention of 1958, on the recognition of foreign arbitral awards, explicitly states:

“Each Contracting State shall recognize an agreement in writing under which the parties undertake to submit to arbitration all or any differences which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not, concerning a subject matter capable of settlement

by arbitration. The term ‘agreement in writing’ shall include an arbitral clause in a contract or an arbitration agreement, signed by the parties or contained in an exchange of letters or telegrams.

The court of a Contracting State, when seized of an action in a matter in respect of which the parties have made an agreement within the meaning of this article, shall, at the request of one of the parties, refer the parties to arbitration, unless it finds that the said agreement is null and void, inoperative or incapable of being performed.”31

Focusing on the European jurisdiction, the European courts have not uniformly interpreted the requirement of a written document as mandated above, when it comes to the validity of an arbitration clause by reference to any document other than the main contract. The reason why this issue is pertinent is because it directly affects enforcement of arbitration awards abroad.32 Article V of the New York Convention 1958 states that one of the conditions in which a court may refuse to recognize/enforce an award is if the arbitration agreement “is not valid under the law to which the parties have subjected it or, failing any indication thereon, under the law of the country where the award was made.”33 Therefore conflict arises when states with different legislations are the contracting parties, as a risk always exists that the party against which enforcement is sought would take advantage of Article V and challenge the validity of arbitration clauses by incorporation, contending that it is contentious with their applicable law.

The arbitration agreements by incorporation have traditionally been of two types:

a.) *Relatio perfecta:* An express reference is made in the main contract to the arbitration clause in the separate document.

---

b.) *Relatio imperfecta:* Insufficient reference is made in the main contract. For instance, there is a general reference to the separate document and the arbitration clause in the separate document is not mentioned specifically.\(^3^4\)

There is a difference in how courts approach the above types of arbitration agreements by incorporation. Looking at this with the perspective of Article II of the New York Convention, we find that Article II is ambiguous and does not directly address arbitration by reference. Article II basically leaves the matter of the validity of arbitration agreements to the different national jurisdictions. One argument in relation to this cited by many is that based on *Jiangxi Provincial Metal & Minerals Import and Export Corporation v Sulanser Corporation.* The Supreme Court of Hong Kong in this case held that since the wording of Article II omits the term ‘only’, hence the definition was not exhaustive and could include both *relatio perfecta* and *relatio imperfecta.*\(^3^5\) However, this approach is not in resonance with the translated versions of the New York Convention in French and Spanish, which use the term that is equivalent to ‘only’ in the respective languages.\(^3^6\)

The general accepted trend is that the courts accept the inclusion of the arbitration clause by reference in the case of *relatio perfecta,* i.e. when a direct reference is made to the said clause and when there is no doubt as to the intention of both the parties regarding the incorporation of such a clause.\(^3^7\)

Dispute arises when it comes to arbitration clauses incorporated indirectly, i.e. *relatio imperfecta.* It is controversial whether general terms can lead to valid incorporation of an arbitration clause. In such a case, the test is whether there was an intention of incorporating the arbitration clause by both the parties or not.\(^3^8\) Later if a dispute arises, what is to be determined is whether the party

\(^3^5\) (1995) 2 HKC 373.
\(^3^7\) ibid 34.
objecting to the application of the arbitration clause had, at the time of finalizing of the contract, complete knowledge of the existence of the arbitration clause and intended to accept it or not. Let us briefly analyze and compare how *relatio imperfecta* has been treated by courts of various jurisdictions in Europe and in India.

**France**

In cases like *Cassation Commerciale, Dreistern Werk v Crouzier*, the French court held that just because the arbitration clause being referred to had not been expressly stated in the main contract did not mean that the arbitration clause was unenforceable. What needs to be checked is whether the party raising objections had the knowledge of the said standard conditions and whether it accepted them by its silence. 39 This decision has been upheld in another significant case like *Bomas Oil N.V. v ETAP*. This case was regarding a sale and purchase contract which referred to ‘other conditions’ of the standard contract which was used by the seller which also included an ICC (International Chamber of Commerce) arbitration clause. The defendant at a later point in time contended that the arbitral award demarcated by the tribunal should be set aside because the arbitration agreement had not been mentioned in the document signed by the parties and hence should be considered non-existent. The court dismissed this contention and reasoned that Article II (3) of the New York Convention did not seek to exclude the incorporation of an arbitration clause. The court further states that such incorporation is valid when both the parties’ consent is unequivocal and clear. For instance when both the parties have been conducting business for some time, the arbitration clause need not be expressly stated as both the parties are aware of all the terms governing their business. 40 The party challenging should be aware of the documents’ content when the contract was being entered into.

Italy

Focusing on the Italian jurisdiction, in the landmark case of *Dreyfus Commodities Italia v Cereal Mangimi*, the principle of ‘relatio perfecta’ was upheld. It was ruled that since a written form was required by both Article II of the New York Convention and Article 808 of Italian Code of Civil Procedure, this requirement was fulfilled by incorporation of arbitration clause contained in another document. However, the incorporation of arbitration clause should be expressly mentioned. A mere generic reference to another document would not completely show that both the parties knew of the existence of the arbitration clause.41 However, there has recently been a shift in the position of Italian courts regarding arbitration incorporation via reference. This can be deduced from the recent case of *Del Medico v Iberprotein*. In this case, the same above court seemed to be inclined towards the opposite principle of ‘relatio imperfecta’. The court decided that if there was an international sale and purchase agreement and if a global reference was made to general terms and conditions, which also contained an arbitration clause, then the arbitration clause in the form would be considered binding and valid. The court reasoned that this decision did not clash with the provisions of the New York Convention, as the definition of “arbitration agreement” is very extensive and can accommodate even arbitration incorporation by general reference. Also, in this specific case, the defendant was a commercial operator and was expected to know the standard terms referred to in the main contract as it was a part of his daily commercial practice.42 Hence this shows that investigation regarding the actual knowledge of the said arbitration clause has to be examined on a case to case basis, depending on the individual circumstances.

England

In England, arbitration incorporation by reference has been shaped by some significant case laws which will be analyzed subsequently. In *Aughton Limited v*

---

42 SL (2011, No 13231).
MF Kent Services Limited, a strict approach was adopted by the Court of Appeal. The Court reasoned that an arbitration clause should be approached differently compared to other terms of a standard form of contract. The Court decided that any arbitration clause “must be expressly referred to in the document which is relied on as the incorporating writing. It is not incorporated by a mere reference to the terms and conditions of contract to which the arbitration clause constitutes a collateral contract.”

In England, recent judgments given in cases like Alfred McAlpine Construction Ltd v RMG Electrical seem to validate the judgment given in the above Aughton case. Hence, if no special circumstances are present, then Section 6 of the Arbitration Act of 1996 enacted in England needs to be applied, which stated that “the reference in an agreement to a written form of arbitration clause or to a document containing an arbitration clause constitutes an arbitration agreement if the reference is such as to make that clause part of the agreement.” The Arbitration Act of 1996 also legislates on and resolves a hypothetical situation when a contract is entered into orally but the arbitration clause being referred to is in writing. In such a situation, a valid arbitration agreement is deemed to have been entered into. This has been provided in Article 5 (3) of the Arbitration Act, 1996, which clearly states that “where parties agree otherwise than in writing by reference to terms which are in writing, they make an agreement in writing.”

However, recently in some circumstances in England, a lenient approach has been allowed by the courts where only a general reference has been sufficient to constitute a valid arbitration agreement when the parties are experienced and frequent players in a well-known market. This has been seen in the case of Sea Trade Maritime Corp v Hellenic Mutual War Risks Association (Bermuda) Ltd.

---

46 Arbitration Act, 1996, s 5(3).
Hence, in the context of Europe, we see that there is no standard approach when it comes to arbitration incorporation by reference. Most jurisdictions do seem to focus on whether both the parties had knowledge and had given consent to the arbitration clause at the time of entering into the contract. However, for the purposes of any business, the parties should play it safe and should mention the arbitration clause of the referred document in the main document expressly and clearly so as to avoid any disputes at a later point in time.

**India**

The position of Indian courts on the matter of arbitration incorporation by reference is made clear by a recent landmark Supreme Court judgment of *M.R. Engineers v Som Datt Builders* in 2009.

In this significant case, there was a contract between Kerela PWD and Som Datt Builders Ltd. (hereinafter, “SDBL”). There was a clause in this contract which stipulated that any disputes arising at a later point in time would be referred to a committee of arbitrators who would be nominated by various departments of the government. A part of its obligations was sub-contracted by SDBL to MR Engineers Pvt. Ltd. (hereinafter, “MREPL”). The relevant document provided that,” This sub-contract shall be carried out on the terms and conditions as applicable to the main contract unless otherwise mentioned in this order letter.” Later, disputes regarding some payments which SDBL allegedly owed to MREPL arose and hence under section 11 of the Arbitration and Conciliation Act, 1996 in India; MREPL filed an application to seek the appointment of an arbitrator. However, MREPL contended that the arbitration clause in the contract between SDBL and Kerela PWD was incorporated into the contract between MREPL and SDBL. However, the Kerela High Court dismissed this application, reasoning that there was no arbitration agreement between SDBL and MREPL as the incorporation was not sufficient. The case then reached the Supreme Court where the judges referred to Section 7(5) of the Arbitration and Conciliation Act, 1996, which states that,” the reference in a contract to a document containing an arbitration clause constitutes an arbitration agreement if the contract is in writing and the reference is such as
to make that arbitration clause part of the contract.” The Court hence deduced that merely a general reference was not sufficient. A “conscious acceptance” of the arbitration clause was needed. Intention of the parties needed to be seen. Hence here, the above clause of the contract did not say “all the terms and conditions” would be incorporated. It stipulated that “this sub-contract shall be ‘carried out’…”, and the Court’s reasons that the term ‘carried out’ implies that the parties only intended to incorporate the provisions related to execution and performance; not the arbitration clause.

Here in this case, the judges then made an important distinction between normal and standard form of contracts, when it comes to arbitration incorporation by reference. The Court relied on Russell on Arbitration and stated that a general reference is sufficient only in the case of a standard form of contract of “trade associations or regulatory institutions”. The Court reasoned that in such cases both the parties are mostly aware of the presence of an arbitration clause, since these terms and conditions are almost always published.48

Hence, there is a distinction between how some jurisdictions in the European Union and the Indian Courts look at arbitration incorporation from standard form of contract. While some jurisdictions in Europe opine that a specific reference to the arbitration clause is necessary for a valid arbitration agreement, in India the current position is that in case of a standard form of contract, arbitration clause incorporated from such a contract by general reference too is deemed to be a valid agreement.

CONCLUSION

In the 21st century, arbitration has become all the more important, as time is of the essence in this fast paced world and long drawn out court proceedings are not desired by any party. In the context of India, an efficient legislation for arbitration has the potential to attract more foreign investment in India, which would significantly improve our economy and lifestyle in the long run.

48 2009 (9) SCALE 298.
Unfortunately, some of the Indian legislation provisions dealing with arbitration contain drafting errors (for instance Section 89 of the Civil Procedure Code, 1908). The legislature needs to rectify such provisions and ensure that in the future such errors do not hamper the development of the arbitration scenario in India.

When arbitration provisions are present in heavily one-sided standard form contracts, this interface gives rise to various pertinent issues like that of consent and unconscionability. The valid consent of both the parties is a basic element of contract law. A standard form of contract might have some provisions for the benefit of the opposite party and some which are detrimental to them. Since it is presented in a take it or leave it manner, it seems as if the non-drafting party had no choice in accepting the detrimental terms as a package with the advantageous terms. Hence in the presence of an unfavorable arbitration clause, the mere signing of the standard form contract containing it does not imply the party consented to arbitrate in the provided manner; it could also indicate a lack of any meaningful choice or any other viable option. Highlighting the important default clauses and explaining the repercussions of such clauses to the opposite party would be desirable. Also, agreement to the arbitration provision separate to the main contract (for instance a separate ‘I Agree’ for such provisions) would go a long way in clarifying whether consent was present or not. The doctrine of unconscionability, which comes into play in standard contracts where a stronger party might exploit the other party, should be used by the courts in the favor of the non-drafting party in such cases.

The validity of arbitration clauses incorporated by reference to a contract is highly contested in various jurisdictions. Even with a particular jurisdiction, judicial decisions do not maintain uniformity in this regard, for instance Italy. In India, a logical and significant distinction has been made between arbitration incorporation by reference to standard form in case of parties with a long standing relationship compared to others. In the former case, even a general reference to the standard contract makes the arbitration provision binding, while this is not so in the latter case.
A uniform standard is needed in this regard transcending jurisdiction. This would ensure that important remedies like foreign awards do not get affected due to conflicting positions as to the validity of arbitration incorporation by reference.
Click Wrap (Dis)Agreements

Sharan Bhavnani* and Madhavi Singh**

Abstract

With the expansion of technology, thousands of people enter into contracts electronically by the click of a button without thinking twice. This article deals with one such type of e-contract called ‘click wrap agreement’. The authors have attempted to answer the question of what amounts to acceptance in such agreements. Click wrap agreements as adhesion contracts and End User License agreements have been studied to highlight the arguments which are commonly advanced against holding such agreements enforceable and the kind of judicial response they might elicit if the same issues are raised before the Indian judiciary. The authors have attempted to find answers to the problem of product liability and identification of contracting party in the Indian jurisprudence and also prove the inadequacy of the existing legislation to deal with the type of problems that such agreements might pose. Finally, recommendations have been made by the authors to fill in the lacuna in the law to ensure that the judiciary is not given unbridled power to decide the fate of click wrap agreements.

Introduction

In the modern and rapidly growing world that we live in now, the globe is being compressed into a global village. The heightened interaction between persons, is due to the development and evolution of technology. The number of contracts people are entering into has also increased manifold due to new means and methods of doing the same. In this context, ‘click wrap’ agreements are a consequence of such evolution of technology leading to new methods of contracting. Click wrap agreements, also called ‘click through’ agreements,

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
**Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
are an increasingly common form of entering into an agreement and is often used in license agreements of software which the user enters into at the time of downloading or installing the software. It is called so because the terms and conditions of the agreement are followed by “I Agree” or “I Disagree” or “I Accept” or some button denoting an action representing acceptance or rejection of the terms. Prima facie, this transaction seems rather straightforward due to its resemblance to other standard form of contracts. On a deeper analysis of such a form of agreements in the Indian context, one finds that it is riddled with several ambiguities and lacks clarity in certain regards. The authors of this article intend to analyse the enforceability and validity issues which emanate from such agreements using the Indian Contract Act, 1872 (hereinafter, ‘the Act’) and the Information and Technology Act, 2000 (hereinafter, ‘the I.T. Act’). The authors, due to the lack of developed jurisprudence on the subject in India, have relied on case law from the United States of America along with American legislations. The Indian position is juxtaposed against the American one to bring out the lacuna in the Indian legislation to deal with the potential issues that such a modern form of contract would give rise to. Finally, the authors make suggestions for amending the existing law and enacting a new law to deal with click wrap agreements.

IDENTIFYING THE IDENTITY QUESTION VIS-À-VIS EVIDENCE

In this age of growing e-commerce, the number of software that can be downloaded from the internet, too, is on the rise. Creators of most of the software that can be downloaded, for the sake of convenience, have a Click Wrap format for their proposed agreement. A simple “I Agree” is what it usually takes to enter into such an agreement. Once such an acceptance of terms is communicated through a simple click of a button, there arise various issues and ambiguities. The main issue that the authors wish to highlight in this section is that of ‘acceptance.’

Section 2(t) read with section 3 of the IT Act list out what constitutes an “electronic record.” This record is recognized by the law under section 4 of the
An acceptance of terms in a click wrap agreement which is conveyed to the offeror, i.e. the creator of the software and is stored as a record shall be, then, counted as an “electronic record” under the said Act. When the said Act was legislated, there was no mention of an electronic contract. In 2008, to counter the possibility of lacunae, the legislature amended the law to include section 10A to the IT Act. This section reads as follows:

“Validity of contracts formed through electronic means
Where in a contract formation, the communication of proposals, the acceptance of proposals, the revocation of proposals and acceptances, as the case may be, are expressed in electronic form or by means of an electronic record, such contract shall not be deemed to be unenforceable solely on the ground that such electronic form or means was used for that purpose.”

The main cause for concern that arises out of such an acceptance is not that such acceptance is in the form of an electronic record but the fact that the identity of the acceptor or promisee is unknown. In this section, the authors shall try and analyse the evidentiary value of an electronic record as a form of assent. The lack of evidentiary value of a mere record is, by virtue of such lack,
problematic. There may be an instance where “it becomes necessary to enforce the agreement in litigation, a Web site owner will need to demonstrate at trial the content and process in place when a particular User accessed the site.”\(^3\) Emphasis, in enforcement of such an agreement, lies on the evidentiary value of clicking on an “I Agree” or “I Disagree.” In India, the question of evidentiary value is addressed by looking into Section 85A of the Indian Evidence Act, 1872.\(^4\) The section of the Evidence Act, in essence, lays down a presumption vis-à-vis electronic agreements. One interpretation of the section argues that a Court shall presume that an electronic agreement is executed if the electronic signatures of the parties have authenticated the electronic record.\(^5\) Section 3 of the IT Act discusses authentication of an electronic record through the affixation of such signature and also keeping in mind that Section 10A of the same Act recognises an electronic record as a valid constituent of an electronic agreement. While Sec. 10A of the IT Act recognises e-record as a valid form of assent, the value of the e-record as evidence is reduced due to its inability to identify the promisor. E-record unlike e-signature can be traced only to the device of its origin and does not act as a unique method of identifying the contracting party. Such a shortcoming may become especially problematic where an ‘uncanned’ software is the subject matter of the click wrap agreement. This is because such software is prepared based on the specifications given by the buyer and the identity of the buyer is of essence in the contract since, the seller intends to sell the software only to the buyer. The validity of several agreements or their enforcement may require identification of the contracting parties and it is here that Courts may consider electronic record as a less admissible evidence than electronic signature thereby, bringing the validity of click wrap agreements into question.

The next issue that the authors would like to deliberate upon is that of

---


4 Sec.85A, Indian Evidence Act, 1872 reads “Presumption as to electronic agreements. The Court shall presume that every electronic record purporting to be an agreement containing the digital signature of the parties was so concluded by affixing the digital signature of the parties.”

'Manifestation of Assent.' This term emanates from Section 112 (a) of the UCITA. In essence, it is proactively authorizing an electronic record to signify one’s assent to terms of an agreement. The difference between mere acceptance and manifestation of assent according to the said section is that the latter provides one with a reasonable chance to review the terms and signify such assent with authorization of the same, thereby eliminating evidentiary lacunae. Such a proactive assent with a reasonable chance to peruse the terms of an agreement is not a requirement in India as per Section 10A read with 2(t) of the Indian Contract Act. Therefore, in India, on the one hand one may signify acceptance through an electronic record thereby completing the formalization of a ‘promise’ according to the Indian Contract Act. On the other hand, mere acceptance, in American law, does not amount to manifestation of assent. The American perspective is vaguely reflected in Section 85A of the Indian Evidence Act read with section 3 of the IT act which calls for an authorization of electronic record.

In conclusion, there exists ambiguity in the current legal position regarding acceptance vis-à-vis click wrap agreements. This is due to the silence of the Indian Contract Act and the IT Act on the question of manifestation of assent. The use of electronic records as acceptance might be valid but doubts arise when the question of evidentiary validity of the same is raised. Such a question is further complicated by the lack of clarity on the manifestation of assent. This issue is open to the Courts to decide. They may have to deliberate upon tools to measure manifestation of assent and to bring in tools to ensure the evidentiary value of such a record.

**Click Wrap Agreements As Adhesion Contracts**

An adhesion contract is a standard form of contract which is offered to consumers on a ‘take it or leave it’ basis and is characterised by an inequity in bargaining power. The inability of the consumer to negotiate in such contracts paves way for the contract to be challenged on grounds that mutual assent is

6 Uniform Computer Information Transactions Act, 2000, s.112.
absent in such contracts. Click wrap agreements also fall into the category of adhesion contracts and their validity has often been challenged on the grounds of the terms being non-negotiable, unfair and hence, unconscionable.

Courts have held that a contract does not become unenforceable merely by reason of it being an adhesion contract. Courts decide matters of enforceability of a click wrap agreement as an adhesion contract using the doctrine of unconscionability which requires substantive fairness in contracts.7 In the case of Forrest v Verizon Communications, Inc., the District of Columbia Court of Appeals dealt with the question of whether a forum selection clause which forced a consumer to come to Virginia to file a suit could be held invalid on grounds of unreasonableness and unfairness. The consumer’s main issue here was with the absence of class action remedy in Virginia which adversely affected his interests in the case. The Court held that unreasonableness and unfairness of the forum selection clause is dependent on the inconvenience in approaching the selected forum and not because of an inconvenient choice of law, that is, the law which would be applicable in the selected forum limits the remedies available to the consumer is not a ground on which a forum selection clause would be held unenforceable. Hence, the validity of the forum selection clause was upheld.8

In America Online Inc. v Superior Court, a case with similar facts, a California Court of Appeals took a stand contrary to that taken in the Forrest case. The click wrap agreement which the plaintiff had entered into contained a choice of forum clause which made the courts of Virginia competent to decide the matters arising out of the dispute to the exclusion of other courts. While deciding the conscionability and fairness of the forum selection clause, the Court laid down three criteria for a forum selection clause to be valid: a) it must be entered into freely; b) the chosen forum must have a logical nexus to either of the parties in the dispute; and c) it should not substantially impair the legal rights of the consumer in a way which violates the public policy of

8 ibid 440-41.
the jurisdiction to which the consumer belongs. The Court further noted that protecting consumers from “unfair and deceptive trade practices” formed a part of the public policy of California and class action lawsuits were a means of ensuring protection of interests of a consumer. As a result, the clause which restricted jurisdiction to a region that did not provide for class action lawsuits was held to be unconscionable and hence, invalid.\textsuperscript{9}

In \textit{Hughes v McMenamon}\textsuperscript{10} as well as in \textit{Stomp Inc. v NeatO},\textsuperscript{11} L.C.C. the click wrap agreement was not held to be unconscionable although the terms had not been freely negotiated because the consumer had freely agreed to the terms of the agreement and had received prior notice of the terms and there was nothing inherently unfair in the terms of the click wrap agreement.\textsuperscript{12}

In \textit{Comb v PayPal Inc.}, one of the landmark judgements dealing with click wrap agreements, the Court devised a test for deciding the question of unconscionability. The Court held that a click wrap agreement must be both procedurally unconscionable and substantively unconscionable for it to be held unenforceable. Although PayPal encouraged consumers to read the terms of the click wrap agreement before clicking on ‘I Agree’ it was held that the agreement was unconscionable. For procedural unconscionability there must be inequity in bargaining power between the parties and obscure contractual terms, that is, an adhesion contract is by reason of its unamenable terms and conditions always procedurally unconscionable unless the party which drafted the click wrap agreement can prove that there existed alternatives for the consumer and it was not the only one offering those services and that the consumer was aware of these alternatives at the time of entering into the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{9} \textit{America Online, Inc. v Superior Court (Mendoza)} 108 Cal. Rptr. 2d 699 (Court of Appeal, First District, Division 2, California 2001).
\item \textsuperscript{10} \textit{Hughes v McMenamon} 204 F. Supp. 2d 178 (U.S. District Court for the District of Massachusetts 2002).
\item \textsuperscript{11} \textit{Stomp Inc. v NeatO} 61 F. Supp. 2d 1074 (United States District Court, C.D. California 1999).
\item \textsuperscript{12} See \textit{Caspi v Microsoft Network, L.L.C.}, 1999 WL 462175, (Superior Court of New Jersey, Appellate Division 1999); \textit{Held: Since, in click wrap agreements the consumer actually scrolls through the terms he cannot claim that he did not receive reasonable notice of the terms.}
\end{itemize}
\end{footnotesize}
contract. Substantive unconscionability exists when the unfairness and one-sidedness of the contract “shocks the conscience.” The PayPal agreement was substantively unconscionable because it gave all dispute resolution powers to PayPal and prohibited customers from consolidating their claims. These clauses were found to be substantively unconscionable. The test evolved in this case is one of the most widely used tests in determining the unconscionability of a click wrap agreement.13

Courts in America have in most instances found click wrap agreements to be enforceable and have dismissed arguments about their unenforceability based on non-negotiable nature of terms and consequent absence of mutual assent. Primarily, click wrap agreements have been held enforceable as the act of clicking on the box next to ‘I Agree’ is considered to be a manifestation of assent. The prospective consumer should be given reasonable notice of the terms of the contract and in click wrap agreements where the consumer is required to scroll through the terms before giving his assent, reasonable notice of terms can be construed. Courts have justified upholding of non-negotiated terms of click wrap agreements as enforceable by accepting the argument that take it or leave it contracts are customary and standard business practices. Enforcing them helps increase economic efficiency and makes the legal position on click wrap agreements less uncertain.

Two factors, which Courts in most of the recent judgements keep in mind while applying the test of conscionability, are that of market choice available to consumers and comprehensibility of terms. If the software supplier successfully proves that the consumer had alternatives to choose from, even unfair and one-sided terms can be justified. In *Brower v Gateway*, Gateway’s shrink wrap agreement mandating arbitration even though found by the Courts to be onerous was held enforceable for two primary reasons. Firstly, the agreement allowed the consumer to return the goods within thirty days of purchase and second, the consumer could have procured comparable goods from other

suppliers.\textsuperscript{14} The reasoning behind such a test is that when the consumer in the presence of other competing options chooses one amongst those, his consent in purchasing that particular product becomes all the more explicit and it can be construed that the consent which the consumer gives under such circumstances is absolute and hence, he would be bound by the terms he has consented to, even if they are one-sided. The enforceability of click wrap becomes all the more certain when the terms of the contract are simple and comprehensible.

**PRODUCT LIABILITY IN SOFTWARE**

The question about whether software is a ‘good’ or ‘service’ is instrumental to understanding the kind of liability which can be attached to software in case of any kind of malfunctioning of the software.\textsuperscript{15} Software programs are more often than not quite complicated and involve coding and changes in their design at several levels. Hence, liability becomes difficult to affix since several people are responsible for finally producing the software in the form in which it is supplied to the user. Moreover, many software are customised to suit the needs of the user.

The ramifications of an erroneous software could range from a computer crash to an airplane crash.\textsuperscript{16} It could result in a nuclear catastrophe\textsuperscript{17} or waste of fuel during Skylab’s descent (that fuel which could have been used to avoid a potential collision)\textsuperscript{18} or a false alert about a world war.\textsuperscript{19} Not surprisingly, governments as well as private entities are interested in devising uniform ways of securing themselves against such harms. It is in this context that the European

\textsuperscript{14} Brower v Gateway 676 N.Y.S.2d 569, (Supreme Court of New York, Appellate Division 1998).


\textsuperscript{16} Marguerite Zientara, ‘CPU Fails, Two Jets Nearly Collide’ *Computerworld* (November 12, 1979).

\textsuperscript{17} ‘Computer Error Closes Nuke Plants’, *Indianapolis Star* (March 16, 1979).

\textsuperscript{18} Tom Henkel, ‘NASA Jumbles Skylab Flight Data’ *Computerworld* (July 9, 1979).

\textsuperscript{19} ‘Norad System Goofs, Calls Alert’, *Computerworld* (Nov. 19, 1979).
Union (hereinafter ‘EU’) directives on Product liability assume importance.

The EU directive provides that the producer, which includes any person in the chain of supply, shall be liable to compensate the victims for any personal injury or injury to private property caused wholly or in part by a defect in the product. The plaintiff does not have to prove negligence on the part of the producer, but only that the product was defective, that the damage occurred, and that there is a casual link between the defect and damage. This liability towards the injured consumer may not be contractually excluded or limited and each member state is required to enact legislation to provide for implementation of the directives. To extend the product liability doctrine outlined in the EU directives to software, the definition of software as given in the directive needs to be analysed.

“Product means all movables even if incorporated into another movable or into an immovable. ‘Product’ includes electricity.”

The definition does not explicitly include ‘software’ as a product, and most EU member nations as well as USA have been trying to deal with the question of whether ‘software’ should fall under the ‘product’ category or the ‘service’ category since liability for the two in Anglo-American law is different. The answer to this question is determined using the ‘essential nature test.’ In terms of this test, the essence of the contract is examined to determine whether it constitutes the provision of a service, in which case the software is a service, or

---

26 EU Directive, Art. 2.
the delivery of a product, in which case it is regarded as a product.\textsuperscript{28} Click wrap agreements mostly deal with standard software which arguably is a ‘product’ since standard software may be the product of a service but it is not service in itself and hence, the EU directives are applicable to it. There is also the issue of whether intangible nature of the software is an obstacle to holding a software to be a ‘product.’ However, most commentators agree that software and its medium constitute a tangible ‘product’ to which the EU directives apply.\textsuperscript{29}

Software is said to be defective if it does not meet the description provided in the user manual, breaches any other implied warranty falls short of the standard expected from a software of its kind\textsuperscript{30} or fails to meet the industry standards. The problem with such a view of defect is that, no software is ever free of bugs and hence, it is impossible to guarantee beforehand that a software does not contain any defects.\textsuperscript{31} The biggest drawback of the EU directives is that, they provide relief only in case of death or personal injury or injury to private property and do not cover economic losses.\textsuperscript{32}

The EU directives which introduce the strict liability interpretation into product liability prove advantageous to the user of the software on two counts. First, the user simply needs to prove that the software was defective and not that there was some negligence on the part of the producer.\textsuperscript{33} Second, the user can institute a claim of damages against a much wider circle of liable persons, including but

\textsuperscript{28} \textit{RRX Industries Inc v Lab-Con Inc} (1985) 772 F 2nd 543 (9th Cir).
\textsuperscript{29} Alheit, “The applicability of the EU Product Liability Directive to software” (n 25) 202.
\textsuperscript{30} EU Directive, Art. 6(1); Also see Alheit, “The applicability of the EU Product Liability Directive to software” (n 25) 203.
\textsuperscript{31} Alheit, “The applicability of the EU Product Liability Directive to software” (n 25) 204; Software often disclaim their liability for any defects through the EULA which is the user is required to accept. The following is a term in the Kapersky Lab End User License Agreement:

“8.4. You acknowledge, accept and agree that no software is error-free and You are advised to back up the Computer with the frequency and reliability suitable for You.”

\textsuperscript{32} Alheit, “The applicability of the EU Product Liability Directive to software” (n 25) 205.
\textsuperscript{33} EU Directive, Art. 1.
not limited to the developer, supplier and importer.\footnote{Alheit, “The applicability of the EU Product Liability Directive to software” (n 25) 208-209.} In addition to the EU directives, the laws of the respective countries are also applicable to product liability in software.\footnote{EU Directive, Art. 13; Also see Alheit, “The applicability of the EU Product Liability Directive to software” (n 25) 189.}

A claim for damages may also be brought under the tort of negligence or a contractual breach of warranty or under the consumer protection legislation of the country. Liability in warranty arises when the software fails to perform according to the express or implied warranty provided by the manufacturer.\footnote{Bruce Ducker, “Liability for Computer Software” (1971) 26(4) Business Lawyer 1081, 1088.} In India, Courts have applied the ‘canned or uncanned software test’ to determine whether or not software should be treated as ‘goods’.\footnote{Tata Consultancy Services v State of Andhra Pradesh, Appeal (civil) 2582 of 1998 (Supreme Court of India 2001).} Sale of canned software is subject to the provisions of the Sale of Goods Act, 1932 which confers the right on the user of the software to repudiate the contract in case of breach of condition and to claim damages in case of breach of warranty.\footnote{Sec. 12, Sale of Goods Act, 1932.} This Act recognises the title of the seller to the software, freedom of the software from conflicting claims\footnote{Sec. 14, Sale of Goods Act, 1932.} and correspondence of the software with the description provided in the user manual or otherwise\footnote{Sec. 15, Sale of Goods Act, 1932; Also see Bruce Ducker (n 34) 1089-1090: In US the UCC prohibits any disclaimer exempting warranty by description or express warranty. It also specifies merchantability and fitness of product as the two implied warranties in every sale of goods.} as implied conditions, violation of which gives the user the right to repudiate the contract. However, the Sale of Goods Act, unlike the EU Directives, deals only with the contract of sale between the supplier and the user and does not determine the relationship between the user and the developer of the software or any other person in the chain of supply. Moreover, the Act deals with transactions which are sales whereas most of the click wrap agreements are license agreements and may not per se be governed by the Act.
An action against the developer of a software in tort can be brought on grounds of negligence or strict liability. Proving tortious liability of negligence puts the onus on the user of the software to prove that the developer or the supplier of the software failed to take reasonable care or meet the minimum standard of special knowledge prescribed by industry practices.\textsuperscript{41} The problem with applying the negligence test to software vendors is that no common industry standard exists and it is difficult to define the minimum knowledge or skill required for development of a particular program.\textsuperscript{42} The doctrine of strict liability which relies on \textit{res ipsa loquitur} would not work in case of software malfunctions since even after extensive testing and debugging a software may fail catastrophically and failure of a software need not necessarily point towards a manufacturing defect, which makes application of this doctrine irrational and inequitable.

The EU directive aims at extending the strict liability doctrine to product liability and consequently to defective software by making manufacturer responsible irrespective of whether or not there was negligence on his part. However, India has no legislation or precedent which specifically deals with the issue and due to the difficulty in proving negligence or absence of reasonable care and also due to the complicated nature of software which makes application of \textit{res ipsa loquitur} difficult, it seems unlikely that a claim for damages under tortious liability would succeed.

The recourse available to the aggrieved user then is claiming damages under contractual liability or on the basis of the warranty provided in the click wrap agreement. However, most click wrap agreements restrict the method and amount of recovery in case of breach.\textsuperscript{43} It also permits contractual exclusion of incidental or consequential damages and may also put a cap on the amount of liquidated damages to be paid in case of a breach of the contract provided


\textsuperscript{42} ibid 190.

\textsuperscript{43} Bruce Ducker (n 34) 1092; Also see Sec. 316 (2) UCC.
the same is found to be reasonable.\textsuperscript{44}

Thus, in the absence of adequate remedy in tort law, it seems likely that Indian courts would rely on the click wrap agreement of the software and the express and implied warranty manifested therein to determine whether the same has been breached and to award damages. Since, the EU directives neither extend to nor bind India, and the principle of strict liability has not yet been extended to software through judicial interpretations, the validity of click wrap agreements as the basis of determining liability assumes importance. If the click wrap agreement is found to be valid, the exemption of liability clauses might also be

\textsuperscript{44} ibid 1092; The following clauses belong to the Kaspersky End User License Agreement and are an example of the manner in which liability is limited by the supplier:

“8.9. The software is provided “as is” and the rightholder makes no representation and gives no warranty as to its use or performance. except for any warranty, condition, representation or term the extent to which cannot be excluded or limited by applicable law. the rightholder and its partners make no warranty, condition, representation, or term (expressed or implied, whether by statute, common law, custom, usage or otherwise) as to any matter including, without limitation, non-infringement of third-party rights, merchantability, satisfactory quality, integration, or applicability for a particular purpose. you assume all faults, and the entire risk as to performance and responsibility for selecting the software to achieve your intended results, and for the installation of, use of, and results obtained from the software. without limiting the foregoing provisions, the rightholder makes no representation and gives no warranty that the software will be error-free or free from interruptions or other failures or that the software will meet any or all of your requirements whether or not disclosed to the rightholder...

9.1. To the maximum extent permitted by applicable law, in no event shall the rightholder or its partners be liable for any special, incidental, punitive, indirect, or consequential damages whatsoever (including, but not limited to, damages for loss of profits or confidential or other information, for business interruption, for loss of privacy, for corruption, damage and loss of data or programs, for failure to meet any duty including any statutory duty, duty of good faith or duty of reasonable care, for negligence, for economic loss, and for any other pecuniary or other loss whatsoever) arising out of or in any way related to the use of or inability to use the software, the provision of or failure to provide support or other services, information, software, and related content through the software or otherwise arising out of the use of the software, or otherwise under or in connection with any provision of this agreement, or arising out of any breach of contract or any tort (including negligence, misrepresentation, any strict liability obligation or duty), or any breach of statutory duty, or any breach of warranty of the rightholder or any of its partners, even if the rightholder or any partner has been advised of the possibility of such damages.

You agree that in the event the rightholder and/or its partners are found liable, the liability of the rightholder and/or its partners shall be limited by the costs of the software. in no case shall the liability of the rightholder and/or its partners exceed the fees paid for the software to the rightholder or the partner (as may be applicable)”. 
held enforceable and if the entire click wrap agreement is found unenforceable the Courts would have to rely on tortious principles of negligence and strict liability.

**ENFORCEABILITY OF CLICK WRAP AGREEMENTS FOLLOWING A STRICT INTERPRETATION OF THE INDIAN CONTRACT ACT, 1872.**

At present, most software suppliers draft click wrap agreements in a way which systematically and unfairly favours the supplier. Either the language is too complicated for a layperson to understand or the cost of getting adequate legal advice to help the consumer understand the terms outweighs the perceived benefit from simply accepting the Terms and Conditions without reading them. Thus, it is not surprising to find that most of the users do not read the terms and conditions of the several click wrap agreements they enter into.\(^45\) Suppliers who are well aware of this take advantage of the situation and make the terms of the agreement one-sided. Under such circumstances, it is not sufficient to say that the consumer was given notice of the terms of the contract as even the offeror does not expect the average customer to read the terms. Deliberately making the terms lengthy and complex to ensure that the consumer does not read the terms also cannot be ruled out. Even where the terms of the contract are biased and unfair most online consumers lack the resources, knowhow and confidence to stand up against big software companies.\(^46\)

Click wrap agreements like other e-contracts in India are governed by the Indian Contract Act, 1872 and the Information Technology Act, 2000 with the latter drafted to deal with the unique situations which expansion of cyberspace and advent of e-contracts have given rise to.


“A contract is no less a contract simply because it is entered into via a computer.”

While Indian law does not contain precedents which could shed light on the way Courts in India would treat click wrap agreements, the authors maintain that if the same arguments which have been put forward in favour of validity of click wrap agreements in America are used in India, whenever the issue comes before the Court, then the Courts might find it difficult to rule in favour of enforceability of click wrap agreements using the existing legislations.

The Information Technology Act, 2000 does not define ‘contract’ and depends upon the definition of contract provided in the Indian Contract Act. All e-contracts therefore, must necessarily satisfy all the elements of contracts as is provided in the Indian Contract Act.

While analyzing a valid agreement that can be enforced as a contract, one must consider the considerable element of ‘consideration.’ The Act defines ‘Consideration’ and makes it an essential element of a contract. If one reads Section 2(h) in conjunction with Section 2(e) and Section 25 of the Act, one can easily adduce the importance of consideration. Over the internet today, there are a large number of mobile applications and software that are available free of cost. According to a study conducted by Cambridge University, “The Android market consists mainly of free applications (73%).” The question then is whether we can consider the click wrap agreements which provide free web-based applications and software, binding, in the absence of

---

47 Forrest v Verizon Communications, Inc., 805 A.2d 1007, 1011 (Court of Appeals, District of Columbia).
48 Sec. 10, Indian Contract Act, 1872.
49 Sec. 2 (d), Indian Contract Act, 1872.
50 Sec. 2 (h), Indian Contract Act, 1872 reads “An agreement enforceable by law is a contract.”
51 Sec. 2 (e), Indian Contract Act, 1872 reads “Every promise and every set of promises, forming the consideration for each other, is an agreement.”
52 Sec. 20, Indian Contract Act, 1872 reads “Agreement void where both parties are under mistake as to matter of fact.”
any consideration. In *Curie v Misa* the following “benefit detriment test” was given for identifying the presence of consideration:

> “a valuable consideration, in the sense of the law, may consist either in some right, interest, profit or benefit accruing to the one party, or some forbearance, detriment, loss of responsibility given, suffered or undertaken by the other.”

Here, then, the ‘benefit’ shall be accrued to the promisor or a ‘detriment’ to the promisee. This view is also called the ‘conventional view’ which simplified “consideration first, to detriment to the promisee or a benefit to the promisor, and then to a single test, detriment to the promisee.” Now, it can be argued that the giving out of the application for free does not amount to any benefit to the promisor or developer since these applications are free and, rather, the promisor bears a detriment. The usage of a free application cannot be said to be detrimental to the user. In fact, such an application or software may benefit the user. Therefore, the promisor or supplier of free software accrues no “legal benefit…to constitute a sufficient consideration” in the agreement and the contract is void as a result of it. The Indian Contract Act, makes consideration an important element of an agreement and only a legally enforceable agreement is a contract. Hence, formation of an agreement leave alone contract is impossible in the absence of consideration. The intent of the Act to treat consideration as a necessary element becomes clear when it lists out exceptions to the requirement of consideration under Section 25 and Section 185 of the Indian Contract Act. In fact, the Indian Contract Act, 1872, in order

---

54 *Curie v Misa*, (1875) LR 10 Ex 153.
55 *Curie v Misa*, (1875) LR 10 Ex 153; Also see *Chidambaram v P.S. Renga*, AIR 1965 SC 193.
59 Sec. 2(e), Indian Contract Act, 1872.
60 Sec. 10, Indian Contract Act, 1872.
to avoid any ambiguity on questions of consideration also expressly provides what is to be treated as ‘consideration’ in the absence of a real consideration in a contract of guarantee. 61 This proves that, consideration is tantamount to an agreement and contract. So, e-contracts must be made an exception to the rule of consideration to make them enforceable.

Indian Contract Act also perceives consensus ad idem and ‘free consent’ not vitiated by coercion, undue influence, fraud, misrepresentation or mistake as essential elements of a legally binding agreement. 62 Thus, unconscionability of a contract as grounds for holding it unenforceable has been recognised by the Act although under the guise of ‘undue influence’. The inequity in bargaining power in the buyer-seller relationship in a click wrap agreements puts the seller in a position where he can exercise real authority over the consumer. 63 This position is used by the seller in the click wrap agreement to dominate the will of the buyer and introduce unfair terms into the click wrap agreement. Hence, applying the doctrine of unconscionability and adopting a strict interpretation of the Act, Courts in India may find the click wrap agreement to be induced by ‘undue influence’ and hence, voidable at the option of the consumer. 64 In contracts where consent seems to have been obtained by ‘undue influence’ the burden to prove that consent was not so obtained is on the party which was in a position to dominate the will of the other party, which in the case of click wrap agreement is the software company. This is a great burden to be discharged failing which the Indian courts may find the agreement unenforceable and sellers in order to prove the absence of any real or apparent authority over the consumer must prove that there existed alternatives to choose from and hence, the consumer was not compelled to buy the product and accept the onerous conditions. This in itself is difficult to prove since products in the software industry are very well-differentiated with each having distinct features. Also, most softwares succeed in creating brand loyalty and thus, exercise real authority over consumers.

61 Sec. 127, Indian Contract Act, 1872.
62 Sec. 13, Indian Contract Act, 1872; Sec. 14 Indian Contract Act, 1872.
63 Sec. 16, Indian Contract Act, 1872.
64 Sec. 19A, Indian Contract Act, 1872.
Analysing the test evolved in the PayPal case in the Indian context, the authors conclude that the enforceability of click wrap becomes all the more doubtful when this test is applied. All click wrap agreements are procedurally unconscionable because of their non-negotiable nature. They also seem to be substantively unconscionable because of the inclusion of exclusion clauses whose validity can be challenged under the Act. The fate of the click wrap agreements which prohibit consumers from filing class action suits is all the more uncertain because such a clause by restricting enforcement of rights by usual proceedings may amount to restraint of legal proceedings thus, rendering the contract void to the extent of such restraint.65

Even scrolling through the terms and conditions of the click wrap agreement before giving assent, may not be enough to prove *consensus ad idem* especially when both the parties are aware that the terms will most likely not be read by the consumer. This is because of their complexity, or their inclusion in a myriad of other terms, or the improbability of fully comprehending their legal significance. Hence, the ability of consumers in most click wrap agreements to review conditions before accepting them is more fictional than real.

**FORUM SELECTION CLAUSE AND ARBITRATION CLAUSE**

A widely contested clause of click wrap agreements is the forum selection clause and the position of law in this regard varies from country to country and depends on the facts of the case. EU in its attempt to protect consumers enforces the forum selection clause only if they favour the consumer, whereas in USA they are enforced unless the terms of the clause are unreasonable and unfairly disadvantage or inconvenience the consumer.66 Indian Courts might also rule in a manner similar to the US courts since only those clauses which ‘absolutely’ restrict a party from enforcing their rights by the usual proceedings in the ordinary tribunals would be held void to the extent that they restrain

65 Sec. 28, Indian Contract Act, 1872.

legal proceedings. Indian Courts have held forum selection clauses to be enforceable if they give exclusive jurisdiction to one out of the several Courts which would have had jurisdiction under ordinary circumstances. Most click wrap agreements contain arbitration clauses which mandate that in case of any dispute arising out of the click wrap agreement the parties resort to arbitration as a dispute resolution mechanism.

According to the Uniform Computer Information Transactions Act of USA (hereinafter, UCITA) an action of the user manifests assent only if the user had an opportunity to review the terms that could have been brought to the notice of a reasonable person. In Specht v Netscape Commc’n Corp the arbitration clause was not enforced against the users since the terms of use that included the arbitration clause were located on the screen below the ‘download’ button. Similarly, in CVent, Inc. v Eventbrite, Inc. where the terms of the agreement could be accessed through a link which was present on the bottom of the first page of the plaintiff’s website, the Court held that a reasonable man’s attention could not have been called to the link and hence, the arbitration clause was found to be unenforceable.

In Vernon v Quest Comm’n Intl., Inc. although the terms of the agreement could be accessed only through a link, the link was provided repeatedly and the user was warned that the terms contained an arbitration clause, the Court held the arbitration clause to be valid. In Rasschaert v Frontier Comm’n Corp. the Court held an arbitration clause which was added unilaterally to the terms of

67 Sec. 28, Indian Contract Act, 1872.
68 Hakam Singh v Gammon (India) Ltd., AIR 1971 SC 740 (Supreme Court of India); Angile Insulations v Davy Ashmore India Ltd., AIR 1995 SC 1766 (Supreme Court of India).
69 Specht v Netscape Commc’n Corp, 306 F.3d 17 (United States Court of Appeals for the Second Circuit).
70 CVent, Inc. v Eventbrite, Inc., 739 F.Supp.2d 927, 936-37 (District Court, Eastern District of Virginia).
71 Vernon v Quest Communication International, Inc., 2013 WL 752155 (District Court, D. Colorado).
72 Rasschaert v Frontier Communication Corp., 2013 WL 1149549 (District Court, D Minnesota).
the agreement as enforceable because the plaintiffs were notified of its addition in their monthly bills.

These cases highlight not just the view which Courts have taken on arbitration clauses but also the emphasis which they lay on prior notification of the terms of click wrap agreement. American Courts have generally found arbitration clauses in click wrap agreements to be enforceable if prior notice of their inclusion in the agreement was given to the users. Courts have to decide about the existence of reasonable notice on the basis of a very subjective criteria mentioned in UCITA, that of the clauses’ ability to attract the attention of a reasonable person. Although a collateral test or requirement does not exist in India, however, in the absence of the terms and conditions being notified to the consumer in their full form or concealment of certain terms (which the seller considers by his own subjective standards to be of less importance but which are actually material to the contract) might result in the contract being held voidable due to ‘misrepresentation’ or ‘fraud’. Several click wrap agreements at present provide the terms of the agreement only in a compressed form with the entire terms and conditions being available through a link somewhere on the page. This makes their enforceability in the Indian jurisdiction following a strict interpretation of the Act quite doubtful.

**End User License Agreement - The End Of Legal Rights?**

The teleological end of a contract is its performance. Such an end is often governed by End User License Agreements (EULAs). More often than not, a transaction vis-à-vis software is concluded through a click wrap agreement. Such an ‘agreement’ is, often, in the form of an End User License Agreement (hereinafter, ‘EULA’). The authors in this portion intend to discuss the distinction between licensing and a sale of software. That shall be followed by a deliberation over a practical hurdle that consumers face in such license agreements. ‘Licensed and not sold’ is the argot that software providers, nowadays, implicitly use to protect their intellectual property. Some even explicitly state the same;

---

73 Sec. 18(2), Indian Contract Act, 1872; Sec. 18 (3), Indian Contract Act, 1872.
74 Sec. 17(2), Indian Contract Act, 1872.
these include major multinational entities like Electronic Arts which include the following provision in its EULA “This Application is licensed to... You do not own the Application.”75 Even Apple, Inc. in its EULA for ‘iTunes’ states “The Products transacted through the Service are licensed, not sold, to You for use only under the terms of this license...”76 The authors shall try and analyse the distinction between sale and license, vis-à-vis software agreements, by drawing from Indian and American jurisprudence. This analysis shall be done in two prongs; the first shall deal with the sale of goods, service, and a license and the second shall discuss the distinction in the American context. To begin with, the authors shall discuss the purpose of an EULA in the context of tax on sale of goods or services. This may seem like a digression at first, but the authors find it necessary to briefly touch upon the tax implications in order to show the distinction between a sale and license of software.

The High Court of Madras, in 2010, clarified the position of taxation on software in the case of Infotech Software Dealers v Union of India.77 The contention of the petitioner, a software reseller association, was that Section 65 (105) (zzzze) of the Finance Act, 199478 was unconstitutional since software was taxed as a good. Software is considered to be a “good,” the argument ran,

77 Infotech Software Dealers v Union of India (2010) 29STT 132 (High Court of Madras).
78 Sec.65 (105) (zzzze), Finance Act, 1994 reads “to any person, by any other person in relation to information technology software Including,- (i) development of information technology software, (ii) study, analysis, design and programming of information technology software, (iii) adaptation, upgradation, enhancement, implementation and other similar services related to information technology software, (iv) providing advice, consultancy and assistance on matters related to information technology software, including conducting feasibility studies on implementation of a system, specifications for a database design, guidance and assistance during the startup phase of a new system, specifications to secure a database, advice on proprietary information technology software, (v) providing the right to use information technology software for commercial exploitation including right to reproduce, distribute and sell information technology software and right to use software components for the creation of and inclusion in other information technology software products, (vi) providing the right to use information technology software supplied electronically.”.
Contracts, Agreements and Public Policy in India

according to the Supreme Court’s ruling in *Tata Consultancy Services v State of Andhra Pradesh*. In that case, it was held that anything “would become ‘good’ provided it has the attributes thereof having regard to (a) its utility; (b) capable of being bought and sold; and (c) capable of transmitted, transferred, delivered, stored and possessed. If a software whether customized or non-customized satisfies these attributes, the same would be ‘good’.” Software having fulfilled this test was classified as a ‘good’. The question in *Infotech*, then, was whether all transactions amount to sale or whether some transactions can be service? The Hon’ble Court at this juncture introduced the “dominant nature test.” Upon perusal of the substance of the EULA forwarded by the petitioner, it was so found that they kept the copyright with themselves and only gave the right to use the software. Therefore, through the license only restricted usage was permitted and the software was not sold. The mere fact that software is a ‘good’ does not necessarily mean that all its transactions shall amount to a sale. The substance of individual agreements decides whether it would be a sale or a service. This allowed for service tax to be levied on software as well, since creation of software could also be considered to be a service. At this stage, there could be a tax on software as a sale of good or provision of a service tax on the transaction involving the software. A possibility of “dual levy of tax” on the “same transaction” turned out to be “the bane of the software industry.” In order to clarify the situation the Union Government introduced section 66E to the Service Tax Act, 1994. This section includes a list of declared services. The relevant sub-section is 66E (f), which reads: “Transfer of goods by way of

79 *Tata Consultancy Services v State of Andhra Pradesh* AIR 2005 SC 371 (Supreme Court of India).
80 ibid.
81 *Infotech Software Dealers v Union of India* [2010] 29STT 132 (High Court of Madras) para 44 reads “The test for deciding whether a contract falls into one category or the other is to as what is ‘the substance of the contract’. We will, for the want of a better phrase, call this the dominant nature test.”
83 Sec. 65B (22), Finance Act, 1994 reads “Declared services” means any activity carried out by a person for another person for consideration and declared as such under section 66E.
hiring, leasing, licensing or in any such manner without transfer of right to use such goods.”84 It thereby states that licensed software (which includes most of the software available for download) is a service. In India, the implication is that if in a license the transfer of the ‘right to use’85 is restricted, it amounts to a service.

Taking forward the ‘right to use’ doctrine, the authors wish to highlight the American distinction between a sale and a license. In India, a license can be considered a sale of good by looking into the dominant nature of the agreement.86 In the event, a EULA is considered to be a sale, then, the rights of the buyer are not restricted as they are in a license. In the former, there is transfer of the right of use, re-sale and license whereas, in the latter, such rights lie with the software provider. American jurisprudence, though, makes a distinction between a sale and a license. In Vernor v Autodesk,87 the US Court of Appeals for the Ninth Circuit Court laid down a test of distinction between a ‘sale’ and a ‘license’, the Hon’ble judges said the following: “We hold today that a software user is a licensee rather than an owner of a copy where the copyright owner (1) specifies that the user is granted a license; (2) significantly restricts the user’s

84 Sec. 66E(f), Finance Act, 1994 reads “transfer of goods by way of hiring, leasing, licensing or in any such manner without transfer of right to use such goods;”

85 Bharat Sanchar Nigam Limited v Union Of India [2006] 3 STT 245 (Supreme Court of India) para 96 reads “To constitute a transaction for the transfer of the right to use the goods the transaction must have the following attributes:

a. There must be goods available for delivery;
b. There must be a consensus ad idem as to the identity of the goods;
c. The transferee should have a legal right to use the goods consequently all legal consequences of such use including any permissions or licenses required therefor should be available to the transferee;
d. For the period during which the transferee has such legal right, it has to be the exclusion to the transferor this is the necessary concomitant of the plain language of the statute viz. a “transfer of the right to use” and not merely a licence to use the goods;
e. Having transferred the right to use the goods during the period for which it is to be transferred, the owner cannot again transfer the same rights to others.”

86 Infotech Software Dealers v Union of India [2010] 29STT 132 (High Court of Madras) para 44 reads “The test for deciding whether a contract falls into one category or the other is to as what is ‘the substance of the contract’. We will, for the want of a better phrase, call this the dominant nature test.”

87 Vernor v Autodesk Inc, 2010 WL 3516435
ability to transfer the software; and (3) imposes notable use restrictions.”88 The commonality between, both, the Indian and American position is that there is a restriction on the transfer of the right to use in order to qualify as a ‘license’ as distinguished from a ‘sale of goods.’

In order to protect intellectual property, “certain restrictions are imperative, which can be met through a license.”89 Often, click-wrap agreements present an EULA which has terms such as, “You may NOT: […] reverse engineer, decompile, or disassemble the Materials;.”90 Such terms may pose a problem, which is not only restricted to click-wrap agreements but also extends to shrink-wrap and browse wrap agreements, of restriction of legal rights. Section 52 (1) (a) of the Copyright Act, 1957 list out those actions of the user which may be considered as part of the ‘fair use doctrine.’91 Such clauses in click wrap agreements may be in conflict with rights guaranteed by legislations pertaining to intellectual property. Therefore, software licenses through click-

88 ibid.
91 Sec. 52(1)(a), Copyright Act, 1957 reads “Certain acts not to be infringement of copyright.— (1) The following acts shall not constitute an infringement of copyright, namely:—
(a) a fair dealing with a literary, dramatic, musical or artistic work [not being a computer programme] for the purposes of—
(i) private use including research;
(ii) criticism or review, whether of that work or of any other work;
(aa) the making of copies or adaptation of a computer programme by the lawful possessor of a copy of such computer programme from such copy—
(i) in order to utilise the computer programme for the purpose for which it was supplied; or;
(ii) to make back-up copies purely as a temporary protection against loss, destruction or damage in order only to utilise the computer programme for the purpose for which it was supplied;
(ab) the doing of any act necessary to obtain information essential for operating inter-operability of an independently created computer programme with other programmes by a lawful possessor of a computer programme provided that such information is not otherwise readily available;
(ac) the observation, study or test of functioning of the computer programme in order to determine the ideas and principles which underlie any elements of the programme while performing such acts necessary for the functions for which the computer programme was supplied;
(ad) the making of copies or adaptation of the computer programme from a personally legally obtained copy for non-commercial personal use;”.

361
wrap agreements, inter alia, pose the problematic question of the enforceability of such licenses. It leaves the Courts to adjudicate upon whether an agreement which takes away the statutory right of the user will be valid. This question is not limited to click wrap agreements, and also may extend to various other forms of online agreements. The authors thought it imperative to briefly touch upon this lacuna in online agreements; most of the times such licenses are extended to a consumer via click wrap agreements. Since the authors have discussed the issue of abridging rights of the licensee, this brings us to consider the question of enforceability of a click wrap agreement when the identity of the licensee is unknown. When an End User License Agreement satisfies the test of transfer of rights of use it, then, is in fact a license agreement. The rights of the licensee as compared to someone who has been transferred the absolute rights of use are limited and are subject to the provisions of the agreement. The obligations of a licensee, too, are different. The issue of identity of the licensee is a contentious one and unless the identity of the licensee who is bound by the EULA is resolved, the question of rights and obligations arising out of the license agreement would remain redundant.

**Revisiting the question of the identity of the contracting party**

Another issue which arises in enforcement of click wrap agreement is that of agency. When the software was downloaded by one user but is being used by several users, does the liability extend to the users who did not consent to the agreement?92 Is the owner of a public computer or a cyber café bound by the terms of a click wrap agreement which one of his customers entered into? Will the subsequent users who use the computer and the software completely unaware of the original click wrap agreement also be bound by the agreement which they never consented to? These are questions which have been brought

---

92 ‘Kaspersky Lab End User License Agreement’ reads “1.4. End User (You/Your) means individual(s) installing or using the Software on their own behalf or who are legally using a copy of the Software; or, if the Software is being downloaded or installed on behalf of an organization, such as an employer” <http://www.kaspersky.com/other/eulawin8-en> accessed on 23 June 2015.
before Courts in very few instances but which need to be clarified in order to extend liability in case of breach and also because principles of fairness require the users of a software to be aware of their legal obligations in cases where they themselves have not created contractual and legal liabilities. Pre-emption of law, although a valid argument, does not extend to pre-emption of contractual liabilities especially in the absence of knowledge of existence of a contract in case of unsophisticated users. Hence, a user of a software who has not downloaded the software himself can be reasonably expected to know about the existence of an agreement as the same can be pre-empted but whether it also reasonable to expect him to pre-empt the terms of the agreement is a question that the US and Indian legislations are ill-equipped to deal with.

In Via Viente Taiwan, LP. v United Parcel Service (UPS), Inc., UPS required the plaintiff to install a certain software which would allow it to use its services. The installation was done by a UPS employee. The click wrap agreement gave exclusive jurisdiction to Courts of Atlanta, Georgia for all disputes arising out of the agreement. When a dispute arose between the parties, the plaintiffs argued that assent to the agreement had been given by the employee of UPS who installed the software and no one in the plaintiff’s organisation gave consent to the agreement, hence, they were not bound by it. The Court observed that presence of a license agreement with a forum selection clause should hardly have come as a surprise to a sophisticated company as that of the plaintiff’s who should have been aware of the standard business practices. It also stressed that the installation must have been done by the UPS employee under the supervision of the plaintiff’s employee and thus, the consent was implied. Finally, the Court held that principles of equity required that the agreement be held valid since, the plaintiff had received benefits from the bargain. Neither the US nor the Indian law is sufficiently equipped to deal with the problem of agency which is created in click wrap agreements or answer satisfactorily the questions raised earlier about who all are bound by the terms of a click wrap agreement.

93 Via Viente Taiwan, LP. v United Parcel Service (UPS), Inc., 2009 U.S. Dist. LEXIS 12408 (District Court for the Eastern District of Texas).
**CONCLUSION**

Law needs to keep pace with the changes in society and for that purpose it needs to be added upon, subtracted from and appropriately amended. To expect that a law formed decades ago can shed light upon issues that became problematic only a few years ago is unreasonable. The authors contend that while the Indian Contract Act, 1872 still provides the broad framework within which all contracts need to be understood, the modern forms of contract require special treatment either because a strict interpretation of the Indian Contract Act renders them unenforceable or because several issues which such contracts give rise to have not been dealt with by traditional legislations.

The authors have in this article attempted to bring out the inadequacy of the existing legislations to deal with one such modern form of contract, namely, click wrap agreements. This inadequacy has been brought out on both of the above mentioned grounds. While the Information Technology Act, 2000 seeks to deal with the unique nature of e-contracts, it fails to clarify ambiguities with regard to certain specific aspects, such as, recognition of electronic record as ‘assent’ which are instrumental to the formation and enforcement of click wrap agreements.

In the absence of a legislation which deals with the issues outlined in this article and provides clarity on the way click wrap agreements should be viewed in India, the onus would lie completely on the judiciary to deal with these contentious issues as and when they are brought before the Courts. This creates uncertainty for both software suppliers as well as users of the software since, their rights and obligations at present, are determined by an agreement whose very enforceability in Indian Courts is doubtful. In the face of such uncertainty regarding the position of law, the argument of pre-emption also fails, since there is no legislation or precedent which the user could view as the standard on which to base his actions so as to ensure that his actions are in consonance with the law.

The authors recognise the importance of click wrap agreements in a world where software plays a seminal role in education, medicine, defence, communication
and almost all other spheres of life. While the authors have, in the entire article, dealt with the interests of the user of the software they recognise the importance of click wrap agreements in protecting the interests of the developer and supplier of software. The authors agree that prohibition of reverse engineering, forum selection and arbitration clauses are necessary for mass-marketed products to protect the economic interests of the software traders.

In order to get rid of the ambiguity on the question of unenforceability of click wrap agreements and to fill the lacuna which exists at present there is a need to amend the Information Technology Act, 2000 to provide for such new forms of contract, such as click wrap, shrink wrap and browse wrap agreement. The authors based on their analysis of the click wrap agreement make the following suggestions to fill the lacuna in legislation and make the enforceability of click wrap agreements less ambiguous.

1. Prior notice of the terms of the agreement must be given to the user and such notice must be given in a manner and form as to attract the attention of a reasonable man. The condensed form of the terms displayed to the user must contain the clauses which limit or exclude liability of the supplier as well as the forum selection clause.

2. All click wrap agreements must necessarily contain a condensed form of the agreement to avoid a situation where users are completely unaware of the terms of the agreement due to the cumbersome nature of the agreement.

3. The hyperlink to the ‘Terms and Conditions’ should be displayed in bold and in a manner that attracts the attention of the user right above the ‘I Accept’ button.

4. Any subsequent change in the terms of the agreement or the privacy policy or the data collection policy or any other policy which binds the user must be intimated to the user.

5. A trial software must necessarily be accompanied by the EULA which would govern the actual software being sold. Although this EULA might not regulate usage of the trial software itself, it would enable the buyer to make an informed decision before buying the software.
6. Every software which is available for sale online and which is delivered to the buyer after the buyer places an order must necessarily allow the buyer to view the terms and conditions of the click wrap agreement (which the buyer would have to consent to at the time of installation) before the buyer actually places the order. This would allow the buyer to make an informed choice after acquiring knowledge of all factors material to the sale.

7. A software which is bought off the shelf and whose terms of the click wrap agreement are available to the user to view only at the time of installation must make provision for return of the software and complete refund within a reasonable period of time.

8. Click wrap agreements which contain terms that are incomprehensible and are too complicated for a layperson to understand should be declared void. The test for incomprehensibility of the terms should depend on two factors, namely, the manner in which the terms are worded including the use of legalese as well as the sophistication of the buyer. For instance, the same click wrap agreement which is incomprehensible to an individual person and considered void for that reason may be considered comprehensible for an organisation with enough resources and sufficient economic interest in the software to acquire requisite legal help to understand the terms of the agreement.

9. Indian Contract Act should be amended to include Click wrap agreement (and other e-contracts, such as shrink wrap and browse wrap agreement) as exceptions to the requirement of ‘consideration’.

10. The legislation on click wrap agreement should make such provision that anybody using the software is bound by the terms of the click wrap agreement irrespective of whether or not he or his agent gave consent to the click wrap agreement. Usage of the software should amount to consent to the terms of the agreement. This is necessary to protect intellectual property.

11. Since, the question of whether ‘software’ is ‘good’ or ‘service’ is ambiguous and since, click wrap agreements do not constitute sale but license agreement, the provisions under Sale of Goods Act are insufficient to provide remedy in case of any defect in the software. Hence, the IT Act needs to be amended to extend the principles of
strict liability as envisaged by the EU directives to product liability in software.

12. The IT Act and Evidence Act should be amended to clarify how the assent to an agreement is to be recognised.

13. A click wrap agreement should be held enforceable if it was presented in a way that allowed for manifestation of assent, i.e. a reasonable chance to peruse the terms.

Incorporating these provisions in the existing legislation would equip the Indian judiciary to deal with the legal issues arising out of enforceability of click wrap agreements. While the issue of validity of click wrap agreement is not contentious in India at present, with one of the largest and fastest growing IT sectors in the world, it is only a matter of time before the question comes before the Indian Courts and it is for this moment that Indian judiciary should be prepared, equipped with an IT Act that recognises and deals with all the modern forms of e-contracts.
Abstract

Indemnification clauses in patent licensing agreements have gained currency, for warranty claims afford mere cosmetic relief in cases of IP infringement. The article, briefly talks about the evolution of the laws of indemnity, and its growing importance. We find that, owing to wide acceptance given to licensing agreements and the mounting costs involved in infringement claims, indemnification clauses act as important risk-shifting mechanisms. Subsequently, the article has looked into the need for such indemnification provisions. Certain sections of the Patent Act warrant the existence of such provisions, in addition to the certain benefits attached to it. Further, we find that, though there is a dearth of case law in India, patent infringement indemnification has engendered a body of precedent claims in the US, which can also arise in Indian courts. While examining the drafting of licensing agreements, the authors have suggested that consideration must be given to certain rights and responsibilities. Ensuring unambiguous and express clauses would help avoid burdensome litigation, while failure to do the same may subject the parties to the uncertainty of judicial treatment.

Introduction

In many areas of contractual dealings, indemnification is often seen as a divisive issue in the sale or licensing of intellectual property, predominantly those involving patents. This is so because commercial buyers often find themselves enmeshed in expensive intellectual property infringement suits. To protect the rights of the buyers, several contracts require the vendor to warrant against intellectual property infringement. It might serve as an incentive for the vendor

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
**Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
to sell products that do not have any third party claims. However, warranty affords only cosmetic reliefs in light of the out of pocket expenses involved in defending patent infringement claims. Thus, indemnification clauses have gained importance, where warranty requirements are being supplemented with such clauses. Considering the perspective of a licensee, indemnification is crucial to ensure that the licensee acquires a proper title to, and the ability to use a patent. Conversely, to a licensor, indemnification imposes a security pledge against a damage claim. It is imperative to have a properly drafted indemnity provision to ensure that parties do not suffer from the uncertainty of judicial decisions, in addition to the management of risk liability. There are various types of hold harmless clauses which purport to indemnify against tortious liability, and there exist infinite possible variations in these. For the purpose of this study, however, it is important to consider only the unilateral nature of indemnity clauses. The indemnification issues relate to intellectual property (Patents, Copyrights, Trade-marks, Trade Secrets etc.) which deal with the licensing of technology and software. However, larger litigation costs and complex issues in play, warrant more attention to patents. Often patent infringement cases arise without the intentional acts of “copying” by the seller, and therefore require greater attention in the drafting of IP indemnification clauses.” For the same, the authors have divided the article into three parts:

The first part of the article seeks to understand the law of indemnity and the manner in which it has evolved. The authors have differentiated between the contracts of guarantee and indemnity. An attempt has been made to distinguish contracts of indemnity on the basis of ‘indemnity against loss’ and ‘indemnity against liability’. The article also seeks to explain the manner in which contracts of indemnity could affect the position at law. The authors have argued that indemnity clauses have gained importance in drafting licensing agreements, and thus serve as important risk allocating mechanisms.

In the second part, the authors have tried to justify the need for indemnification clauses in intellectual property licensing agreements. The authors have explained the need for indemnification in light of the various provisions of the Patents Act which protect the rights of patent holders. Additionally, the dearth of case
law in India has led the authors to analyse American Jurisprudence, through which the authors have highlighted situations under which litigation can arise in the Indian courts.

The third and last part of the article deals with the drafting of license agreements. The authors have analysed the various factors that need to be taken into consideration while constructing indemnity clauses. Further, the authors have looked at the limitations on indemnity provisions and the importance of such considerations in drafting intellectual property licensing agreements.

### THE LAW OF INDEMNITIES

The term ‘indemnity’ has been used in law in many varying, although principally similar senses. In its widest amplitude, it has been construed to mean an unconditional promise to pay a loss upon the happening of an event insured against.\(^1\) It could be also described as a promise to save another harmless from a transaction into which he enters at the request of the promisor.\(^2\) Such a duty to recompense may arise from a contract of indemnity (either expressed or implied) or from an obligation that arises as a result of the relation between two parties.\(^3\) An indemnity claim may arise by the operation of law\(^4\) or through contractual agreements.\(^5\) The earliest form of contracts of indemnification can be observed among both Greeks and Romans, where carriers guaranteed the safe arrival of goods carried by sea route in the form of covering risk of loss or damage to the goods carried.\(^6\) Indemnity contracts in its modern form were employed in the early years of the 14th century in the cities of Italy in the form

---

of contracts for marine insurance.\textsuperscript{7} Legislations on indemnity in the form of a comprehensive code on insurance law were codified in Barcelona in 1484.\textsuperscript{8}

Contractual indemnity in the form of maritime contracts and fire insurance contracts can be found in England as early as the 16\textsuperscript{th} century. However, such contracts were necessarily supposed to be in writing, since the judges in the Eyre of Kent adjudged in the case of \textit{Bokeland v Leanore} that indemnity was not valid by parol under common law.\textsuperscript{9} The codification of this principle can be observed under Section 4 of the Statute of Frauds, 1667, which states that contracts of guarantee or indemnities would be unenforceable if not witnessed in writing.\textsuperscript{10} Modern forms of contractual indemnity can be witnessed in the form of codification of indemnity provisions in the form of statutes in the United Kingdom\textsuperscript{11} as well as common law countries such as The United States of America\textsuperscript{12}, India\textsuperscript{13}, Ireland\textsuperscript{14}, Scotland\textsuperscript{15} and Australia.\textsuperscript{16}

With the evolution of the law on indemnities in various common law jurisdictions there has been an attempt to distinguish between a contract of indemnity and a contract of guarantee or suretyship. A contract of indemnity can be described as a promise “to save and keep harmless against loss”\textsuperscript{17} or to “secure against loss”.\textsuperscript{18} On the other hand a contract of guarantee (surety) is a

\begin{footnotesize}
\textsuperscript{7} ibid 87.
\textsuperscript{8} cf Holdsworth (n 6) 94.
\textsuperscript{10} Statute of Frauds 1667 (SOF 1667) (UK) s 4.
\textsuperscript{11} Trustee Act 1925.
\textsuperscript{12} Uniform Commercial Code 440.7601 1962.
\textsuperscript{13} Indian Contract Act 1872 s 124-125.
\textsuperscript{14} Indemnity Act 1923.
\textsuperscript{15} Professional Indemnity Insurance Rules 1995.
\textsuperscript{16} Medical Indemnity Act 2002.
\textsuperscript{17} \textit{Victorian Work Cover Authority v Esso Australia Ltd} [2001] 207 CLR 520 (Court of Appeal, Victoria).
\textsuperscript{18} \textit{Turner v Leda Commercial Properties Pty. Ltd.} [2002] 171 FLR 245 (Supreme Court of the Australian Capital Territory).
\end{footnotesize}
contract where the guarantor undertakes to be answerable to the creditor for the liability of the principal debtor whose primary liability to the creditor must exist or be contemplated. An important distinction between a contract of guarantee and a contract of indemnity is the number of parties to the contract. A contract of guarantee is necessarily a tri-partite agreement between the creditor, principal debtor and the surety, while a contract of indemnity involves only two parties where the promisor undertakes liability solely and agrees to discharge such a liability. In addition, if a contract is one in which the guarantor is connected with the creation of a primary obligation and derives a benefit from it then the contract is not a contract of guarantee but one of indemnity. The obligation of a guarantor in a contract of guarantee is dependent on default on part of the principle debtor, while in a contract of indemnity the promisor’s liability arises from loss incurred to the promisee by the conduct of the promisor or any other person.

Although there exists differences between contracts of indemnity and guarantee, their objectives in commercial transactions is similar. Since under common law, it was necessitated that indemnity provisions should be in writing, thus, the courts in deciding whether a contract is one of guarantee or indemnity have relied on the construction of the contractual agreement. Contracts of indemnity have been distinguished on the basis of ‘indemnity against loss’ and ‘indemnity against liability’. In the case of indemnity against loss, obligation of the promisor will arise only in case of an actual pecuniary loss through which the promisee pays money. But in the case of indemnity against liability it is not actual loss but imminent loss which might arise in the form of a legal liability which gives rise to the promisor’s obligation to indemnify the promisee. A contract of indemnity against liability has also been understood

21 See n 9.
22 Moschi v Lep Air Services Ltd [1973] House of Lords AC 331.
23 Shea v U.S Fidelity Co. (1923) 120 Atl. 287.
24 cf (n 1) 175-176.
Contracts, Agreements and Public Policy in India

as “an undertaking of the indemnitor to stand in place of the indemnitee in the performance of some act.”

Indemnity obligations arising from contracts are the products of agreements formed through mutual consent of the contracting parties and hence the obligations and interpretations arising out of such agreements are purely to be decided on the construction of the contractual agreement. An important aspect of contractual indemnities is that such agreements may affect the position at law. In the matter of *Morris v Ford Motor Co. Ltd.* James LJ stated that, “It is open to the parties to a contract of indemnity to contract on the terms of their choice, and by the terms they choose they may exclude rights which may otherwise attach to the contract.” This leads to various instances in which indemnity could affect the position at law. Such instances are:

a) Indemnity provisions might be drafted in order to operate subsequent to the expiry of contractual limitation periods.

b) An indemnity provision might operate through its construction to remove the condition that recoverable losses must be foreseeable and not too remote.

c) Through construction of indemnity clauses an indemnified party could claim compensation even if such a party had not taken reasonable steps to mitigate the loss.

The interpretation of indemnity clauses is done by applying the rule of *contra proferentem*, which includes a strict interpretation of the contractual agreement, with any ambiguities interpreted against the drafter. The test laid down by Lord Morton in the case of *Canada Steamship Lines Ltd v R* is also applied in order to interpret indemnity clauses.

In modern day commercial contracts, indemnification arises in various

---

29 Chitty, cf (n 5) 83.
Licensing agreements are seen as one of the methods through which technology is transferred between firms and is a commonly observed inter-firm contractual agreement. A licensing agreement in matters of intellectual property involves the grant of a right by the licensor to the license to produce and sell goods, apply a brand name or trademark or use patented technology. The typical use of licensing new products is either to facilitate its development or the commercialization to end users. Licensing of intellectual property may have various advantages: One, it is seen as the cheapest way of penetration into foreign markets without any investment. Second, it reduces the risk in terms of doing business and making investments abroad. As corporations become increasingly mindful of the costs arising out of intellectual property infringement litigation, potential infringement defendants are pursuing means of allocating liability through licensing agreements as it is seen as a vital risk shifting mechanism.

30 Indian Contract Act 1872 s 222.
31 Companies Act 1956 s 62.
32 Skylink Techs. Inc. v Netscout Serv. Level Corp. [2005] 400 F.Supp.3d 982 (7th Cir.)
34 Hart-Carter Co. v HCC Inc. [1995] 68 F.3d. 165 (7th Cir.).
35 Cover v Hydramatic Packing Co.[1996] 83 F.3d 1390 (Fed. Cir.).
In light of such developments the subsequent chapter analyses the need for patent indemnification and also looks into potential litigation that could arise out of contractual indemnity agreements through licensing agreements in the Indian context.

**NEED FOR PATENT INDEMNIFICATION AND SPECIFICITY IN TYPES OF CLAIMS- ANALYZING SELECT CASE LAW**

A patent is a bundle of exclusive rights granted to an inventor whose invention satisfies certain pre-requisites such as novelty, non-obviousness and utility. The general principle of indemnity is a contractual obligation undertaken by a licensor to relieve a licensee of any loss accruing to the licensee. An indemnification clause is one of the most important aspects of a licensing agreement, however it has been observed that contracting parties often overlook significant business and economic risks stemming from the inclusion or omission of an indemnity clause. The licensor of intellectual property after having conducted due diligence is in the best position to determine whether its patented technology infringes a third party’s rights. Because of this reason it is the licensor’s duty to indemnify the licensee from any liability arising out of the licensor’s product or technology.

In the context of patent and know-how license for a particular technology, a licensee requires indemnification to produce the technology because, without an explicit indemnification provision, the licensee would have no recourse if the patented technology is found to infringe upon third party rights. The Patents Act, 1970 also incorporates the contractual aspect of intellectual property by virtue of Section 140 through which it seeks to protect the licensee from any restrictive agreements in the licensing clause and renders such provision void. Such restrictive agreements include the licensor restricting or prohibiting the


licensee from acquiring any other patented product or technology other than the licensor’s patented product or technology.43

The primary objective of indemnity in patent licensing is to hold harmless the licensee for any infringement of a third party’s rights caused by the actions of the licensor. The indemnity clauses also act as an incentive for the licensees to avail of the licensor’s product or technology. The following are the rights which a patent holder has under the Indian Patents Act, 1970:-

a) “where the subject matter of the patent is a product, the exclusive right to prevent third parties, who do not have his consent, from the act of making, using, offering for sale, selling or importing for those purposes that product in India;”

b) “where the subject matter of the patent is a process, the exclusive right to prevent third parties, who do not have his consent, from the act of using that process, and from the act of using, offering for sale, selling or importing for those purposes the product obtained directly by that process in India.”44

The licensee would have to suffer a loss in situations in which the licensor supplies an infringing product or technology. Such a loss would come into force by application of certain provisions of The Indian Patent Act which are in place to protect the rights of intellectual property holders. Because of the existence of such provisions in the Patent Act, there exists a need for the licensor to indemnify the licensee. Such provisions are:-

1) Revocation of Patent - Revocation proceedings can be instituted against the licensee by a person interested or by the Central Government by virtue of the powers granted under Section 64 and Section 104 of the Patents Act, 1970. Section 64 lays down the various situations in which revocation proceedings can be instituted.45 In such a situation the licensee would have to bear the cost of litigation and if the patented technology is revoked, it would lead to financial losses suffered by the licensee.

43 The Patents Act, 1970 s 140.
44 The Patents Act, 1970 s 48.
45 The Patents Act, 1970 s 64.
2) Institution of infringement proceedings - If a third party is of the opinion that the licensed technology or product infringes a patent owned by the third party, then such a party can institute infringement proceedings against the licensee. In such a situation the licensee would have to bear the cost of litigation and might have to pay damages towards the third party whose patent was infringed by virtue of Section 108 of the Indian Patents Act.\(^{46}\) The Courts might also grant an injunction against the licensee, ordering the licensee to cease manufacturing of the licensed technology. Such measures will lead to a financial loss on behalf of the licensee, which such a licensee could seek to recover through an indemnification clause in the licensing agreement.

3) Compulsory License - According to Section 84 of the Patents Act, 1970, “At any time after the expiration of three years from the date of the grant of a patent, any person interested may make an application to the Controller for grant of compulsory licence on patent.”\(^{47}\) Through such a procedure the licensee would be forced to license the technology to others. This might reduce the monopoly of the licensee in the market and would lead to a decline in expected profits. However, since such an act of compulsory licensing does not arise out of any fault on behalf of the licensor, the licensor would not agree to indemnify the licensee from loss arising out of compulsory licensing.

4) Parallel Imports - Section 107A of the Patents Act covers certain acts which are not to be considered as infringements.\(^{48}\) Among such acts, one particular act, “importation of patented products by any person from a person who is duly authorised under the law to produce and sell or distribute the product” could affect the rights of the licensee.\(^{49}\) However, since parallel licensing is a legitimate activity and the licensor is authorised to license his rights to multiple parties, the licensor

---

\(^{46}\) The Patents Act, 1970 s 108.

\(^{47}\) The Patents Act, 1970 s 84.

\(^{48}\) The Patents Act, 1970 s 107A.

\(^{49}\) An example of parallel imports would be when there exists a licensor, A, operating out of the United States of America and a licensee, B operating out of India. A licences its technology to C, a second licensee operating out of Germany. C sub-licenses the technology to D, a company operating out of India.
would not agree to indemnify the licensee from losses caused out of parallel imports.\textsuperscript{50}

In the above mentioned situations in which indemnity arises, the provisions of Section 125 of the Indian Contract Act will come into play which states the rights of indemnity holders when sued. According to Section 125:-

“The promisee in a contract of indemnity, acting within the scope of his authority, is entitled to recover from the promisor”-

1) “all damages which he may be compelled to pay in any suit in respect of any matter to which the promise to indemnify applies”;

2) “all costs which he may be compelled to pay in any such suit if, in bringing or defending it, he did not contravene the orders of the promisor, and acted as it would have been prudent for him to act in the absence of any contract of indemnity, or if the promisor authorized him to bring or defend the suit”;

3) “all costs which he may be compelled to pay in any such suit if, in bringing or defending it, he did not contravene the orders of the promisor, and acted as it would have been prudent for him to act in the absence of any contract of indemnity, or if the promisor authorized him to bring or defend the suit”;\textsuperscript{51}

The Indian Patents Act, 1970 does not have any significant provision that governs indemnification arising from licensing agreements, however regarding matters of intellectual property rights the Indian Courts have heavily relied on American Jurisprudence\textsuperscript{52} and hence the authors have relied on American Jurisprudence for the matters of analysing indemnity clauses in patent licensing agreements. There is a dearth of case law in matters of indemnification arising from intellectual property licensing agreements in the Indian context. In light of


\textsuperscript{51} Indian Contracts Act 1872 s 125.

\textsuperscript{52} Novartis AG v Union of India AIR 2013 SC 1311 (Supreme Court of India).
such development the authors have analysed American case law on this subject in juxtaposition with the Patents Act in an attempt to envisage situations in which litigation can arise in Indian courts with respect to indemnification under patent licensing agreements.

Union Insurance Co. v Land and Sky Inc.\textsuperscript{53}

This case, before the Supreme Court of Nebraska, involved the interpretation of an ambiguous term in the indemnity clause. The insurance policy required the insurance company to indemnify claims arising from ‘piracy’. The insurance company argued that the term has to be interpreted in accordance with the torts listed in the policy. On the other hand, the insured party pointed to dictionary meaning of the term to depict that it could include patent infringement. The court held that in such instances the standard contractual interpretation principles\textsuperscript{54} have to be applied and ambiguous terms have to be construed against the drafter.

Carter Wallace v Tambrands Inc.\textsuperscript{55}

This decision by the Appellate division of the New York Supreme Court deals with exclusion of claims of infringement from indemnity clauses for those infringements caused by changes made to the goods after delivery. As a general principle, the party who controls the development of product will bear the risk of any patent infringement arising out of such a product. Thus, the courts have opined that the supplier of any product might exclude infringement claims arising from changes made to the product after delivery.\textsuperscript{56} In the instant case, the plaintiff purchased Hyegia Sciences, a wholly owned subsidiary of the defendants that manufactures pregnancy kits. The indemnity agreement entered into by the two parties excluded claims for infringement caused by post-delivery modification. The plaintiff, through changes in the original

\textsuperscript{53} [1995] 529 N.W.2d 773 (Neb.).

\textsuperscript{54} Mead Corporation v ABB Power Generation Inc. [2003] 319 F.3d 790 (6th Cir.).

\textsuperscript{55} [2002] 744 N.Y.S.2d 11 (Sup. Ct. N.Y 1st Dept.).

\textsuperscript{56} Metabolite Labs Inc v Lob. Corporation of America Holdings [2004] 71 U.S.P.Q.2d 1081 (Fed. Cir.).
product made faster kits and in doing so infringed the patent of New Horizon Inc. The court held that it was clear from the negotiations between the parties and the indemnity clause that the parties intended that some change could be made to the kits. The court held that the change incorporated by the plaintiff fell within such changes. The court further stated that a finding to the contrary would defeat the sole purpose of the indemnity clause and in saying so ruled in favour of the plaintiff.

**Motorola v Varo**

The instant case is based on the principle of indemnity based on contribution. Claims for contribution involve the allocation of liability among joint tortfeasors. This theory is rooted in tort law and traditional notions of equity and fairness. In this case the plaintiff filed a suit against the defendant for infringing its patent. The defendant had procured the product from a third party. The question that the court faced is whether the defendant could claim contribution from the third party. The court denied a claim for contribution between joint tortfeasors in the absence of a warranty that the product would be delivered free of infringement of patent claims. However, there is no coherent view held by courts in different jurisdictions. In the case of *Adobe Systems Inc. v Southern Software Inc.* the United States District Court for the Northern District of California allowed for an equitable indemnity claim and held joint tortfeasors liable because they had worked together to develop the infringing product. In the case of *Foley v Luster* the United States Court of Appeal, on the application of Florida law limited the availability of contribution to situations where (1) the party seeking indemnification was without fault, (2) the indemnified party’s liability arose solely from the acts of the indemnified party, and (3) the indemnifying party alone was alone responsible for the infringement. Thus, whether a party would succeed in distributing the liability would depend, at least in part on the jurisdiction of the suit.

---

60 [2001] 58 U.S.P.Q.2d 1728 (11th Cir.).
61 cf Epstein (n 58) 2-22.
Tenneco Oil Co. and Tenneco Natural Gas Liquids Corp. v Gulsby Engineering\(^{62}\)

A major factor in contractual indemnity is to determine the manner in which the defence against a patent infringement suit will be handled. In various cases indemnitors have argued that they have a *per se* right to control or participate in the defence of the indemnitee. However, in the instant case the Court of Appeal of Texas held that no such right exists with the indemnitor. In the absence of an express provision to the contrary such a right does not exist because the right to indemnity does not come into force until after a judgement is passed against the indemnitee.\(^{63}\) In spite of the indemnitor not having a right *per se* to control or participate in the defence of the suit, numerous courts have opined that the indemnitee must offer the indemnitor an opportunity to either control or participate in the defence of the infringement suit.\(^{64}\) An indemnifying party would usually reserve the right to defend a claim of infringement as a judgement against the indemnitor’s product would adversely affect the same product sold to other parties.\(^{65}\) Another important factor to be taken into consideration is the duty of the indemnitee to give notice of an infringement suit to the indemnitor. It has been held that, “Proper notice of the litigation must be given so that the indemnitor will have reasonable time in which to prepare a defense.”\(^{66}\) In light of such a scenario the most practically viable solution, in the absence of any contractual agreement for the same for the indemnitee would be to offer the indemnitor, before any settlement is concluded the choice of (1) approving the settlement or (2) taking over the defence of the case and agreeing to hold the indemnitee harmless in the event of damages in excess of

---

the proposed settlement.\textsuperscript{67}

\textit{Hobbs v Teledyne Movible Offshore Inc.}\textsuperscript{68}

This case deals with situations in which an indemnitee is owed indemnity from more than one party. In such situations the indemnitee would want to control the defense such that any one indemnitor would not be able to influence the litigation in order to reduce its liability by increasing the liability of its co-indemnitors. The United States Court of Appeal has held that the obligation of the co-indemnitors is joint and severable and the indemnitee has the right to require any of the indemnitors to fully indemnify it.

\textbf{DRAFTING LICENSE AGREEMENTS - CONSTRUCTION OF INDEMNITY CLAUSES}

Management of liability and protection of the customers depends heavily on the drafting on the licensing agreements. The customs prevalent in the industry and the concerns of the customers play a significant role in shaping the licensing agreements. While it is not possible that the seller’s risk can be totally eliminated, it can be managed and minimized with the use of such provisions. A well drafted provision would envisage the terms, scope and the quantum of the seller’s obligation and his defence. Thus, in the construction of Indemnity clauses, there are several important factors that need to be taken into consideration. The scope of such provisions remains the primary concern of both the parties. Thus, the scope of such a provision must encompass (1) The extent of the liability of the seller in such cases, and (2) The limitations to such a liability of the seller. Thus, it is imperative that such provisions take into account the aspects listed below.

\textbf{I. Considerations for Drafting Indemnity Clauses}

\textit{(A) The Type of Agreement Being Drafted}

One of the initial considerations in drafting an express indemnity provision

\textsuperscript{67} cf Rutkowski (n 64) 288.

\textsuperscript{68} [1980] 632 F.2d 1238 (5\textsuperscript{th} Cir.).
is to determine the type of contract to be used. In cases of standard purchase order type agreements, the seller may provide a basic indemnity for direct infringement, but may limit the liability for post purchase modifications. As against this, in a joint development agreement, the liability would be limited to the tune of technology provided by each party. Thus, such express indemnity provisions can be drafted that provide indemnity to only one party or various parties indemnifying each other.

(B) Control over the Design of the Provided Item

As a general rule, the risk that the product does not infringe any intellectual property of a third party is generally borne by the party that controls the development of the product. Such a provision is found to be implied under various laws. Thus, in cases where the recipient of the goods exercises control over the development of the product, the vendor might demand an indemnification. Furthermore, exclusion of claims can be done on grounds such as infringement of specific claims as well as infringement caused by changes made to the good after being delivered. Instances where multiple parties contribute to a single product as suppliers of different components, the liability for infringement caused by their individual components may be assumed by the parties in lieu of similar indemnification from other parties.

(C) Parties Covered Under the Contract

An additional factor of interest would be defining the specific persons or parties who need to be indemnified. Some of these parties would include:

1. Officers and agents of the corporation.
2. Members of the board of directors of the corporation

---

71 Uniform Computer Information Transactions Act s 401(a).
(3) Division and subsidiaries of the corporation
(4) Subcontractors and Original Equipment Manufacturer’s
(5) Partners in a partnership or joint development project
(6) End users versus distributors, and
(7) Authorized agents of the parties who sign the relevant agreements
and/or authorize payments.

It is important to consider the parties to whom the indemnification would
extend because the extent of coverage and the amount of liability exposure is
governed by the listing of the parties to be indemnified.\textsuperscript{73}

\textit{(D) The Duty to defend}

The indemnifying party would normally reserve the right to defend a claim
against the item or technology. Through such a provision, the indemnifying
party will be able to prevent judgments against a particular product that might
adversely “affect the same or similar products sold to other parties”.\textsuperscript{74} To effect
control of the defence, the indemnified party will usually be required to perform
the following tasks:

1. Provide a prompt notice of a claim of infringement
2. Furnish assistance as requested by the indemnifying party,\textsuperscript{75} and
3. Allow the indemnifying party the exclusive right to settle the claim

A violation of any such condition would be considered as a breach of agreement.
A breach, such as settling an infringement claim voluntarily, would provide
grounds to preclude the indemnified party from seeking costs associated with
such infringement. On the other hand, on a failure to comply with the duty to
defend, the indemnifying party would be liable for a breach of the agreement.
Liability for the failure would extend to reasonable costs associated with the

\textsuperscript{73} Manley v Ambase Corp., [2003] U.S. App. LEXIS 14933 (2d Cir.).
\textsuperscript{74} Aeroquip Corp. v United States [1997] 37 Fed. Cl. 139, 43 U.S.P.Q.2d 1503 (Fed. Cl.).
\textsuperscript{75} New Era of Networks, Inc. v Great N. Ins. Co. [2003] U.S. Dist. LEXIS 14247 (S.D. Tex.).
claim. The indemnifying party may be interested in express indemnification provisions that may seek to further limit the exposure to unduly burdensome litigation costs. Conversely, the indemnified party may be interested in obtaining apposite contractual provisions. The indemnified party may be interested in expanding the scope of indemnification.

(E) Miscellaneous considerations

Among other considerations argued above, the following suggested provisions must also be given consideration:

1. The required timing of any indemnification payment,
2. Whether the indemnification payment can be made in a series of payments,
3. Whether to include a liquidated damages provision as an alternative mechanism to limit liability,
4. Whether salary and other personnel costs should be included in costs recoverable for cooperating in defence,
5. Will a payment by the indemnified party’s infringement insurance policy issuer obviate the indemnification warranty,
6. Whether the indemnification will be indefinite in duration or for a specific term of years?

II. Limitations on Indemnity Provisions

One of the most important considerations that arise in drafting indemnity agreements is the limitation of liability. A limitation of liability may disclaim indemnification for the indemnified party’s failure to comply with the material provisions of the indemnity agreement. Examples of such a failure to comply could include entering into unauthorized settlements and failure to provide timely notice of a potential claim. Additional limitations could exist with respect to post receipt modifications made by the receiving party.

which resulted in the infringement or the amalgamation of products with other items which subsequently ended up in infringing the rights of any third party. The type of liability to be incurred should also be given consideration while drafting the agreement. For example, an indemnity agreement might attempt to limit liability only to direct damages and would disclaim liability for incidental or consequential damages. An indemnity clause could also include attorney’s fees. However, such a limitation on the liability should not pose an encumbrance on the essential purpose of the indemnity provision.

(A) Limitation as to Wilful Infringement Damages

Generally, the courts are unlikely to enforce any agreements that permit wilful infringement of patents. As such, indemnity agreements would be rendered unenforceable where the infringing party had prior knowledge of the infringement before committing the act. In the context of insurance claims, the courts have been of the view that insurance coverage for claims based on inducement to infringement cannot be provided. Further, in the cases of indemnity based on contribution, courts may not impose an equitable indemnity, where the party indemnified infringed the patent intentionally. However, in certain special circumstances, parties may enter into indemnity agreements that may allow the indemni/fi ed party to infringe known intellectual property rights, without any liability arising thereof. There appears to be an uptick in the support for enforcing a limitation of damage clause that would discount wilful infringement liability, but only to the degree that the “indemnifying party lacks both knowledge of the infringement and intent to induce the infringement”. Thus, the parties may bid to induce a provision that would require non-infringement of all known intellectual property.

78 cf Henry (n 65) 3.
79 Olan Mills Inc. v Linn Photo Co. [1994] 23 F.3d 1345 (8th Cir).
(B) Unconscionability of Indemnity Clauses

To make a general case of unconscionability of indemnity clause, the provisions of the licensing agreements must be more than merely inequitable. There must be a showing of unfair surprise or duress in the signing of the agreement.\textsuperscript{82} In terms of the Indian Contract Act it can be shown that there was duress under Section 16 of the Contract Act. The aspect of economic duress could also be brought in. Although the Indian Contract Act does not speak about unfair or unconscionable terms of a contract, the 199\textsuperscript{th} Law Commission Report elucidated about the usage of unfair terms in contract within the jurisdiction of the Indian Contract Act, 1872. The Commission made use of the case of \textit{Poosathurai v Kannappa Chettiar},\textsuperscript{83} in which the court stated that in the interpretation of Section 16(3) of the Contract Act, the elements of dominant position and unconscionable nature of the contract established, before a contract can be brought under undue influence. Thus, even though the Indian Contract Act does not contain provisions for dealing with unfair terms of contract the common law position on unfair terms is very clear. Hence, unfair or unconscionable terms in indemnity clauses of licensing agreements of intellectual property will be treated in the same way.

(C) Miscellaneous Considerations

The parties entering into an agreement might have unique considerations. Both sides of the contract must assess the implications of the contract, and negotiate such a clause that would take into consideration each parties’ risks and obligations effectively. Thus, a clear and unambiguous clause is imperative as it would help avoid litigations arising out of patent infringement claims. Because the hold harmless clauses may even extend to the lost profits of the buyers, the expenses incurred at the time of business interruptions, and other consequential damages, the provisions must be evaluated to include only “reasonable” damages. Thus, the provisions must be purported to render the

\textsuperscript{82} cf Epstein (n 58) 2-44.
\textsuperscript{83} \textit{Poosathurai v Kannappa Chettiar} [1919] ILR Mad 43 546 (Privy Council).
buyer in the same position, as would have been in the absence of such an infringement claim. Consequently, the scope of such a provision must have well defined limitations that would discount lost profits and consequential, indirect damages. The above mentioned considerations should be kept in mind while drafting indemnity clauses. Failure to do the same would subject the involved parties to the uncertainty of judicial interpretation and burdensome litigation.

**CONCLUSION**

Indemnification is often seen as contractual assurance that relieves parties from the risk of financial losses in case there is an infringement claim. The increasing litigating costs in defending patent infringement claims has made it necessary to protect the customers from high damage awards. Thus, indemnification clauses can be useful risk-sharing tools that ought to be carefully considered and obtained on a timely manner. Highlighting the same, the authors have:

Through the first part, analysed the evolution of the law of indemnity and differentiated it from the contract of guarantee. It has been argued that patent infringement indemnification clauses have come to serve as means for sharing risk among parties, with the increasing proliferation of licensing agreements.

The authors, through the second part, have argued for the importance of patent infringement indemnification clauses, while looking at the provisions of the Indian Patent Act. Further, looking at the benefits of the indemnification clauses agreements, the authors have also looked at the interplay between the contract law and the provisions of the Patent Act, 1970. Lastly, the authors have argued that although there is a dearth of case law in India and the Patent Act falls short of provisions that govern indemnification clauses, potential litigations may arise in the Indian courts, which has been analysed by employing American case law.

Through the course of the final part, the authors have concentrated on the various aspects that need to be taken into consideration while drafting patent licensing agreements that would manage the risk liability of both the parties entering into the agreements. The authors have, towards the end, analysed the
limitations that can be imposed on the liability of the seller, to make sure that the indemnification award is reasonable, and renders the buyer in the same position, as would have been, in the absence of such infringement claim.

To conclude the article, the authors wish to submit that the purpose of an indemnification provision is never to afford any of the parties to a contract an opportunity to take advantage of the other. Rather, it works as a method of apportioning risk liability, which may arise with any licensing agreement. The same can be realised by employing provisions that have been discussed above, which would also ensure that there remains a balance between offering a licensee the protection it requires and ensuring the risks of the licensor remain manageable.
CONFIDENTIALITY AND PRIVACY CLAUSES IN CONTRACTS WITH SOCIAL NETWORKING SITES

Nishi Ankita Kujur*

ABSTRACT

Modern forms of communication have helped satisfy the inherent human need to stay connected but have also raised multiple threats to the privacy of an individual. Coming of the internet and later the social networking sites have brought a drastic change in our worldview. The ugly side of the trend started coming into the picture. The free flow of data resulted in the possibility of its misuse being quite high. The users of these sites have to enter into contracts with the site before they can become the members of these site. Such contracts are to some extent the root cause of many problems. These are standard forms of contracts. The consent given by the party is vitiated by the inequity of the bargaining position. The legislations enacted to protect the misuse of data take into account the consent given but fail to look into the problem of the contract being a standard form of contract where the true consent was never obtained in the first place.

INTRODUCTION

Man has come along a long way from the initial days of hunting and scavenging for food to the modern times where he is capable of doing more complicated tasks. Needless to say that as the society evolved the values that formed the basis of the society also underwent changes to keep up with the various changes that the society was undergoing. Some of these changes where gradual and others where more radical. This depended on the agents that brought these changes to the society. Privacy as a value is cherished by modern man and it is important in many ways. Privacy allows an individual to maintain his autonomy and his individuality. In very crude terms the idea of privacy allows the individual to

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
have control over the various information.\textsuperscript{1}

The right to privacy has been recognized by many countries all over the world. In the Indian Constitution the right to privacy has been seen as fundamental right under the Article 21 of the Indian Constitution. In the modern period, the most important crisis that the advocates of the right of privacy are facing is the danger that is imposed on this right by the very quick proliferation of personal data through the usage of social networking sites.

Everyone will agree that one of the most important inventions of the 20th century was the internet. It took the world by storm. Another development that followed the coming of internet was the coming up of the social networking sites (hereafter referred to as the SNS). Social networking sites since their very inception have brought changes in the very way we connect with the world. Social networking as a concept was born on the very day “QWERTYIOP” - the first email was sent in 1971 by Ray Tomlinson.\textsuperscript{2} Since then many changes have come in the arena of social networking and it has brought many changes to the world around us. In 1978 Usenet, the earliest online bulletin board was created by Jim Ellis and Tom Truscott. This site provided the users to post news, articles and funny posts.\textsuperscript{3}

1994 saw the birth of the first social networking site in the form of Geocites. It gave the users the freedom to create and customize their own websites. The site grouped the websites created by the users into different cities based on their content.\textsuperscript{4} Various other websites like Classmates, Friendzy, Hi-5 soon followed. In 2002 Friendster was launched and a year later in 2003 MySpace joined

\textsuperscript{1} ‘Why is Privacy Important?’ (Privacilla.org) <http://www.privacilla.org/fundamentals/whyprivacy.html> accessed, 5 July 2015.


\textsuperscript{4} ibid.
the world of social networking sites. The social networking scene completely changed when a Harvard dropout, Mark Zuckerberg launched Facebook in the year 2004. Initially Facebook had an “exclusive” feature and one could join in only if the person was invited by a member of the community. This very feature made it very popular among the student community in Harvard and then it never looked back. Another important player in the field is Twitter. It was created in 2006 by Jack Dorsey, Evans Williams, Biz Stone and Noah Glass.

The development of these sites have helped the world connect with each other but the speed with which there is free flow of information in these sites is a question of concern for everyone. One of the leading SNS of the modern period is Facebook. “Connect with friends and the world around you on Facebook”. When a user opens Facebook page these are the very words that greet him/her. The world of Facebook offers the user connectivity not only to the near and dear ones but also to the world around the user. The very line captures one of the basic needs that is found in the humans, the need to be connected. “No man is an island” - these are the immortal words by John Donne and Facebook as well as the other social networking sites seemed to have to build their whole business model on this very need that is found among the humans. In the modern world where time is the most precious commodity the need for connectivity is not fulfilled by the face to face interactions with friends and family but it is done with the help of these sites and thus, they are used extensively by the users. Thus, the danger to the right of privacy becomes even more probable.

Social networking sites have changed the very way in which we interact with the world. All over the world the first thing that people do when they wake up in the morning is to check their mails and Facebook accounts. These sites have helped people connect and share important moments of their lives with many others with a single click of the mouse. Many have found their love on these sites and some have become rich using these sites as a platform to advertise their

5 ibid.
6 ibid.
products. These sites have changed the whole game of advertising products and connecting to the customers. Some of these achievements of the social networking sites may look frivolous but it contributed in a big way during the Arab Spring that took place in the year 2010. The protestors used Facebook and Twitter to organize their protests and highlight the injustices that were meted out to the masses in countries like Egypt, Tunisia, Libya etc. Social networking sites have helped transform the world into a more integrated community. Whenever there is a natural disaster or any other tragedy the whole online community comes forward and try and help the affected in their own way. These are some of the ways in which the social networking sites have brought changes in us and our world.

The coming up of these social networking sites has led to the challenging of the traditional notions of ownership as well. According to the very famous philosopher John Locke the fruits of one’s labour are part of the possession of the individual as the individual had contributed towards its creation. It is a very important concept and had been used for many years but the same idea cannot be used in the modern period with the SNS like Facebook, Twitter and Myspace. According to the idea of ownership that was put forward by Locke if an individual works on something he has the right to claim at least the partial ownership of the product that is produced as a result of it.9 The users of the SNS constantly enhance and create the content that is available on these sites. A good example is that every time a user posts a selfie he/she is enhancing the content of the SNS and the content is a fruit of his/her labour and thus, the user should at least have partial ownership over the content. According to the Lockean idea users should have some ownership of the information that they provide but it is easy to see that this does not happen in the case of the SNS because here the information thus created is placed under the ownership of the multinational companies by the SNS.10

SOCIAL NETWORKING SITES AND THE PREVALENT LAWS

For the purpose of this article the term “Social Networking Site” can be defined as. As web based services that allow users of the site to do at least three things. The first one is the construction of a profile that may be public or semi-public within the system itself. Secondly, the SNS allow the users to communicate a list of those users with whom the users express their desire to share and receive their information and thus, connect. Thirdly, provide the users with the option to view their connections as well as the connections that are constructed by the others. Connection is the most important thing on the SNSs and the nature and the nomenclature that is used for the connections may vary from site to site.

In this article the author will use Facebook as an illustrative example and try and look into the aspects of privacy and confidentiality. The reasons for doing this is that Facebook claims to be the biggest online community in the world with a total of 1.44 billion users. This is even more that the population of India. As Facebook is used more than any other site, this creates the chances of violations even more. In the recent times Facebook has been accused of violating the privacy rights of users by indulging in various activities. These issues of violations have managed to capture the imagination of the author.

In the very beginning of the article the human need to stay connected was emphasized but even more important than that is the right to privacy. It is one of the basic rights that is provided to an individual. It essentially focuses on the right of the individual to make the choice regarding what he/she wants to share or not. In the modern world where SNSs provide connectivity, it is important to look into the fact if they undermine our privacy in any way. In our times the right of the individual to make choices is the most important of all rights as it lets individual exercise his faculties and this is one thing that separates humans from animals.


There have been various instances where the privacy of the individuals has been compromised on these sites. A few such instances have been discussed here to bring out to the reader the gravity of the situation. In the year 2010 one of the major incidents that brought out the dangers related to the usage of the web space and the drawbacks of the uninterrupted flow of information by the means of SNS was the case where a security consultant had used a simple and not too complicated code to scan the Facebook profiles of millions of users of the SNS and had harvested the personal data of the users that was not hidden from the public by the profile owner by the usage of the privacy settings. In no time the data was available on Pirate Bay, which is one of the biggest file sharing websites of the world. From here the data could be downloaded and used by anyone. There was huge outcry among the users of the site. The reaction of the Facebook authorities to this incident was that the information that was harvested from the profiles of the users were the personal information that they had chosen to be public and had adjusted the user settings in that manner and thus, the privacy was not compromised in any manner as the data was already available for public view.

The unprecedented usage of the SNS leads to the sharing of personal data in the form of public posts, pictures and others at such a rapid rate which raises serious concerns for the privacy of the individuals using the sites. It is important to take into account the key guarding the information available, which is the privacy settings that most of the SNS have. In a majority of the social networking sites these settings are by default such that anyone can see the information unless the user specifically changes these settings and makes the information private. Thus, people end up sharing more information when they fail to actively change their settings. It is an illusion that one’s own proactive

---

14 ibid.
step taken by the user in form of changing the settings may save the misuse of the data as a large portion of the personal data of a user may be found in the profiles of other users and long as the other user has no private settings the data of the initial user can also be seen by the public. A good example of this in the case of the users of Facebook is that a user may share a picture and he may tag someone else in the picture so even when the other person’s settings are private the picture in which he is tagged is available to the public because the person that is sharing the picture has no privacy settings.

Another concern here is that the data that is once shared by the users in the SNS is never lost even when the users choose to leave the sites and delete their profiles. This aspect will be discussed later. The problem of the license that these sites have over the usage of the data that is available to them is vast and it will be discussed later in the article.

The right to privacy has been guaranteed by the Constitution to the citizens of the country. The right to privacy has been brought under the Article 21 of the Indian Constitution that deals with the right to life and liberty. The Supreme Court has recognized this right by looking at the concept of personal liberty in a very broad sense. These rights like the various other Fundamental rights that are guaranteed by the Constitution is not absolute in nature and certain restrictions can be imposed on it on various grounds. While deciding various issues related to privacy the courts have looked into other rights and interests that may come into a clash. Most of the cases related to the matters of privacy infringement are against the State in India. It is important to note that if the right can be exercised only against the state then the claim in such cases involving private bodies is not going to stand well. The Supreme Court of India in its

---


19 Apar Gupta, ‘ Balancing Online Privacy In India’ (2010) 6 Indian J.L.& Tech. 43.
many judgments has stated that once the personal information related to an individual becomes a matter of the public record then the individual cannot claim the right to privacy in matters related to such information and such a right will not be recognized by the court.20

Information and Technology Act, 2008 is an important legislation of India and Section 72 of the same can be seen when we deal with matters related to the privacy of the individuals in the digital space in the country. It will be dealt with in detail in the later part of the article.

If we look at the aspect of privacy in the light of the Indian Contract then the Section 37 deals with obligations that the parties have to each other when they enter into a contract. The first part Section 37 says- “The parties to a contract must either perform, or offer to perform, their respective promises unless such performance is dispensed with or excused under the provisions of this Act, or of any other law.” It can be seen as if one of the parties to the contract promises that he will protect the privacy of other party then he is under the obligation to fulfill it unless it done away with due to a statutory provision.

USA and UK have the Electronic Communication Privacy Act of 1986 and the Data Protection Policy, 1998 respectively to deal with matters relating to privacy in the web space. Part II of the Data Protection Policy of UK deals with the “rights of Data Subjects and others”. Section 7(1)(a) of the Act says that the data controller has to inform the individual if his personal data is being processed by the data controller. Section 7(1)(b) says that the data controller has to give description of the data, the purpose for which it is being used and who will be the recipients of the data. Schedule 3 of the Act deals with processing of sensitive personal data. All these legislations aim to protect the privacy of an individual.21

---

Nature of Contract and The Problems Associated With It

Most of the social networking sites (SNSs) have a standard form of contract with their users. It is generally referred to as the “contract of adhesion”. In a standard form of contract the terms of the contract are dictated by one party to the other and the latter has no say in the process of the formulation of the contract. The latter is merely a signatory of the contract. The mere registration in one of the social networking sites means that the user has accepted the terms and conditions that have been put forward by the site. When these SNSs have such a large user base it is important to note that it will be very difficult for the site to negotiate the various terms of the contract with each and every user. It will not only lead to wastage of time but will take toll on the limited resources.

Standard form contracts face two main enforceability problems. The first problem is related to the fact that whether the user has truly given his assent to the standard form of electronic contract. The second problem is that the courts may apply in these cases the doctrine of unconscionability which may result in these contracts being scrutinized.

One of the really famous cases related to assent in standard forms of contract is Specht v Netscape Communications Corporation. In this case the defendant provided various freeware programmes on its website. Communicator and SmartDownload were among the freeware services provided. When the user wanted to download Communicator the installer would show the terms and the conditions of Netscape that the user had to accept before the programme could be downloaded. The installation of Communicator would not continue unless the “yes” button to indicate acceptance was clicked by the visitor.

But when a user tried to install SmartDownload then no terms and conditions appeared on the screen. The terms and conditions could be seen by the user

24 *Specht v Netscape Communications Corporation*, 306 F.3d 17 (2nd Cir. 2002).
25 ibid.
only when the hyperlink at the end of the page was clicked. Initially the court
took up the issue if the users were given “constructive notice” of the terms and
conditions to use the programme. The plaintiffs admitted to having given their
assent to the terms and conditions of Communicator, then the court focused
on the enforceability of the terms and conditions related to SmartDownload.
The court came to the conclusion that Netscape did not notify the users about
the terms and conditions of SmartDownload as a reasonably prudent person
will not scroll down the page to look for the terms and conditions.

The importance of the case is that the court differentiated between “clickwrap”
and “browsewrap” contracts. The former is a type of agreement that is
automatically presented to the user by website and the users have to click on the
“I agree” button whereas the latter means that the vendor can place a contract
on the website and it will bind the visitor to the contract just by the act of
visitation of the site. This distinction is based on the concept of constructive
notice used by the court in the previous case.26

The doctrine of unconscionability demands a two step analysis of the contract.
They are the circumstances involving the formation of the contract that is in
question and the fairness of the terms of the contract to the party that has
not drafted the contract. A contract is deemed procedurally unconscionable
if the party that was not involved in the formation of the contract does not
have meaningful choices. Standard forms of contract by their very nature tend
to be procedurally unconscionable when they are compared to the contracts
are bargained for. In the standard forms of contracts the users do not have
meaningful choices available to them because firstly, they cannot bargain
and secondly, even the competitors have similar forms of contracts. So the
choice is just an illusion. A contract is substantively unconscionable if it puts
unreasonable burden on the weaker party and to decide on this the courts have
look into specific terms of the contract.27

26 R.L. Dickens, ‘Finding Common Ground in the World of Electronic Contracts: The
Law Review 379.

293.
The problem of data accessibility and data security are crucial that will help further our understanding of the working of the SNSs and how it affects the privacy of individuals. It is important to specify that data here means pictures, biographical information and various other information like credit card numbers. Data accessibility here means that users ability to do three things. Firstly, ability to access the users network information through third part websites (these third party websites are called Social Network Portals or SNP); secondly, the ability to export data to other mediums and lastly to share data with others. This is important to those people who use multiple social networking sites.  

It is interesting how the SNPs work and help the users access their data. If a user has an account in two of the SNSs and want to access both the accounts simultaneously then this could be done with the help of a SNP. For this the user has to first visit an SNP website and provide there the username as well as passwords for both the SNSs that he want visit. The SNP will use this information to log into both the accounts. Then SNP will download all the data from both the pages and send it to the user and the user will have the experience as if he has logged on to both the sites simultaneously.

Other than this if the users want to export data from one SNS to the other so that they don’t have to manually input the data again. This is done using a programme that downloads the required information from the profile and save the information in the computer of the user and this information can be uploaded again by the user in the new SNS.

The next question to be looked into is data security. Data security means protection of the data from any and every kind of unauthorized usage. The users of SNSs may want to protect their private information from the strangers. There are two ways in which the data can be protected - data encryption and


29 Black’s Law Dictionary (8th ed.2004)(defining data protection as “[a] ny method of securing information, esp. information stored on a computer, from being physically lost or seen by any unauthorized person).”
limiting the access to the data.\textsuperscript{30}

Data encryption means the process by which plain text is transformed into coded or cipher text.\textsuperscript{31} The main aim of the whole process is not only to prevent unauthorized use of the data of an individual but also to make the data useless for anyone other than its intended user.\textsuperscript{32} This process does not protect the data from falling into wrong hands but it just makes it useless to anyone who does not has the means to decrypt it.\textsuperscript{33} There are three approaches to secure data through encryption in SNSs. The first approach places the burden on the users for the protection of their data. Here only the users know how to encrypt their data and they provide the decryption keys to their friends. Here the SNSs only store and transfer the data. It neither encrypts nor decrypts data. Thus, the data of the user is secure and it does not matter where the data is going.\textsuperscript{34}

The second approach is the network encryption.\textsuperscript{35} This type of encryption protects the data while it is in transmission to and fro from the SNSs. In this process the user encrypts the data when it is send to the SNS and the SNS on receiving decrypts it and vice- versa. The last approach to encrypt the data is called the disk encryption.\textsuperscript{36} Here the social networking sites encrypt all the data that is stored in its servers. It is important to remember that the data on the profile of the users remains unencrypted otherwise the users of the site will not be able to view each other's profile and make sense out of it. This approach protects the data from physical threats but in this approach the data is vulnerable to network attack like unauthorized interception of data.

This approach does not require the user to sacrifice the accessibility of the data but this approach has many practical problems related to it. The companies

\begin{itemize}
\item \textsuperscript{30} Chris Brenton, Mastering Network Security (1999).
\item \textsuperscript{31} S. Harris, CISSP All-In-One Exam Guide (Timothy Green ed., 5\textsuperscript{th} ed. 2010).
\item \textsuperscript{32} See n 29.
\item \textsuperscript{33} ibid.
\item \textsuperscript{34} Christopher Soghoian, ‘Caught in the Cloud: privacy, Encryption, and Government Back Doors in the Web 2.0 Era’ (2010) Journal on Telecomm. & Tech. L. 359.
\item \textsuperscript{35} ibid.
\item \textsuperscript{36} ibid.
\end{itemize}
present in the market do not have the incentive to provide free services to those sites who use such an encryption. The SNSs generate their income from data mining and advertisement. They collect information using the data that is uploaded in the profiles of the users. This information is either sold or it is used for advertisement. In the first approach the user information is encrypted and the SNS lacks the means to decrypt it. Thus, the source of income is lost and such a service can only be provided if the SNSs charge the users for it.

Secondly, the problem that comes with the first approach is that the potency of the encryption lies in the confidentiality of the decryption keys. In the SNSs there is no limits to the friends made and thus, trying to secure the keys given to each and everyone is a cumbersome task and greater costs will be involved.

In the second and the third approach there is no problem of encryption and the SNSs are able to easily mine the data and use it to generate income. In the network-encryption approach the security is provided only to the data that is transmitted between the user and the SNSs and in the disk encryption SNSs can encrypt the data that is in its servers or the servers that it has control over. In both the ways the accessibility of the data is compromised.

The second way to secure the data is by limiting access to the data. Here data can be protected by the way of setting up various software controls which limit the access that people have to certain types of files without the proper authentication. A good example of this is that the SNSs requires its users to provide their user name and password before they could log in. Like in the case of the second and the third approach to data encryption, even while limiting the access to data the SNSs can only limit the access to those data that is in a medium on which it has control.

The new development in this area is interactive contract. It is similar to a standard form of contract but the difference is that there are certain parts in the

37 ibid 395-396.
38 Harris (n 30) 153-156.
39 Harris (n 30) 166.
40 See n 7.
contract where the user is provided some choices in between the clauses and can select from them, each of the different clauses have been predrafted by the site. Various things have to be kept in mind drafting an interactive contract. Some of them are selections of the terms that can be customized, if such customization will be free or chargeable, the defaults that will be available for each option.

All of these look really attractive on paper but there are many barriers which may prevent its implementation. First barrier is the cost of drafting such a contract. The advocates have to think about different variations to put in each clause and they have to keep in mind how the different choices by the users will interact with each other. It is true that it will be a one time expenditure but still the initial expenditure may act as a barrier.

The cost will prevent the sites from making their contracts too interactive. Over-customizable contracts may overwhelm the users. Another potential problem is that the whole notion of interactivity depends on how the users actually interact with the contract. The sites can ensure interaction by placing all the customizable terms at prominent locations but this may disincentivise the users from reading the whole contract and may in turn affect the enforceability of such a contract. Thus, these are the few barriers that may affect interactive contracts.

**Contracts with Social Networking Sites: a Study of the Facebook Contract**

Facebook here has been as an illustrative example and the author will study the contract that the users of the site sign when they want to become members of the site. Most of the SNS try to avoid any form of liability and try to provide the website the maximum level of freedom that can be provided in the case of their usage of the user’s information that is available on the site. The privacy policies of most of the SNS more often than not prove to be unfavourable to the users of the site and they tilt the scales in favour of the sites. The most obvious roadblocks to the enforceability of these contracts are due to factor of “free consent” which is somewhat absent due to these contracts being in the standard form where the terms and the conditions of the contracts are not discussed.
between the parties. A contract can be enforceable only on the condition that both the parties to the contracts have given their free and unvitiated consent to the various terms and the conditions of the contract.⁴¹

The homepage of Facebook consists of the terms, data policy and cookie use, the whole thing spans more than 14,000 words and even for a reader with considerable speed it will take no less than two hours to read the whole thing for themselves. In this page itself the user of Facebook is informed that by clicking on the “sign up” button the user agrees to all the three things that are mentioned above.

Terms mentioned in the homepage further results in the Statement of Rights and Responsibilities. The contract the author is studying was last revised on 30th January, 2015. The Statement of Rights and Responsibilities has a total of 18 sections under it. Section 1 is related to privacy and it is covered under the data policy of Facebook. Section 2 is related to the sharing of the content and the information of the users. The sub-section 1 of Section 2 says-

“For the content that is shared that is covered by intellectual property rights, like photos and videos (IP content), you especially give us the following permission, subject to your privacy settings and application settings: you grant us a non-exclusive, transferable, sub-licensable, royalty free, worldwide license to use any IP content that you post on or in with Facebook (IP License). This IP License ends when you delete your IP content or your account unless your content has been shared with others, and they have not deleted it.”⁴²

By a single click the user hands over many right to Facebook for the usage of the data that has been uploaded by the user in their profile on Facebook. Facebook has the right over all the data especially all the photographs and the videos that are uploaded by the users on their profiles. Facebook gets the right to use the content that has been uploaded on profiles in any manner that it deems fit. The site has the license that goes beyond covering this aspect of service

---

⁴¹ Indian Contract Act, 1872, s 10 (India).
⁴² See n 7.
beyond its current form and usage. Facebook even has the right to transfer its rights or sub-license its rights to another company if it wants to do that. Even the de-activation and the process of deletion of the account does not solve the problem as the site has a license that does goes beyond all of this. The only way in which the content can be released from the license of Facebook is when all the users that were involved in the content have broken all their ties from it.43

The Section 3 of the terms discusses safety related issues and this section lays down everything that the users must refrain from doing to keep Facebook for their usage. These lay down the general guidelines to the users and addresses issues like not indulging in activities like bullying, discrimination and not using Facebook to advertise about unlawful content.44 The Section 4 of the Terms is related to registration and the account security. Like Section 3, this section provides the general guidelines to the users regarding the obligations they must discharge to help Facebook maintain the security of the account. This covers issue like providing correct personal information, keeping the contact information up-to-date, and not sharing the password with anyone. In sub-sections 9 of Section 4 Facebook prevents users from transferring any account, page or application to anyone else without its written permission. This means that Facebook reserves with itself all the rights to any account that is created in it. The Lockean principle that was mentioned earlier has been avoided and the users are not the owners of their own profile.

Section 5 deals with various things that the users should do to protect the rights of others. Here Facebook informs its users in the sub-section 2 that any content can be removed if it violates the statement and policies of Facebook. In this section Facebook informs its users about various IP infringement issues and according to the sub-section 5 repeatedly infringing on the IP of other users may invite stern actions like the disabling the account. In this section

44 See n 7.
Facebook provides users with ways to protect their own as well as others intellectual property.

Section 6 to Section 8 deals with issues like usage in mobile and other devices, payments and the various special provisions that are applicable to the developers of applications and websites (for then the Facebook Platform Policy applies). In the Section 9(1) of the terms Facebook reserves with it the right to use the name, profile picture, content and information of the user when it is in connection to the service enhanced by Facebook. It means that any business can pay Facebook for the usage of this data and the owner of the data cannot raise voice against it.45

Section 10, 11 and 12 deal with the special provisions that are applicable to the advertisers (this is guided by the Self-Serve Ad Interfaces and Advertising guidelines), pages (here the Page Terms of Facebook apply), and software. Section 13 deals with amendments and here it is specified that before any changes are made the users will be notified and given any opportunity to express their views regarding the same. Section 14 deals with all the situations in which Facebook can terminate the account but even when the account is terminated by Facebook the following provisions will still be applicable-2(2), 2(4), 3(5), 9(3) and 14 to 18.

Section 15 deals with disputes. Sections 16 talks about the special provisions that are applicable to users outside the United States. The sub-section 3 specifies certain special terms and conditions that apply only to the users in Germany. The Section 17 and 18 deal with definitions and other aspects of the contract respectively.

In the terms Facebook deals with many issues to protect the consumers but like any business it reserves certain very essential rights with itself regarding the data and the account itself to help it carry forward its business and generate money.

If we discuss the terms of the use and the privacy policy of the SNSs in general then there has been wide consensus among the scholars that these can be stuck

45 See n 7.
down due to various crucial reasons. The foremost being they have been found to be both procedurally as well as substantially unconscionable. This may be due to grounds like standard forms of contract, the undue length of the contract, fine print, undue bargaining position and the confusing language. The same was seen when the contract with Facebook was studied.\textsuperscript{46} The contract can be said to be procedurally unconscionable due to the fact that there is no way that the users of the Facebook can bargain with it for altering the terms and the conditions of the site before the free consent is given by them and the second thing being that the contract strengthens the claim that Facebook has the unilateral right to amend the terms of the policy. The substantive unconscionability can be shown due to the one-sided arbitral clause.\textsuperscript{47} The forum for litigation is the same for all the users. It is unreasonable and it may cause inconvenience to the users who live outside USA. In the case of Facebook the forum selected for litigation is California.\textsuperscript{48}

Unlike UK or the USA, India does not have a very comprehensive policy related to data protection and the aspects of digital privacy in the country. The Indian legislation relating to the same is the Information and Technology Act., 2000. For a long time the provisions of this act were considered inadequate. An amendment was brought to the act in the year 2008 and it has been hailed as a step in the right direction by many writers but the even after the amendment the Act still seems inadequate to the author.

Section 72 of the Information and Technology Act, 2002 deals with breach of confidentiality and privacy-

\begin{quote}
Save as otherwise provided in this Act or any other law for the time being in force, any person who, in pursuance of any of the powers conferred under this Act, rules or regulations made thereunder, has secured access to any electronic record, book, register, correspondence, information,
\end{quote}


\textsuperscript{47} \textit{Circuit City Stores Inc. v Adams}, 279 F 3d 889 (9th Cir 2002); \textit{Ticknor v Choice Hostels Int'l Inc.}, 265 F 3d 931; \textit{Armendariz v Foundation Health Psychare Services Inc.}, 6 P 3d 669(200).

\textsuperscript{48} See n 7.
document or other material without the consent of the person concerned discloses such electronic record, book, register, correspondence, information, document or other material to any person shall be punished with imprisonment for a term which may extend to two years, or with fine which may extend to one lakh rupees, or with both.\footnote{49 Information and Technology Act, 2008, s 72 (India).}

In India the IT Act, 2002 is used to deal with various issues related to the electronic mediums and other related things. Section 72 of the IT Act deals with breach of confidentiality and privacy. If we look at this section the main thing to be noticed is that the access to the “electronic record, book, register, correspondence, information, document or other material”\footnote{ibid.} has been acquired without the consent of the person to whom these material belong. In the contract with Facebook the user gives consent to everything when he creates an account on Facebook. The homepage of Facebook informs the newcomers that by clicking on the “Sign Up” option they will be accepting the Terms. Thus, the consent of the person is obtained as soon as account is created.

This sections invites punishment if the above mentioned material is disclosed without the consent of the said person who is “concerned with” with the material. This section not only covers within its ambit the owner of the material but also any other person who might in any way be concerned with the material. Section 2 of the Terms informs the users that the IP of all their data belongs to Facebook. The acceptance of the contract gives Facebook the right to all the data usage. Thus, as the consent of the user has already been taken it is not the violation of the Section 72 of the IT Act, 2002.

In the Section 9(1) of the Terms, Facebook informs the users that it has every right and it reserves the right to use their name, profile picture, content and information in relation to all the business that are enhanced by Facebook. So Facebook can transfer the information to any other business and the business is not compelled to pay the user and can still display his information. Even here the Section 72 of the IT Act is not applicable as the consent of the user is already taken. Another problem with the Section 72 of the Act is that it insists
that wrongful loss or gain without the consent has be established. This cannot be done because initially the users have given consent. Unless the nature of consent is taken into account there is not much use of the whole provision.

Another important provision of the amendment is Section 43(A) which deals with the provision to compensate someone when there is failure to protect the sensitive information by a body corporate.\textsuperscript{51} There is no upper limit for the compensation but it is important to note that in order to get the compensation the plaintiff has to prove that the body corporate was negligent in the matters related to the maintenance of the security.

\textbf{CONCLUSION}

When Facebook came in the year 2004 it took the world by storm. Not only did it make a 20- something Mark Zuckerberg a billionaire, it also caused a huge drama by the filing of a law suit over the very origin of the idea of the social networking site. But the most important thing to be remembered here is that the way it changed the very idea of connectivity and how we connect with the world around us. In one way it brought the whole world to us with the click of the mouse. Like every invention even Facebook was surrounded by many controversies regarding its negative effects once the initial zeal among the people regarding its usage calmed down and people realized that even Facebook had many side-effects. Other than the usual cry over how it had replaced the face-to-face interactions with parasocial interaction various serious issues like privacy violations were raised.

In this article the author tried to bring forward the problems related to the standard forms of contract. The standard forms of contract to a very large extent the tilt the balance in the favour of the drafter of the contract and the other party has no other choice but to sign the contract and be done with it due to the paucity of time as well as money. But then there are two important issues related to the enforceability of the standard forms of contract - the issue of real consent being given and the issue of unconsonabiltiy.

\textsuperscript{51} Information and Technology Act 2008, s. 43 (India).
When we look at the standard form of contract the issue arises if the users had actually given his “real consent” to the terms and conditions of the said contract or most importantly did the user actually had the choice or the negotiating power to get a clause removed from the contract if he was not pleased with it. The answers to such questions are not very hard to find. In standard form of contract the will of the user is never asked for. In most of the cases it is a “take it” or “leave it” situation. The next issue of unconscionability is related to the first one. Standard forms of contract cannot be considered reasonable because the other party is not given any say on the matter. The test for unconscionability that includes the test for the availability of meaningful choices does no good in the case of standard forms of contract that the social networking sites signs with their users because the user is never given the chance to bargain and the competitors also have the same type of contracts and thus, choice is just an illusion.

While data has been made more accessible to the users the issue of maintaining the security of the data is very crucial. The social networking sites have through various means like SPNs made the data more accessible to the users but such accessibility endangers the security of the data. Data can be made secured either by the use of encryption or limiting the access to data. Encryption is generally not preferred by the networking sites because it meddles with the income they obtain from data mining. A balance has to be maintained between the accessibility and the security of data.

A new variation to the field of standard forms of contract is the interactive form of contract. It is a kind of evolved form of standard contract. In this form of contract the issue of choice has been taken into account and the other party is given choices for certain clauses of the contract. The basic obstacle before it from becoming widely used is the problem of cost.

Facebook was used as an illustrative example: The analysis of the contract that Facebook has with its users raises two basic contentious issues. The first is the issue of Facebook having the IP of all the user data and the second is it using all the user data for products that are enhanced by it. If we look at it is clear violation of the privacy of an individual but as the contract that Facebook has
with its users is a standard form of contract and even here the users do not have much choice and a mere click of the mouse signifies consent and these violations cannot be contested. Under section 72 of the IT Act, 2002 the unauthorized usage of data is punishable only when the consent is not given. Thus, though Facebook uses the user’s data in a variety of ways that the users may not want it be used for but the consent given initially when they “sign up” transfers all their rights to Facebook. Thus, if we look at it Facebook is the owner of the user data.

When looking at such crucial issue we need to see if the consent given was consent given is true sense of the term. In the case of Facebook the consent is vitiated by the fact there is not much choice available to the users and the contract is heavily tilted in favor of Facebook. Thus, this whole issue is not a black and white issue but there are grey areas that must be discussed for laws to develop that take into account the “actual” consent of the parties to the terms of the contract.
IMAGE RIGHTS IN SPORTS CONTRACTS

Nikita Garg

ABSTRACT

Image rights and their relevance in sports contracts is an area that has acquired significance in sports law only in the last few decades. Image rights refer to the rights of individuals to own, control and administer all distinguishable attributes of their image such as their name, appearance or signature. In today’s sports world, where sportspersons are widely recognized and followed by the general public, their images hold immense commercial value. Thus, the right of a player over the use of his image for commercial and promotional purposes plays an important role in contracts entered between sportspersons and the clubs/teams that they play for. In this article, I deal with the contractual mechanism of image rights contracts that is employed to prevent the exploitation of the image of the players. These contracts have been faced with several contractual issues that range from establishing a link between these contracts and the main employment contract of the players to the problem of such contracts amounting to a restraint of trade. In the course of bringing out these issues, ways to resolve these issues such as establishing that the image rights contract cannot override or ignore the provisions of the main employment contract, are also brought out. Problems relating to enforcement of image rights also arise due to the way in which image rights are recognized and protected in a particular jurisdiction. The recognition of image rights as intellectual property in the form of right of publicity in the USA and the right of personality in several European countries or the recognition in India stemming from the right to privacy falling under Article 21 of the Indian Constitution, does not adequately address the wide-ranging problems associated with image rights contracts. Therefore, the article shows that a solution to this lacuna in the existing framework entails enacting legislations that exclusively seek to protect all aspects of an individual’s image by centralizing the ownership of a person’s image and clearly laying down the grounds for infringement of a protected image.

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
INTRODUCTION

The world today, is a place that is absolutely fascinated with professional sports. Sport has become an industry today, accounting for more than 3% of world trade.¹ In this ever-expanding sports world, branding has acquired a very significant role leading to the ‘commodification’ of sport. This commercialization of sport events, teams and sports personalities that has occurred over the past three decades has transformed sports into a marketing industry with its own peculiar characteristics.

Faces of sportspersons can now be spotted everywhere, from billboards to the magazines and newspapers or even on a packet of wafers. These sportspersons are in a position to capture the imagination of the masses and the purses of the advertisers.² Their personality is widely recognized as a valuable asset and therefore generates economic value through celebrity merchandise and endorsements. Different companies and advertisers seek to exploit the ephemeral popularity of these sportspersons, which further paves way for unreasonable exploitation of their commercially valuable reputations.

In this light, this article begins with an attempt to answer the crucial questions of what image rights of sportspersons are and why they need to be brought within the ambit of legal protection. In the course of answering these questions, this article will comprehensively deal with image rights contracts that are used to provide legal protection to sports image rights to ensure that the player gets adequately remunerated for the use and exploitation of his image. The first section will also reflect on the different ways in which image rights have been recognized in different jurisdictions, ranging from the right to publicity in the United States of America to the right to personality in several European countries. A look at these ways provides a deep insight into the genesis and

The evolution of image rights across the globe and the different mechanisms used to protect the same.

The second section delves into the crucial contractual issues that image rights contracts are confronted with in the modern world. These issues include the problem of enforceability of such contracts by the player and the problem of conflicting clauses in the image rights contracts and the main employment contract. A discussion of these problems is followed by an examination of the way in which the courts have resolved these problems by determining the relationship between the main contract and the image rights contract. Further, questions involving vital aspects of contract law such as: Do image rights contracts spanning over a long period of time amount to restraint of trade? Is an image rights company entitled to receive commission over the life of a contract even after rights vested in it have been transferred to a new company? are shed some light upon through an analysis of landmark judgments decided by courts in this regard.

Following a discussion on contractual issues in image rights contracts, the author will bring forth the various remedies that are provided on infringement of sports image rights. These commonly accepted remedies range from compensatory damages to an injunction on illegal exploitative practices. The fact that image rights are still in formation in several jurisdictions around the globe lends an interesting feature to these contracts by enabling the aggrieved party to seek remedy for infringement in provisions of intellectual property law like the trademark law or by bringing an action for the tort of passing off.

The last section of the article is an attempt to examine the protection provided to image rights under the Indian law so as to emphasize on the need to develop a regime that comprehensively protects these rights by plugging the holes in the existing framework. The model adopted by the proposed Guernsey legislation that exclusively provides legal protection of image rights will be also discussed to project some light on the future of image rights contracts. As image rights continue to become an indispensable part of sports contracts, it is essential that the contractual problems they give rise to, are effectively dealt with and the
existence of these rights is adequately balanced with the right to free speech.

**CONCEPT OF IMAGE RIGHTS AND IMAGE RIGHTS CONTRACTS**

*Concept of Image and Image Rights*

A person’s image encompasses all attributes such as their name, appearance or signature that distinguish them in their social and professional relations. As the knowledge of these distinguishing characteristics increases, the image of a person becomes more powerful. Therefore, the concept of ‘image’ not only includes the physical characteristics of a person, but also the knowledge that other people have about that person.³

A conception of image, as highlighted above, clearly indicates that in today’s sports world scenario, a sportsperson’s image is of immense commercial value, as they have become a brand in themselves due to the wide recognition they receive from the general public.⁴ It is this commercial value that several companies seek to exploit by attaching the image to a certain product, to promote and expand their sales. The possibility of widespread exploitation of image of sportsmen makes it imperative to adequately maintain, promote and protect the rights that sportspersons have over their image. These rights, commonly known as ‘image rights’ refer to the rights of individuals to own, control and administer their image.⁵

Image rights of players are brought under the purview of legal protection through image rights contracts. Image rights contracts are essentially entered into to provide payment for the use of the player’s image for promotion, endorsements etc. These image rights contracts emerged in the late 1990s,

---


⁴ Of $50.6 million revenue of David Beckham for 2012, approximately $44 million was generated by (off-field) commercial activity; over 85% of his annual revenues (Forbes, 2013).

against the backdrop of increasing sponsorship amounts that triggered the value of the image rights of the top players. The existence of such contracts has resulted in off-field commercial activity becoming immensely lucrative for accomplished sportspersons like David Beckham and Tiger Woods.

**How do sports image rights contracts work?**

Image rights payments are made through image rights companies, to whom a player assigns his image rights. Assignment of image rights to such specialized companies provides an effective vehicle to prevent any unauthorized commercial use of the player’s image. The club and the image rights company (on behalf of the player) then enter into an image rights contract, which is separate from the main employment contract since the employment contract provides for the payment of a basic salary as employment income. The idea behind entering into two separate contracts is that the player has an exploitable image and personality that has its own value and should be separated from the remuneration for the player’s professional activities and should thus fall outside the scope of his employment income.

Through an image rights contract, the image rights company assigns the use of the player’s image to the club, for commercial and promotional purposes set out in the contract. The club, in return, undertakes the obligation of paying a specific amount to the image rights company. Once the club pays the amount to the image rights company, it is transferred to the player. The image rights payments provided for through such contracts are negotiated between the club

---


and the image rights company to arrive at a fair market rate of the player’s image. The company looks at the club’s commercial revenue and the amount that the player contributes to such revenue through promotions etc. and then negotiates a percentage of that revenue that is due to the player. Therefore, assessment of factors such as past revenue of the club is essential before entering into image rights agreements.

**Image rights in India and other jurisdictions**

Another important facet of image rights relates to the different forms in which these rights have been recognized and protected across different jurisdictions. In India, while certain provisions of the intellectual property laws (such as the trademark law and the copyright law) protect particular aspects of the image of a person such as their name, the overall recognition of image rights is rooted in the right to privacy enshrined in Article 21 of the Constitution that seeks to protect the right of an individual over the use of their name or likeness.

The constitutional approach to image rights protection adopted in India is contrasted with the protection granted to image rights in other jurisdictions where these rights are treated as intellectual property. For instance, in the United States, image rights have taken the form of a *right of publicity*, which is considered to be an intellectual property right that gives the player an exclusive right over his image and the commercial exploitation thereof. Any infringement of this right of publicity constitutes an offence and amounts to a practice of

---


unfair competition.\textsuperscript{14} The judiciary or legislature of twenty-seven states in the USA recognize this right.\textsuperscript{15}

On the other hand, the regulative approach adopted by European countries like Germany, is human rights based, in the form of a \textit{right of personality}.\textsuperscript{16} This grants a person the right to control the entire public portrayal of their personality. In contrast to such recognition of image rights across Continental Europe, there is no particular acknowledgement of image rights as a personality right or publicity right in United Kingdom. However, the existence of image rights and their commercial value has been noted in several judgments by the English Courts including the famous \textit{Sports Case}.\textsuperscript{17}

It is therefore clear that the market of sports image rights is more developed in some countries than in others and each country has its own unique way of describing and protecting such rights. However, despite the differences in the way image rights are recognized, the common development that is seen across all jurisdictions is that athletes have now begun to vigorously defend their right to be paid for the use of their image.

Having dealt with the conception of image rights of sportspersons and the mechanism of image rights contracts to protect these, this article will discuss the various contractual issues that sports image rights give rise to and the resolution of the same in the next section.

\begin{flushright}


\textsuperscript{17} \textit{Sports Club Plc v Inspector of Taxes} [2000] STC (SCD) 44.
\end{flushright}
Contractual Issues Involved in Sports Image Rights Contracts

The development of provisions relating to image rights in sports contracts, led to the advent of various suits being brought before the courts in the United States and in other European countries that highlighted and dealt with several issues that arose out of such contracts. These contractual issues range from the problem of establishing a relationship between the image rights contract and the main employment contract to the problem of such contracts amounting to a restraint of trade in some specific instances. This section seeks to provide a clear perspective of such issues through an examination of the way in which various courts and arbitral tribunals have dealt with them.

Problem of establishing an inter-relationship between the image rights contract and the main employment contract

Establishment of a relationship between the main employment contract and the image rights contract entered into by the player and the club is crucial for two purposes: firstly, it helps to determine the jurisdiction in case the two contracts provide for overlapping constructions; secondly, it helps to resolve the problem of enforceability of the contract by the player.

Determination of Jurisdiction

The problem of determining jurisdiction due to overlapping clauses in the two contracts arose with respect to basketball leagues in the United States. Since a player’s remuneration is provided through a matrix of several contracts, including the main employment contract as well as the image rights contract, there exists a possibility for the dispute resolution clause of both the contracts to refer to different forum in case a dispute arises. In the cases that arose in the United States, the main contract’s arbitration clause generally provided for the Basketball Arbitration Tribunal’s (BAT) jurisdiction over any dispute arising in connection with the main contract, while the image rights contract included its own dispute resolution clause.
that did not refer to the BAT.\textsuperscript{18} Given such provisions, the issue was whether a player could approach the BAT under the arbitration clause of the main contract for bringing a claim for outstanding payment or whether the provisions of the image rights contract would have an overriding effect on the main contract.

To resolve this issue, the BAT evolved a two-fold test that draws upon the common intention of the parties and examines the wording of the arbitration clause in the main contract.\textsuperscript{19} Firstly, the common intention of both the parties to guarantee the payment of the player’s salary, despite modifications with respect to mode and timing of payments in subsequent contracts is looked into. If the existence of common intent to pay the full amount can be established, any further agreement regarding the mode of such payment is construed to be a mere supplementary provision.\textsuperscript{20} The second criterion, seeks to examine the wording of the arbitration clause, to establish whether it encompasses disputes relating to non-payment of the player’s salary or a part thereof. On the fulfillment of such criteria, the jurisdiction provided in the main contract becomes valid.\textsuperscript{21} Therefore, the courts have rejected the argument based on the principle of \textit{lex posterior derogare legi priori} (subsequent law imparts the abolition of a previous one), that would otherwise validate the overriding effect of the provisions of image rights contract over that of the main employment contract.\textsuperscript{22}

\textbf{Enforcement of the image rights contract by the player}

The second issue that a clear inter-relationship between the image rights contract and the main employment contract resolves, is the enforcement of the image rights contract. Since the image rights contract is entered into by the image rights company and the club, the player becomes a third

\begin{itemize}
\item \textsuperscript{19} ibid.
\item \textsuperscript{20} Dalibor Bagaric v Fortitudo Pallacanestro Sr, FAT 0105/10; See Richard Hendrix v Club Baloncesto Granada, FAT 0115/10 (n 10) 16.
\item \textsuperscript{21} Diathespoulou, ‘Image Rights in Professional Basketball’ (n 18).
\item \textsuperscript{22} Diathespoulou, ‘Image Rights in Professional Basketball’ (n 18).
\end{itemize}
party and is unable to enforce it. This is because, such a contract does not stipulate any rights and obligations for the player and acts as a mere license agreement between the image rights company and the club.\(^{23}\) However, from a contractual perspective, the fact that the main employment contract sufficiently provides for the player to claim the entire amount owed to him cannot be ignored. In other words, the fact that the payments for the image rights is being made through a third party does not allow the club to deny the player of his right to full remuneration.\(^{24}\)

It is therefore clear that a relationship between the image rights contract and the main employment contract, in a way that establishes that the image rights contract can neither override nor ignore the provisions of the main employment contract, aids in resolution of critical contractual issues in sports contracts.

**Problem of image rights contracts and restraint of trade.**

The question of image rights contracts amounting to restraint of trade under certain circumstances was first discussed in the famous *Wayne Rooney case*.\(^{25}\) Rooney, at the age of 17, had entered into a contract with Proactive Sports Management Ltd., to represent him in his commercial affairs for a period of eight years. When Proactive brought a suit against Rooney seeking unpaid commission from him, it was contended that such a contract between the parties was unenforceable on grounds of unreasonable restraint of trade.\(^{26}\)

Against this setting, the Court of Appeal held that a person’s ancillary activity that involves exploitation of their image rights is equally capable of being subjected to the doctrine of restraint of trade as any other major activity. The Court’s decision was based on an examination of several factors such as the unusual length and duration of operation of the image rights agreement, the absence of legal advice to the player at the time of entering the contract, high cost of termination of contract, which clearly indicated an inequity in the bargaining

---

23 Richard Hendrix *v* Club Baloncesto Granada, FAT 0115/10 (n 10) 16.
power between the parties. This inequity was reflective of the oppressive nature of the contract and also clearly revealed the wish of the company to restrict Mr. Rooney from contracting elsewhere.  

Therefore, in light of such jurisprudence with regard to image rights contracts causing a restraint of trade, it is evident that where the circumstances surrounding the execution of the contract between the player and the image rights company and the terms thereof, imply a desire to exploit the player’s image rights unreasonably and oppressively, it amounts to a restraint of trade.

**Problem of claims for post-termination commission by initial image rights company in cases where player transfers his image rights to another company.**

It may often be the case that a player wishes to transfer his image rights from one image rights company to another. In such cases of transfer, a peculiar situation arises wherein the initial image rights company seeks commission after the termination of the contract with the player, for the services provided in pursuance with the object of the initial contract. The Court, in the *Rooney case*, had also discussed this problem of post-termination commission.  

The Court noted that the right of the initial company to post-termination commission is contingent upon the service provided by the company. In other words, the provision of post-termination commission for endorsement contracts negotiated with the third parties by the initial image rights company is necessary to protect the legitimate interests of such a company. The position of law in this regard can therefore be laid out in lucid terms, i.e. a company has the right to receive commission, after the termination of the contract, only on the services that it has provided to the player in pursuance of the objective of that contract.

---


29 ibid.
As discussed in this section, the contractual issues relating to image rights that arise in sports contracts bring to light, the emphasis that should be given to a careful drafting of these contracts so as to reduce ambiguity and minimize the scope for any loopholes that may give way to exploitation of the player’s image rights.

**Remedies for Infringement of Image Rights Contracts and Possible Defences**

The remedies provided for infringement of image rights contracts vary across countries due to the different forms in which the right is recognized across different jurisdictions. Furthermore, in most countries, provisions of intellectual property law, copyright law or trademark law are often used and applied to provide remedy for infringement of image rights.

**Remedies under the English law**

Under the English law, a person whose image rights have been infringed can seek several legal remedies, ranging from damages to the grant of an injunction. In situations where trademarks are involved, Section 14-16 of the UK Trademarks Act provide for civil remedies such as damages, an account of profits and the grant of interim and final injunctions.

For the purpose of assessing damages, the concept of ‘license fee’ is applied to arrive at the amount that the player would have received, had the offending party carried out the exploitation of his image rights with his consent. An interesting trend to be noted in the awarding of damages is that the amount of damages awarded in countries across Europe tends to be lower than the damages awarded in other Common Law jurisdictions and the United States. And as far as the equitable remedy of providing injunctions is concerned, the courts usually make the grant of such a remedy, only when it is felt that damages may not provide adequate remedy. In certain circumstances, specific injunctions

such as *quia timet*, which prevent an anticipated breach of a legal right, can also be sought, as provided for under the law in Spain.\(^\text{32}\)

Furthermore, in case of copyright infringements, the UK Copyright Designs and Patents Act, 1988 gives the aggrieved party the right to seize and detain material that infringes upon his rights. Section 107(1) of the same act makes provisions for criminal consequences in cases where the infringer is *aware*, or has reason to believe that his activities may be resulting in an infringement. However, it is essential to note that most aggrieved parties generally resort to sending ‘cease and desist letters’ to the infringer before they initiate legal proceedings.\(^\text{33}\)

**Remedies under the American Law**

Per the law in the United States, plaintiffs (including professional athletes), who are successful in bringing a right of publicity action, are entitled to monetary damages as well as injunctive relief.\(^\text{34}\) Injunctive relief has been accepted as the standard remedy for infringement of the right of publicity of an individual and the Courts have also acknowledged that the failure to provide such a remedy often leaves the aggrieved party inadequately compensated.\(^\text{35}\) A major advantage associated with the grant of injunctive relief is that it can be usefully tailored in cases where the defendant is granted some rights to exploit a person’s image, but exceeds the terms of the agreement.\(^\text{36}\)

With regard to damages as a remedy, three types of damages can be awarded to a professional athlete who is successful in bringing a right of publicity case.

\(^{32}\) In Spain, Article 9.2 of the Basic Law (Ley Organica) provides for adoption of all measures to achieve the following: to stop illegal interference by third parties, to restore the owner’s full enjoyment of their image rights, and to prevent any further interferences.


\(^{36}\) Stapleton, ‘The Professional Athlete’s Right of Publicity’ (n 34) 54.
These measures of damages include ‘fair market value of identity’, ‘damage to professional standing’ and ‘unjust enrichment and infringer’s profits’. The first potential measure of damage is the market value of the plaintiff’s image in the commercial setting in which the defendant has exploited it. The Courts have ascertained this market value by examining the fee charged by similarly situated sportspersons for the use of their image.\footnote{A case decided by the Virginia Supreme Court, \textit{Town & Country Properties, Inc. v Riggins} involved this method of computing damages.} The second measure, which examines the damage to the professional standing and publicity value of the athlete, is used in cases where the use of the athlete’s image exceeds the fair market value of the image. Such damages are awarded in instances where the athlete’s image is used to endorse shoddy products or products that fall outside the scope of his developed image, thereby creating an adverse impact on the future income and publicity value of his image. Lastly, in certain cases, profits made by the infringer from the unlawful use of the player’s image are a standard form of damages awarded.\footnote{Stapleton, ‘The Professional Athlete’s Right of Publicity’ (n 34) 56.}

\textbf{Defenses to an infringement of image rights claim}

Generally, there are two main accepted defenses that can be availed by a person against whom a suit for infringement of image rights is brought. The first defense is the consent given by the player himself and the second is the right of the other party to free speech and expression.

\textbf{Consent of the Player}

The defense of consent is centered on the question of the player giving consent to the other party to take the particular actions in question. In this regard, the courts have taken the stance that the player can recover damages for infringement of his image rights only when he has not expressly consented to the use of his image for the purpose in question or where the advertising or exploitation exceeds the scope of the consent
granted by the player.\textsuperscript{39} In \textit{Sharman v C. Schmidt \& Sons, Inc.},\textsuperscript{40} where the bowler had given the defendant the unrestricted right to use his image for commercial purposes but had later brought a suit against him for the use of his image in an advertisement promoting beer, the Court recognized the initial consent given by the bowler, as a valid defense and rejected the player’s argument of the picture’s form exceeding his consent.\textsuperscript{41} Therefore, in the present scenario, an effective use of this defense can prevent the clubs from being targeted unreasonably for the lawful use of the image of the player.

\textit{Free Speech and Expression}

The second and a more complex defense to a claim for infringement is the right of the other party to free speech and expression, a logical extension of which provides for the freedom of press. A distinction between what is ‘newsworthy’ and what is ‘unauthorized commercial use’ therefore plays a pivotal role.\textsuperscript{42} In this regard, legal scholars explain that a communicative use gives predominance to free speech over the right of a person to his identity and a ‘commercial’ use entails conveying of ideas that have a commercial overtone to them and therefore infringe upon the player’s image rights.\textsuperscript{43} While this distinction seems to be sound and clearly established in theory, in practice however, the boundaries of communicative and commercial use of image often overlap and the disputes arising from the same are therefore subjected to the interpretation of the courts.

\textbf{LOOKING AHEAD - FUTURE OF SPORTS IMAGE RIGHTS AND THEIR RELEVANCE IN THE INDIAN CONTEXT}

The protection provided to the image rights of individuals, including sportspersons, has witnessed a dramatic increase over the years. In most

\begin{itemize}
\item \textsuperscript{39} Stapleton, ‘The Professional Athlete’s Right of Publicity’ (n 34) 42.
\item \textsuperscript{40} \textit{Sharman v C. Schmidt \& Sons Inc} 216 F. Supp. 401 (E.D. Pa. 1963).
\item \textsuperscript{41} Stapleton, ‘The Professional Athlete’s Right of Publicity’ (n 34).
\item \textsuperscript{42} Stapleton, ‘The Professional Athlete’s Right of Publicity’ (n 34).
\end{itemize}
In countries, this protection has either been provided through case law or through limited inclusion in intellectual property laws. In India, however, the development of image rights is in its nascent stage, which is clearly reflected in insufficient case laws and absence of any codified law governing image and publicity rights.

**Legal Scenario of Image Rights in India**

The limited jurisprudence concerning image rights that has developed in India has stemmed from the right to privacy, which is premised on the concept of human dignity enshrined in Articles 19 and 21 of the Indian Constitution. The first judicial recognition of publicity rights in India came from the Supreme Court in *RR RajaGopal v State of Tamil Nadu*, where the Court stressed on the significance of the right to privacy, which is implicit in the right to life and personal liberty granted under Article 21 of the Constitution. The Court further went on to note that the first aspect of violation of this right is the use of a person’s name or likeness without their consent, for advertising or other purposes. The applicability of this right was held to be reserved for real persons by the Delhi High Court in *ICC Development (International) Ltd. v Arvee Enterprises*, where the Court observed that the persona of an individual couldn’t be monopolized and the right of publicity vested in an individual entitles only that individual to profit from the use of his personality.

The constitutional approach to publicity rights adopted by the Indian courts is opposed to the approach prevalent in other jurisdictions whereby publicity rights are treated as intellectual property. Interestingly, in some cases, known personalities in India have enforced their image rights by basing their claims

on a framework of intellectual property laws, such as the trademark and the copyright law. In the recent unreported case of *Sourav Ganguly v Tata Tea Ltd.*, the tea company had used Sourav Ganguly’s popular image to promote the sale of its tea packet in the Indian market. The Court then ruled in favour of Sourav by accepting the contention that his fame and popularity formed part of his intellectual property.

**Protection as trademarks and copyrights and problems with such protection**

Since the Trademark Act, 1999 allows registration of names, nicknames and images, the Indian courts have attached trademark significance to the name of a celebrity and have restrained the misappropriation of such names as domain names by third parties. Furthermore, provisions of Section 14 of the Trademarks Act can be used to protect a well-known personality against the unauthorized use of their personal name as the property right in one’s name is granted to the celebrity. The Copyright law also grants an individual the right to protect a specific image in the form of a painting, photograph or other derivative works. Moreover, in the absence of a statutory provision, individuals can seek the protection of their names by bringing in an action for the tort of passing off. However, the success of such an action is contingent upon the fulfillment of the three

---


49 Kumar, ‘When your Face is Your Fortune’ (n 44) 107.

50 § 2(m) of Trade Marks Act, 1999 that provides the definition of a ‘mark’ includes names.

51 In *DM Entertainment v Jhaveri, Daler Mehndi*, a famous Indian singer, brought an action against a party that had registered the domain name ‘dalermehndi.net’. The Delhi High Court, recognized that an entertainer’s name may have trademark significance and therefore prohibited the defendant from using the mark and domain name.

52 § 14 of the Trade Marks Act, 1999 prohibits the registration of a mark that falsely suggests a connection with a living person or a person whose death took place within 20 years of the application date for registration of the trademark; *See* Tabrex Rehmad & Satya Ranjan Swain, ‘Celebrity Rights: Protection under IP Laws’ (2011) 16 Journal of Intellectual Property Rights 7, 14 <http://nopr.niscair.res.in/bitstream/123456789/11021/1/JIPR%2016(1)%207-16.pdf> accessed, 4 May 2015.

53 George, ‘Celebrity-focused Culture Highlights Need for Statutory Right to Publicity’ (n 48).
essential elements of the tort of passing off: reputation of the individual, some form of misrepresentation and irreparable damage resulting from the misrepresentation.  

While image rights can be brought within the ambit of provisions of intellectual property (IP) laws, it is essential to note that such statutory protection under the IP law regime also suffers from inherent difficulties. For instance, in the case of trademarks, the law provides for the protection of the registered image only and not the general image of an individual. Similarly, the copyright law can only be used to protect a photograph or painting of an individual as a piece of art, but this protection cannot be extended to the individual as such. Thus, it is evident that there exists a grave lacuna, as intellectual property and tort laws such as passing off, do not squarely subsume and provide for publicity rights.

**The way forward: Exclusive image rights legislation proposed in Guernsey**

The lacuna in the existing legal framework that protects image rights has been addressed by a legislation proposed in Guernsey in 2012 that exclusively seeks to deal with the protection of all aspects of an individual’s image rights. The personality of the individual forms the basis of the protection granted under the said law. The scope of the image under the proposed law is wide ranging and therefore includes names, signatures, characteristics, likenesses, gestures, photographs and illustrations.

This legislation allows people to centralize the ownership of their image, registerable in Guernsey as a registered personality. This registered personality

---

54 Kumar, ‘When your Face is Your Fortune’ (n 44).
55 George, ‘Celebrity-focused Culture Highlights Need for Statutory Right to Publicity’ (n 48).
is a legal right, akin to a trademark, that is vested in the registered proprietor and is capable of being licensed and assigned like a trademark. The law also grants the proprietor of the registered personality exclusive rights over all images registered against or associated with the registered personality, thereby making it possible to protect an image without registering it. The legislation comprehensively deals with the kind of images that would be construed to be infringing upon a protected image, such as those which can easily be confused with the protected image and those which have a detrimental effect on the repute of the registered personality. The legislation also elucidates upon the kind of uses that would not amount to an infringement of the registered personality’s image rights such as fair dealing for purposes of news reporting or satire.

Therefore, assignment of property rights can effectively plug the lacunae in the existing laws used to address the issue of image rights. However, in dealing with image rights, it is important to work out the dynamics of public vis-à-vis private interest. Since prominent sportspersons are an integral part of the public domain and acquire their eminence in society due to the interest that their activities evoke, conferring special rights on them that place them on a higher pedestal is a dangerous proposition. This is because, image rights can often be used to prohibit expression that can change the public perception about the player and lead to a re-interpretation of his/her image. The law therefore enables the individual to control public opinion and thereby causes hindrance to creativity by curbing free speech and expression.

These concerns should be adequately addressed before enabling any statutory framework for the protection of these rights. The protection granted to individuals should not impede upon the freedom of speech and expression and

58 ibid.
60 For instance, the Elvis Presley Estate (EPE) prohibited artists from using Elvis in their paintings as they argued that the art did not meet the “quality standards” set up by the EPE. Similarly, John Wayne’s estate had also proceeded against greeting cards that pictured him wearing red lipstick contending that it would flaw his “macho heterosexual image”. See <http://www2.warwick.ac.uk/fac/soc/law/elj/eslj/issues/volume12/rupp/> accessed, 10 April 2015.
freedom of the press enshrined in the Constitution. Most of the countries like the USA, give unparalleled importance to free speech despite the existence of publicity rights. It is essential that all future legislations and interpretations by the Courts strike balance between the principles of free speech and a person's right to his image.

**CONCLUSION**

The significance and impact of the commercial aspect of a sportsperson’s image has gained wide recognition over the last few decades. Consequently, image rights contracts are increasingly being used to provide legal protection to sports image rights. These contracts allow the player to transfer his image rights to an image rights company, which then enters into contracts for commercial purposes with the clubs etc., to ensure that the player receives adequate remuneration for the use of his image.

In this article, through an account of the contractual issues that arise with respect to image rights in sports contracts, I have tried to bring out the paramount role that detail plays in the drafting of such contracts. The scope of the rights to be granted should be clearly defined and agreed to by the parties so as to prevent any ambiguity in the terms of the contract and reduce scope for interpretation of the same. Further, a discussion of the different ways in which recognition and protection has been extended to image rights in different jurisdictions, brings forth the lacuna that exists in the legal framework that seeks to protect these rights. This is because, in most countries, these rights are protected either through the provisions of intellectual property laws such as trademark law, or through legal precedents. The existence of such a lacuna necessitates the exclusive recognition of image rights in statutes, modeled on the proposed legislation in Guernsey so that the commercial aspects of these rights like transferability and licensing can be adequately addressed.

Lastly, as discussed through the course of this article, protection of sports image rights must always strike a balance between general public interest, i.e., the ideals of free speech and freedom of press and the private interest of the
celebrity. The importance of this balance cannot be undermined and therefore, any statutory provision to protect sportspersons or their rights should strive to attain this balance. The future of sports image rights contracts lies in working out these balances and the assignment of property rights to all aspects of an individual’s image by way of exclusive legislations to plug the lacunae in the existing framework.
Escrow Agreements

Kshitij Sharma

Abstract

Escrow Agreements have gained popularity as a new mode of risk reduction in commercial transactions. Escrows are cheap and effective instruments for making the business transactions more secure. The article talks about the uses of escrow agreements in detail. Further, the article also talks about the drafting of escrow agreements, the essential clauses which needs to be included to avoid ambiguity. The article then looks into the duties and responsibilities attached to the escrow agent. The escrow agent has the fiduciary duty of loyalty, full disclosure and care towards the principal. There are no specific laws in India to regulate the behaviour of escrow agents. The courts have tried to apply agency principles or trusteeship rules to the escrow agent. However, these principles cannot be consistently applied to escrow agent. Finally, I suggest that there is a need to treat escrow agent as sui generis, attach particular meaning to it and clearly define its duties and responsibilities. This would be able to cure the hardship that results when the escrow agent become bankrupt.

Introduction

In simple terms, an escrow can be defined as “a deed, a bond, money, or a piece of property held in trust by a third party to be turned over to the grantee only upon fulfilment of a condition”. It is an instrument which creates contractual relationship between the parties. Escrow agreements are tripartite agreements. The three parties which are involved in an escrow agreement are, namely, grantor, grantee and escrow agent.

Escrow agreements are gaining popularity in India as a new mode of risk reduction. Escrows help in safeguarding the interests of the contractual parties. However, escrow agreements have not attracted much attention of the legal scholars in India till now. This area of study has remained a monopoly of western scholars. Now, there is a need to study the escrow agreements after looking at

* Student, B.A. LL.B. (Hons.) course, National Law School of India University, Bengaluru.
the increase in their use in India. Therefore, the author has done this study with the objective of providing valuable insights to the study of escrow agreements.

The first part deals with the definition of Escrow agreement as provided in the California Financial Code along with the definition of the parties involved in it. Further, it deals with the uses of Escrow agreements in business contracts entered into in today's volatile business environment to make the contracts more secure.

The author has further reflected on the use of Escrow agreements in the Indian context and made an attempt analyse the position of Indian contracts in this regard. The third part deals with the legal implications of an escrow agreement and discusses the relevant clauses in detail that constitute them.

In the last part, the author has looked into the duties and responsibilities of an escrow holder. The author has tried to analyse the duties attached to the escrow agent with the help of judicial decisions. The article then suggests that specific meaning should be attached to escrow agent and his duties should be clearly defined in Indian law.

**Definition of Escrow Agreements**

The term 'escrow' has its origin from the Anglo-French word 'escrowe', which originated from the Old French word 'escroe', meaning scroll or parchment. According to the traditional legal definition, an escrow can be defined as a legal device which by virtue of its terms and conditions, entrusts a third party with an asset, which he has to hold until the conditions specified in the contract are met, and then has to deliver the asset to the party specified in the contract. This kind of legal mechanism is set into place by a contract which is called escrow agreement. Escrow, has the same base meaning in the modern times, as it had in the 15th -16th century in France. A more comprehensive definition of an

---

2 W.A.Ingraham, 'Escrow Agreements' (1953) 8 Miami Law Quaterly, 75.
escrow has been given in the Sec. 17003 of the Financial Code of California. An escrow has been defined in it as,

“any transaction in which one person, for the purpose of effecting the sale, transfer, encumbering, or leasing of real or personal property to another person, delivers any written instrument, money, evidence of title to real or personal property, or other thing of value to a third person to be held by that third person until the happening of a specified event or the performance of a prescribed condition, when it is then to be delivered by that third person to a grantee, grantor, promisee, promisor, obligee, obligor, bailee, bailor, or any agent or employee of any of the latter.”

Escrow agreements are tripartite agreements. The three parties involved in an escrow agreement are:

1. Depositor – Depositor is the one who deposits some asset with the escrow agent. He is also known as Grantor.

2. Escrow Agent - Escrow Agent is the depository who holds the asset deposited by the grantor, and then delivers it to the grantee after the conditions of the agreement are fulfilled.

3. Beneficiary - Beneficiary is the party who receives the asset from the escrow agent, once he fulfils the conditions mentioned in the contract.

A common example involves the down payment in the purchase and sale of a property. The down payment amount is been given by the buyer to the property dealer, or some other third party and contractual obligations requires that the buyer’s down payment has to be paid to the seller, only after the title has been transferred to the buyer. In this escrow, the buyer is the depositor, and the

---


4 California Financial Code, §17003.

seller is the beneficiary. The property dealer is the escrow agent here.\textsuperscript{6}

**USES OF ESCROW AGREEMENT**

Escrow plays an important role in the modern business contracts, but it has attracted comparatively little litigation.\textsuperscript{7} The concept of escrow agreements was developed in the United States of America.\textsuperscript{8} The primary aim of these agreements was to make real-estate transactions more secure and to ensure the safety of interested parties’ interests. Now, these agreements are also used for safeguarding the interest of parties in other business transactions.\textsuperscript{9} There are many advantages of using an escrow agreement. The most basic advantage which comes along with an escrow agreement is security provided by it to all the parties. Escrow agreements have proved to be a new mode of risk reduction in business transactions. Escrow agreements safeguard the rights of the parties to a contract and facilitate smooth business transactions. The vendor is provided protection against the bad cheques, insolvency, fraud, etc. The interests of the purchaser of the property are secured by ensuring that his money will be safely returned if the seller fails to fulfil his contractual obligations like transfer of ownership.\textsuperscript{10}

Nowadays, attaining security of payment under business contracts has become more of a challenge. There are traditional ways of securing payment like bonds, but they can now be exorbitantly expensive to obtain. Escrow accounts are gaining popularity as modern instruments to ensure security of payment and save the day in cases of insolvency.\textsuperscript{11} Escrow agreements are generally used for

\begin{thebibliography}{9}
\bibitem{7} Ingraham (n 2) 76.
\bibitem{8} Prakash (n 3) 153.
\bibitem{9} Ingraham (n 2) 76.
\bibitem{10} Prakash (n 3) 156.
\end{thebibliography}
securing Business to Business (B2B) transactions. Therefore escrow agreements are usually B2B contracts and not B2C.

Escrow agreements have gained popularity in India after the privatization of power sector, in 1991. The advent of Information Technology industry has also led to the increased use of the escrow agreements. Escrow agreements are used in the software agreements. Source Code Escrows are gaining popularity these days. These are used by most of the business houses which rely on some third party’s software for their functioning.

Source Code escrows require the owner of the software to deposit the source code of the software with a neutral escrow agent. This type of escrow agreement represents a harmonising of risks between the software developers and the purchasers of the software. Software purchasers get protected from the risk of insolvency, bankruptcy, or failure of software developers. Whereas, the source code escrows protect the software product developers from the risk of infringement by the customers or contractors.\(^\text{12}\)

Escrow agreements are used for many other business transactions in United States of America. Some of the examples are escrow accounts for advance fees paid to automobile and property brokers; down payment amount paid to builders, constructing houses; rent security deposits; deposits for homeowners associations; advance membership fees paid to health and sports clubs; deposits and entrance fees paid on life-care community contracts; and real property tax escrow accounts needed by mortgage lenders.\(^\text{13}\)

Another advantage of using escrow agreement is its effectiveness in pre-emptively settling disputes between the parties of a sale agreement.\(^\text{14}\) An escrow agreement provides equal bargaining power to the parties of the contract and

13 Miller (n 6) 72.
therefore secures their positions.\textsuperscript{15} The conditions on which the asset has to be delivered to the beneficiary are clearly provided in the agreement which makes the business transactions smooth. There are less chances of breach of the contractual obligation if there is an escrow agreement between the parties. Therefore, from the above mentioned reasons and explanations, it can be clearly said that escrow agreements are providing a new way of risk reduction in the business transactions.

**LEGALITY OF ESCROW AGREEMENTS**

Escrow is an instrument involving contractual arrangement among the parties. Escrow agreements are tripartite agreements.\textsuperscript{16} In United States of America, there are specific laws available for governing and regulating escrow agreements.\textsuperscript{17} European Union, in November 2009, also has issued Payment Services Directive (PSD) through which they have allowed the introduction of low cost government regulated internet escrows. The EU laws allow these web-based escrow services the ability to secure commercial transactions. Article 15 of European Union Commission regulation 874/2004 also deals with the laws relating to escrow agreements.\textsuperscript{18} However, in India, there are no such specific laws for governing escrow agreements. Escrow agreements in India are still at a very nascent stage and have not gained much popularity.\textsuperscript{19} These agreements are usually self-regulated and governed by the contractual terms. However, some special kinds of escrows in India are regulated by the provisions of Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997. Reserve Bank of India has also interfered in the functioning

\textsuperscript{15} Prakash (n 3) 156.
\textsuperscript{17} R. Davis, ‘Escrow accounts: trust or charge?’ <http://login.westlawindia.com/maf/wlin/app/document?&suppsrguid=i0ad69f8e0000014d3a8f124a80a8ae637&docguid=IDFF7EAD0843411E49BAAB31FDDA3C840&hitguid=IDFF811E0843411E49BAAB31FDDA3C840&rank=7&spos=7&epos=7&crumb-action=append&context=5&resolvein=true> accessed on 10 May 2015.
\textsuperscript{19} Prakash (n 3) 154.
of the securities escrows. They have permitted the Authorised Dealer-I category (AD-I) banks to open and maintain escrow accounts on behalf of residents and/or non-residents in Indian rupees in India, towards payment of share purchase consideration without the prior approval of the Reserve Bank of India. However, these escrow accounts have to be non-interest bearing accounts. They have also decided to permit AD category-I banks to provide escrow facilities for keeping securities to simplify and secure FDI transactions. These changes were made by the Reserve Bank of India vide its Circular RBI/2010-11/ 498 A. P. (DIR Series) Circular No. 58 dated May 02, 2011. However, they have also imposed certain terms and conditions on the non-residents for holding and maintaining escrow accounts in India.

The term ‘escrow’ need not be used in an agreement to make it an escrow agreement. The courts will look into elements of the contract to decide on the question whether it is an escrow agreement or not. An escrow agreement need not compulsorily be in writing, it can also be an oral agreement. The most distinguishing element of an escrow agreement is the irrevocable deposit payable on the fulfilment of a certain condition.

The first element required for an escrow is the condition. It is the distinguishing feature between a normal instrument and an escrow. There has to be expressed conditions imposed on both grantor and grantee, fulfilment of which will lead to the delivery of the asset to the beneficiary.

Another element which is required to convert a normal agreement into a valid escrow is that delivery of the asset to the depository should be absolute and irrevocable. The delivery of the asset to the escrow agent should be as complete as delivery to the seller. The asset should lie outside the control of the buyer or the grantor after depositing it. If the delivery of the deed is subject to grantor’s

---

21 Prakash (n 3) 154.
22 Home-State Royalty Corp. v McClish (1940) 103 P 2d 72.
23 Ingraham (n 2) 76.
24 Conner v Helvik (1937) 73 P 2d 541.
25 Ingraham (n 2) 76.
orders, then it will not be a valid escrow.26 The security of the delivery of payment is the main aim of the escrow agreement. If the delivery can be revoked by the buyer, then the sole purpose of the escrow will be defeated. The escrow can be legally revoked only if the condition of the agreement is breached.27 Another ground for revocation of an escrow could be the unreasonable time taken by a party.28 Although, time is not the essence of an escrow agreement, unless an intention to the contrary has been shown by the parties.

The author has looked into some of escrow agreements and tried to compile a list of the clauses which are essential part of an escrow agreement. Following are the important clauses:

1. Escrow Agent - The identity of the person who is appointed as escrow agent should be specified in the contract. It is advisable to appoint a neutral, unbiased person as the agent.29 Nowadays, banks are gaining popularity in the field of escrow services. They provide escrow account services for various kinds of transactions including real estate transfers, loan repayments and equity deals. Banks provide escrow services for both cash and demat transactions. Escrows kept with banks are more secure than those kept with private individuals as the risk of bankruptcy of the agent is lower in banks. Banks also provide support in drafting and vetting of the escrow agreements.

2. Asset - The asset which is delivered to the escrow agent should also be described in the agreement. If the asset delivered to the escrow agent is money, then it has to be deposited in a bank account which is separate from the escrow agent’s personal bank account.30

3. Condition - The condition which is required to be fulfilled for the delivery of the asset to beneficiary should be clearly stated in a valid

---

26 Loubat v J-ipp & Young (1860) 9 Fla 60.
27 Bingham v Taylor (1926) 12 F 2d 15.
28 ibid.
29 Siddhivinayak Realities Pvt. Ltd. v Tulip Hospitality Services Ltd [2007] 4 MLJ 772 (Supreme Court of India).
escrow. This clause has been clearly explained by the author in the previous parts of this article.

4. Indemnity Clause - An indemnity clause indemnifies the escrow agent. The main purpose of this clause is to limit the liability of the escrow holder for the actions under the escrow agreement. Normally, the buyer and seller jointly agree to indemnify the escrow holder for any loss arising out of the dispute in the escrow agreement.

5. Confidentiality clause - Normally, the escrow agreements do not have such clause. However, this is a very important part of source code escrows. This puts an obligation on the escrow agent to keep the source code confidential. There is a huge value attached to the source code, therefore its confidentiality is essential.31

6. Dispute resolution - The method, in which a dispute arising out of the agreement should be settled, should be clearly specified in the contract. If the dispute has to be settled through arbitration then the place of arbitration has to be specified.32 Nowadays, the parties normally appoint the escrow agent as the arbitrator to settle the dispute. Later, the parties cannot contend that the joint escrow agent is biased if the parties by themselves have appointed that agent.33

These were the important clauses which should be present in an escrow agreement. Now, there is a need to answer another important question i.e. what are the duties and responsibilities of an escrow agent? It is very essential to answer this question to understand escrow agreement in its entirety. The author has tried to answer this question in the next part of this article.

**DUTIES AND RESPONSIBILITIES OF ESCROW AGENT**

There are numerous illustrations in the law where courts or legislatures have given precise definition to a certain legal status.34 Such words as “trustee,”

31 Mezrich (n 12) 118.
32 Narayanan (n 14).
33 Siddhivinayak (n 29).
“guarantor,”35 and “pawnor”36 have come to have fixed meanings and definite legal incidents attached to them. However, the term “escrow holder” or “escrowee” has not been defined anywhere in any Indian legislation. Neither the courts have attached any specific meaning to this term. There are no specific provisions mentioned under Indian law regarding the duties and responsibilities of an “Escrowee”.37

Till now, no court has felt the need to regard escrow agent as *sui generis*. Courts persist in finding the legal incidents of the escrow holder’s status in terms of other concepts which have already been delineated. The judicial bodies have tried to facilitate escrow holder in some or the other pigeon hole. This process ultimately leads to a thing which is called a “jurisprudence of conceptions,” a phenomenon which has been assailed as unsound. There are many labels attached to escrow holder, but the most common among them are of agent and trustee.38

Now, there is a need to look into the duties and obligations imposed on the escrow agent after getting attached to these labels.39 The consequences of the same are also required to be looked into. This is a jurisprudential debate on the nature of the duty of an escrow holder. The current judicial status regarding escrow is not very clear. There is not much clarity as to whether he is agent or a trustee or a combination of both.40 The main reason behind these complications of the law of escrow is the fact that the escrow holder provides service to two parties with contrary interests. The law of escrow has not yet succeeded in placing a reasonable duty upon the escrow holder who has been elected to perform this difficult task with its inherent potential for conflict.

The courts in United States of America have held in many cases that an escrow

35 § 126, Indian Contract Act, 1872.
36 § 172, Indian Contract Act, 1872.
37 Prakash (n 3) 154.
38 Garrison (n 34) 46.
39 Ingraham (n 2) 78.
40 Prakash (n 3) 164.
holders is both a trustee and an agent.\textsuperscript{41} The most common problem which has arisen in escrow agreements is: upon whom does the loss fall when an escrow holder becomes insolvent or absconds with the funds of an escrow transaction? The court of Washington State in the case of \textit{Lieb v Webster,}\textsuperscript{42} equated the duty of the escrow holder with that of an agent. The court said that the loss in case of escrow agent becoming insolvent or bankrupt will fall on the person for whom the escrow holder was acting as an agent at the time of default. The court has laid down the test of ‘ownership of property’ for determining that the escrow holder is acting as whose agent. The reasoning was based on a general proposition that when a property is lost, the loss has to be borne by the owner of the property. In this case the court said that the money deposited with the escrow holder is the property of the buyer until the seller is entitled to receive it. The seller will not become entitled to the money until he fulfills the conditions of the escrow placed by the buyer on the payment of the money.\textsuperscript{43} Therefore, it can be said that the loss of his money has to borne by the buyer himself prior to the performance of the conditions of the escrow, and after the performance of the conditions, the loss of the money has to be borne by the seller as he becomes the owner of the property. It is logically plausible that the money after the performance of the conditions of escrow belongs to the seller but the other part of this argument that the money prior to the performance of conditions belongs to the buyer is not clear. The buyer loses the usual incidents of ownership, e.g. right of ownership and control, at the time he deposits the asset with the escrow holder. He doesn’t even have the right to revoke the delivery, so it cannot be said that the ownership is vested with the buyer at that time. However, the other side could argue negatively, by saying that he owned it, because no one else has become the owner. But, this argument is based on the dubious validity of the argument that the ownership must be with one or the other party and not with both of them concurrently.\textsuperscript{44} This proposition of

\textsuperscript{41} \textit{Re Copeland} (1976) 531 F 2d 1195 (3d Cir).
\textsuperscript{42} \textit{Lieb v Webster} (1948) 230 Wn.(2d) 43.
\textsuperscript{43} Garrison (n 34) 47.
\textsuperscript{44} Garrison (n 34) 47.
The Lieb case was followed in many other cases like Angell v Ingram \(^{45}\) and Schrock v Gillingham.\(^ {46}\) The most essential fact for the utility of this rule is the time at which the funds are lost. This rule is impossible to apply without the knowledge of this fact.\(^ {47}\)

The author does not really agree with this proposition because of the arguments he has put forth above. The use of this rule puts the burden of loss on any one of the equally innocent parties. The author argues that the agency rules should not be used in the escrow transactions at all, rather than inconsistently using them. The consistent use of agency rules in this area is not possible. For example, if the buyer delivers an asset in escrow, he may not demand it back legally until the lapse of time, as irrevocable deposit is the most important element of an escrow, and if the buyer dies, the ‘agency’ of escrow agent is not terminated with the death of the buyer, which demonstrates that the escrow holder is not an agent as per the principles of Indian Contract Act.\(^ {48}\) The above mentioned arguments are sufficient to show that a consistent application of agency law to the escrow holder is impossible. Now, the other title attached to an escrow holder is that of a ‘trustee’. But this can also be dismissed on the basis of the fact that the title of the asset is never vested with the escrow agent in an escrow transaction. A trustee is responsible for maintaining the assets in such a way so that they benefit their beneficiary above all others.\(^ {49}\)

**Fiduciary Duty of Escrow Agent**

The courts have imposed fiduciary duties on an escrow agent.\(^ {50}\) It is settled law that an escrow agent is a fiduciary of the contracting parties.\(^ {51}\) The Dallas

---

\(^{45}\) Angell v Ingram 135 Wash Dec 551.

\(^{46}\) Schrock v Gillingham 136 Wash Dec 386.

\(^{47}\) Garrison (n 34) 49.

\(^{48}\) Garrison (n 34) 51.

\(^{49}\) Ingraham ( n 2) 77.


\(^{51}\) Zimmerman v First American Title Co (1990) 790 S W 2d 690.
court observed that:

“An escrow agent owes fiduciary duties to both the buyers and the sellers of the property, including the duty of loyalty, the duty to make full disclosure, and the duty to exercise a high degree of care to conserve the money placed in escrow and pay it only to those persons entitled to receive it.”

The fiduciary duties of an escrow agent are:

1. Duty of loyalty - It requires that the escrow agent must act in good faith and only in its principals’ interests.52

2. Duty of full disclosure - It requires that the escrow agent should disclose all the known material information to its principals which affect their interests.53

3. Duty of care - It requires that the escrow agent must act with due diligence and care in keeping the assets in escrow and delivering them to the beneficiary as per the instructions.54

So, the author suggests that the most plausible solution to this problem would be to treat the escrow holder as sui generis and attach specific meaning to it. This action of legislature would be able to cure the hardship that results when the escrowee absconds with the funds of an escrow transaction or become bankrupt.

**CONCLUSION**

Escrow agreement is a necessary tool in the prevailing complicated business environment. There are numerous advantages of escrow, the most important one being that it safeguards the interest of contracting parties and facilitate smooth business transactions. Escrow agreement is the best available solution for attaining security of payment in the business transactions. The proven effectiveness of escrow agreement in pre-emptively settling disputes between

parties of a business transaction is another advantage attached to it.

An escrow agreement is an agreement between three parties, namely, buyer, seller and escrow agent. The buyer deposits the asset with the escrow agent which needs to be delivered to seller on the fulfilment of certain condition described in the agreement. There are specific laws in United States of America and many other countries for governing escrow agreements. However, Escrow agreements in India are at a nascent stage and there are no such specific laws governing them. An escrow agreement does not require use of the word ‘escrow’. The Courts construe an escrow agreement on the basis of its elements. The existence of an irrevocable deposit payable on the accomplishment of a pre-defined condition is the most distinguishable element of an escrow agreement. There are few important clauses which should necessarily be included in an escrow agreement like indemnification clause, confidentiality clause, dispute resolution mechanism etc.

The article then answers an important question i.e. what are the duties and responsibilities of an escrow agent? No specific meaning has been attached to an escrow holder. Courts, all around the world have tried to attach different labels to an escrow agent like that of an agent or a trustee or a fiduciary. However, the most common among them are agent and trustee. The agency rules cannot be consistently applied to escrow transactions due to the difference in the nature of work. Neither can the trusteeship rules be applied to escrow transactions.

Therefore, the author has suggested that escrow holder should be regarded as *sui generis* and particular meaning should be attached to it. He also suggests that, the main problem in India is that there is no law governing escrow agreements, especially escrow agents, and this should be rectified.
ABOUT THE EDITOR

Dr. Sairam Bhat teaches Law of Contracts at National Law School of India University. He was awarded the ‘Young India Environmental Law Fellowship’ at Golden Gate University, California. He is a Fulbright-Nehru Fellow and also a Linnaeus-Palme Academic Exchange Fellow at the Royal Institute of Technology, Stockholm, Sweden. His publications include books Environmental Law for Law Practitioners; Law Relating to Business Contracts in India, SAGE; Natural Resources Conservation Law; and Right to Information. He is the Chief Editor of the Journal on Environmental Law, Policy and Development, and Journal of Law and Public Policy. He is also the Chief Editor of the IN LAW magazine and the March of Environmental Law, published by NLSIU. Currently, he is the Coordinator of the Centre for Environmental Law, Education, Research and Advocacy [CEERA], and also the Coordinator of the Distance Education Department, NLSIU.

ABOUT THE ASSISTANT EDITORS

1. Shiva Santosh Yelamanchili completed his B.A. LL.B. (Hons.) from NLSIU, Bengaluru in 2015. In addition to academic honours, he won laurels in mooting. He has multiple academic publications to his credit and was actively involved in several committees and research panels at Law School. He is going to join the chambers of the Advocate General of Andhra Pradesh and practice at the Hyderabad High Court. He focuses on public law.

2. Arpitha H.C completed her Master’s in Law at NALSAR University of Law and is presently working as Assistant Professor at the National Law School of India University. She also holds responsibility as the Assistant Coordinator of the Distance Education Department at the Law School. Her areas of research include Corporate Law, Right to Information, Contract Law, and Competition Law. She has been invited as the Resource Person at various organizations on emerging areas of law. She has also presented papers and participated in various National and International Conferences.
3. **Anita Yadav** is currently working as a Research Associate at the Distance Education Department of National Law School of India University (NLSIU) Bengaluru. She is also pursuing her PhD from NLSIU. She has been recently awarded with the Erasmus Mundus Scholarship as a PhD exchange student to pursue her research at George August University, Germany. She was awarded with UGC Junior Research Fellowship (JRF) award in Human Rights and Duties in December, 2013. She has also qualified the UGC- NET Examination in Law subjects twice. Her teaching experience includes more than a year spent at Christ University, as an Assistant Professor of Law.

4. **Ashwini Arun** completed her BPSc (Hons) LLB (International Trade and Investment Law Hons) from National Law University, Jodhpur, in 2015. She has served as an Associate Editor of the Indian Journal of Arbitration Law (IJAL) for one year and been a member of the centre for arbitration research at NLU Jodhpur. Her areas of interest are Trade, International Contracts, and Public Policy.