SAGE LAW

LAW OF BUSINESS CONTRACTS IN INDIA

Edited by

SAIRAM BHAT

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Edited by
Sairam Bhat

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Foreword

I feel honored to write a foreword to an unusual book edited by my young colleague Dr Sairam Bhat on different aspects of contractual relationships shaping economic development in a globalizing society. It gives me a lot of vicarious satisfaction and a sense of fulfillment when I realize that the different chapters of the book are products of student research done as part of their legal education at the National Law School, Bangalore. I recall a similar volume compiled and edited by a senior student of National Law School published in early 1990s on the subject of cyber law, perhaps the first book of its kind on the subject. The students of the 5-year LL.B. course have indeed redeemed the falling standards of legal research in India and made research-based learning a part of legal education.

For the last few years I have been involved as a Member of the Jury in the final evaluation of the Manupatra All India Essay Competition for Law students. Reading over 750 research essays submitted in 2008 by many students from 130 colleges on fairly complex legal issues make one appreciate the quiet revolution underway in legal research and writing and the potential it offers for future legal practice. The 5-year integrated L.L.B. program and the National Law School movement, which I had the good fortune to pioneer from Bangalore in 1980s, have made a significant difference in legal education and legal practice. The present volume edited by Dr Sairam Bhat is another demonstration of this success story.

The book is unique for several reasons. It is not yet another conventional book on contract law of which there are many in the market. Its content is not about the making and breaking of contracts and its legal consequences. He gives a foretaste of the volume with his two introductory essays, first, interrogating the relationship between students and their colleges from a "contract" perspective and the second, exploring the prospects of "socialist" governance under the public–private partnership model in managing utilities. The concern in the discussion is not merely on theory but on the practice of living relationships fast changing into the commercial mould under the impact of economic liberalization. Today we talk about trade in services including legal services under the World Trade Organization (WTO) regime. The elements of trade and commerce have invaded every aspect of life making

"contract" an organizing principle of every type of relationship in society. Freedom of contract is the foundation of capitalist model of development and socialist models are adjusting themselves to this universal truth in varied forms and shades. His two essays illustrate this proposition. As he himself writes in his Preface to the book, ideas arise from interactive learning and out-of-the-box thinking. Students ask unconventional questions based on what they understand from contemporary events and relationships. That, in turn, compels strategic thinking on the part of teachers and students to find innovative solutions. The book in hand is an example of what happens in such a scenario.

Most of the essays which follow are written by groups of students looking at commercial contracts being negotiated by parties for different purposes, innovating new terms and models to suit their ends. They analyze the practices and draw principles which sustain them, thereby building new theories and justifications. The attempt is to look at the new facets of contractual jurisprudence hitherto unexplored at least at the level of students in law colleges. The articles on "consortium loan agreements," "joint venture agreements," "shareholders' agreements," and "escrow agreements" are interesting pieces where the authors make comparative assessments of the law and practice in different jurisdictions.

A variety of specialized contracts are now in vogue which may not fit in squarely with the existing forms and models. With the economy growing in unprecedented ways, entrepreneurs have evolved new practices based on expediency and convenience. Standard form contracts have thus become a dominant form of commercial intercourse. Based on the rules of interpretation adopted by courts, an essay in the book attempts to look at the evolving regulatory jurisprudence in this sector.

With the adoption of the Information Technology Act, electronic contracts have been legally recognized compelling modification of traditional rules of procedure and evidence. There is a piece analyzing the various dimensions of electronic and software contracts.

A series of specialized sectors of the economy are attempted to be studied from the "contract" perspective which the authors have grouped under "hospital contracts," "entertainment contracts," "sports contracts," "employment contracts," "farming contracts," and "insurance contracts," each forming a chapter of the book. They are introductory essays inviting the readers to look at these relationships as innovations arising from simple contract and accomplishing a lot of desirable goals in a free-market economy. They also suggest the need to study contract law from new perspectives

accommodating new demands of users and consumers within the framework of the Constitution and the laws.

Unlike other laws which are made by the state, contracts are laws made by individuals, corporations, and state entities. They need to react and respond to changes in the economy, in technology, and in society. The role of the state is only to regulate them with a view to ensure fair play, equity, and common good. A new and growing field of regulatory jurisprudence is now a part of Contract Law. The book invites our attention to this emerging field and alerts the reader to its strengths and weaknesses. In this respect it serves a social purpose apart from the dissemination of legal knowledge in this vital sector of jurisprudence.

Dr Sairam Bhat and his students deserve congratulations for having put together a set of informative and instructive articles on a theme of abiding interest to those associated with economic development and its legal regulation. Apart from serving as a teaching tool, the book will be of help to lawyers and entrepreneurs involved in business transactions.

As a teacher who experimented for long with new ideas in improving legal education, I welcome the initiative of Dr Bhat in making a difference in the teaching of Contract Law. The idea of a teacher himself developing study materials in each subject has been part of the National Law School tradition and it is strengthened by this publication. Let this be an inspiration to other teachers and students of every law school everywhere.

New Delhi
January 5, 2009

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Preface

The law and regulations governing business and contract law are becoming increasingly complex and now affect all industries and every type of commercial agreement; from entering into a contract, to validity of purchase conditions. If you are involved in commercial contracting or dealing with external parties at any level, you need to grasp the practical legal implications of these relationships to ensure that you do not expose your organization to unnecessary risk. Additionally you need to protect your company from litigation and anticipate legal pitfalls. The purpose of this edited volume is to bridge the gap between the theoretical understanding of contract law and its practical orientation, need, relevance, and challenges. While modern contracts have numerical pages of negotiations, they are often complex and hence require detail precision. Moreover modern contract law has developed itself into specialized branch of law in itself. Traditionally, contract law is taught and learnt vis-à-vis the Indian Contract Act, 1872. Though this law is still the governing, foundational law in terms of regulation of all forms of contract, one must appreciate that business contracts have grown beyond the proposition of the century-old Contract Act. When contracts transcend national boundaries, the national legal regime of any single country becomes inadequate to grapple with the situation. When the parties to the contract are located in different countries, at least two systems of law impinge upon the transaction and the rules of Private International Law come into play. The best way to ensure the application of a particular legal system to international contracts is to choose a particular law to govern this contract. This law is called the "Proper Law of the Contract." The courts have held that "Proper Law is the law which the parties have expressly or impliedly chosen, or which is imputed to them by reason of its closest and most real connection." Modern contract is largely involved in multinational, or transnational, jurisdiction, with International Conventions such as Convention on International Sale of Goods (CISG) or the clauses of International Arbitration governing formation of contracts in India. Issues of international taxation and multinational contractual jurisdiction are also areas which govern modern forms of contract. Largely, these complex issues are seen in e-contract which is a multinational personality in the chain of production,

distribution, and consumerism. Further, one must seek the modern developments of contracts which have changed the meaning and facets of traditional contractual terms. More and more minors do enter into contracts in the field of entertainment and sports. No longer are the courts sticking to the notion that a contract with a minor is *void ab intio*. Rather, freedom of contract rules dominates the decision of the courts in such cases.

The idea to compile such a book comes from a realization that contract law needs to be taught with incorporation of newer facets of practices and issues which confront modern-day contracts. Teaching the 1872 Contract Act did not provide the students with an exposure to modern forms of business contracts; neither did it in any way teach us the growing jurisprudence toward the law in relation to these contracts. Further, I found that students were keen to take projects of some of the modern forms of contracts rather than the traditional topics. I myself learnt from many of the writings of my students both in the classroom and off it. This book explores some of the forms of business contracts and analyzes the law applicable and related to these forms of contracts. The purpose of these set of chapters is to give the reader an in-depth study of the position of law and to also state the best possible practices in drafting these forms of contracts. An attempt has been made to state the positions taken by judges on the various forms of contracts in a comparative analysis of decisions in India, the US, and the UK.

The first chapter deals with *student–university contractual relationship*. The chapter advocates that higher education in India must be based on contractual obligation, and not imparting of education may not only amount to education malpractice but may also give rise to a remedy for damages for breach of contract. Tracing the relationship between a student and university from *loco parentis* to consumer v/s service provider to modern-day education which is business centric, this chapter argues for recognition of a contractual bond between the student and the educational service provider. The chapter takes examples and cases from the United States and the United Kingdom, where higher education is contractual, to suggest that unless a change occurs in the Indian legal regime, legal problem may be far more complicated than one may presume.

The next chapter analyzes the evolution of public–private partnership in *infrastructure contracts* in India. In infrastructure development, the practice is to establish a private limited company which may be formed from a joint venture agreement between the partners. Project vehicle for investment in infrastructure projects is usually through a joint venture agreement between stakeholders. The joint venture agreement is entered by companies and corporations to facilitate the process, speedy incorporation

and commencement of business. The joint venture agreement is usually a follow up of a Memorandum of Understanding among the partners. A joint venture (the new consortium) is floated as a private limited company, registered under the Companies Act. To sort out the management part of the joint venture, the partners also enter into a shareholder agreement, in which the concerns of management and decision-making are clearly laid down to avoid confrontation and litigation. In India, as a project development vehicle, the private limited company model is preferred over the partnership model for the following reasons: (i) according to the Partnership Act, 1932, the liability in a partnership is unlimited; (ii) tax holidays under the Income Tax Act are not available to partnerships; (iii) there are limited sources for financing of a project in a partnership; and (iv) it is very difficult to get new partners and enable exit of old partners.

The next chapter is on *consortium loan agreements*. Loan agreements in essence are simple contracts laying out the obligations of the lender and the borrower. The nature of consortium loans, and more importantly the purpose for which they are made out, greenfield and brown-field infrastructure projects, corporate acquisition, etc., are such that they warrant huge amounts of money. Such loans often cannot be made out by a single lender, and even if a group comes forward to make such a loan, securing the repayment of such an amount is an important consideration. Consortium loans can either be in the form of a syndicate or a participatory loan. In the former, the several lenders liaise directly with the borrower and the borrower is severally liable to each lender. In the latter, a single lender enters into a loan agreement with the borrower, and later the loan is sold to other lenders. In a participatory loan, the borrower is directly liable to the borrower it has contracted with. The different kinds of legal relationships in consortium loan agreements require different set of contracts. The clauses in a syndicate loan agreement, a participatory loan agreement, and inter-creditor agreement, though largely similar, have some very significant differences which are reflected in the clauses. Though consortium loan agreements are not different from a normal loan agreement, they operate on a different plane because of the magnitude of the loans made. Loans that run into billions of rupees cannot be secured through normal means such as collateral or mortgage. However, necessity is the mother of invention, and the need to be able to ensure repayment of the loans has led to the development of complex and innovative clauses, such as negative pledge and material adverse change, that to a large extent act to secure a portion of the loan amount if not all, without resorting to collateral. These clauses have developed entirely out of usage and practice and are not sanctioned by any statute or regulation, domestic or international. They are

at best a part of *lex mercatoria*. Legal interference has been moderate and only in the form of judicial decisions in the United Kingdom and the United States. Consortium loans are relatively new to the Indian corporate sphere, and are set to grow. The area is not regulated as yet in India, though the decisions of the UK courts forming part of common law have persuasive value in India. However, India could take the lead in not so much regulating but guiding transaction in this area by outlining the duties of various parties.

The next chapter deals with *licensing of intellectual property rights*, focusing on patent, copyright, and trademark licensing. The objective of the chapter is to examine whether any specific legislation is required in India to regulate the realm of licensing of these intangible property rights. In order to reach a conclusion on this moot point, the chapter examines the concerned areas of law, statutory provisions (Indian and international), prevalent business practices, nature and variety of standard provisions regularly used in such business contracts, and also practices relating to such licenses in specific industries. The conclusion arrived at is that the legislators should not be looking to legislate a very specific regime to govern and regulate the licensing of these intangibles. The reason is mainly that the nature and scope of these agreements are so varied and complex that a detailed and very specific legal regime governing this vast area might adversely affect the business transactions in the area by not being able to account for the unique nature of each case and the differences in the nature of the transactions at hand.

The chapter on *joint venture agreements* argues that the advent of globalization has led corporations to forge joint ventures to achieve efficiency in access to capital, skill, and new markets. In order to ensure harmony among parties, the joint venture agreement needs to be drafted carefully to address and avoid possible conflict of interest that parties may encounter. The chapter studies the drafting of such agreements. At the very outset, it would be pertinent to note that the chapter looks at the two different types of joint ventures—the unincorporated (which is similar to a partnership) and the incorporated (where a joint venture is in the form of an incorporated company). The chapter is written in two parts. Part I focuses on the approach and issues of conflict of interest and antitrust. Conflict of interest can arise between the parent companies and the joint venture parties since there are interlocking directors with interest in both the entities and it may arise in self-dealing transactions as well as in situations where both the parties compete to avail of same corporate opportunity. Conflict can happen in disclosure problems where the moot issue is to what extent one party can disclose without causing disadvantage to the other. This is more important in the case of high-tech joint venture agreements where confidentiality of

information is very important. This chapter looks at the judicial approach, different legislations, and drafting techniques that might help in resolving conflict of interest to ensure smooth functioning of the joint venture. It also traces the issues relating to antitrust in the United States and India. Here, the focus has been on studying the tests that have been adopted in different jurisdictions to hold joint ventures liable under existing regimes for violation of antitrust norms. It also focuses on the new structure of Limited Liability Partnership (LLP) which might be useful in a joint venture. The authors have studied the UK LLP Act and the corresponding Indian LLP Bill, underlining the characteristics of such a structure with its benefits and shortcomings in relation to joint ventures. Part II of the chapter highlights the clauses that such an agreement should have and the legal issues involved in these clauses. This part includes issues like ownership/governance/management structure, intellectual property rights, pre-contractual confidentiality as well as confidentiality clause under the agreement and the termination clause and the legal issues that the drafters should take into account while drafting a joint venture agreement. To highlight the importance of some of these clauses, conditions, precedent may arise even prior to the coming up of joint venture into existence, where parties may want a fixed management structure even in an incorporated venture. Confidentiality is a paramount concern both during and subsequent to the end of the venture. Termination is an ever lingering issue which if addressed properly can avoid protracted litigation and, thus, the chapter spells out the various course of action relating to termination which can be incorporated in the venture. The aim of the chapter is to make parties aware of the legal intricacies which can help in making a joint venture a successful business enterprise.

Shareholders' agreements are a common feature of the corporate world. However, despite widespread usage, the legal nature of a shareholders' agreement and its implications are often not clear and certain, leading to litigation. Hence, the following chapter studies shareholders' agreements from the perspective of business contracts. The next chapter begins by analyzing some of the basic issues pertaining to shareholders' agreements. Thereafter issues that have been the source of litigation and divergence of opinions have been looked at. As a result, the chapter provides critical insight of the law relating to the shareholders' agreements. It also offers some valuable guidelines for the drafters of shareholders' agreements such that litigation can be avoided. In order to effectively deal with the issues, the author has largely relied on judicial decisions by the Indian and the English courts.

Next, we have a chapter on *escrow agreements*. An escrow is a legal instrument in which the desired property, deeds, source code, or any other important property in a transaction is stored until the conditions which

are stipulated in the escrow contract are fulfilled. This chapter looks into the rising need of an escrow agreement and the business expediency that it provides. The advantages of using an escrow agreement is that the property being protected in an escrow is irrevocable, and cannot be withdrawn or recalled by the maker. It further reduces the risk of litigation. The standard clauses of this agreement are then analyzed and the best, fair, and precise construction of these terms in the larger interest of justice is highlighted. An escrow agent has a special and vital part in an escrow agreement and this role has been examined in detail. The authors believe that an escrow agreement is a business reality today and is inevitable in dealings across many sectors. While delivering an instrument in escrow the intention should be made clear to all parties in writing and the escrow conditions should be expressly set out. This chapter highlights the usage of securities, software, and real estate escrows via examples.

Given the rapid growth and increasing importance of the outsourcing industry in India, it is pertinent to study the contractual aspects of how outsourcing transactions, especially offshore ones, are agreed upon and implemented. Contractual terms associated with outsourcing transactions will undoubtedly receive greater judicial scrutiny in the near future, thus making an analysis of issues involved in *outsourcing contracts* a significant contribution to the new forms of business contracts. The chapter also analyzes several issues that are common to most types of outsourcing contracts including, *inter alia*, maintaining confidentiality of information, tax implications, protection of intellectual property, meeting labor requirements and dispute resolution clauses.

Standard form of contracts is the current norm of practice. The growing relationship between contract law and consumer law has seen a growing jurisprudence of the reasonability, fairness, and equitableness principles in the interpretation of *contra proferentem* rule. Standard forms of contract are here to stay and grow. Very often, these contracts do not give an equal bargaining position to the parties on the terms and conditions. From *caveat emptor* to *caveat venditor* one sees the growing significance of protecting consumer rights when there is lack of negotiating ability on the other party to the contract. Standard form of contracts have become a common fixture in everyday life today. It becomes important to look into the principles which govern these contracts due to the difference between these contracts and other contracts in terms of consent, exclusion of liability, bargaining power, inability to negotiate, etc. The courts have, thus, branded these contracts differently from others and formulated special principles regulating the same. These include principles involving the nature of document, adequacy of notice provided, and previous dealings. In cases where these principles are

not applied, certain rules of interpretation have been followed. This chapter attempts to review and analyze the general principles as well as the rules of interpretation involving standard form contracts. The researchers have also tried to look at how different legislations in the United Kingdom and the United States have been used to tackle the problems related to these contracts and how this can be incorporated in Indian law as well.

Law has always tended to lag behind technology, and given the pervasive nature of such transactions in our everyday lives, the chapter on *electronic and software contracts* assumes particular relevance. First part of the chapter is devoted to examining the legal regime that governs electronic contracts, and attempts to relate the same to established principles of contract law. It touches upon the various types of electronic contracts, and the possibility of courts enforcing the terms contained therein. The implication of the mailbox rule on contract formation is discussed, as are relevant portions of the IT Act, 2000. This section also posits certain best practices to be kept in mind while deploying electronic contracts. Users often encounter electronic contracts in the context of purchasing/downloading software. Such agreements often incorporate restrictive terms such as those relating to copyright and non-transferability. These limitations on usage lead to the pressing issue of whether software contracts are contracts of sale or licenses. The latter part of this chapter notes that software tends to be heavily encumbered by restrictions that detract from ownership as it is conventionally understood, and makes a compelling argument for treating such contracts as licenses. Finally, the chapter, in addressing the interesting aspect of consumer protection, examines issues of private international law and calls for a unifying convention on this subject.

The next chapter on *hospital contracts*, again being a standard form contract, looks at the contractual nature of the relationship between a hospital and a patient, and discusses the liability of a hospital under various circumstances. The issue of consent for medical treatment and the judicial expansion of this concept have been studied in this chapter, with a focus on consent forms as a means of obtaining the requisite consent. The existing standards for consent forms have been looked at vis-à-vis the actual practice in hospitals in India. Finally, certain suggestions have been made with respect to possible reform in existing law in order to better regulate hospital consent forms.

The chapter on *entertainment contracts* seeks to explore the laws relating to entertainment contracts in the Indian entertainment industry. There is no separate legal framework dealing with entertainment contracts in India and the existing legal framework dealing with contract law is often extended to

the entertainment contracts as well. The chapter deals with certain specific aspects of entertainment contracts, namely, issues relating to copyright, restraint of trade clauses, and contracts with minors. Most importantly, the different remedies for breach of these contracts and also the dispute resolution mechanisms are dealt with in the final portion of the chapter. It is concluded that although a separate legislation may not be in demand by the industry presently, there are possibilities to ensure that the weaker party and his interests are safeguarded effectively.

The chapter on *sports contracts* deals with the relationship between, and the rights and obligations of, parties involved in the conduct of sporting activities. Such parties are varied and diverse, from coaches, players, and team managers, to sports agents, broadcasting companies, and advertisers. This chapter deals with the relationship between a professional sports player and the team he will play for, that is, professional player contracts. The practice in today's world is generally to adopt a uniform contract for all players in a league, and hence such contracts are more commonly referred to as standard player contracts. In this chapter, the authors examine not only the clauses required to be incorporated into such a contract, but also the legal issues that arise in relation to these contracts. The focus being on the Indian position, the effort at each stage is to determine the direction an issue will take within the Indian legal system. However, owing to the lack of scholarship and jurisprudence on the subject, this takes the form of conjectures and recommendations rather than conclusive answers. It is the authors' submission that players' contracts require special treatment and cannot simply be grouped under the category of contracts for personal services. Thus, what is required is a forward-thinking attitude of the judiciary, with possible modifications and innovations in the law on the part of the legislature. Lastly, the authors also suggest that the standard player contracts which exist in India today are highly inequitable, and India would do well to take a leaf out of the books of the leagues in the United States and make more conscious efforts toward the drafting of such contracts on the basis of fairly negotiated collective bargaining agreements.

Employment contract being a standard form contract is a dynamic issue which changes with time as the nature of employment and scope of employment progresses. Historically, the Indian law on restraint, whether general or partial, despite being in service contract or business contracts were generally held void by the courts. The terms and conditions of an employment contract signify the working style and culture of an organization. While employing a person in your organization or commercial set-up, you need to define the relationship in a fair and unambiguous manner. An employment contract helps a company protect the interests of the organization

while being fair to the employee. Restrictions such as non-competition, non-disclosure, and non-solicitation agreements have long been present in many employment contracts. Courts, however, have historically been skeptical of such provisions and often refused to issue injunctions to enforce them. The resulting uncertainty has proven to be a major problem for employers in many industries, who are left with no reliable means of keeping their key employees from joining a competitor or competing themselves. With more employment opportunities available in recent years, employees are more mobile than they have been earlier. However, as employee mobility increases, so do employer's concerns about the possible disclosure of trade secrets when employees leave to join other companies. Restraint of trade clauses usually contain restrictions on the employee's ability to work in a geographical area, or for a defined length of time. It is not uncommon or illegal for an employer to restrict a former employee from working within a fixed geographical area, or from working with a rival business to the former employer for a period of time after the cessation of the contract of employment. However, the restrictions must not be excessive. What is excessive depends on the nature of the work in question and the structure of the business. Faced with a similar problem, employers in England developed a concept called "garden leave," in which employees are paid their full salary during the period in which they are restrained from competing.

While insurance law in India has been covered by many authors over the years, the law *of insurance contracts* in the context of the present day deserves a fresh look with a view to remedy anachronisms in the present system. The last chapter in studying insurance contracts covers various aspects of personal, property, and liability insurance. The component on personal insurance basically focuses on life insurance contracts. Following a conspectus of the various categories of such contracts, the authors argue for recognition of cohabiting couples in the realm of life insurance with respect to the issue of whether cohabiting partners have an insurable interest in each others' lives. The second issue with respect to life insurance involves the question of whether constitutional remedies have been affected by the removal of the Life Insurance Corporation's monopoly over the life insurance sector. The portion on property insurance looks at marine and fire insurance, stressing on the need to make marine insurance conform to modern practice and contemporary developments. The section on liability insurance includes a study of motor vehicle insurance, which is technically a hybrid form of contract involving liability, property, and also personal insurance. The chapter concludes with a reasoned argument in favor of specialized regimes dealing with insurance contracts and for a legal framework which is relevant in the modern context.

Contract farming has of late been portrayed as the solution to all ills of Indian agriculture. We have a chapter on contract farming that analyzes the legal regime and the contractual framework in this area. It has been surmised that with the amendments in the State Agricultural Produce Marketing Committees (APMC) Acts, investment from corporate sector in agriculture will increase and this will lead to decrease in wastage of agricultural produce, increase in income for the farmers, and provide opportunity for the corporate to achieve backward vertical integration. The importance of studying the concept and practice of contract farming in India can be better appreciated against the backdrop of these prophecies. Several studies have been conducted in this area but these studies have been restricted to economic aspects of contract farming. The importance of law as an enabling tool for drafting a clear contract to facilitate a smooth transactional relationship between corporate and farmers cannot be underestimated. The author, in this chapter, has attempted to elucidate the concept of contract farming as practised in India and to illustrate the salient features of a contract between a corporate (sponsor) and a farmer. The objective of this chapter is to examine contract farming from the perspective of farmers as well as corporate bodies so as to afford a practitioner the vantage point wherefrom he may ascertain such a path for his client as suits the latter's short-term as well as long-term interest.

This book contains all modern forms of contract which can be used as teaching tools in all law schools across the country. Moreover, contract practitioners will find this book most desirable for their day-to-day drafting. The book will help legal counsels to know the best possible practices for drafting specific contracts. It is sincerely believed by the authors that the book will create a new jurisprudence in the field of contract law. Thus, we hope that students, researchers, advocates, draftsmen, legal advisors, and HR managers will find the contents in this book useful. The book contains chapters authored by students of NLSIU. A huge contribution made by the fifth-year batch of 2008–09 by putting their valuable time, energy, and resources in publishing this book is acknowledged. As I offer a seminar course in business contract every year; it is hoped that this book will provide the much needed reading material for the course, with contract drafting also being a part of the exercise.

Sairam Bhat

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1

Student–Institution Relationship: Basis for Contract Law

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At present there are 388 universities in the country. This number is insignificant in view of the estimation of National Knowledge Commission, when it said that at least 1,500 universities are needed to make India a knowledge society.

Introduction

Since 1990s, there has been a tremendous growth in higher education in India. The sudden proliferation in the number of colleges implies that now colleges are insatiably marketing themselves in order to make a distinct mark and hence, no longer wait for student applications to set the ball rolling. Although marketing is no longer an intolerable word in higher education, ethical and appropriate marketing tactics still remain a subject of debate. Earlier, during 1970s and 1980s, institutions used to develop new academic programs and courses to attract new students. Today, colleges are increasingly relying on "image" marketing for their promotion.

In India, the biggest bone of contention is that most of the higher education is heavily subsidized and funded by government funding. Institutes which receive a Lion's share of the funding include the Indian Institute of Managements, Indian Institute of Technologies, Indian Institute of Science and the prestigious Central Universities. Private institutions receive funds through the University Grants Commission (UGC) for programs and seminars and this funding has remarkably increased over a period of years. In some quarters of education planning, views have been expressed that higher education must be increasingly self-funded, following which a large number of private and deemed universities have sprung up considerably over the past

5 years. By asking for a higher tuition fee, these universities have increasingly played to the market prices.[1]

At the same time, students taking recourse to legal action on universities for varied reasons and disputes are growing in numbers. It is about time this nature of student–university relationship is closely examined to understand a university's legal obligation towards a student, especially if it arises from a contract for educational services. There are many theories on the kind of relationship between a student and a university, but the contract theory is growing in importance with the state not willing to subsidize higher education any more in the growing private sector at all levels of education. The issue arises from disputes between a student and an educational service provider. If the dispute is one of debt not being paid by a student, would a breach of contract suit be appropriate? Or if it is withholding of examination results or shortage of attendance or other criteria not being fulfilled, would a judicial review on the policies of the university be appropriate? Is the dispute between a student and a university a private dispute or a public law review? Can there be any such consideration to deem "education" in all forms a fundamental right? This paper explores the question: Is contract law a suitable way of governing and defining the student–university relationship? Or, is creating a formal contract an overreaction, dreamt by the university managers?[2]

Although offer and acceptance should not be hard to identify, one recent incident involving Cornell University demonstrates how contract principles could be used to resolve problems when they arise.[3] In response to one student's admission application, Cornell mailed a two-page response stating, "Welcome to Cornell. We are delighted to welcome you to the university. Please confirm your acceptance with a deposit." In the event that the student is later rejected and decides to sue, the issue arises as to whether the letter from Cornell constitutes an acceptance binding Cornell to admit the student. This is an issue that contract principles are quite capable of resolving.

A simple analysis of this issue can be as follows: First, the student submitted an application for admission. This was an offer. Next, the university

[1] Belgium, for that matter, directs institutions to respect promises published in the institution as "contractual obligations."

[2] Melanie Newman, "NUS Alarmed by 'one-sided' student contract," *Times Higher Education*, July 13, 2007.

[3] National Public Radio Broadcast, February 24, 1995 (transcript available in LEXIS, News Library, NPR File).

mailed its response. The question is whether a person in the student's position would understand Cornell's response to constitute an acceptance—that is, whether the letter was "a manifestation of assent to the terms thereof made by the offeree in a manner invited or required by the offer." Although the Cornell response states, "Please confirm your acceptance with a deposit," a reasonable person in the place of the student could interpret this as an acceptance of her offer to matriculate to Cornell, an acceptance binding both the parties. Cornell may argue that its letter was not really an offer of acceptance as this goes against a university's traditional practice of not admitting students to whom it has erroneously sent an acceptance letter. Consequently, the student should be admitted because she has a binding express contract of admission to Cornell University. Of course, a one-paragraph analysis is too rudimentary to adequately resolve the issue; it is only my intention to show that contract law embraces the type of principles needed to resolve such issues.[4]

A student fulfills the requirement of consideration when she sends her deposit to the university or pays her tuition fee with cash or services. In addition, a student likely to join or accept the offer forgoes his opportunity to attend other colleges or universities. This too constitutes a consideration. The negotiation process establishes the "bargained-for" element of consideration, required in some jurisdictions.

The other elements of contract formation are easily satisfied. The parties to the contract are obvious: the student and the school. Where the student is a minor and may not have the legal capacity to enter into a contract, the courts recognize that the contract is between the student's parents and the school.

The relationship described above has all the elements of a binding contract with the possible exception of the specific terms governing the relationship. Although parties may intend to enter into a contractually binding agreement, unless the terms of the agreement are "sufficiently definite or reasonably certain," no contract exists. Contract terms are reasonably certain if they produce a basis for determining when a breach occurs and if they suggest an appropriate remedy. A court must be able to delineate the terms of the agreement between a student and a school in order to determine when a breach occurs. One point of contention is determining what representations, publications or university documents define the terms of the contract between a student and her school.

[4] *Ibid.*

Proposition 1

Whether the right to education in the Constitution makes any impact on the contractual relationship.

Education is an empowerment for socio-economic mobility, an instrument for reducing socio-economic inequalities and an equipment to trigger growth and development. There has been a paradigm shift in this sphere: First, from education being of transcendental and metaphysical value to it having a market value and second, from being a subsidized education to the one where it becomes a cost recovery system. The features such as commodification of education, private sector's dominance in higher education, and market-driven education flowing from world trade law stand juxtaposed to this fact. It is a universally accepted fact that education empowers people and leads to an overall development of human personality, augments one's respect for human rights and helps to overcome exploitation and age-old inequalities of caste, class, and gender. As viewed by B.N. Kirpal, J., it is the single most powerful tool in the uplift and progress of the society.[5]

There is also an increased focus on the phenomenon of knowledge-based world[6] and its emergent socio-economic and cultural dimensions have put the knowledge dissemination process at the center of interactions of several rights and freedoms, making them more meaningful and, in turn, reinforcing educational rights. While the Indian Constitution laid the policies of the state toward education, it stated that compulsory and free education must be a subject matter of importance.[7] Initially, the three judges bench of the Supreme Court in *Mohini Jain* v. *State of Karnataka*[8] ruled that right to education at all levels is concomitant to the fundamental rights and observed, "The State is under a constitutional mandate to provide educational institutions at all levels for the benefit of citizens. The educational institutions must function to the best advantage of the citizens."

The role of freedom of association in forming educational institutions is given judicial recognition in *D.A.V. College* v. *State of Punjab*[9] and *Unnikrishnan*

[5] *TMA Pai Foundation* v. *State of Karnataka,* [2002] 4 LR 1.

[6] See for discussion, separate judgment of S.B. Sinha, J. in *Islamic Academy of Education* v. *State of Karnataka*, 2003(6) SCALE 325 at 309–91.

[7] Article 45 of the Constitution states that the state shall endeavor to provide, within a period of 10 years from the commencement of the Constitution, free and compulsory education for all children till they reach the age of 14 years.

[8] Per Kuldip Singh, J. in *Mohini Jain* v. *State of Karnataka*, AIR [1992] SC 1858 at p. 1864.

[9] *D.A.V. College* v. *State of Punjab*, AIR [1971] SC 1737.

v. *State of A.P.*[10] In *Unnikrishnan* v. *State of A.P.*, the court ruled that Professional Education Institutions could only be established by registered societies. The Supreme Court rejected the argument that education institutions could be established in exercise of freedom of business by reasoning that commercialization of education at any level should be eschewed.

The above proposition of right to education[11] only means that education is a subject matter of public policy, hence extreme caution is required in the exercise of the freedom of contract principles vis-à-vis education. What is public policy is laid down by stating that right to education[12] is a fundamental right. Therefore, student contract is a subject which the state shall have the power to regulate as a matter of public policy. Thus, even if student contract is not within the express domain of a consumer forum, the reasonability of private institutions and their policies can be tested with the contractual test of "public policy."

However, this view may have to be changed due to the effects of globalization, as endeavored by the State of Chhattisgarh in passing the Private University Act to create an economic scope for commodification of education. In *Prof. Yashpal* v. *State of Chhattisgarh*,[13] the petitioner had questioned the legality of sec. 5 of the Chhattisgarh Private University Act, 2002, permitting establishment of private universities for higher education. This legislation allowed the registration of private universities in the state, completely doing away with the role of the UGC which was the sole authority to examine the infrastructure available with and the courses of studies prescribed by an institution before being conferred with a deemed university status. Justice G.P. Mathur, writing for the bench,[14] also accepted the petitioner's argument that the Act was unconstitutional as it gave "uncanalised and unguided power" to the state to establish a university by simply issuing a notification without complying with the infrastructure,

[10] *Unnikrishnan* v. *State of A.P.* AIR [1993] SC 2178.

[11] The 83rd Constitutional Amendment guarantees the right to free and compulsory education for children from 6 to 14 years of age. It also makes it a fundamental duty of parents/guardians to provide opportunities for education to children in this age group.

[12] See art. 21 A of the Indian Constitution. Under International Covenant on Social, Economic, and Cultural Rights, primary education is directed to be compulsory and free for all, whereas concerning higher education, equal accessibility based on individual capacity is assured (art. 13.2(a) and art. 13.2(c)). Universal Declaration of Human Rights also makes such a distinction (art. 26).

[13] Date of judgment is February 11, 2005, as per G.P. Mathur, J.

[14] The bench of Chief Justice R.C. Lahoti and Justices G.P. Mathur, and P.K. Balasubramanyan.

faculty positions, and financial resources as prescribed by the UGC. But the bench, which quashed the establishment of 117 universities in Chhattisgarh, however, recognized the state's and a private individual's "right to establish a university." The court said every state legislature passing a law enabling the establishment of private universities should insist that "only an institution with all the infrastructural facilities where teaching and research on a wide range of subjects and of a particular level are actually done, acquires the status of a university." It underlined the role of the UGC in recognizing universities and said the Chhattisgarh University Establishment Act had negated the UGC's role and hence deserved to be struck down as "null and void." The UGC already has a set of regulatory guidelines in its Establishment and Maintenance of Standards in Private Universities Regulations, 2003, available on the UGC website.

In the first section of the regulations, it is noted that a suitable regulatory mechanism is essential by way of laying down the conditions, specifically for the establishment and operation of private universities, for safeguarding the interests of the student community "with adequate emphasis on, the quality of education in order to avoid commercialization of higher education."

For the purpose of these regulations, a private university means:

> A university duly established through a State/Central Act by a sponsoring body, viz. a Society registered under the Societies Registration Act 1860 or any other corresponding law for the time being in force in a State, or a Public Trust or a Company registered under Section 25 of the Companies Act, 1956.

The Regulations specify that each private university shall be established by a separate State Act and shall conform to the relevant provisions of the UGC Act 1956, as amended from time to time. The Regulations have three key sections: dealing with establishment and recognition, inspection, and consequences of violations. With regard to recognition, for instance, it is stated that a private university shall fulfill the minimum criteria in terms of programs, faculty, infrastructure facilities, financial viability, and so on, as set down from time to time by the UGC and other statutory bodies concerned such as All India Council for Technical Education. Similar directives are written with regard to courses of study. It is also stated that the admission procedure and fixing of fee shall be in accordance with the norms/guidelines prescribed by the UGC and other concerned statutory bodies. There are provisions for periodic inspection of the private university and its various constituents. Finally, if the UGC were to find that the private university has, even after getting an opportunity to do so, failed to comply

with the provisions of any of the Regulations, then it could pass an order prohibiting the private university from offering any course for the award of the first degree and/or the postgraduate degree/diploma, as the case may be, till the deficiency is rectified. The Regulations are as general as possible giving ample scope for discretion. Some might not agree with the effectiveness of such discretion.[15] Thus, one can see that more and more private universities can be established in the country with the approval of the UGC. This effectively means that state governments cannot pass Private Universities Act circumventing the guidelines of the UGC.

If one compares our present day scenario with that of the United States, we can see that more prevalent than the status or privilege theories, and catalyst for the proliferation of contemporary contract cases filed against postsecondary institutions, is the constitutional theory of relationship between a college and a student which applies within the context of cases involving public institutions. In the United States, public institutions are amenable to public review, especially in the light of right to education. *Dixon* v. *Alabama State Board of Education*[16] is the case often considered as the "death knell" of *in loco parentis* and the genesis of the constitutional theory.[17] Constitutional theory advances the philosophy that students at public colleges and universities possess rights under the US Constitution, particularly under the Fourteenth Amendment's due process guarantees, concerning notice and hearing. Relative to these due process protections, a federal appeals court in *Dixon* held that students at state-supported institutions had the right to notice and a hearing prior to any disciplinary action that might result in dismissal.[18] Publicly funded higher education, it was reasoned, was no longer a privilege extended to the student, but an entitlement protected by due process of law.[19] Constitutional theory analysis is thus restricted to cases involving public-funded higher education institutions because independent institutions are not government agents and thus, not bound to provide constitutional protection. As a result, private college and university students rely more heavily on a contractual analysis, which has been increasingly applied since the advent of Dixon in 1961. In totality, both in India and in

[15] Available online at http://www.thehindubusinessline.com/2005/03/08/stories/2005030800190800.htm (accessed on August 12, 2008).

[16] 294 F.2d 150 (5th Cir. 1961).

[17] Gerard A. Fowler, *The Legal Relationship between the American College Student and the College: An Historical Perspective and the Renewal of a Proposal*, 13 J.L. & Educ. 401, 408 (1984).

[18] Dixon, 294 F.2d at 158.

[19] *Ibid.*, at 156–57.

the United States, institutions, public authorities and state-funded organizations come within the purview of the test of non-arbitrariness, equality, and fairness, thus falling within the domain of public law.

Proposition 2

Is education a "service" and student a "consumer"?

Many other theoretical interpretations have been developed by the courts in the assessment of university–student relationship as successors to the doctrine of *in loco parentis*.[20] Fiduciary, status, privilege, and constitutional theories have all emerged in case laws describing the nexus between a college and a student.[21]

A fiduciary relationship is created when one party reasonably entrusts and reposes confidence in another party to act on his or her behalf. Kent Weeks and Richard Haglund[22] have written that although universities no longer embrace the doctrine of *in loco parentis* and stand in the place of the parent, where students "specifically rely on faculty and administrators to pursue their education," colleges and universities still maintain their fiduciary obligations toward students.

In the 19th and early 20th centuries, the doctrine of *in loco parentis* framed the relationship between an institution and a student in American higher education.[23] Colleges and universities exercised strict control not only over the academic lives of their students but also over the moral,

[20] Jonathan F. Buchter, *Contract Law and the Student-University Relationship*, 48 IND. L.J. 253 (1973).

[21] Theodore C. Stamatakos, *The Doctrine of in loco parentis. Tort Liability and the Student-College Relationship*, 65 IND. L.J. 471 (1990).

[22] *Fiduciary Duties of Colleges and Universities, Faculty and Administrators*, 29 J.C. U. & L. 153 (2002). Available online at http://www.stcl.edu/txeslj/fall-2005.pdf.

[23] Federick Rudolph, *The American College and University: A History*. Vintage Books (1962). See also Perry A. Zirkel and Henry F. Reichner, *Is the in loco parentis Doctrine Dead?* 15 J.L. & EDUC. 271 (1986), discussing a Kentucky case from 1913 in which a state court upheld a college's rule forbidding students to frequent certain restaurants and brasseries:

> [C]ollege authorities stand in loco parentis concerning the physical and moral welfare and mental training of the pupils K [T]here is no question that the power of school authorities over pupils is not confined to the schoolroom or grounds, but to extend to all acts of pupils which are detrimental to the good order and best interest of the school.
> *Ibid.*, at 281 [quoting *Gott* v. *Berea Coll.*, 161 S.W. 204, 206 (1913)]

spiritual, and social aspects of a student's daily life.[24] Twentieth-century shifts in social policy and the changing nature and composition of the student population in American higher education, however, led to a retooled legal concept of the relationship between institutions of higher learning and their students.

The contractual relationship between a student and a university has undergone an evolutionary process through which it has been firmly established as a characterization of the relationship between institutions of higher learning and their students. In its nascent stages, it existed as a simple written agreement through which a student pledged to uphold the rules, regulations, and codes of the college. In its contemporary manifestation, contract theory provides students an outlet that was previously unavailable to seek redressal against their colleges and universities. Now characterized as consumers, students have specific and often precise expectations of an institution's performance and actively seek judicial relief through contract theory for perceived abrogation of these expectations. Institutions counter that judges should refrain from intervening in these disputes and grant deference to institutional decision authority.[25]

Most of the universities in India are statutory bodies created by legislature for imparting education. Some of the educational institutions are also operated by registered societies or trust. These include universities, technical or medical institutes, or other similar institutes. But one needs to distinguish between universities as public authorities, especially, under art.12[26] of the Indian Constitution amenable to public review from that of private education institutions including computer, tuition, and tutorial education institutions.

The new image should be one of the shared responsibilities, depicting the fine balance between a university authority and a student freedom. Students partially partner in the progress of any educational institution. So, if educational service has to improve, then the students ought to be treated as a consumer (which is one step close to contractual relationship) in India.

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[24] Christopher J. Lucas, *American Higher Education: A History*. St. Martins Pr (December 1994).

[25] K.B. Melear, "The Contractual Relationship between Student and Institution: Disciplinary, Academic, and Consumer Contexts; National Association of College & University Attorneys," 30(1) *Journal of College and University Law* 175 (2003) at 180.

[26] Article 12: In this Part, unless the context otherwise required, "the State" includes the Government and Parliament of India and the Government and the Legislature of each of the States and all local or other authorities within the territory of India or under the control of the Government of India.

The question is that is education a “service” u/s2(1)(o) Consumer Protection Act, 1986 (CPA)? The term education has not been included under sec. 2(1)(o). In *Board of Examination, Madras* v. *Mohideen Abdul Kadar*,[27] the National Commission held that conducting examination, evaluating papers, and declaring result do not perform any service for hire, as contemplated under the CPA. In *Amirt Kaur* v. *Appejay College of Fine Arts,*[28] it was held that there was no deficiency in rendering services while giving lessons. University is a statutory body performing the statutory function of conducting examinations. Though it charges a fee, it can hardly be considered as a contract for rendering service, as contemplated under the CPA.

In Central Academy Educational Society,[29] it was said that the relationship of a teacher and a student was not a “service” on hire and education and so cannot be linked with any of the economic goods. The term service is always paired with goods; symmetrically shared with it, the character of marketability. Education contemplates a variety of activities, some of them are marketable and others are not. Whether it is “consumable” will depend on the difference between what is marketable and what is not? For instance, sale of text books is marketable. Thus, being a product, it can safely be argued that it falls within the definition of service under the CPA. Similarly, boarding and lodging facility in a university/institution falls under the definition of a service under the Act.

When admission has been taken on the basis of capitation fee, which involves a colossal amount, it can be covered under the CPA. Private coaching institutes may be answerable under this Act. In *Mohan Singh Siddhu* v. *Km. Sarala Badkul*,[30] the complainant took admission in a computer course. He paid the fee but the institution got closed. The District Forum ordered for the refund of fee which was upheld by the State Commission. Similarly, in *Sonal Matapurkar* v. *S.N. Institute of Dental Science*,[31] the institute fraudulently took admission of 44 additional students more than the consented strength without any proper sanction.

Thus, under the CPA, education services provided by the state are not amenable under the Consumer Courts, but other “education-related” services provided by private tutorial and computer institute can be accessed under

[27] 1997 (1) CPJ 49.
[28] 1999 (1) CPJ 239.
[29] 1996 (III) CPJ 230.
[30] 1999 (1) CPJ 324.
[31] 1997 (III) CPJ.

the purview of the CPA. In their book, K.B. Melear and Joseph C. Beckham call this relationship as Collegiate Consumerism.[32]

Proposition 3

Educational malpractice: Principle of good faith in contract.

At the formation stage, good faith and fair dealing compels honesty and avoids any kind of fraudulence and misrepresentation. At the performance stage, good faith and fair dealing demands cooperation and observation of reasonable commercial standards and excludes "any kind of behavior inconsistent with common standards of decency, fairness, and reasonableness, and with the parties' agreeing upon common purposes and justified expectations".[33] As one court explained, good faith requires that one party "do nothing destructive to the other party's right to enjoy the fruits of the contract and to do everything that the contract presupposes they will do, to accomplish that purpose".

Good faith and fair dealing provides a bridge between institutional autonomy, flexibility, and student vulnerability. Even in those cases, where a catalog provision broadly permits unbridled changes and disclaims liability, the demand for good faith and fair dealing in instituting changes does confer on some protection to students.

Courts are understandably reluctant to step into the heart of university–student disputes. They correctly note that it is inappropriate to substitute their own judgment for the institution's academic and management decisions. Courts, however, must find a comfortable and unobtrusive role that acknowledges the consumer nature of the student–university relationship and demands more accountability from the institution. Courts needed a workable framework to hold universities accountable for their administrative and business judgments—as opposed to the disciplinary and academic decisions—and for this; the law of contract should provide the potential remedy.

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[32] K.B. Melear and Joseph C. Beckham, "Contract Law & the Student-University Relationship," Ashville, NC: College Administration Publications, Inc, 2003.

[33] *Centronics Corp.* v. *Genicom Corp.*, 562 A.2d 187, 191 (N.H. 1989).

As the court stated in *Ross* v. *Creighton University*,[34] "To state a cause of action for breach of contract, the plaintiff must do more than just simply allege that the education was not good enough. Instead, he must point to an identifiable contractual promise that the defendant failed to honor."

It was a case of education malpractice, where the plaintiff, in *Ross* v. *Creighton University*,[35] was a Creighton University athlete who sued for the failure to obtain an appropriate education. The court held that the educational malpractice is a tort theory which, though is venerated by the commentators, is not adored by the courts. In rejecting the plaintiff's claim for educational malpractice, the court found that imposing a duty of care upon the school would put an onerous burden upon the educators, forcing them to litigate every suit claiming negligence in the selection of curriculum, teaching methods, teachers, or extracurricular activities, for which the educators cannot be expected to foresee mental injuries arising from education.

The court upheld that in education, the ultimate responsibility for its success always remains on the pupil. It was found that while in other professions like law and medicine, where lawyers and doctors are exposed to malpractice liability, the nature of education radically differed from these professions.

"Education is an intensively collaborative process, requiring the interaction of student with teacher. A good student can learn from a poor teacher; and a poor student can close his mind to a good teacher. Without effort by a student, he cannot be educated."[36]

In August 2002, in the United Kingdom, the University of Wolverhampton paid £30,000 to a nature student who was dissatisfied with the quality of the Wolverhampton law degree.[37] The student's complaint included the university's failure to provide specific courses that it had advertised as being available in the course brochure—potentially, a clear instance of failure to provide the customer with what he had contacted for. Further, there were allegations of the university cramming up to 60 students into seminar rooms designed to seat 15 and of university examination being deeply disrupted due to the university's allegedly poor organization skills and general incompetence. Again, these instances would amount to breach of contract because the prospective student clearly does not fork out on tuition fee,

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[34] 740 F. Supp. 1319 (N.D. Ill. 1990)

[35] *Ibid.*

[36] *Ibid.*

[37] See Phil. Baty, "Whistleblowers: 'I blame government,' says £ 30,000 winner", *Times* August 2, 2002.

pass up employment opportunities, and undertake massive debt, with the intention of studying under such conditions. Thus, in the United Kingdom, it is clear that students can argue litigation on "educational malpractice" or "academic negligence" in tort as well. Thus, a common law duty with vicarious liability on the university for the specific acts of its representatives has clearly been established.

Proposition 4

Establishment of an educational liability.

There are six reasons why contract law deserves greater consideration by both the courts and the commentators as a method of addressing educational liability claims. First, both the legal commentators and the courts have, by far inappropriately, given too little a consideration to the propriety of such claims. Second, contract principles avoid the concerns that induce courts to apply the doctrine of academic abstention. Third, the emerging student–school relationship is one, particularly, amenable to an application of contract principles. Fourth, courts have so widely rejected other theories of educational liability that contract law may provide the last hope for potential plaintiffs. Fifth, educational liability actions comport with the goal of contract law: to protect parties' reasonable expectations. Finally, contract theory has already met with limited success; consequently, plaintiffs would not be asking courts to make new law but to take the minor step of expanding the existing law.[38]

The result is that education is being evaluated more from an economic market perspective, where the relationship between a student and a school is that between a consumer and a producer. Educational liability claims comport with the purpose of contract law. The essential functions of contract law are "to promote the realization of K parties' reasonable expectations," to supply terms that the parties would have agreed upon, had they negotiated the terms themselves, and to promote economic efficiency. As the comment demonstrates below, the courts would be acting in accordance with these goals by allowing educational liability actions to proceed in contract. Because many commentators discuss the student–school contract as an implied contract, it is important at the outset to recognize that there is no difference in

[38] Kevin P. McJessy, *Contract Law: The Proper Framework for Litigating Education Liability Claims*, *Northwestern University Law Review* (Summer 1995).

legal effect between an implied and an express contract. The only difference between the two is the mode of acceptance.

In academic affairs, a contractual relationship exists between a student and an institution. The basic provisions of the college catalog, recruiting brochures, various bulletins, and the student handbook become a part of the contract. The institution sets forth certain requirements for passing courses and successful completion of programs and subsequent graduation. If the students fail to meet the required standards, they can be penalized through actions such as dismissal, suspension, or failure to graduate on schedule; if the institution fails to respect its own regulations, then the student may seek judicial relief. It is important that the tutors bear in mind that universities have a contractual relationship with the students. What constitutes a student contract? All documents which pertain to all or any one among all of the admission and discharge of a student, rules, regulation, admission, and code of conduct may constitute a student contract. Pressure to clearly define the contract is growing as the payment of tuition fee becomes more significant for students and the legislation affecting higher education becomes more exacting. The likelihood of claims for breach of contract, negligence, or appeals to the visitor is also increasing. Student expectations, for example, relating to guaranteed delivery of specific modules as set out in publications, quality and availability of learning and teaching resources, quality of lecturing, tutoring, and supervision are likely to continue to increase.

The college, as an entity, maintains several types of contractual agreements with the students, which are not subject to college disciplinary procedures because they are not disciplinary in nature but rather place the college in the role of a proprietor. In this role, the college may terminate a student's admission, who fails to pay tuition expenses, or may evict residents from their residence for actions which are vitally inconsistent with the college's rules.[39]

An institution may create certain contractual obligations through the statements it issues in its publications. Advisors' obligations and responsibilities usually appear in an advisor's handbook and publications readily available to the student. An increasing emphasis to enhance retention places added responsibilities on the advisor. More and more advisors are expected to not only understand things, such as scheduling, registration procedures, degree, and program requirements, but also function as a referral service or

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[39] *Nichols College Student Handbook. 2006–2007*. Available online at http://www.nichols.edu/campuslife/handbook/contractual.html.

possibly as career counselors. Thus, if the institutions promise such services from their advising system, then they should ensure that their advisors deliver these services. Where an advisor did not, or could not, perform his contractual obligation, then possibly liability could be present. Thus, institutions should be conscious of an advisor's obligations which might be created by unequivocal statements regarding advisors' responsibilities.

Most institutions' catalogs state that the ultimate responsibility for knowing degree requirements rests with the student. This type of statement normally would protect the advisors if they commit an advising error. Usually, the advisor will not be held personally liable for erroneous advising in the absence of gross negligence, irresponsible behavior, arbitrary, or capricious treatment of the student. Advisors should keep notes of their discussions with the students during the counseling sessions. An accurate record of counseling sessions would help solve any disputes over the content of previous advising and also serve as a legitimate protection against claims of erroneous advising.[40]

Institutions across the globe[41] have evolved the student contract. The contract begins during the admission process, with the information provided in prospectus and publicity materials, and reaches its final form when the student accepts offer of a place, signs the registration form, and pays the fee. For example, the University of Leeds[42] has a standard form of student contract in which the university reserves the right to make reasonable changes at any time to the terms and conditions as it deems appropriate or necessary. Any substantial change would be brought to the notice of the student. Further, the university excludes its liability[43] in cancellation of program of study or services in circumstances beyond the university's reasonable control which includes industrial action, over or under demand from students, staff illness, lack of funding, severe weather, fire, civil disorder, political unrest, government restrictions, and concern with regard to the transmission of serious illness. The university also reserves the right to suspend or exclude a student on disciplinary or academic grounds.[44] The Intellectual Property Rights (IPR) clause states that all IPR shall belong to the university and

[40] *University of Texas, Arlington, Advisory Handbook for Students*. Available online at http://www.uta.edu/advisorhandbook/legal.htm.

[41] In the UK, Bristol, Leeds, Oxford, Chester, and Aberdeen, universities have student contracts.

[42] *2006 University of Leeds Student Contract*. Available online at http://www.leeds.ac.uk/aqst/studentcontract.htm.

[43] *Ibid.*, cl. 8 of the contract.

[44] *Ibid.*, cl. 11.

will be normally regarded as owning all intellectual property generated by a student during his/her studies.[45]

Proposition 5

Student–university relationship: Basis for breach of contract.

Inflation invades nearly every segment of life, including the educational process. When tuitions in private schools, colleges, universities, and graduate schools increase appreciably, many students are faced with the specter of financial inability to complete the courses of study already undertaken. Several modern suits, against medical schools which raised tuition rates, challenged such increases on the basis of breach of contractual obligation. In two of these cases (stated later), it appeared that the school catalog had cautioned that tuition rates were subject to change "without notice" or on a short notice. Such caution was deemed to constitute a reservation of rights to the schools issuing the catalogs. Attention is called to the fact that reservations of rights contained in school or college catalogs have been held effective in other cases dealing with such matters as expulsion for misconduct and promotion. And likewise, specific terms in a catalog relating to return of moneys paid, in the event of a student's withdrawal, have been held binding.[46]

In another UK case, *Moran* v. *University College of Salford*,[47] Moran, aged 34, was employed with a company, Manpower Services Commission. He wished to obtain a qualification as a physiotherapist and applied for degree courses in physiotherapy. Having submitted the application after the closing date of December 15, 1992, Moran's application was considered "late." Therefore, the institutions had discretion whether to consider the application or not, subject to suitable vacancies remaining. On June 22, 1993, Moran received a "statement of decision" indicating that he had received an unconditional offer from University College of Salford (UCS). A leaflet accompanying the statement of decision explained that an unconditional offer meant that "the institution is satisfied, from the information given, that you have fulfilled all its entrance requirements, and that it is prepared

[45] *Ibid.*, cl. 12.

[46] Increase in tuition as actionable in suit by student against college. American Law Reports ALR3d.

[47] [1994] ELR 187.

to admit you to the course." Moran replied with a "firm acceptance" of the offer from UCS and gave a notice to leave his accommodation in Lewisham and to terminate his employment. He did not attend a second interview for a job for which he had applied. On August 16, 1993, Moran telephoned the course leader at UCS to request for certain information. He was informed that he had never been offered a place on the course and that there was no place for him. The course was funded by the Department of Health and the funding covered 34 places. Moran's application should have been rejected, but because of a clerical error he was made an unconditional offer. Moran sought: (i) specific performance of the agreement, (ii) a mandatory injunction compelling UCS to admit him onto the physiotherapy course in September 1993, and (iii) further, or alternatively, damages for breach of contract.[48] The court held that the unconditional offer apparently made by UCS of a place for Moran was on the face of it, intended to create a legal relationship between the parties, and appeared to be an offer capable of acceptance. When Moran accepted it, and at the latest when he notified UCS of his acceptance on July 8, 1993, there was a strong case for saying that an agreement was reached under which UCS agreed to offer him a place if he sought to enroll on the due date. However, Moran would not have been bound to enroll or pay fee until he did enroll. He was entitled to withdraw completely from the scheme and to give up any place he was holding up to September 30, 1993. If he had enrolled, he would then have been bound by a separate contract to pay fee. By accepting the *unconditional offer* Moran gave up the chance, however small, which entry into clearing would have offered. This was a sufficient detriment to provide *consideration* for the agreement. Further, Moran had resigned from the current employment to take up a course at UCS. Thus, holding the case in favor of Moran, the court held that given this conclusion, there was no need to decide the arguments on "estoppel by convention."[49]

However, in *Guckenberger* v. *Boston University*,[50] the court concluded that the personal promises made in letters and orally by employees at the college constituted enforceable contractual agreements which the college breached. In *Guckenberger* v. *Boston University*, three disabled students

[48] The law in New Zealand, for example, makes the student–university relationship strictly contractual. Victoria University of Wellington has establishment terms and condition for contract. See http://www.vuw.ac.nz/home/studying/student_contract.html.

[49] Available online at http://www.btinternet.com/~akme/stdtl029.html.

[50] 974 F. Supp. 106 (D. Mass. 1997).

alleged that Boston University broke specific promises that the school had made during recruitment to accommodate students with disabilities. Their breach of contract claim alleged that Boston University had provided printed promotional materials to the students touting a "highly trained staff" and offering "reasonable accommodations in testing and coursework" and that the college breached specific promises made to the students during recruitment.

In *Russell* v. *Salve Regina College*,[51] a complex and interesting case involving a private university and its disciplinary actions, a student was expelled from the nursing program at Salve Regina College because of her unwillingness or inability to control an egregious obesity problem. During her junior year of study (instead, "While she was studying in the junior college"), she executed an agreement with the university conditioning her future in the nursing program upon an average weight loss of 2 pounds per week. The student was unable to meet that commitment and was subsequently dismissed from the program and the college. She filed a suit in the federal court against the university on a number of counts, including breach of contract. The district court ruled in favor of the university, regarding her claims of intentional infliction of emotional distress and invasion of privacy, but allowed her contract claim to go to (on?) trial, for which a jury awarded her US Dollar($)43,903 in damages for breach of contract due to her expulsion. The college appealed, and the First Circuit Court of Appeals affirmed the decision of the lower court. The college then appealed to the US Supreme Court, which reviewed the case and remanded it back to the federal court of appeals for a *de novo* review of the contract claim in relation to the doctrine of *substantial performance*. On remand, the federal appeals court acknowledged the contractual relationship between a student and a college and stated that her contract claim should be based on whether she substantially performed her part of the contract.

In this instance, case after receiving a substantial performance instruction from the trial court, the jury apparently found that Russell had substantially performed her part of both the underlying matriculation agreement as well as the "side agreement" relating to her weight loss.

The appellate court thus affirmed the jury's determination that the student had substantially performed in accordance with the guidelines set forth in the contract and that the college had breached this contract by expelling the student. The monetary damage award against the university was also upheld.

[51] 499 U.S. 225 [1991].

Proposition 6

Judicial deference to disciplinary decisions: Violation in disciplinary matters.

Universities exercise wide discretionary powers to impose restriction under "disciplinary grounds." Such rules of conduct are necessary to maintain educational excellence and avoid politicization of campus from external disturbances. The use of the discretion can be questionable at times, the basic authority of the decision maker may be disputed, the application of the rules rigidly may impinge on the interest of the victim, the principles of fair hearing[52] may not find place in the rule book, and above all this, a decision regarding punishing the student who has been restricted under disciplinary grounds, may have already been made.

The internal regulation of any university or institution may be regarded by the courts as its internal matter or domestic law. This poses a problem: if a student wants to question or complain that the same has been broken or not been followed in a particular case, would such violations, disputes, come within the purview of private or public law is a question based on the nature of prevailing circumstance. Would expulsion of a student on disciplinary ground be treated as wrongful breach of contract?

Courts, however, are surprisingly insensitive to the relationship that exists between the inexperienced students and the faculty or the advisors. Courts generally regard the "normal student–teacher relationship" involving "usual job duties of teaching, supervising, advising and evaluating" as insufficient to establish an informal fiduciary relationship based on trust and reliance. In light of the tremendous judicial deference to the self-governance of universities and their academic freedoms and the vulnerability of students, perhaps the glib rejection of a fiduciary status is not particularly grounded in law.

In a strikingly similar case, the court in *Eisele* v. *Ayers*[53] ruled that medical students had no cause of action when their medical school increased its yearly tuition more than the average amount of increase imposed over the previous decade. The increase complained of was some 57.6 percent more than the previous year's tuition fee and seven times greater than the past

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[52] Principles of Natural Justice. Rule of *audi alteram partem*. Under this rule no person shall be tried in his/her absence or without giving notice of the charge against him/her and given adequate time to prepare his/her defence, with a chance to question any witness and to see and contest any evidence brought against him/her.

[53] [1978] 63 Ill App 3d 1039 21 Ill Dec 86, 381 NE2d 21, 99 A.L.R.3d 876.

average increase. Although the parties agreed that the relationship between the school and its students was contractual in nature, that the relevant terms of the contract were those set forth in the school catalogs, and that the catalogs in question reserved the right to the defendant school to increase the tuition "without notice" or "on a short notice," the plaintiffs alleged that the students had enrolled at the medical school for an academic year and entered into an agreement with the defendants to pay annual tuition in a specified amount in exchange for a medical education. The plaintiff students maintained that the language in the medical school catalog stating that tuition rates were subject to change without notice or on a short notice did not imply that the defendants' right to increase tuition was unfettered. Further, they said that the defendants were bound by statute to a standard of reasonableness in deciding whether and by what amount to raise the tuition. The court explained that the statute specifically excluded the defendant university from its application to pre-1945 universities, of which the defendant school was one. In response to the plaintiffs' suggestion that the contract was ambiguous and the ambiguity should thus be construed against the party formulating the contract,[54] the court declared that the fact that the plaintiff students did not agree with the defendants' interpretation of the provision relative to the tuition increase did not create an ambiguity. And contrary to the plaintiffs' contention that the doctrine of partial performance was applicable in which they had attended the school and paid the tuition for some semesters, the court pointed out that no 4-year contract was entered into, when the plaintiffs enrolled at the university; on the contrary, it was a renewable contract on a semester-to-semester basis. Rejecting, too, the argument, that duress[55] was evident, the court declared that nothing was inherently wrong or oppressive in the defendants' decision to raise tuition, particularly in light of the financial realities, and reduced federal government funding, and thus, duress was not demonstrated simply because the plaintiffs, at least in part, were required to bear the additional expense. Likewise, the doctrine of promissory estoppel[56] was inapplicable, the court

[54] *Contra proferentem* is a rule of contractual interpretation that provides that an ambiguous term will be construed against the party that imposed its inclusion in the contract or, more accurately, against (the interests of) the party who imposed it.

[55] Economic Duress is recognized under the United Kingdom contract law. See *CTN cash and Cary Ltd* v. *Gallagher Ltd.* [1994] 4 All ER 714 and *D & C Builders* v. *Rees* [1966] 2 QB 617.

[56] Promissory estoppel is defined in the Restatement (Second) of Contracts as: A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if

asserted, noting that the defendants had made no promise to limit future tuition increases to the amount by which it had been raised in the previous years. The court denied that the defendants' unilateral imposition of the tuition increase, coupled with the plaintiffs' lack of bargaining power, rendered the contract one of adhesion,[57] explaining that the defendants did not take unfair advantage of the plaintiffs and, in fact, had indicated that the tuition increase was a financial necessity and that the university would make sums available to those persons unable to bear the additional expense.

Further, in *Beukas* v. *Farleigh Dickinson University*,[58] students filed suit alleging breach of contract when the university decided to permanently close the dental college as well as the graduate studies program leading to the Doctor of Dental Medicine degree. The decision to terminate the program was based upon a financial exigency and was communicated promptly to the students and faculty. Furthermore, students were given a number of options concerning degree completion, including transfer to other institutions that were, in some cases, state subsidized. The *Graduate Studies Bulletin* contained a reservation of rights clause permitting the university to make changes to programs and curriculum as it deemed necessary, including a statement that "[t]he foregoing changes may include, without limitation, the elimination of colleges, schools, institutes, programs, departments, or courses K".

The students filed suit for breach of contract arguing that a contract to educate was created by the university bulletin and other publications and that it was breached by the elimination of the dental program. The university argued that the doctrine of *judicial deference* should apply and that even if a contractual relationship were to be found, the reservation of rights clause included in the bulletin would prohibit the students from establishing a contract breach.

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injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires. Restatement (Second) of Contracts sec. 90(1) (1981). In *Royal Assocs.* v. *Concannon*, 490 A.2d 357, 361 (N.J. Super. Ct. App. Div. 1985), the court set forth a *prima facie* case for promissory estoppel: (i) [there must be a] clear and definite promise by the promisor; (ii) [the] promise must be made with the expectation that the promisee will rely on thereon; (iii) [the] promisee must in fact reasonably rely on the promise; and (iv) [a] detriment of a definite and substantial nature must be incurred in reliance on the promise. This is a more stringent standard than under the Second Restatement.

[57] Contracts of adhesion are contracts which one party did not bargain for. These contracts are standard forms of contract based on *take it* or *leave it*.

[58] 605 A.2d 776 (N.J. Super. Ct. Law Div. 1991), aff'd, 605 A.2d 708 (N.J. Super. Ct. App. Div. 1992).

The Superior Court of New Jersey cautioned against applying classic contract principles to this case. The court acknowledged that there were prior cases concerning program termination that involved a contractual analysis, but said that the theoretical underpinnings of these decisions have been criticized as lacking in a coherent and unified application of the law.[59] In reaching its conclusion, the court rejected the application of classic contract theory, but stated that even if it were applied, the university reserved the right to eliminate programs from the bulletin. Lacking a display of bad faith, arbitrary action, or insufficient notice given to students, the court saw no reason to force the application of contract principles, only to reject them.

The court held that:

> In sum, this court concludes that applying quasi-contract theory to resolving university-student conflicts over an administrative decision to terminate a college or program for financial reasons is the most effective way to avoid injustice to both the university and its students. The judicial inquiry should be directed towards the bona fides of the decision making and the fairness of its implementation: whether the institution acted in good faith and dealt fairly with its student body should be the pole star of the judicial inquiry. This approach will give courts broader authority for examining university decision making in the administrative area than would a modified standard of judicial deference and will produce a more legally cohesive body of law than will application of classic contract doctrine with its many judicially created exceptions varying as they must from jurisdiction to jurisdiction.[60]

In a case with a similar outcome involving the application of contract theory to the award of a degree, two students at Harvard University brought suit claiming that the university's refusal to award their degrees constituted a breach of contract. In *Dinu* v. *The President and Fellows of Harvard College*,[61]

[59] *Ibid.*, at 781 (citing *Peretti* v. *Montana*, 464 F. Supp. 784 (D. Mont. 1979), rev'd, *Montana* v. *Peretti*, 661 F.2d 756 (9th Cir. 1981); In re Antioch Univ., 418 A.2d 105 (D.C. 1980); *Pham* v. *Case W. Reserve Univ.*, No. 265625, 1997 WL 156689 (Ohio Ct. App. Apr. 3, 1987); *Behrend* v. *Ohio*, 379 N.E.2d 617 (Ohio Ct. App. 1977)). The Beukas court opined that "[a]lthough the result in each of the foregoing cases has not been questioned, the theoretical bases underlying these decisions have been criticized as lacking in a unified and legally consistent application of the law." Beukas, 605 A.2d at 781. See Eileen K. Jennings, *Breach of Contract Suits by Students Against Post-secondary Education Institutions: Can They Succeed?* 7 J.C. & U.L. 191, 217 (1980–81). See also Virginia D. Nordin, *The Contract to Educate: Toward a More Workable Theory of the Student-University Relationship*, 8 J.C. & U.L. 141, 179 (1981–82).

[60] *Supra* n. 25.

[61] 56 F. Supp.2d 129 (D. Mass. 1999). See also *Williams* v. *Franklin & Marshall Coll.*, No. CIV.A. 99-0234, 2000 WL 62316 (E.D. Pa. January 13, 2000); *DeMarco* v. *Univ. of Health*

two students had been found guilty of stealing money from Harvard Student Agencies, a student-run enterprise. The university required them to withdraw their respective admissions for 1 year and withheld their degrees despite the fact that they had completed the requirements for graduation. The students filed suit arguing that because they satisfied the formal requirements for graduation prior to their mandated withdrawal, they had a vested right to their degrees. The students also contended that Harvard could not punish their misconduct by withholding their diplomas. The court dismissed their argument after applying the standard of *reasonable expectations* and noted that the university's enforcement of its disciplinary standards was reasonable in light of the circumstances. The court concluded that although there are instances in which an institution might withhold a degree for improper reasons, "this case is manifestly not one of them."[62]

In another dispute turning on disciplinary matters, a Maryland appeals court addressed the importance of judicial deference to academia in *dictum*, but granted a narrow window of review regarding institutional compliance with established procedures. In *Harwood* v. *Johns Hopkins University*,[63] a student, who had murdered a fellow student and convicted, filed a suit against a private university after being expelled and was denied his degree. During the fall term of 1995, the student had completed all the degree requirements necessary for graduation; however, because the university held the graduation ceremony only once annually, after the spring semester, he was compelled to wait until May 1996 to receive his degree. It was during this interim period that he murdered the other student and was expelled. The convicted student filed suit arguing that he was not subject to the university's disciplinary action after he had completed all his degree requirements and that the university had acted in an arbitrary and capricious fashion by declining to confer his degree.

The Court of Special Appeals of Maryland first sounded traditional concerns of judicial deference regarding the role of the courts in the examination of academic matters and cited the difference between public and private institutions relative to the due process protections afforded to students in each context: "Although the actions of public universities are subject

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Sciences/Chicago Med. Sch., 352 N.E.2d 356 (Ill. App. Ct. 1976); *Harwood* v. *Johns Hopkins Univ.*, 747 A.2d 205 (Md. Ct. Spec. App. 2000). In these cases, the courts upheld the denial of a student's degree, concluding that the student provided insufficient evidence to demonstrate that the university failed to follow its stated procedures.

[62] *Supra* n. 25.

[63] 747 A.2d 205, 209 [2000].

to due process scrutiny, private universities are not bound to provide students with the full range of due process protection." The court then limited itself to the contractual standards of review employed when scrutinizing judicial actions of private institutions: whether Johns Hopkins University (JHU) had the authority to withhold the student's diploma after he had completed the required coursework and whether JHU acted in an arbitrary or capricious fashion in expelling the student. The precise language of the university handbook was relied upon to resolve both the issues.

The policy outlined in the handbook clearly states that a student will not receive a degree based solely on the completion of coursework. Moreover, the policy informs students that they must comply with JHU's policies in order to receive their degree and must resolve all outstanding charges of misconduct before being approved for graduation. Appellant's dismissal was based on specific provisions of JHU's Conduct Code. Finding no arbitrary action on the part of the institution, the trial court ruled in favor of the university and the student appealed.

Though the courts are usually hesitant to intervene in academic decision-making, they must balance judicial deference to institutional expertise with intrusion into the disciplinary decision-making process by examining the institution's policies and determining the extent of college or university compliance with these stated policies. In some cases, it is a precarious balance and the courts at various levels of appeal find themselves in disagreement on the permissible extent of intrusion into academia. For example, in *Schaer* v. *Brandeis University*,[64] the university board on student conduct found an undergraduate, at this private institution, guilty of violating several provisions of the student handbook after engaging in a sexual encounter with a female student. The student argued that the encounter was consensual and that he was not interviewed prior to his hearing, a requirement clearly stated in university policy as part of the judicial process. Also, the student alleged that the hearing was not properly recorded and was not conducted in strict compliance with the institution's student code. The student was suspended for 3 months and ordered to serve probation for his remaining tenure at the university. His university appeal of this decision was denied and he filed a suit for injunctive relief. The lower court dismissed his complaint on the grounds that he did not state a claim for which relief could be granted. A state appeals court determined that the lower court had erred in dismissing the student's claim and ruled that the university failed to follow the disciplinary procedures outlined in its student code.

[64] 432 Mass. 474, 735 N.E.2d 373 (Mass. 2000).

The Supreme Judicial Court of Massachusetts, however, disagreed with the lower appellate court and affirmed the ruling of the trial court, concluding that the student had failed to state a claim on which relief could be granted. The state high court's majority emphasized that the judiciary is "chary about interfering with academic and disciplinary decisions made by private colleges and universities." In addressing the claims for breach of contract, the majority ruled that the student had failed to demonstrate sufficient evidence of specific breach in the disciplinary process, stating that "[a] university is not required to adhere to the standards of due process guaranteed to criminal defendants or to abide by rules of evidence adopted by courts." The court concluded that institutions of higher learning must have broad discretion in the construction of appropriate disciplinary sanctions and that while a university should adhere to its stated policies, the student failed to present sufficient evidence of a material breach.[65]

The Schaer and Harwood decisions underscore the balance of judicial deference to university decision making exhibited by the courts. These cases demonstrate the reluctance of the courts to intervene in academia, allowing only a narrow window of review in disciplinary cases to determine whether the institution acted arbitrarily or capriciously or whether express policies and procedures were followed.

The UK cases make a point of contract in higher education. First case establishes the implied theory of contract to university–student contract. *Herring* v. *Templeman*[66] is an unusual case of dismissal of a student. The plaintiff was a student at teacher training college. Clause 27 of the university trust deed provided, *inter alia*: "K subject to the general responsibility and control of the Governing Body the Academic Board of the College shall K make recommendations to the Principal for the dismissal of students whose standard of work is unsatisfactory K"; cl. 24 provided: "The Principal shall have power to recommend the dismissal of a student from the College. Every such recommendation shall require to be confirmed by resolution of the Governing Body after considering such representations in writing or in person as the student may wish to make." When the plaintiff was near the

[65] Dissenting justices, however, embraced contract theory and emphasized that institutions must follow their own express procedures: "While the university's obligation to keep the members of its community safe from sexual assault and other crimes is of great importance, at the same time the university cannot tell its students that certain procedures will be followed then fail to follow them. In a hearing on a serious disciplinary matter there is simply too much at stake for an individual student to countenance the university's failure to abide by the rules it has itself articulated."

[66] [1973] 3 All ER 569.

end of his third and final teaching practice, the academic board provisionally graded his teaching practice as failed and resolved that if that assessment was confirmed by an external assessor, then the plaintiff should be advised to leave on academic grounds. The external assessor confirmed the assessment and the principal conveyed the board's decision to the plaintiff and informed him that he was recommending formally to the chairman of the governing body, on behalf of the academic board (of which he was the chairman), that the plaintiff be dismissed. The academic board sent a report to the governing body about its recommendation for the dismissal of the plaintiff. A copy of it was given to him 10 days before the governing body met. In it, the board outlined the course of events that had led to its recommendation and gave the plaintiff's grades in his first two teaching practices and referred to adverse comments on his competence by his tutors and teachers and added that the plaintiff happily seems to be unaware of or unable to understand his deficiencies and to be lacking in that capacity for self-criticism which might have given hope that he would one day be able to equip himself satisfactorily for the teaching profession. When the meeting of the governing body was held, the only document made available was the report. The plaintiff was present at the meeting and was invited to give his reasons as to why he should not be dismissed. Having heard him, the governing body resolved unanimously to accept the recommendation from the academic board. The plaintiff brought an action against three representative members of the governing body in which he sought, *inter alia*, a declaration that the resolution of the governing body and the recommendation of the academic board were *ultra vires*, null and void, and an order that he be readmitted as a student. He alleged that it was an implied term of a contract made between him and the governing body on his acceptance as a student that he would not be dismissed from the course without observance of the rules of natural justice in the processes leading to such dismissal. He contended (i) that he should have been accorded a hearing (a) by the academic board, before it recommended his dismissal, on the grounds that in deciding on its recommendation, it took into account extraneous matters (i.e., it did not confine itself to consideration of his marks and grades) and (b) by the principal and (ii) that there had been a departure from the rules of natural justice in the proceedings before governing body; in that, it had refused to reopen the academic board's assessment of his fitness to be a teacher and allow witnesses to be called, examined, and cross-examined in that connection and to reveal to him all the evidence, opinions, and reports on which the assessment had been reached by the academic board. The defendants moved for an order

that the plaintiff's statement of claim be struck out and the action dismissed as disclosing no reasonable cause of action.[67]

The court held that should the allegations in the statement of claim be struck out, there had been no breach of the rules of natural justice. The court held that there was no implied obligation to accord a hearing to a student, imposed on a board which only had the power to make recommendations to expel; it was the board's duty to form an unbiased assessment of the plaintiff's standard of work based on the entirety of his record and potential, and in making such an assessment with a view to deciding on its recommendation, it was entitled to take everything it thought relevant into account and that the board had taken into account nothing that it was not entitled to do. Further, the court held that the assumption that the plaintiff was entitled the right to a full legal trial on every detailed matter was fallacious; the hearing before the governing body was neither a law suit nor a legal arbitration; its purpose was to give the student a fair chance to show as to why the recommendations of the academic board, which was a competent body to make an assessment, should not be accepted; it was the duty of the governing body to act fairly, as there was no evidence to show that it had acted unfairly in any way; the plaintiff was just being made aware of the relevant facts and recommendations of the case. Thus, a student cannot expect a full-fledged hearing in case of his dismissal from the university. Although the actions of public universities are subject to due process scrutiny, private universities are not bound to provide students with the full range of due process protection.[68]

Clark v. *University of Lincolnshire & Humberside*[69] is another interesting case from the United Kingdom. Clark, a student of first degree humanities, had to submit a paper in 1995. On the last day before the deadline, all her stored data were lost from the hard disk. Clark was able to put together some notes copied from a commentary. The university's board of examiners failed her for plagiarism. While Clark explained the reason for her poor submission to her tutor, so that the examiners could be informed, the academic appeal board accepted that she had not set out to deceive and so referred the paper back for remarking. The board of examiners marked it 0. Clark appealed to the governors and it was decided that the mark 0 was not "an appropriate academic response." The vice-chancellor was advised that

[67] Available online at http://www.btinternet.com/~akme/stdtl029.html.

[68] *Harwood* v. *Johns Hopkins University* 747 A.2d 205 (Md. Ct. Spec. App. 2000): Court of Special Appeals of Maryland.

[69] [2000] 3 All ER 752.

mark 0 was permissible so long as the examiners had treated the paper as a failure rather than as plagiarism. Clark was made to re-sit in her finals and was awarded a third class degree which was not good enough for further career options that she wanted to pursue. Clark's claim was pleaded in contract. The claim was to the effect that the appeal board had misconstrued the meaning of plagiarism, awarded a mark beyond the limits of academic convention and failed to take into account the claimant's explanation.

Shortly before the deadline set by the court, a mutual settlement was reached by means of conciliation and the matter was resolved. This case does definitely raise a debate as to how universities must seek to address issues of plagiarism and assessment of projects and also whether an assessment by marking "0" is an appropriate academic response or should a student be directed to reappear in a particular project? Contractually, if the same procedure of the university is challenged, such cases might prove very problematic for judges to adjudicate.

Universities and institutions must necessarily provide for appeal procedures within the institutions. Further, it is important that authorities such as the UGC adjudicate disputes between an institution under its recognition and a student, so as to avoid litigation in educational matters. Thus, the UGC as a regulator and a facilitator must also perform the role of an adjudicator, so as to address the grievances concerned. This may require empowerment of the UGC with powers and functions, so as to perform the above aspirations of the student community. If this happens, assessment by National Accreditation and Assessment Council (NAAC)[70] can take into consideration the role of an institution in anticipating and resolving disputes as one of the criteria for the grant of merit.

Conclusion

Educational service is no longer a public service but is considered a public "good" or "commodity".[71] Especially, after the evolution of General Agreement on Trade-Related Services, higher education has assumed a contractual relationship. This hardly changes the scenario when such education is given by public or private institutions. Students are deemed to enter into contractual relationship with the university for the service of education. As education becomes increasingly commercial, the relationship between

[70] NAAC certificates Universities and Colleges for their performance in any given year.

[71] Available online at http://www.eaie.nl/pdf/conf2003/814.pdf.

educational institutions and consumers of education inevitably becomes contractual in nature, similar to other business relationships. Courts should be willing to adopt a contractual framework for administering litigations involving educational liability issues. Moreover, courts should recognize that contract law is already widely applied to many aspects of the student–school relationship.

The work horses of contract law, the implied obligations of good faith, and fair dealing hold the potential to define and to police the student–university relationship while avoiding the pitfalls of judicially second guessing and intruding into the management of the institution or its academic freedom.[72]

The courts can look into three theories of contract law for administering suits against schools: express contract, promissory estoppel, and third-party beneficiary. Express contract law can be applied nearly to all aspects of the student–school relationship at all levels. However, where courts are unwilling to adopt a rigid contract approach, they should apply more flexible theories of promissory estoppel and third-party beneficiary.

The public policy concerns that inhibit courts from recognizing a cause of action against schools based on tort law either do not apply in contract law or are ameliorated through an application of contract principles. Therefore, as our system of education changes, it becomes more apparent that some structured method is needed for litigating educational liability claims. The courts, therefore, should be willing to adopt a contract framework to provide that structure.

Courts are understandably reluctant to step into the middle of university–student disputes. They correctly note that it is inappropriate to substitute their own judgment for the institution's academic and management decisions. Courts, however, must find a comfortable and unobtrusive role that acknowledges the consumer nature of the student–university relationship and demands more accountability from the institution. The implied obligations of good faith and fair dealing give courts an appropriate role that allows the right mix of discretion and accountability. By asking schools to abide by the standards in the educational community and to refrain from decision-making for improper motives, courts can provide at least some protection to students while not usurping the university's autonomy. After all, students potentially have foregone other opportunities and purchased an educational product based on promises and representations that the institutions induced them to enroll. To state and to completely ignore the "consumer nature" of this relationship is to allow too much of discretion.

[72] Hazel Glenn Beh, "Student Versus University: The University's Implied Obligations of Good Faith and Fair Dealing," *Maryland Law Review* (2000).

2

Infrastructure Contracts

Sairam Bhat

Introduction

Lack of cash has virtually led every state in the nation to explore innovative finance techniques that allow important improvements in infrastructure projects, in public–private partnership (PPP) model to move forward while keeping taxes and fees low.[1] Private sector involvement in infrastructure has required regulatory reform, implying not only a new set of rules but an in-depth review of the way governments traditionally think about regulation.[2]

Infrastructure facilities include any form of facility, whether in the nature of a physical structure or a resource, commodity or a service, that is provided with an objective to be used by a society or a section of society.[3]

Infrastructure is the most critical item for any development and even more so for industries. Despite heavy expenditure on it in for the past so many years, infrastructure was still inadequate for the needs of the country. In fact, one of the motivations behind giving so much prominence to the

[1] Jeffrey N. Buxbaum and Iris N. Ortiz, "Protecting the Public Interest: The Role of Long-Term Concession Agreements for Providing Transportation Infrastructure," Cambridge Systematics, Inc. 1 Research Paper 07-02 – June 2007, The Keston Institute for Public Finance and Infrastructure Policy Research Paper Series Index, http://www.usc.edu/schools/sppd/keston/research/index.html, accessed on February 2, 2008.

[2] Evamaria Uribe, "Building Regulatory Institutions in Latin America: From Penalties to Incentives," Inter-American Development Bank (1999), http://www.iadb.org/sds/IFM/publication/gen_154_666_e.htm, accessed on February 2, 2008.

[3] Piyush Joshi, *Law Relating to Infrastructure Projects* (New Delhi: Butterworths, 2003) at 2.

public sector in the initial years was the necessity of bridging the gap in the infrastructure—the heavy requirement of funds which, it was thought, could only be provided by the government.[4] Unfortunately, over the years, the public sector started becoming active in areas other than infrastructure. This left a huge gap between demand and supply, which was impossible for the government alone to make good. Ideas of involving the private sector more actively began to be mooted in the late 1980s, but not with much force, and nothing worthwhile was achieved in this regard. It is in this context that the government, in 1991, emphasized the creation of infrastructure, both by stepping up investment by the government itself and by providing fiscal incentive to the private sector.[5] Two main reasons provided for last of infrastructure development in the country have been identified as inadequate user charges and regulatory uncertainty.[6] States are increasingly turning to toll finance and PPPs to begin to fill the funding gap, instead of financing infrastructure projects on their own. Long-term concession agreements with equity participation by the private sector are one form of what are generically called "public–private partnerships"—also known as PPPs or P3. Over the last year or so, PPP has been typically referred to these concessions, but PPP refers to any contractual agreements between the public sector and a private entity that allow for private sector participation in the delivery of infrastructure projects. PPPs range from the simplest form, design-build, to more complex transactions, including design-build-finance-operate (DBFO) or long-term leases/concession agreements which are based on build-own-operate and transfer (BOOT). PPPs are now being developed on greenfield projects,[7] which are start-up infrastructure projects.

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[4] P.S. Palande, *Coping with Liberalization: The Industry's Response to New Competition* (New Delhi: Response Books, 2000) at 37.

[5] *Ibid.*

[6] Anupama Rastogi, "Infrastructure Sector in the Report of the PM's Economic Advisory Council," available online at http://www.iimahd.ernet.in/~morris/iir02/chap%203(1).pdf, accessed on February 3, 2008.

[7] A "greenfield" project is one where the government does not have any infrastructure facility in place. It is building of a project right from scratch. A greenfield project involves land acquisition, design, building, maintenance, operation, and, finally, transfer to the government after the period of concession is complete. In a greenfield project, the parties may even have a clause in the concession agreement for an extension of the period of concession. For example, the Hyderabad and Bangalore International Airports are greenfield projects as in both cities the government was operating airports on military airbase runways. These airports are being built by private consortiums for a concessional period of 30 years with a possible extension of 30 years.

Constitutionality of PPP: Historical Origin

The economic crisis faced by India in 1990–91 provided an opportunity for unshackling the economy by de-licensing a number of sectors. This led to the opening up of the infrastructure sectors, including power and telecommunication, to enhance private participation. Sectoral policies as well as those governing foreign investment were liberalized. Sector-specific developments were aimed at improving the policy climate for private investment. The power sector has witnessed various phases of policy developments. The earliest phase, which began in the early 1990s, was aimed to improve the policy climate for private investment. In 1991, the Government of India amended the Electricity Supply Act (1948) to allow the entry of private investors in power generation and distribution.[8]

Similarly there is no need to describe the importance of airports in the national economy. However, considering the public utility nature of the air transport industry the government has also sought to retain a direct stake in the sector. As such the PPP model which exists in India seeks to combine the strengths of both these sectors. Constitution of India refers to civil aviation as a subject on the Central List, and the subject falls within the legislative competence of the parliament. The Aircraft Rules, 1937, have been amended to allow airports to be owned by citizens of India or companies or corporations which are registered and have their principal place of business in India. While the public sector faces budgetary constraints and lacks required expertise, the private sector faces problems in acquiring land, obtaining environment and forest permits, and other clearances, such as securing approvals from local authorities, and overcoming inordinate delays caused by the central, state and local governmental authorities. As government contracts have strict procedural requirements, the initiation of PPP started with a very cautious note. Enron and Bangalore–Mysore corridor (BMIC) provide important lessons for PPP in the country. At Enron, the controversial Power Purchase contract for extremely expensive electricity was suspended by the Maharashtra Power Board, which nearly went bankrupt as a result of high power prices. It is widely believed that the deal was reached through shadowy, secret negotiations, and in violation of the Electricity Supply Act. Begun in 1992, the Dabhol power plant near India's financial capital

[8] Anoop Singh, "Policy Environment and Regulatory Reforms for Private and Foreign Investment in Developing Countries: A Case of the Indian Power Sector," available online at http://www.adbi.org/discussion-paper/2007/04/26/2236.policy.environment.power.sector/policy.developments.for.private.investment.in.the.indian.power.sector/, accessed on February 10, 2008.

of Bombay in Maharashtra state was to have gone online by 1997. It was supposed to supply energy-hungry India with more than 2,000 megawatts of electricity. But endless disputes over prices and terms of the deal turned the venture into a symbol of what can go wrong in large-scale development projects when cultures collide. The first power project sponsored by the Enron Corporation at Dabhol in the state of Maharashtra ran into a series of hurdles, including renegotiation of the initial agreement, because of a change in the state government. It also faced several legal challenges in public interest litigation, including challenges of the validity of environmental clearances. Fortunately, these obstacles, including 25 court cases, have been overcome.[9]

On the other hand, the overenthusiastic Government of Karnataka entered into a Memorandum of Understanding (MOU) with Nandi Infrastructure Corridor to build an expressway between Bangalore and Mysore. On February 20, 1995, the Government of Karnataka entered into a MOU with the consortium of M/s Vanasse Hangen Brustlin Inc. and S.A.B. Engineering and Construction Inc., USA. A separate agreement was also signed by M/s Kalyani Group Ltd. with the Chief Minister Devegowda in 1995. Later in February, 1997, the Framework Agreement (being the constitution of the project) was entered into with NICE Limited [the name of the consortium] under the leadership of Chief Minister J.H. Patel. The privatization of the project had been done after taking into consideration the following documentation by BMIC:

1. Environment Impact Assessment with Socio-economic Components
2. Rehabilitation and Resettlement Report
3. Environmental Risk Assessment Report
4. Techno-economic Feasibility Report
5. Memorandum of Understanding
6. Project Report
7. Framework Agreement, 1997
8. NICE (Nandi Infrastructure Corridor Enterprise)–KIADB (Karnataka Industrial Area Development Board) Agreement
9. NICE–BWSSB (Bangalore Water Supply and Sewerage Board) Agreement
10. NICE–KEB (Karnataka Electricity Board) Agreement
11. 1999 October Supplementary Agreement

[9] Montek S. Ahluwalia, "Financing Private Infrastructure: Lessons from India," available online at http://planningcommission.nic.in/aboutus/speech/spemsa/msa009.doc, last accessed on February 10, 2008.

Since the cost of building the road and expressway cannot be fully recovered by a toll, the Government of Karnataka allowed the developer Nandi Infrastructure Corridor Enterprise Ltd. (NICE) to build five townships along the expressway. Lands required for the project as per Schedule 1 of the Framework Agreement is held to be final by the Hon'ble High Court of Karnataka while disposing the PIL (W.P. No. 29221) filed by Somashekar Reddy. On page 70 of the judgment it observes as follows:

> "As the matter was discussed at various levels of the government including the cabinet and the legislature, it cannot be held that the agreement entered into by the government of Karnataka was entered in any arbitrary manner, in secrecy or in any way in a clandestine manner."[10]

On the issue of whether the Framework Agreement is binding on the government in any adverse circumstances affecting the public interest, the Hon'ble Court clarified as follows:

> The contract does not promise to do anything that is unlawful. The power of the legislature to enact laws within the sphere allotted to it under the different lists of the Seventh Schedule being plenary in nature, the clauses in the agreement cannot be construed to have the effect of binding the Legislature which can reject the proposal of the executive to enact any law as agreed to by the government. *The Legislature in its wisdom can even nullify an agreement already entered into* (Emphasis added).[11]

In the first phase of PPP the government took to the competitive bidding route, wherein the government invited interested private players to invest and manage public utility services. Competitive bidding route was ideally suited for government contracts.[12] It involved "public auction and tender process" to ensure fairness in selection of the private player. After such decision was taken on selection, the policy of selection could hardly be challenged in the courts as was held in the BALCO case[13] by the Supreme Court. Government would then have the freedom of contract, with the rule of reasonableness

[10] [2006] Indlaw SC 166.

[11] For the Hon'ble Supreme Court has upheld the High Court decision that: "the legislature in its wisdom can even nullify an agreement already entered into." Considering the frivolous arguments and the *mala fides* with which the state of Karnataka and its instrumentalities have conducted this litigation before the High Court and Supreme Court, the apex court order that the state of Karnataka shall pay Nandi costs quantified at Rupees Five Lakhs as damages. *State of Karnataka & Anr.* v. *All India Manufacturers Organization & Ors*. Date of Judgment: April 20, 2006. http://judis.nic.in/supremecourt/qrydisp.asp?tfnm=27655.

[12] As held by the SC in *Sachindanand* v. *State of WB,* [AIR] 1987.

[13] AIR [2002] SC 1950.

and non-arbitrariness in its action and conduct.[14] The primary issue involved in the BALCO case was regarding the validity of the decision of the Government of India to disinvest and transfer 51 percent shares of M/s Bharat Aluminium Company Ltd. The question that arose for consideration in that case was whether such a decision to disinvest is amenable to judicial review?

The petition was dismissed and the Supreme Court held that:

> ...the process of disinvestment is a policy decision involving complex economic factors. The courts have consistently refrained from interfering with economic decisions as it has been recognized that economic expediencies lack adjudicative disposition and, unless the economic decision, based on economic expediencies is demonstrated to be so violative of constitutional or legal limits on power or so abhorrent to reason, that the courts would decline to interfere.[15]

The Supreme Court held that in such a case the appropriate forum for testing a policy is the parliament and not the court. This judgment of the Supreme Court gave impetus to the PPP idea in the country. PPP is based on economic factors, wherein the realization that the government did not have adequate funds to own, control, and manage all infrastructure projects in the country, it had to look into inviting private players who would do build-and-maintain public utility services on behalf of the government. PPP envisages "governmental developmental project" to be built, operated, and maintained by private investors and later, after realization of a reasonable return, transfer the project to the government. Thus, one may notice that the nature of contract in a PPP is not a license for a private player. As a license would not have any sense of ownership (though in a PPP it is a limited type of ownership), the contract tends to create a usufructuary right in the framework of a "Grant." The contract under a PPP grants a right of a public utility service for a limited time to a private player who then transfers it after the expiration of the said time period.

The challenge then is to find out the nature of contractual relationship between the government and PPP. Whether such PPP contracts are statutory contract or mere government contracts? Whether a writ will lie even in the matter of non-statutory contracts? In the case of a non-statutory contract a writ will lie if there is violation of art. 14 or some other provision

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[14] A government contract is judicially challengeable if one can prove violation of art. 14, bad faith, or procedure laid down in art. 299 is not followed.

[15] It is important to note here that BALCO was not created by any Act of the parliament. Would the decision of the Supreme Court been different if BALCO was created by an Act of the parliament?

of the Constitution. However, in the case of a statutory contract, a writ will lie not only on the above-mentioned (constitutional) ground but will also lie on the ground that there is violation of the statutory provisions relating to that contract. In other words, in the case of a non-statutory contract, a writ will only lie on constitutional grounds, but in the case of a statutory contract, a writ will lie on both grounds, namely constitutional as well as statutory grounds. This is really the essential distinction between the cases of a statutory and non-statutory contract.[16] Most of the PPP are based on statutory contracts, but the growth story of PPP is so strong that in Mysore a market place has been handed over to a private player under a concession agreement.

What constitutes a PPP? In Enron and BMIC (Bangalore-Mysore Infrastructure Corridor), the government sought to privatize public utility services such as power generation and building road network. The lesson drawn shows that in telecom, the government has given license to private companies to give services in certain spectrums only. The license is for operation and service of telecom and other related activities. Whereas in the sector of airports, the Airport Authority of India (AAI) and the state governments are active stakeholders. The stakeholding of the AAI and that of the state governments in the PPP of building airports is in the range of 16–18 percent each.

Judicial quest in administrative matters in PPP has been to find the right balance between the administrative discretion to decide on matters, whether contractual or political in nature, or issues of social policy; thus, they are not essentially justiciable as to remedy any unfairness. Such an unfairness is set right by judicial review. But the courts are quick to point out that there must be judicial restraint in administrative action so as to ensure transparency, accountability and procedural fairness.[17]

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[16] *Ram Dhyan Singh* v. *State of U.P.* Special Appeal No.323 of 2004.

[17] In *Tata Cellular* v. *Union of India and others* AIR [1996] SC 11(vide paras 85 and 86) it has been observed:

> It cannot be denied that the principles of judicial review would apply to the exercise of contractual powers by Government bodies in order to prevent arbitrariness or favouritism. However, it must be clearly stated that there are inherent limitations in exercise of that power judicial review. Government is the guardian of the finances of the State. It is expected to protect the financial interest of the State. The right to refuse the lowest or any other tender is always available to the Government. But, the principles laid down in Article 12 of the Constitution have to be kept in view while accepting or refusing a tender. There can be no question of infringement of Article 14 if the Government tries to get the best person or the best quotation. The right to choose cannot be considered to be an arbitrary power. Of course, if the said power is exercised for any collateral purpose the exercise of that power will be struck down.

The first impression one gets about PPP is that this is very much a government contract and hence the stipulations under art. 299 of the Constitution are mandatory.

As a contract between the government and the licensee[18] (concessionaire), it would be covered by the provisions of art. 299 and 300 of the Constitution. Thus, judicial review of government contracts is determined by duty of courts in confiding itself to check the legality of:

1. whether a decision-making authority exceeded its powers;
2. whether the contract committed an error of law;
3. whether the contract committed a breach of rules of natural justice;
4. whether the government reached a decision which no reasonable tribunal would have reached; or
5. whether there is abuse of powers.

Further the court has held that the grounds upon which an administrative action in government contract is subject to control by judicial review are as follows:

1. Illegality: This means the decision-maker must understand correctly the law that regulates decision-making power and must give effect to it;
2. Irrationality: Namely, Wednesbury unreasonableness; or
3. Procedural impropriety.[19]

The Legal Framework for Establishing a Project Vehicle for Infrastructure Projects

In India, the practice is to establish a private limited company by a joint venture agreement between the partners. Project vehicle for investment in infrastructure projects is usually through a joint venture agreement between stakeholders. The joint venture agreement is entered by companies and corporations to facilitate the process, speedy incorporation and

[18] Telecom infrastructure was the first to be brought under PPP model. Hence, the contract between the government and the private player came to be known as a license agreement and the private player a licensee.

[19] *Supra* n. 17.

commencement of business. The joint venture agreement is usually a followup of a MOU among the partners. A joint venture (the new consortium) is floated as a private limited company, registered under the Companies Act. To sort out the management part of the joint venture, the partners also enter into a shareholders agreement,[20] in which the concerns of management and decision-making are clearly laid down to avoid confrontation and litigation. In India, as a project development vehicle, the private limited company model is preferred over the partnership model for the following reasons:

1. According to the Partnership Act, 1932, the liability in a partnership is unlimited.
2. Tax holidays under the Income Tax Act are not available to partnerships.
3. There are limited sources for financing of a project in a partnership.
4. It is very difficult to get new partners and enable exit of old partners.

Thus, compared to private limited company, the most suitable model in these cases would have been the Limited Liability Partnership (LLP) which in a sense will change the perception of the "jointly and severally liability" principle in partnership. Countries like the United Kingdom and the United States have amended their partnership laws to suit joint ventures in infrastructure projects long time back. India brought the LLP Amendment to the Companies Act in 2008. This will provide impetus to the growth of Joint Venture business. LLP shall be a body corporate and a legal entity separate from its partners. It will have perpetual succession. While the LLP has a separate legal entity, liable to the full extent of its assets, the liability of the partners would be limited to their agreed contribution in the LLP. Further, no partner would be liable on account of the independent or unauthorized actions of other partners, thus allowing individual partners to be shielded from joint liability created by another partner's wrongful business decisions or misconduct. LLP simplifies registration process and does away with complicated documentation. A consortium can

[20] This shareholders agreement is for use by two existing companies that wish to form a limited company together in order to pursue a commercial venture. The agreement sets out the scope of day-to-day management by the appointed directors and also clearly states the limits of their powers—in order to protect the respective interests of the shareholder companies. This agreement is ideal for companies that wish to maintain as much control as possible over the new company structure and important shareholder decisions.

commence business with limited legal formalities and intervention.[21] The Registrar of Companies (RoC) shall register and control LLPs also.

State Legal Framework for PPP

Except for Andhra Pradesh and Gujarat, none of the states in India have passed enabling legislation to make policies and guidelines for PPP. The Government of Andhra Pradesh enacted the Andhra Pradesh Infrastructure Development Enabling (APIDE) Act, 2001. This was in order to provide for the rapid development of physical and social infrastructure in the state, attract private sector participation in infrastructure building, to present bankable projects to the private sector, and to improve the level of infrastructure in the state. Andhra Pradesh also has created Infrastructure Corporation of Andhra Pradesh[22] as a part of the Department of Infrastructure and Investment.[23]

The APIDE Act attempts to anticipate every contingency relating to infrastructure projects and their bidding process. It lays down precise rules for a variety of development models and concession agreements—the permissions that would be required, operating conditions and controls, payment modalities, penalties for lapses and abuse of development rights or pollution of the environment by developers. The statute specifies how sole bids would be treated or how a limited response would be dealt with or how consortium bids would be evaluated. The allocation of generic risks and their disclosure is laid down along with the facilities provided by government.[24] A conciliation board with precise proceedings for arbitration, settlement, and judicial proceedings are spelt out. For the first time, the penalties

[21] We have seen the lack of expertise of Indian companies in the airport sector, which forces them to ally with companies who have already built airports in other counties or companies which have expertise in airport infrastructure.

[22] Infrastructure Corporation of Andhra Pradesh Ltd. The corporation was created on May 31, 2005. For more see http://www.incap.co.in/html/about-incap.htm

[23] The following projects are notified as infrastructure projects under the purview of Department of Infrastructure and Investment: Knowledge Corridor; All Inland Water Transport Projects; Development of old Gandhi Hospital Premises Project; Infrastructure for all Natural Gas Projects; All New Airport Projects; Satellite Town Ships Projects. All PPP in greenfield airport sector are based on Private Ltd Company model.

[24] Enabling Infrastructure Development, Andhra Pradesh Style. http://www.rediff.com/money/2002/mar/28dalal.htm

specified under the Act for omissions and contraventions by developers are as high as Rs 10 million (Rs 1 crore).[25] An Infrastructure Authority has been created which will administer an Infrastructure Projects Fund established by the government. All rules, clearances, and permissions to be sought or complied with have to be disclosed upfront by the government, so that no transgressions can be imputed later or occur because nobody knew about the requirements in the first place. Also, by making it an overriding statute, a serious attempt has been made to provide a genuine single window for all project clearances.

State of Gujarat was second to follow and it passed the Gujarat Infrastructure Development Act (GIDA) as the first law of its kind in India. The Infrastructure Act focuses on facilitating infrastructure development through private participation within its territory. The Act establishes the Gujarat Infrastructure Development Board (GIDB), comprising of members appointed by the state government, and provides for the basic framework along which the GIDB would function and facilitate private participation in infrastructure projects. Several options for such participation are envisaged in a schedule to the law [build, operate, transfer (BOT); build, operate, lease, and transfer (BOLT); renovate, operate, and transfer (ROT)]. The scheme for the concession agreement is to be separately prescribed. The nature of projects listed as falling within the jurisdiction of the Act are specified in Schedule 1 to the Act consistent with state subjects under the Constitution. Schedule 1 also mentions "Power Generation, Transmission and Distribution Systems," which is in the Concurrent List. While facilitating projects on this subject, due compliance would have to be made with the Union laws prevalent in this sector. The Act provides for selection of a project proponent through the process of competitive bidding. Direct negotiations are also envisaged in the event that proposals are submitted not as response to any specific bidding process, but by the initiative of the concerned entity(ies). The law prescribes selection of bidders in an open bidding process based on three successive sets of criteria: prequalification; technical; and financial. Of these, the Act lays down the criteria for financial evaluation.[26]

The Gujarat Act allows the project developer to charge fees as specified in the concession agreement. Such fees can also be revised, based on criteria specified in the agreement. The Act recognizes that rate of inflation and variation in rate of foreign exchange are factors which may be taken into

[25] Although it is not clear why a finite limit on penalty has been prescribed instead of linking it to the size of the project and the nature of the offence.

[26] For more see www.ibef.org

account for revision of fees. As financial security, the project developer is required to open an escrow account or execute a performance bond.

The Act identifies several ways in which the state government or its agency can provide assistance for the project, such as through participation in the equity of the project company, extending of subsidies, senior or subordinate loans, executing government guarantees, operation of escrow account, conferment of development rights in respect of any land, and incentives in the form of exemption or deferral of taxes.

The Act also considers the possible scenarios which may emerge from termination of the concession agreement with a project promoter, and provides for:

1. payment of compensation to the developer in accordance with the concession agreement;
2. takeover of the project without repaying the investments made by the developer upon termination for default of the developer, but at the same time assuming liabilities of the developer for repayment of loans taken in lieu of the project; and
3. new concession agreement with a person recommended by the lenders, on the same terms as specified in the earlier concession agreement. The GIDA is in the nature of an overarching framework. Almost all of its specific provisions would require greater implementation and single-window clearance mechanism from the state.

A Study of PPP in Infrastructures Sector

Infrastructure contracts deal with public works. Some of these public works may be divided according to the area and sector of operation. They are:

1. physical infrastructure (bridges, roads, highways, ports, airports);
2. system infrastructure (electricity, pipeline);
3. maintenance infrastructure (railway, mass transport system, waste management); and
4. commodities (natural gas, petroleum, water supply).

Private participation in public works relate to design, construction, operation, maintenance, renovation, or upgradation.

The importance of PPP in infrastructure projects need not be overemphasized, considering that India is targeting a growth rate of nearly 10 percent per annum. Further, with practical difficulties in the country there is a considerable acceptance that a welfare state with socialistic concerns can move competitively by balancing both the ideals of welfarism and socialism in building key infrastructure projects.

Telecom Sector

The only sector that seems to be attracting private capital is telecommunications, where large projects are being implemented.[27] If we trace PPP of the recent history, post-1991 liberalization policy of the Government of India, probably the first private participation in infrastructure happened in the telecommunication sector. The Telegraph Act, 1885 was amended and sec. 4 allows the central government to grant a license on such condition and in consideration of such payment as it thinks fit to a "service provider."[28] Section 2(1)(e) of the Telecom Regulatory Authority of India (TRAI) Act defines a "licensee" to mean any person licensed under subsection (1) of sec. 4 of Indian Telegraph Act, 1885 for providing specified public telecommunication services and licensor to mean the central government. Thus, for the first time the government eliminated the "permit" system to grant "license" to private companies for providing public utility services. The change to license system is significant as the state is bound under the Constitution to keep providing these essential public utility services. Thus, from a monopoly in telecommunication, the state moved on toward a contractual regime of licensing to involve and attract private participation in such essential services. Validating this move, the Supreme Court in *Tata Cellular* v. *Union of India*[29] held that a telegraphy license is essentially a contract between the licensor and the licensee with the lawful object of providing communication services. To regulate the private players the Telecom Regulatory Authority of India Act, 1997 was passed. Section 11(2) of Telegraphy Act authorizes TRAI to fix tariff for telecommunication services. The licensee is bound by any subsequent changes in the tariff order as per terms of license agreement itself. Section 10 states that "no service provider shall, in

[27] *Supra* n. 6.

[28] Vikram Raghavan, *Communication Law in India* (New Delhi: Butterworths, Lexis Nexis, 2006) at 267.

[29] AIR [1996] SC 11.

any manner, discriminate between subscribers of the same class and such classification of subscribers shall not be arbitrary."[30]

The Cellular Mobile Service Agreement between the Department of Telecommunication and private investor has a license period of 20 years and is renewable for 10 years at a time upon a request made by the licensee.[31] The decision of the licensor in this regard is final. The license is revocable before the period of 20 years for reasons specified in the agreement.[32]

While governmental control over the telecom sector remained, the establishment of a regulatory authority provided a level playing field between the government-owned Bharat Sanchar Nigam Limited (BSNL) and other private players in providing telecommunication services in the country.

Airports[33]

"Due to the unavailability of public funds," the Airport Infrastructure Policy, 1997, as well as the 2003 amendment to the AAI Act, both recognizes the importance of private participation in the Airport Infrastructure sector.[34] The policy suggested modernization and upgradation of airports in accordance with International Civil Aviation Organization standards.[35] The policy specifies that greenfield airports[36] may be permitted where an existing airport is unable to meet the projected requirements of traffic.[37]

There is no certain policy of the exact manner in which the project should proceed after the private developer has been selected, and it has been seen that in India two major models have been followed; one regarding the

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[30] India Infrastructure Report, *Issues in Regulation and Market Structure* (New Delhi: Oxford University Press, 2001).

[31] Cl. 3 of General Conditions of the Telecom License Agreement.

[32] See cl. 10 and 11 of the Telecom License Agreement.

[33] Seventh Schedule, List I, Entry 29 read with sec. 246 of the Constitution of India vests the Union Parliament with the exclusive jurisdiction in relation to "airports; aircraft and air navigation; provision of aerodromes; regulation and organization of air traffic and of aerodromes."

[34] Section 14 of the policy of 1997.

[35] Section 7 of the Policy on Airport Infrastructure 1997.

[36] At present, Bangalore and Hyderabad have greenfield airports. Cochin International Airport Limited (CIAL) in Kerala has been a pioneer in airport privatization. It is funded by NRI travelers from Gulf and from exclusive rights to private companies for doing business at the airport. CIAL is built on a BOO (Build Own Operate) basis.

[37] The policy states that no greenfield airport will normally be allowed within an aerial distance of 150 km of an existing airport. For more see sec. 8(3) of the 1997 policy.

upgradation and modernization of existing airports and the other regarding the construction of new airports.[38] Regarding the ownership of the airport the policy seeks to keep all options open stating that airports may be owned by the central government, state government, urban local bodies, private companies and individuals, and also by joint ventures involving one or more of the above.[39]

The Airports Authority of India (AAI) Act, 1994, as amended in 2003, provides for the concept of "private airports." Any airport owned by any person, agency other than AAI, or any state government, or in case of joint venture with the AAI or the state government, being owned by such a person or private agency to an extent of over 50 percent is considered as a private airport.[40] The AAI shall be competent to enter into or perform any contract necessary for discharge of its functions provided that no contract exceeding such value or amount as the central government may, from time to time, by order fix, provided further that no contract for acquisition or sale of immovable property or for lease of any such property for a term exceeding 30 years is made.[41] The modernization, operation, and maintenance of the Delhi and Mumbai airports were done in 2006 through the joint venture (JV) route with 74 percent participation by private key party and 26 percent by AAI.[42]

Power Sector

Power is a concurrent subject falling under Entry 38, List III of the Seventh Schedule read with art. 246(2) of the Constitution of India. The legal framework in the power sector can be traced to three main legislations and rules made thereunder:

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[38] In the case of Bangalore and Hyderabad we see construction of Greenfield airports (new airports built under PPP) whereas in the case of Mumbai and Delhi, the airports were upgraded and limited modernization was carried out but thereafter operation and maintenance was handed over under PPP.

[39] Section 15 of the policy.

[40] Section 2(nn) of the AAI Act.

[41] Section 20 read with sec. 21 of the AAI Act. Thus, airport concession agreement can be for a maximum of 30 years and not more.

[42] Delhi airport was won by a consortium comprising of GMR Group and Fraport AG. Mumbai was won by a consortium of GVK and Airport Company of South Africa.

1. The Indian Electricity Act, 1910.
2. The Electricity [Supply] Act, 1948.[43]
3. The Electricity Regulatory Commissions Act, 1998.

The first of these governed the transmission, supply, and the use of electricity. The second, on the other hand, provided for the formation of three statutory bodies at the central, regional, and state levels to govern the generation, transmission, and distribution of electricity but mainly regulates the generation of electricity. The last Act provides for the setting up of Regulatory Commissions at the central and state levels and for the rationalization of electricity tariffs, setting transparent policies regarding subsidies, and promotion of efficient and environmentally friendly policies.

In 2003 the Government of India enacted the Electricity Act which seeks to create a liberal framework for the development of the power sector. At present, power projects by the private developers can relate to generation, transmission, or distribution and supply. A license has to be for a period of 25 years unless revoked earlier.[44] The Electricity Commission can grant two or more persons license to distribute electricity in the same area. Further, no license is required to distribute electricity in rural areas. Further, the licensee can franchise the distribution in a specified area within his licensed area and the franchisee does not require a separate license. Further, a license can be amended in public interest and the licensee has a right to raise objection. The Appropriate Commission can suspend a distribution license if it is necessary either in case of public interest, or where the standards regarding quality of electricity has failed, or there is persistent default in complying with the directions of the commission or where the licensee has broken the terms and conditions of the license.[45] All suspensions shall be reasoned orders and the suspension shall be for a maximum period of one year, during which the distribution shall be managed by an administrator appointed by the commission.

The commission may also terminate the license in public interest or in case of willful and prolonged default. Licensee can sell his utility to any person

[43] Private participation was present in the power sector even during British times. Indian Electricity Act, 1910, contained a framework for PPP through grant of licenses. However, the 1948 Act created a virtual state monopoly with only a few exceptions. Joshi, Piyush. *Law Relating to Infrastructure Projects*, 2nd Edition: pp. 259, Lexis Nexis Butterworths.

[44] Section 15(8) Electricity Act, 2003.

[45] Section 24. *Ibid.*

found eligible by the commission. The primary criterion for selection of purchaser has to be the "highest and best price offered for the utility."[46]

The Act entrusts the State Commission to determine tariff for supply and wheeling of electricity; however, if open access is permitted for a category of customers under sec. 42(2), it can determine only wheeling charges.[47]

The State of Delhi passed the Delhi Electricity Reform Act, 2000 which, in Part Vi, deals with licensing of transmission and supply. Section 20(4) lays the general parameters for license to be entered into agreement for purchase of power (under a transparent power purchase agreement), supply in bulk electricity to other licensee or to customers, may be entrusted with appropriate powers to take actions for revenue realization, prosecution of theft, meter tampering, diversion of electricity, or similar matters. The license holder has the duty to develop and maintain an efficient, coordinated, and economical system of electricity supply and for the operation and maintenance of power system. Licensees also have to submit statement of accounts to the commission and such statements shall be published with the rules.[48] The commission may inquire into the conduct or functioning of any licensee and may revoke a license in public interest.[49]

For the first time, under sec.20 of the Delhi Reform Act, 2000, a license was granted to a PPP in 2004.[50] North Delhi Power Ltd was founded in July 2002 through PPP framework, JV[51] between TATA Power and Government of Delhi. The term of the license is 25 years and the annual license fee is 0.05 percent of the amount billed during the previous financial year.

Highways[52]

There are a number of reasons for the inadequacies of our road networks. Primarily it has been the lack of resources provided to the sector which had

[46] Section 20, Electricity Act, 2003.

[47] Generally See *Blueprint for Power Sector Development: Vision 2012-Power for All*, Ministry of Power, Government of India, August 2001, Reports on India's Power Sector, New Delhi, Academic Foundation, 2003. http://www.powermin.nic.in, accessed on 10 February, 2008.

[48] As per sec. 27 of the Delhi Act, 2000.

[49] As per sec. 23, for revocation a 3 months notice has to be given to licensee and principles of natural justice have to be followed.

[50] License is granted by the Delhi Electricity Regulatory Commission.

[51] JV ratio is 51:49 percent shareholding between TATA and Government of Delhi. NDPL serves a population of 4.5 million spread across 510 sq. km. It has a registered consumer base of about 1 million.

[52] Piyush Joshi and R.V. Anuradha, *The Legal Framework for Private Participation*. India Infrastructure Report 2002.

decreased from the 9th to the 10th five year plan. The National Highways Act, 1956 was amended in 1995 to specifically vest the central government with the discretion to "enter into an agreement with any person in relation to the development and maintenance of the whole or any part of a national highway."[53] Thus, private participation in the development and maintenance of national highways has now become possible through a contractual arrangement between the central government and the private entity(ies). Certain basic elements for private participation are still missing in the legal framework. The National Highways Act specifies that national highways shall vest in the Union of India.[54] This provision inherently limits the scope and nature of rights that can be vested in a private developer as the relevant provisions only state that the government can enter into an agreement with the private participant in relation to the "development and maintenance" of a national highway. This limits the scope of private participation to "development" and "maintenance"; and do not include activities such as "operation" and "management" of the national highway, development of land appurtenant to national highways, etc.[55]

Another concern for any private entity is the scope and powers of the National Highways Authority of India (NHAI) constituted under the NHAI Act, 1988. The NHAI has jurisdiction over a national highway or part of a national highway which has been "vested" in it or "entrusted" to it by the central government. Both terms have significantly different legal consequences: through "vesting," there can be an absolute transfer of interest in the property, depending on the nature of the vesting; whereas "entrustment" would mean transfer in trust for a specific purpose only. This is significant in view of the fact that it is the NHAI, and not the central government itself, that has been constituted as the authority who would be signing the concession agreements for private participation in the national highway sector. Unless there is clarity as to the scope of powers and jurisdiction of the NHAI itself, the very basis of the concession agreement through which rights are sought to be granted to private developers would be in question.[56]

[53] Section 8 A, National Highways Act.

[54] Section 4, National Highways Act.

[55] State highway between Coimbator and Palgaht has been constructed by Larsen and Toubro.

[56] For a greater discussion on the scope and limits of private participation under the NH Act, the NHAI Act, and the Model Concession Agreement, see Piyush Joshi [2003], *Supra* n. 43, at 508–40.

Unlike most of the other infrastructure projects, the main asset of the project company in case of highways is not worth anything without the right to collect, manage, and appropriate the toll revenue. Thus, the lenders are exposed to the traffic risk as well as the risk of termination. Though the risk of termination can be managed with adequate legal and contractual framework being put into place, the lenders do face a direct risk.[57] Further, management of the project (as opposed to construction, operation, and maintenance) is very complex and expertise in the areas which include adjusting toll rates, planning maintenance for long-term benefits, and managing financial obligations are required. Lower usage of roads would put an immediate pressure on the object to increase the toll; in such cases, the reduction of toll in order to attract users would not be a viable option for purpose of financial projections, and it would be an uncertain assumption that a person not using a toll road would start using it just because the toll rate is lowered. Further, unlike other infrastructure projects, roadways hardly can advertise and sell Highway projects to increase revenues. Road networks are also poorly coordinated and further the government may have political compulsion to extend the roads near popular vote banks areas. The BMIC has been a bad example for private infrastructure projects in the country. It is thus imperative to have a regulator in place for such projects.

Even the Indian railways has allocated 100,000 crore for PPP for development of containers and inland depots on railway land. Delhi, Mumbai, Patna, and Secunderbad railway stations have been offered for PPP development into world-class terminals. Private investment has also been invited in locomotive and coach manufacturing. Already cleaning and maintenance of super fast trains has been outsourced.[58]

Socialistic Regulatory Framework for Governing PPPs

After a contract to operate, manage, and build a public utility service has been entered into, granting private players right to manage the PPP, the role of a regulator in such a PPP should never be ruled out. The regulator is not only a facilitator and a provider but also is an important agency to regulate conflict of interest between the state and private parties and among private parties themselves. The main stakeholder in any infrastructure development

[57] *Ibid.*, at 501.

[58] V. Jayanth, "Efficient Use of Rolling Stock Earns More Profits for Railways," *The Hindu*, March 3, 2008.

facility is the government, as it is the government which appoints the concessionaire for building of the infrastructure facility for public good.

The traditional analysis of the regulation problem as a natural monopoly has tended to concentrate on price or quantity instruments, with little concern about the institutions within which such instruments are operationalized. An alternative perspective can be gleaned from the so-called *new institutional economics* literature on regulation. This literature exhorts us to be sensitive to the fact that public utility provision is characterized by long-term contracts, and therefore the regulator can itself be viewed as an agency that balances the interests of both the consumers and the providers of a service over a long period of time. If perceived in this manner, the regulation problem becomes tractable as an exercise in institutional analysis. Given the fiat to regulate, a regulator has to choose an appropriate instrument to achieve a regulatory end.[59] An independent regulatory framework for ensuring economic regulation in each infrastructure sector is a core essential as there may be many operators. A regulator must be facilitator in terms of single-window clearance for PPP, an administrator for tariff determination and policy certainty, and an adjudicator to redress the grievances of the consumers as well between the government agencies and the private operator.[60]

Thus, in the power sector the National Electricity Policy (NEP) stresses the need for regulatory certainty through independent regulation (GOI, 2005): "....the need for regulatory certainty based on independence of the regulatory commissions and transparency in their functioning to generate investor's confidence." Such policy statements need to be translated into a political resolve to distance the government from the selection process of regulators and to provide financial independence to the regulatory institutions.[61]

Similarly the center is also considering the appointment of an independent economic regulator for airports to fix airport tariff and safeguard public interest. An autonomous statutory Airports Economic Regulatory Authority (AERA) has been proposed as a long-term measure for the limited economic regulation of airports in view of the inherent monopoly characteristics of airport services. The regulator will be delinked from government control.

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[59] T.C.A. Anant and Jaivir Singh, "The Constitutional and Legal Framework for Governance," available online at http://www.iimahd.ernet.in/~morris/iir02/chap%204.pdf, accessed on February 22, 2008.

[60] The Telecom Regulatory Authority can be cited as an example.

[61] *Supra* n. 9.

Independence of Regulators

Currently TRAI[62] has budgets allocated from the Consolidated Funds of India. This requires them to follow the employment, promotion, and other rules and regulations as applicable to government departments, reducing their autonomy and restricting choices for appointments. TRAI has been perceived as following the government's perspective rather than having an independent view. This has led to weakening of the regulatory process. Further, the employees of the commission and the Appellate Tribunal are to be appointed, as well as their salaries and other conditions of service are to be determined, by the central government. In addition, the Secretary General, who will play a very important role in the functioning of the commission will be only on deputation from the central government. These points seem to compromise the independence and autonomy of these two bodies.[63]

Thus, in addition to resolving issues of contract formation and adjudication, the provision of public utility services is involved with issues of distribution, equity, and fairness. Therefore, specialized structures of governance are required to mitigate the problems associated with public utilities. The problem is exacerbated by the traditional bureaucratic and legalistic approach of the public administration in the country. When the regulator becomes a co-administrator of the contract, it risks the creation of inefficiencies and perverse incentives.[64] It has been suggested that regulation can provide such a structure, where the regulator is seen as an agent who devises, allocates, and administers a collective contract for the provision of some natural monopoly output. This effectively means, to use phrases coined by Goldberg, that the regulator has to achieve a balance by protecting the producer's "right to serve" against protecting the consumer's "right to be served."[65] Conceptualizing regulation in this manner places an emphasis on mechanisms for maintaining, adjusting, and terminating long-term relationships and also raises questions about the appropriate instruments one can use for effective regulation. The discussion on instruments has often

[62] TRAI is the most prominent regulator in infrastructure projects in the country.

[63] Australia followed PPP only after independent regulatory authorities were established in each area. Major airports in Australia are now privately managed, but publicly regulated.

[64] Fred Aarons, *Bankable Concession Agreements: A Reality Check*, Inter-American Development Bank, http://grupobid.org/sds/IFM/publication/gen_154_224_e.htm.

[65] V. Goldberg, "Regulation and Administered Contracts," *Bell Journal of Economics and Management Science* 7 (Autumn) (1976) at 426–52.

been couched in terms of trade-offs between prices and quantities (tariffs versus quotas), command and control versus market-based instruments as in the discussion of environmental issues, and property rules or liability rules in the discussions of law and economics.[66]

The Role of Incentive Regulation

As said before, one of the great difficulties of this type of contract is that the regulator (or the public authority) is not only in charge of the standard regulatory duties but needs to guarantee to the public authority that every clause of the contract is fulfilled. It is, therefore, very important to develop a modem approach to this duty. Incentive regulation is an important way of prompting the private party to comply with the contract. Some examples can illustrate the point. First, contract design is critical to guarantee efficient performance. Rather than design a very detailed contract, it is preferable to introduce in it mechanisms that prompt efficient performance and avoid excessive regulatory supervision. If this is the case, the contract and the bidding process should encourage the private contractor to design, for example, an efficient tariff system. The formulas for tariff regulation become critical in providing the right incentives to metering, to induce efficient consumption, optimize long-term investment requirements and, therefore, reduce the cost of service. Second, longer periods to review the contracted tariff regime will be preferable if profit-sharing mechanisms have been foreseen in the negotiation of the concession agreement, and they allow the customer to share some of the efficiency gains without introducing uncertainty about the final outcome of the tariff review. Third, built-in investment incentives or mechanisms are necessary to overcome the disincentive the concessionaire faces in the later years of the concession agreements. Fourth, regulatory authorities have to rely more on *expost* evaluations of results, rather than *exante* evaluations of inputs and means. A better alternative, and a more efficient instrument to guarantee compliance, is reliance on incentives for desired behavior rather than penalties for undesired behavior.[67]

The government must levy fees to meet administration and regulatory costs, along with universal service obligation charges, through revenue sharing,

[66] *Supra* n. 43.

[67] Evamaria Uribe, "Building Regulatory Institutions in Latin America: From Penalties to Incentives," Inter-American Development Bank, http://www.iadb.org/sds/IFM/publication/gen_154_666_e.htm, accessed on February 22, 2008.

and not as an avenue to raise resources for the government. Increasing competition within the sector will ensure benefits of reduction in license fees which is passed on to consumers. In relation to telecom the only area here government should collect rent is in the allocation of spectrum, which is a scarce resource.[68]

Thus, a regulator in each independent infrastructure project is necessary:

1. Consumer interest to be protected: Private enterprises must not make undue profits from public works executed by them.
2. Government regulation in key infrastructure projects: Government control over infrastructure is the key for development in any country. There cannot be complete privatization of infrastructure projects. Also regulation of PPP should not end up in control but must rather balance competition interest between the government, the private investor, and the citizen.
3. Grievance redressal mechanism: A regulator has an important role in this matter.
4. It helps in fixing tariffs.
5. Courts usually uphold the judgments of such authorities as they are expert bodies with statutory role and function. This avoids a lot of litigation.
6. It gives greater credibility for long-term investment.
7. It reduces direct government interference by political decision.

The Possible Approaches in Contract for Infrastructure Projects in India: Concession Agreement[69]

Contractually, the move of creating PPP in India should be traced to the Enron power project and the Bangalore–Mysore Express Corridor. In Enron, the government entered into a Power Purchase agreement while providing free access to Enron to purchase land and establish its power generation unit at Dhabol. The realities were exposed when the government felt that in the

[68] *Supra* n. 6.

[69] Concession agreements involve the temporary transfer of service assets to the private partner who makes the investments necessary to maintain the service provision in good condition during the term of the contract. The assets are transferred back to the public authority at the end of the concession period.

effort of inviting foreign investment, its consumers would be exploited for higher tariffs. The Power Purchase agreement did not provide for licenses or grant of rights to generate power nor did it in turn give socialistic control of the project to the government. The government was left with no alternative but to litigate the high tariff in the courts and thereby delaying foreign investment into this country for nearly 5 years. Private players pressed for the application of the principle of promissory estoppel against the government for going back on its promise in MOU (contract). Supreme Court has held that there is limited application of the rule of promissory estoppel in contract against the government and hence the argument in this case against the government failed.[70]

Today having learnt from Enron and BMIC, the government enters into a contract with the PPP. This contract is titled as a concession agreement.

Concession is a right granted by a government to a corporation. Concession means a *long-term leasing agreement*, with a difference, made between and by the state and a concessionaire for the purpose of making foreign investments, exploitation of natural resources, and doing business-related thereto. Special conditions of concession shall be provided in concession agreements; comparatively a lease would create some type of interest or a right of the leasee over the leased property. In a concession agreement, the government "grants" a right to the private consortium to own the assets for a limited period of time. Further, this ownership is neither absolute nor qualified. It is ownership only for management purposes according to the nature and requirements of the concession agreement. The agreement is also a "grant" for a limited time, ranging from 10 to 30 years, depending upon the infrastructure project. The time is important so as to give reasonable opportunity for the concessionares to recover the cost of investment in the project and also to make atleast 20–25 percent returns over and above the incurred cost of building, maintenance, and operation.

Fundamental principles of concession are as follows:

1. longevity of concessional rights to use land and natural resources and to conduct specific business activities;
2. competitive approach to the selection of concessionaires, based on the assessment of tenders, specific regulations which will be provided by the legislation on the infrastructure sector; and
3. compliance with statutory legislation in relation to the specific infrastructure sector as well as the contractual provisions.

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[70] For more on promissory estoppel see *M.P. Sugar Mills* v. *State of U.P.* AIR [1979] SC 621.

Thus, a concession agreement specifies rules under which the company can operate locally. Some concession agreements might include tax breaks for the corporation, in order to keep them from moving to another jurisdiction. It is an understanding between a company and the host government that specifies the rules under which the company can operate locally.[71]

Since the early 1980s, developing countries have used the BOT structure to finance infrastructure projects in sectors ranging from roads, to power, to water supply and treatment systems, among others. The BOT structure is based on a concession agreement, such as a toll road concession or contract for a power plant. The concession codifies the credit/financial structure in the legal documents to create what should be a watertight set of provisions acceptable to all parties to the transaction.

The operation period must be for a fixed term that is sufficient to pay back the project debt and provide a return to equity. For this reason, the agreement should contain provisions for the extension of the operation period. When a project's financial return has been jeopardized by a government's default on its contractual obligations, then the period of the concession should be extended. Of course, adequate termination provisions must be included along with proper compensation (e.g., by establishing liquidated damages) to those affected.

Owing to the risk of default from either the government or private investor, safeguards are necessary to provide adequate security to the project's lenders. Standard techniques to avoid default also include offshore escrow accounts and/or the assignment of the benefits of various contracts to the lenders, and the lender's right to "step in" and take over the rights of the project company. In the case of the assignment of rights under a concession agreement, lenders seek the prior consent of the government to ensure project continuity and loan repayment. Governments, however, are reluctant to assign concession rights. If they do, their preference is for assigning these rights just before the actual transfer is required. A sound assignment provision is necessary to both provide comfort to the lenders that their loans will be repaid and to permit the government to verify that the recipient of the concession ("assignee") is capable of satisfying the terms of the contract.[72]

There are regulatory issues of particular importance that must be addressed in all concession agreements. These include (i) whether the public is willing to pay for services that were previously subsidized; (ii) whether regulations will restrict the freedom of the operator to set and review appropriate fare/toll levels; (iii) whether and when the concession will

[71] http://financial-dictionary.thefreedictionary.com/Concession+Agreement

[72] *Supra* n. 47.

revert back to the government; (iv) what will be the policy on competing infrastructure providers; and (v) whether the legal framework for awarding concessions, permits, and land acquisition, if necessary, is well defined.

Operational risks arise from an operator's technical inability to fulfill its obligations, the failure of equipment to meet specifications during commissioning, or a host of other factors. A concession agreement must address these factors, while providing comfort to each party without encouraging the abandonment of the project at some stage. To mitigate some operational risks and ensure that the service is provided to the population, the contract can require the implementation of an operation and maintenance manual and/or the use of performance bonds/Bank Guarantee as mechanisms to monitor and control proper project operation.

Normally, the law of the country in which the project is developed applies to concession agreements. Yet, governments are not always forthcoming in accepting alternative dispute resolution mechanisms (such as mediation and arbitration) to resolve controversies arising from a concession. These mechanisms are internationally recognized and provide a viable means to resolve problems expeditiously and transparently. Their inclusion in the concession will provide comfort and reliability to the parties involved in the agreement and, therefore, should always be considered. Further ADR (Alternative Dispute Resolution) clauses are not adverse to government contracts. As for an arbitration, judicial review is still a possible approach for resolution of disputes.

Some of the earlier PPP projects included *non-compete clauses* that precluded the public sector from making any improvements that would increase capacity that competes with the privatized toll facility. Such clauses were intended to give the private sector comfort that the public sector could not unilaterally decide to undercut the revenue stream of the investors. There are enough examples of this occurring that this seemed like a reasonable provision that would be necessary to attract bidders. The Government of Karnataka also decided to compete with BMIC by going ahead and building its own expressway from Bangalore to Mysore which may act as an alternative to the BMIC. Though this does not seem to have been challenged by BMIC in any of the court arguments, this is something the government must desist from to avoid discouraging PPP in any infrastructure project.

It should be remembered that a concession agreement represents a partnership between public and private sectors.[73] Borrowed from Latin America, where it is popular, concession may be fully privatized with

[73] *Supra* n. 47.

government holding a stake in the project or the public utility serviced.[74] Selection of concessionaire is strictly by bidding—the ground which quotes the highest concession fee payable to the government. Concession fee is that which is collected by toll (such toll can be collected as soon as the concession agreement is entered into). A concession agreement can be amended at a later stage also. For example in 2006, in Bangalore International Airport Limited (BIAL) PPP, the central government approved the change in the contract in design (redesigning the terminal building) so as to increase the capacity of handling passengers at BIAL. Grant of concession for airport is usually between 20 to 30 years, for highways, not more than 10 years in state highways and not more than 20 years in case of national highways.[75]

The lack of basic infrastructure services in poor urban and rural areas, the impact of infrastructure on overall economic performance, and its economic and social implications, are powerful incentives for governments to take an active role in the provision of infrastructure services. From a political perspective, state ownership of infrastructure assets and the provision of services are assumed to guarantee that social obligations will be met. It is also believed that ownership will allow the government to intervene whenever it perceives that the service provider is not fulfilling its obligations to provide adequate service.

Another impetus for the concession approach is the belief that the private sector can deliver services at less cost than the public sector. They can do this because they have a stake in the long-term cost structure of the project and have an incentive to control costs and maximize their return on investment at every step. Most importantly, the private sector has agreed to operate and maintain the facility at a particular price: if it cannot contain costs and be efficient, it will lose money.[76]

Conclusion

The legal regime surrounding airport privatization continues to evolve and there are many questions that are yet to be answered or are only just being

[74] Ellis J. Juan, "Privatizing Airports-Options and Case Studies," in *Public Policy for Private Sector* (The World Bank, June 1996).

[75] For more see www.nhai.org

[76] Jeffrey N. Buxbaum and Iris N. Ortiz, "Protecting the Public Interest: The Role of Long-Term Concession Agreements for Providing Transportation Infrastructure," Cambridge Systematics, Inc. Research Paper 07-02 – June 2007; The Keston Institute for Public Finance and Infrastructure Policy Research Paper Series Index: http://www.usc.edu/schools/sppd/keston/research/index.html

considered. For example, the law relating to tender auctions that has stood since *R D Shetty* v. *Airports Authority of India*[77] has only recently been considered and restated in *Reliance Airport Developers Ltd.* v. *Airports Authority of India*.[78] The Supreme Court re-examined the law governing public auctions in the context of privatization, and upheld the government's right to exercise its discretion and good judgment while re-emphasizing the importance of natural justice in the granting of such concession. The court held, "with all rights comes responsibilities." Thus, MIAL (Mumbai International Airport Ltd) (the company developing Mumbai's Chhatrapati Shivaji International Airport) was held to be a "State" for the purpose of the Constitution in *Flemingo Duty free* v. *Union of India*.[79]

With a pinch of salt, a look at some of the concession agreements between government and private parties show that many of these agreements lack a deep understanding of the future positions which is highly volatile and unpredictable. Take for instance, clauses in which the concession period is granted has often left aside the procedure for transferring the infrastructure facility after the period of concession is over. Further, vague and very general remarks of renewing the concession agreement have also been found. The agreement(s) fails to lay any guidelines as to the nature of the extension or the ground for denial of the period of concession. Thus just a few years with the emerging of the concept, these agreements are bound to create legal problems after 20 or 30 years for which many of them may come up for review.

The use of eminent domain for public projects is a sensitive issue which transcends long-term concessions. The public perception is that the power to use eminent domain is transferred to the private sector under a long-term lease agreement when in fact this has not been the case for any private concession agreement in any part of the world, especially in Latin America[80] where concession agreement first arose for public attention.

Further the constitutional framework in India does not permit for a single law governing grant of rights for development of projects in all the infrastructure sectors. While infrastructure remains an exclusive public sector monopoly, the rationalization of user charges in infrastructure is absolutely vital. A regulatory regime that is seen to be fair to consumers, and also sensitive to the legitimate needs of investors, is absolutely essential.

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[77] 1979 Indlaw SC 16.

[78] 2006 Indlaw SC 913.

[79] 2008 Indlaw Mum. 228.

[80] In Peru the Lima Airport was first example of a concession agreement.

In this context, regulation can fall into grey areas where the PPP results in the co-administration of the contract and the operation. Inspection and control of the contract is sometimes conceived as the only required regulatory duty, but entails the danger of becoming a permanent auditing and co-administration of the contract. Intrusive regulation thus substitutes for a modem economic regulation (that should conceive its role as an ex-post verification of performance and regulatory compliance), increasing the risks associated with regulatory uncertainty. To avoid the above pitfalls, the design of the concession contract is critical to ensure proper and efficient regulation. Furthermore, the fact that the ownership of the assets remains in the hands of the public sector may not provide the appropriate incentives to the parties involved and will be a factor that increases the regulatory risk.[81]

The concession model has grown from the reality that our infrastructure system needs far more money than is available from traditional sources. For example, in Mysore, the building of a shopping complex has been granted in a PPP model through a concession agreement.[82] This only goes to show the importance of PPP which may range from building highways and airports to building important public utility systems for greater and improved developmental activity within the country.

There are no silver bullets in public finance and there are no easy answers to this fundamental dilemma. Parts of the system are more than half a century old and need to be rebuilt. Some areas of our country are growing so fast that substantial and costly investments are needed simply to keep pace. The concession approach to project financing has many advantages over traditional methods and has met many concerns with its non-traditional techniques.

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[81] *Supra* n. 50.

[82] Development of Commercial Complex at Makkaji Chowk, Mysore. Copy of this draft concession agreement is with the author.

3

Consortium Loan Agreements

Sindhu Sivakumar and *Raguvaran Gopalan*

Introduction

Loan agreements are among the simplest commercial contracts. In essence, a lender advances a certain sum of money to a borrower, who has to pay it back within a certain period of time with interest, the interest being the amount the borrower pays for *use* of the money for the duration of the loan agreement. However, this straightforward concept has attracted unwarranted controversies, primarily because of very large amounts which have to be marshaled and protected in *commercial* lending arrangements.[1]

Loan agreements can be categorized into two broad segments—loan agreements governing commercial loans made out to governments, industries, and businesses; and agreements governing loans to individuals and households. The former is often in the nature of consortium lending, or syndicated lending, because of the sheer volume of the loan amount and the risk involved; on the other hand, the latter is almost always a bilateral agreement, and is usually subject to strong consumer protection laws.

In this chapter, the primary focus is on consortium lending, which is one of the most favored financing mechanisms for corporate activities.[2] In the year 2005, the global share of consortium lending in financing corporate activities was US$3.5 trillion, six times the share of bonds and shares.[3] Indian appetite for consortium loans has also been expanding at a phenomenal rate. As corporate India has grown in size and stature, so too have its needs for

[1] P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2008) at 93.

[2] D.J. Mullineaux, "Monitoring, Financial Distress, and the Structure of Commercial Lending Syndicates," 33(3) *Financial Management* 107 (2004) at 107.

[3] P. Wood, *International Loans, Bonds, Guarantees and Legal Opinions* (2nd edn., London: Sweet & Maxwell, 2002) at 3.

larger and larger volumes of money (to undertake bigger projects, to acquire companies, to facilitate large-scale expansion plans, etc.). Such needs can no longer be fulfilled by a single bank or lender. Hence, multi-lender facilities like consortium lending are stepping in to fund corporate India's breathtaking growth story.

This appetite for consortium loans and the growing use of consortium loan facilities in many infrastructure projects across the country deem a detailed study of the nature and legal framework of consortium loans imperative. This paper proposes to do exactly that, with a detailed examination of consortium loan agreements and the law governing such agreements,[4] including the nascent regulatory framework in India.

Consortium Loans—the Basics

What are Syndicated Loans? How are they Different from Loan Participations?

Syndicated loans need to be placed within the broader context of financing, as a source of finance for companies, governments, and municipal bodies. At an international and domestic level, there are two main sources of finance available to interested parties (which include companies, sovereign governments)—loans and capital market instruments. Capital market instruments include the debt capital market (i.e., international and domestic bonds), the equity capital market (i.e., share issue) and what is sometimes called as the equity *cum* debt market.[5]

[4] The loan agreement and the syndication agreement form the touchstone of the syndication process. They are vital documents for the banks and borrowers, and must be carefully negotiated so as to balance the various parties' often competing interests. Banks must especially be wary of boilerplate language as in the absence of clear language, commercial understanding is not the only guide used by courts in determining their meaning. The whole mess that ensued when a vulture fund sought to give a textualist interpretation to the commonplace *pari passu* clause is an excellent illustration of the dangers lazy drafting may expose banks to. This and other vital clauses of the loan agreement, which govern borrower–banker relationship and inter-creditor relationships, will be studied in detail so as to highlight the possible risks they pose to banks and how best to mitigate such risks.

[5] This includes instruments like convertible bonds, equity sweeteners, convertible debentures, and redeemable preference shares. Essentially, these are hybrid instruments with equity *and* debt characteristics. See P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 230–73.

Loan facilities are the other major sources of finance. This is where banks and syndications come in. Lending is central to a bank's business.[6] The most basic is the term loan, where a specified maturity date sets the time for ultimate repayment. It can have a fixed repayment schedule or be a revolving facility, that is, during its term the borrower can repay amounts but then re-borrow, so long as the overall limit of the facility is not exceeded.[7]

Now, loan facilities can be either single party based or multi-lender facilities. Multi-lender financing, such as syndicated loans, provide a preferred mechanism for financial institutions to loan large amounts of money to borrowers.[8] Generally, there are two types of multi-lender financing—syndicated loans and syndicated participations. A bank syndicate (or bank consortium) comprises a number of banks making a loan to a company or government, and often includes the arranging, managing, and underwriting of the said loan (each role is performed by a different member of the syndicate usually). Hence, a syndicated loan agreement is nothing but an agreement to severally lend money.[9] In a syndicated participation, one bank agrees to lend money to a borrower, and other banks, called participants, buy this loan from the first bank through separate participation agreements by making deposits of an equivalent amount in the first bank.[10] In contrast to participation, in a syndicated loan the lending banks are all party to the loan agreement and are directly involved. In a syndicate participation there is no privity of contract between the participants and the borrower, which is the case with a syndicate loan.[11] The practical outcome of this arrangement

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[6] In fact, it is one of the two elements defining a bank, the other being the receipt of deposits. See M.L. Tannan, *Tannan's Banking Law and Practice in India* (21st edn., Nagpur: Wadhwa and Company, 2005) at 12–13.

[7] R. Cranston, *Principles of Banking Law* (2nd edn., Oxford: Oxford University Press, 2002) at 299.

[8] Multi-lender financing allows financial institutions to, among other things, efficiently allocate risk, manage borrower relationships, and ensure their continued compliance with capital adequacy standards.

[9] See generally, R.P. Mc.Donald, *International Syndicated Loans* (London: Euromoney Publications, 1982) at 158–59.

[10] A.W. Armstrong, "The Evolving Law of Participations," in *Banking and Commercial Lending Law* (R. Nassberg ed., Philadelphia: ALI-ABA, 1992); R. Rendell, "Current Issues in Participation and Other Co-lending Arrangements," in *International Banking Operations and Practices* (J.J. Norton et al. eds., Dordrecht: Martinus Nijhoff, 1994); D.L. Threedy, "Loan Participations-Sales or Loans? Or is that the Question?" 68 *Oregon Law Review* 649 (1989).

[11] W.H. Knight, "Loan Participation Agreements: Catching Up with Contract Law," *Columbia Business Law Review* 587 (1987) at 589.

is that a participant faces a double risk—of borrower insolvency *and* lead bank insolvency.[12]

Why are Syndicated Loans becoming Increasingly Popular?

The development of lending syndications occurred mainly because certain types of loans were becoming so large that any one lender did not wish or was not able to lend such amounts. This is because when sums get large, individual lenders lack the funds necessary to supply all the credit needs of a borrower. Banking regulations also restrict the amount of loans, banks may make to any one borrower. For instance, in India, the RBI Credit Exposure Norms limit it to 15 percent of capital funds in case of a single borrower and 40 percent of capital funds in the case of a group of borrowers. Credit exposure to a single borrower may exceed the exposure norm of 15 percent of the bank's capital funds by an additional 5 percent (i.e., up to 20 percent) provided the additional credit exposure is on account of extension of credit to infrastructure projects.[13] Further, banks are required to hold a certain amount against their assets, otherwise known as regulatory capital restrictions, which may preclude a bank from adding a large loan or commitment to its balance sheet. By syndicating, the amount of capital a bank is required to maintain against the particular loan is less than if the bank was the sole lender for the entire amount.[14] At other times, lenders do not want to supply those funds because of their desire to diversify investments. Lenders, thus, band together so that collectively the sums required by the borrower may be advanced,[15] and the risk involved in advancing a large loan is spread.[16]

Another important, but often ignored, reason is that syndication as a technique minimizes the direct transaction costs associated with the contracting process.[17] Also, no further costs are incurred by the lenders on monitoring of the lead arranger. The group of lenders allows the lead arranger

[12] E.G. Behrens, "Classification of Loan Participations Following the Insolvency of a Lead Bank," 62 *Texas Law Review* 1087 (1984) at 1115.

[13] RBI Master Circular DBOD No. Dir. BC. 19/13.03.00/2008–09 dated July 1, 2008.

[14] *Supra* n. 3.

[15] T.H. Donaldson, *International Lending by Commercial Banks* (New York: Wiley and Sons, 1979) at 68; S.A. Dennis et al., "Syndicated Loans," 9(4) *Journal of Financial Intermediation* 404 (2000) at 406 (*Supra* n. 3).

[16] M.A. LeCompte, "International Loan Syndications, the Securities Acts, and the Duties of a Lead Bank," 64(6) *Virginia Law Review* 897 (1978) at 899.

[17] Generally speaking, it provides a convenient way of several banks making individual commitments under the umbrella of one agreement. Instead of a borrower separately negotiating

to negotiate and document transactions on the group's behalf because even the lead arranger is a lender with a significant stake to lose. The lead arranger has the same incentive as the other members of the group to negotiate a favorable transaction and the lead arranger signals this alignment of interest by retaining a portion of the credit facility. Further, the lead arranger will suffer reputational harm if it fails to properly negotiate, document, and monitor a transaction, which will in turn impair a lead arranger's ability to earn future fees as a loan syndicator.[18] Given such a situation, it is unlikely that the group of lenders will require additional monitoring of the lead arranger.

From the borrower's point of view, entering into a syndicated loan transaction may serve a variety of useful purposes. The borrower may need an immediate loan, or may want a committed borrowing facility from which it can borrow on relatively short notice, since the terms and conditions have been negotiated "up front."[19] The borrower may also enjoy several benefits from being in a direct relationship with several lenders. The competition among the banks to obtain the loan may result in the borrower obtaining more flexible and favorable loan terms.[20]

The Law Governing Each Stage of the Syndication Process

The Beginning

Once a borrower has decided to raise money using the syndication route, the borrower approaches one or more banks to negotiate the key terms of the loan facility. Interested banks then present an offer document. Each offer letter contains particular terms and conditions that, besides the bank's qualifications, would be the basis upon which the borrower determines

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with multiple lenders for the funds needed in its specific operations, multiple negotiations at the borrower level are replaced by a single negotiation for the benefit of the borrower, with the agent acting for the syndicate. Similarly, contracting efficiencies also result from common documentation. Thus, the total direct negotiation and documentation costs for the borrower come down. See, "Syndication," in *Offshore Commercial Lending by U.S. Commercial Banks* (F.J. Mathis ed., Washington: Bankers Association for Foreign Trade, 1975) at 1583.

[18] *Supra* n. 17, at 1591.

[19] This is known as a "revolving line of credit" and frequently includes a subfacility for the issuance of letters of credit to fund the working capital needs of the borrower. *Supra* n. 6.

[20] *Supra* n. 3, at 179.

which is the best proposal. An arranger is then chosen, and the borrower delivers a mandate to it to begin the process of syndication and raise the expected funds.[21]

The Mandate—Definition, Legal Nature, Commercial Practice and the Obligations

The letter of intent or mandate[22] usually sets forth the principal financial terms of the proposed loan (which is sometimes a separate document called the "term sheet").[23] This financing proposal, when agreed upon, will be expressed and detailed in a loan agreement.

The mandate is a preliminary instrument which reflects preliminary agreements or understandings of one or more parties to a future contract.[24] From a legal perspective, letters of intent are ambiguous.[25] In general, bankers or businessmen do not pretend to give legal force to this agreement. They are mainly meant to constitute an *assurance* to the arranger that the borrower intends to obtain financing from him but exclude the lender from any firm or specific commitment.

In spite of this commercial understanding, according to common law principles, a document cannot be said to be non-contractual just because it is denominated as a "letter of intent."[26] Hence, the wording of the letter of intent, expressing the objective intention of the parties, is the crucial factor for the courts to determine if the document is intended to be contractually enforceable or not.[27]

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[21] A.G. Romero, "The Letter of Intent in International Syndicated Financing: An Analysis of the English and American Law from a Sovereign Borrowers' Perspective," 3(3) *NAFTA: Law and Business Review of the Americas* 74 (1997) at 76–77.

[22] This document may have different names, such as mandate letter, commitment letter, term sheet, financing proposal, and credit offer.

[23] This includes the amount of the loan, the interest margin, the repayment schedule, fees, special terms, and choice of law.

[24] R.B. Lake et al., *Letters of Intent and Other Precontractual Documents: Comparative Analysis and Forms* (2nd ed., Massachusetts: Butterworths, 1994) at 59.

[25] *Ibid.* Lawyers never participate in their drafting—they get involved only from the loan agreement and beyond.

[26] In *Wilson Smithett & Cape (Sugar) Ltd.* v. *Bangladesh Sugar and Food Industrial Corporation*, [1986] 1 LR 378, it was held that the particular label for identifying the document (letter of intent) was not an indication of its legal nature.

[27] In *Branca* v. *Cobarro*, [1947] 1 KB 854, the Court of Appeal held that there was a binding agreement even though a clause of the agreement said, "this is a provisional agreement until

All letters of intent are intended to be binding at least in relation to two issues. First, they contain a commitment from the borrower to pay costs and expenses to the lender or arranger in regard to the arrangement of the credit. Second, some mandate letters state that the arranger will use its "best efforts" to arrange the deal.[28] Additionally, in the United States, "good faith"[29] has been regularly added to the obligations deriving from pre-contractual agreements. In a New York case, *Teachers Insurance and Annuity Association of America* v. *Tribune Company*,[30] it was said that courts will consider whether the defendant has "failed as a matter of law to negotiate in good faith."[31] However, as a matter of commercial practice, it is widely acknowledged that it is risk of reputational loss, and not legal liability per se, that is the biggest motivator in making lead banks comply with "best efforts" standards in arranging the syndicate.

The Arranging Bank—Role, Functions, and Exposure to Legal Liabilities

Once the mandate is granted, the arranger commences the process of marketing the loan facility to prospective participant banks. As part of the marketing process, the arranger, in conjunction with the borrower, customarily prepares an "information memorandum" (IM), which furnishes key information about the borrower to a prospective participant bank, including its business, financial position, and future prospects, and distributes both

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a fully legalized agreement is signed." Lord Greene M.R. held that the agreement between the defendant and the plaintiff was *intended* to be a legally enforceable contract. The phrase "provisional agreement" only meant that a new contract would eventually be signed to replace the preliminary agreement. However, till then, the provisional agreement was binding. Hence, the inclusion of the phrase "subject to contract" is crucial.

[28] If an arranger agrees to use its *best efforts*, then this should be construed in the light of diligent market practice. If an arranger states that it is *highly confident*, then this should be based on realistic assessment of the market and not merely an expression of unsubstantiated optimism and hope. *Supra* n. 48, at 6.

[29] Even though the terms good faith and best efforts might be mistakenly seen as synonyms, they are different concepts which imply different duties. Whereas best efforts obligations are related to the concept of diligence of the promisor, good faith is connected with honesty and fair dealing.

[30] 670 F. Supp. 491 (S.D.N.Y. 1987).

[31] The United States Uniform Commercial Code establishes that contracts or other duties regulated by this code impose "an obligation of good faith in its performance or enforcement."

the IM and term sheet to the prospective participant banks. After this, the arranger and other participants begin to prepare the loan documentation which is negotiated further with the borrower and finally signed.[32] The arranging bank's role as such comes into being when it is given the mandate, and the arranging process will cease either on execution of the facility documents or on syndication (when the participant banks enter into direct contractual relations with the borrower).

The three primary functions of an arranging bank are:[33] (i) coordination of the loan facility and arrangement of the syndication, including obtaining funding commitments from prospective participant banks; (ii) assisting the borrower with the preparation of the IM, including limited due diligence; and (iii) documentation, including preparation of the term sheet and the appointment of and liaising with the participant bank syndicate's legal counsel. Arranging banks, in lieu of performing these functions, are remunerated by the borrower by way of payment of "arranger fees."

The complex relationships formed between the arranger, the borrower, and the participant banks under a syndicated loan expose the arranger to considerable legal risk. These liabilities can arise out of the following contexts.

Liability Arising out of a Fiduciary Relationship

Establishing a fiduciary relationship in a commercial environment means *one*, the injured party may have a weak or no cause of action at common law in tort or contract, and *two*, establishing a breach of an equitable duty allows the plaintiff to seek equitable remedies.[34] In the context of syndications, if the arranger is a fiduciary, it will have a duty to act with care and skill, and

[32] While negotiating the key terms, the arranger must balance the interests of the syndicate against the expectations of the borrower and the acceptability of the proposed terms in the loan syndications marketplace. A failure to balance these competing interests may result in its losing its reputation in the "arranger marketplace" or later being unable to obtain funding commitments from prospective participant banks. See G. Skene, "Syndicated Loans: Arranger and Participant Bank Fiduciary Theory," 6 *Journal of International Banking Law and Regulation* 269 (2005) at 275.

[33] M.A. LeCompte, "International Loan Syndications, the Securities Acts, and the Duties of a Lead Bank," 64(6) *Virginia Law Review* 897 (1978) at 901; J. Lehane, "The Role of Managing and Agents Banks: Duties, Liabilities, Disclaimer Clauses," 1 *International Financial Law Review* 235 (1982) at 236.

[34] C. Qu, "The Fiduciary Role of the Manager and the Agent in a Loan Syndicate," 12 *Bond Law Review* 86 (2000) at 90.

must disclose any conflict of interest in relation to, or benefit from, the borrower, to the participants, and vice versa.[35] And fiduciaries will not be able to contractually limit these liabilities on account of undue influence principles.

On the other hand, the "arm's length" theory is the proposition of law where *one*, parties in *commercial* transactions are presumed to have dealt with each other at arm's length, that is, in circumstances where no special reliance or trust has been placed by one party in the other, or where no special vulnerability exists, and *two*, as a consequence of this presumption, there is no justification for a court to impose upon one of the parties fiduciary duties in favor of the other. Commentators within the banking and finance industry have supported this position to determine the nature of the relationship between the borrower and the arranging banks.[36]

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[35] R. Cranston, *Principles of Banking Law* (2nd edn., Oxford: Oxford University Press, 2002) at 59. That bank syndicates may give rise to fiduciary duties on the part of the lead to the other banks receives support from the obiter remarks of the English Court of Appeal in *UBAF Ltd.* v. *European American Banking Corporation*, [1984] 2 All ER 226:

> …the transaction into which the plaintiffs entered was that of contributing in a syndicate loan where, as it seems to us, the *defendants were acting in a fiduciary capacity for all the other participants*. It was the defendants who received the plaintiff's money and it was the defendants who arranged for and held, on behalf of all the participants, the collateral security for the loan. If, therefore, *it was within the defendant's knowledge at any time whilst they were carrying out their fiduciary duties that the security was, as the plaintiffs allege, inadequate, it must, we think, clearly have been their duty to inform the participants of that fact* and their continued failure to do so would constitute a continuing breach of their fiduciary duty.

These remarks must be treated with caution as a general statement of the law. The case involved the sale of an existing loan where the arranger was also the security trustee of the participants. In these circumstances the fiduciary obligations of the lead are more obvious than in a true syndicate where there is no security. Furthermore, the fact that the defendants had a longstanding relationship with the borrowers may have also influenced the court. See E.P. Ellinger, *Ellinger's Modern Banking Law* (Oxford: Oxford University Press, 2006) at 720.

[36] Clarke and Farrar opine: "Fiduciary obligations should not be imposed on the arranger. The members of a syndicate are 'buying' a product developed, marketed and serviced by the arranger. While the members undoubtedly rely on the reputation and experience of the arranger, the relationship is not fundamentally different from the relationship between IBM and the purchaser of a large computer system ... the better view is that the syndication process represents a classic arm's length transaction and, therefore, fiduciary obligations should not be imposed on the arranger." S.F. Farrar et al., "Rights and Duties of Managing and Agent Banks in Syndicated Loans to Government Borrowers," 1 *University of Illinois Law Review* 229 (1982). See also, J. O'Sullivan, "The Role of Managers and Agents in Syndicated Loans," 3 *Journal of Banking and Financial Law and Practice* 162 (1992).

Hence, something more than the standard relationship between the arranging bank and the syndicate members should be required before fiduciary obligations are held to supersede contractual terms.

Negligence

It usually arises where the loan documentation is found to be invalid or inadequate—the borrower then sues the arranger for negligence. Some commentators have indicated that the arranger would owe the borrower a duty of care based on "'implied agency"[37] principles; but this is not really necessary—ordinary tort principles mandate that the lead will need to act, as with any person providing a service, with reasonable care and skill.[38]

Liability Arising Out of the Information Memorandum—Prospectus Liability, Misrepresentation Liability, and the Legal Effect of Disclaimers

The arranger, on behalf of the borrower, will often prepare an IM, which is nothing but an information package about the prospective borrower and the proposed loan.[39] Since the IM is prepared for distribution to potential participants in the syndicated loan, and may be used and relied upon by other banks in committing themselves to the loan, there is a very clear potential for the lead manager to be liable to those banks should the contents of the IM be inaccurate or misleading.

First, an issue that merits serious attention is whether information contained in a memorandum constitutes a regulated prospectus. Generally speaking, if an IM is a prospectus which is regulated by domestic legislation, then (i) it may have to contain prescribed information; (ii) it may have to be registered with a securities commission, a registrar of companies or some other authority; and (iii) the liability for misrepresentation may be more onerous.[40] However, it will almost invariably be found that the IM is not

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[37] R. Cranston, *Principles of Banking Law* (2nd edn., Oxford: Oxford University Press, 2002) at 62. A claim based on negligence is not precluded because of any contractual limitations on the imposition of fiduciary duties. *Banque Bruxelles Lambert SA* v. *Eagle Star Insurance Company Ltd.*, [1996] 3 All ER 365.

[38] In considering whether the requirements for negligence are made out there must be sufficient proximity between the parties and it must be foreseeable that if care was not taken that loss would arise—*Caparo Industries Plc* v. *Dickman*, [1990] 1 All ER 568.

[39] The IM will, for example, contain details of the borrower, its background and business, as well as the amount, currency, and duration of the loan and its essential terms including the interest rate.

[40] As examples, these may be by throwing the onus of proof on to the defence, by avoiding exclusions of liability for misrepresentation, by imposing express liability on the directors and

a prospectus, for one or the other reason—such as the fact that the circular constitutes a private offering and not an invitation to the "public," or that it is issued only to sophisticated investors who can be expected to look after themselves, or that the loans per se do not constitute "securities" or "debentures" within the securities legislation.[41]

Second, the potential liability for misrepresentation in relation to the solicitation of participants is important—to both the borrower and the arranging bank. If the borrower induces the loan by misrepresentation, then it will be liable to an action for rescission of the loan contract or be liable for damages. The misrepresentation may be fraudulent,[42] innocent,[43] or negligent,[44] and it may be made expressly or impliedly. With respect to the arranger, an important case is *Sumitomo Bank Ltd.* v. *Banque Bruxelles Lambert.*[45] Here, an arranging bank was held liable for an assertion to a participant that credit insurance was validly in place and that there had been full disclosure to the insurer; the exclusion of liability clause in the credit agreement only covered the agent bank, not the arranging bank.[46]

Third, given the real possibilities for arrangers to be liable for the contents of the IM, it is common for the memorandum to contain an expressed disclaimer of liability and for the syndicated loan agreement to buttress this with contractual provisions to the same effect including a provision that no reliance is placed on the memorandum. The typical limits on exclusion

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on the arrangers of the loan, by overriding tort doctrines limiting liability for economic loss, and by giving investors direct rights. See, the Companies Act and SEBI Act and Guidelines in this regard. Section 62 of the Companies Act imposes civil liability on all officers and directors of the company for misstatement in the prospectus to the extent of the damage or loss caused. Section 63 of the Companies Act imposes criminal liability.

[41] P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 219.

[42] *Derry* v. *Peek*, [1889] 14 AC 337. Here it was said that, "carelessness will not constitute fraud or dishonesty. In order to establish an action for deceit, there must have been a false statement of fact made with the knowledge that, or recklessly as to whether, it was false and with the intention that it should be acted upon by a plaintiff who in turn acts upon it and suffers loss."

[43] *Supra* n. 80, at 189. The essential characteristic of innocent misrepresentation is the presence of such an actual honest belief in the statement.

[44] The essentials for proving this have been laid down in the *Caparo* case, discussed above.

[45] [1997] 1 LR 487.

[46] Regarding failure to disclose, in *NatWest Australia Bank Ltd.* v. *Tricontinental Corporation Ltd.*, Unreported, Supreme Court of Victoria, BC9300770, 2493-of 1990, the arranger was held liable to a participant for failing to disclose guarantees given by the borrower in the IM. However, this is not the standard position. In this case, the participant had specifically enquired about contingent liabilities and also the arranger was the recipient of one of the guarantees.

clauses are that *one*, there can be no exclusion for fraud, and *two*, the restriction must be "reasonable." Hence, the participant should rely on its own due diligence and not on that of the arranger.[47] The most recent case in this regard is *IFE Fund SA* v. *Goldman Sachs International*.[48]

The Loan Agreement

The terms of each individual credit agreement depends upon the type of borrower and its credit standing. However, core market practices are more often than not followed in syndications, and it is these standardized clauses that will be discussed here.

Type of Facility and Repayment

From the commercial viewpoint, the terms relating to the type of facility and its repayment are central. These terms deal with when can the facility be drawn upon, whether the borrower is obliged to borrow, and the bank to

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[47] *Banque Arabe et Internationale d'Investissement* v. *Maryland National Bank*, 819 F. Supp 1282 (S.D.N.Y. 1993). Also see *IFE Fund SA* v. *Goldman Sachs International* [2007] 1 LR 264.

[48] [2007] 1 LR 264. Here, Goldman Sachs acted as arranger and underwriter of syndicated debt facilities for Autodis S.A. to fund its acquisition of Finelist plc. IFE (Intermediate Finance Europe Fund) was a participant. Goldman sent an IM to IFE that annexed an accountants report prepared on that date. This contained an explicit statement that GSI was not making any representation, warranty, or undertaking, expressed or implied, in respect of the information contained in the information memorandum and did not accept any responsibility for the accuracy or completeness of the information. The Important Notice also made clear that GSI was not accepting any responsibility for updating the information contained in the IM or for advising any potential or actual participant of any information which subsequently came to its attention.

The main issue that arose in this case was regarding the effectiveness of this disclaimer in protecting Goldman from misrepresentation liability. The court held that there was no duty on Goldman to investigate the matter further in light of the terms of the disclaimer in the IM. If, on the other hand, Goldman had had actual knowledge that the information previously supplied was misleading, then it would be necessary for Goldman to disclose this. The courts expect sophisticated contractual counterparties to look after themselves and determine where their rights and liabilities lie. Hence, the courts will not strain to find implied representations or duties of care in commercial dealings particularly where they have been negated by the terms of the contractual arrangements. Hence, the disclaimer was effective against a claim of IM misrepresentation.

lend, the purpose for which the facility can be used, the time and method of repayment, interest payable, and default payments, if any.

The Purpose of the Syndication

The Preamble usually details the purposes for which the loan agreement is being concluded. The purpose usually influences the banks' decision to lend.[49] If it is violated, the borrower will be in default and will usually hold the money subject to a trust, giving the bank an advantage in case insolvency follows default.[50]

Illegality and Vires

If a facility is illegal, common law will treat it as void and disallow any action seeking recovery of the sum advanced.[51] Subsequent illegality is regarded differently, and the bank can recover, although any remedy may be blocked in cross-border lending by the action of the other jurisdictions in enforcing its law.[52] Regarding the effect of an illegality on the bank's obligation to lend, banks try to insist on an "illegality clause,"[53] whereby, if it becomes unlawful for them to continue with a loan, the borrower must immediately repay. Banks must also check on the *vires* of the borrower—*ultra vires* transactions are *void ab initio*.

Disbursement Clause, Obligation to Lend/Borrow, and Remedies

In the disbursement clause, the specific periods of availability of the amounts (totalling the amount of the loan) appear.[54] It also specifies the currency

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[49] The bank will see whether the lending has a commercial logic, whether it is consistent with the bank's policy, and what the documentation must contain to protect its position.

[50] *Barclays Bank Ltd* v. *Quistclose Investment Ltd.*, [1970] AC 567.

[51] *Allan Merchandising* v. *Cloke*, [1963] 2 QB 240.

[52] *Kleinwort Sons and Company* v. *Ungarische Baumwolle Industrie AG*, [1939] 2KB 678.

[53] The clause typically provides: "If it becomes illegal for a bank (a) make the loan, (b) fund the loan in the market as contemplated, or (c) have the loan outstanding, the bank can cancel and the borrower must repay." P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 50.

[54] R. Cranston, *Principles of Banking Law* (2nd edn., Oxford: Oxford University Press, 2002) at 305.

in which the payment is to be made, the place of payment, and the consequences of default on the part of the syndicate. The borrower's remedy is solely for damages determined in accordance with ordinary contract principles. Damages should aim to put the party suffering the loss in the same position as it would have been, had the contract not been broken. It will generally comprise two elements:

1. *Reasonably foreseeable losses*, including extra interest/costs incurred in arranging another loan.[55]
2. *Specially contemplated losses*, but only if the bank knows at the time the loan agreement is entered into that the loan is to be used for that contract and of the potential consequences. These may include loss of business profits where such loss was within the parties' contemplation. Reputational losses may be recoverable if they lead to pecuniary loss.[56]

Conditions Precedent

These are conditions precedent to the bank's performance under the facility; not to the agreement coming into effect.[57] These are usually to ensure that all legal and financial matters are in order before they make a disbursement.

Margin Protection Clauses

These are clauses designed to protect the margin or spread payable to the bank which is the bank's gross profit, or the whole of the interest. They

[55] P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 58–59.

[56] *Ibid.*

[57] R. Cranston, *Principles of Banking Law* (2nd edn., Oxford: Oxford University Press, 2002) at 312. Sometimes, the bank needs to co-operate so that the borrower can satisfy the conditions precedent. It depends on whether or not the condition precedent can be construed as imposing on the bank a duty to act. Here, by preventing fulfillment of the condition, the bank may be precluded from claiming that the condition has not been satisfied. However, if such a condition precedent can be construed as an agreement to agree, the court will not oblige the bank to act. *Ibid.*

include tax grossing-up,[58] increased costs,[59] currency indemnity,[60] and default indemnity.[61]

Representations and Warranties

Representations and warranties are statements the borrower makes to assure the lenders about its status, the lawfulness of its entering the agreement, and the absence of any default. They also perform an investigative role, going further than the common law, in covering omissions and failure to update.[62] Banking practice distinguishes between legal and commercial warranties. Legal warranties basically deal with the legal validity of the agreement. Commercial warranties deal with the borrower's financial condition and credit-standing.[63]

If a warranty is incorrect, it's an express event of default, and the bank can suspend drawdowns under the "conditions precedent" clause. Warranties are often continuous—called "evergreen" warranties, these must *stay* true throughout the life of the loan agreement.[64]

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[58] Such a clause provides that if the borrower must deduct taxes, the borrower will pay extra so that the bank receives the full amount. "Grossing-up" means that borrower will pay extra so that, after all tax deductions, the bank receives the full amount on the due date as if there had been no deduction. P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 60–61.

[59] This clause provides that if any law or notification increases the bank's underlying costs, the borrower must compensate this increased cost. This is simply a protection against erosion of the bank's return by central bank reserve requirements, special taxes, capital adequacy rules, and liquidity requirements which may impose costs on the bank which are attributable to the loan but which are not reflected in the cost of funding. P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 62–63.

[60] This clause provides that if the borrower's payments are converted into a non-contractual currency, the borrower will pay extra to ensure the bank receives the full amount in the contractual currency, plus costs of exchange. *Ibid.*

[61] This clause provides that the borrower will pay losses resulting from any default on his part. P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 64.

[62] For example, misstatement, omission, or failure to update will constitute default, even in the absence of any reliance on the part of the syndicate bank. P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 65–68.

[63] R. Cranston, *Principles of Banking Law* (2nd edn., Oxford: Oxford University Press, 2002) at 313.

[64] Examples of subsequent changes are the introduction of exchange controls, a moratorium, an embargo, a change in insolvency law introducing priority creditors, or subordinating security to super-priority rehabilitation loans.

The primary drafting issue that arises with such clauses is the decision as to whether one must include materiality and group tests as qualifications. These are inherently vague and lenders usually strive to avoid these.

Covenants

Covenants are undertakings by the borrower as to what it will or will not do in the future, designed to preserve the entity and its income-producing assets against which the bank lent. With covenants, the first legal issue is their interpretation, and the second is their breach and the legal consequences that ensue. Consequence of a breach of a covenant will be part of the default clause—so the bank can cancel any outstanding commitment and accelerate repayment. Failure to act may constitute a waiver of the breach and, in certain circumstances, a variation of the agreement.[65]

Information Covenants

These require the borrower to provide accounts, information requested by any bank, compliance certificates, notification of defaults and of potential or actual (material) litigation, etc. This clause is standard and intended to enable the banks to monitor the loan and to check the financial status of the borrower and potential defaults. Auditor liability is an interesting issue in such cases—if an audited financial statement is materially false and the borrower's financial condition is not as represented, the lender might face a serious loan loss (as, by now, the borrower will be close to insolvency). Despite the deep and entrenched reliance by lenders on audited financial statements, courts around the world have responded to calls for protection by the accounting industry and have severely reduced the ability of lenders to rely on audited financial statements.[66]

Financial Covenants

Financial covenants are nothing but triggers which provide an early warning to lenders that the borrower is likely to default on the loan. The tests variously measure liquidity, solvency, and capital adequacy but not usually the quality

[65] R. Rajan et al., "Covenants and Collateral as Incentives to Monitor," 50(4) *Journal of Finance* 1113 (1995) at 1126.

[66] See L.C. Roberts, "Courts Threaten Lender Reliance on Audited Financial Statements," 11(20) *Banking Policy Report* 1 (1992), for a detailed discussion on why this interpretation is extremely harmful to lenders' abilities to recover damages from auditors.

of the assets. These tests are based on specified generally accepted accounting standards.[67]

While there is no doubt that these covenants are integral, they are also very contentious. Borrowers may view debt covenants as an unwanted intrusion into corporate management's freedom to run the business.[68] Bankers, on the other hand, will be concerned about how far they afford them credit protection or give them influence over borrowers or control over a loan.[69]

Negative Pledge

In its most basic form, this clause provides that the borrower (and its subsidiaries) will not create or permit to subsist any security interest on any of its assets. In another form, there may be a promise on the part of the borrower to grant equal and rateable security in the same asset to the bank, or matching security in other assets, if it does grant security to a third party (the "equivalent security" negative pledge).[70] Some negative-pledge clauses go further and provide that the bank shares in any security the borrower grants in breach of the clause, or that security is automatically conferred in the same asset should a breach occur (the "automatic security" negative pledge).[71]

The main purpose of this clause is to protect unsecured syndicate lenders against the borrower granting security to other creditors, as this will render the *pari passu* clause redundant. Hence, it ensures equality between creditors, and also acts as an indirect control on the incurring of excessive liabilities by the borrowers.[72] Ideally, from the lender's perspective, the clause

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[67] Lenders should decide whether they want the standard to be fixed or frozen as at the date of the agreement. P.D. Berger et al., "Determination of an Optimal Revolving Credit Agreement," 8(3) *Journal of Financial and Quantitative Analysis* 491 (1973).

[68] This intrusion may arise because financial indicators which are the subject of covenants, such as gearing, net tangible worth, or interest cover, may become the focus of regular and costly internal monitoring and management by the indebted company to ensure that breaches do not occur. J.F.S. Day et al., "Bankers Perspectives on the Role of covenants in Debt Contracts," 11 *Journal of International Banking Law* 201 (1996) at 205.

[69] Either ways, it is generally felt that in order to improve the ability of financial covenants to act as more effective early warning signals, bankers should not use the same narrow range every time. They should question whether financial covenants actually provide effective early warning of financial distress. J.F.S. Day et al., "Evidence on the Practices of U.K. Bankers in Contracting for Medium-term Debt," 9 *Journal of International Banking Law* 394 (1995) at 396.

[70] D. Asiedu-Akrofi, "Negative Pledge Clauses in International Loan Agreements," 26 *Law and Policy in International Business* 407 (1995) at 407.

[71] *Ibid.*

[72] C.S. Bjerre, "Secured Transactions Inside Out: Negative Pledge Covenants, Property and Perfection," 84(2) *Cornell Law Review* 305 (1999) at 311.

should be structured to apply to existing security, as well as future securities. Furthermore, the reference to security must include all forms of security interest like mortgages, liens, pledges, and charges.

If this clause is violated, then as against the borrower, the bank has three remedies (apart from remedies arising from a triggering of the event of default clause): *one*, it can obtain an injunction to prevent breach of the basic negative-pledge clause; *two*, it can obtain specific performance of an "equivalent security" negative pledge; and *three*, if an "automatic security" negative pledge is in place, this will give it security which trumps any security taken by the third party.[73] As against a third-party creditor taking the security, he might be liable in damages for the tort of procuring a breach of contractual relations.[74] Generally the third party must know of the restriction if he is to be made liable,[75] and must possess a specific intention to inflict economic harm.[76]

Pari Passu Clause

This clause provides that the borrower's obligations under the loan agreement will rank on par with all its other unsecured liabilities, that is, it requires the equal legal ranking of unsecured claims on a forced distribution of available assets to unsecured creditors, primarily on insolvency.[77]

[73] However, this is controversial. First, in an equivalent security clause, the bank has simply a contractual undertaking that the borrower will give equivalent security. The automatic security clause goes further. The assumption is that, although the bank remains unsecured until breach, the happening of that contingency automatically triggers security in favor of the bank, that security having a priority over what the third party has taken. However, the security may fail in some jurisdictions because the asset is future and has not been presently identified. Second, the third party may not be affected if he has no notice of the clause. Similarly, the security may fail for non-compliance with legal formalities. Lastly, the security may fail as on insolvency preference if it arises in the suspect period (security for existing debt). P. Gabriel, *Legal Aspects of Syndicated Loans* (London: Butterworths, 1986) at 85–89. However, there is some authority in the United States whereby an affirmative covenant to secure when other debt is secured was held to create an equitable lien on the assets concerned. *Commercial Company* v. *New York NH and HRR Company*, 203 U.S. 372 [1906].

[74] See generally, J.R.C. Arkins, "Ok-So You've Promised, Right? The Negative Pledge Clause and the 'Security' it Provides," 17(1) *Journal of International Banking Law* 198 (2000).

[75] *Swiss Bank Corporation* v. *Lloyds Bank Ltd.*, [1979] Ch 548; *Torquy Hotels Company Ltd* v. *Cousins*, [1969]1 All ER 522.

[76] In *Mainstream Properties Ltd*. v. *Young*, [2005] EWCA Civ 861, it was held there must be an intentional infliction of economic harm on the claimant, either as an end in itself, or as a means to another end. Recklessness will not suffice. Ignorance is a defence so that a third party could rely on a mistake of law to explain why he took the action that he did.

[77] It does not require concurrent or equal payment prior to that time.

A typical formulation of the *pari passu* clause will be as follows:

"*The loans rank pari passu in right of payment with all other present and future unsecured and unsubordinated indebtedness of the borrower*."

In commercial circles, it was accepted that this clause only affirms the mandatory ranking of debt where there is competition between creditors—it is not an agreement that the debtor will in fact pay debts pro rata without discrimination after the debtor is actually insolvent. The clause asserts legal ranking, not equal payment in fact, and not equal treatment.[78]

Then came *Elliott Associates, L.P.* v. *Banco de la Nacion*.[79] It was essentially a sovereign defaulting on its debt due to insolvency.[80] Its loan agreements had the usual *pari passu* clause, and it was on the basis of this clause that Elliot, a vulture fund, persuaded the Brussels Court to say that the sovereign (Peru) couldn't preferentially pay off certain other creditors.

After this case, a number of hedge funds instituted similar actions against sovereign defaulters.[81] On the basis of this ratable payment interpretation of the *pari passu* clause, they sought specific performance of the covenant, and judicial orders directed to third-party creditors instructing them not to accept a payment from the debtor unless the *pari passu*-protected lender receives a ratable payment. It may make a third-party creditor that has knowingly received and accepted a nonratable payment answerable to the *pari passu*-protected creditor for a ratable share of the money.[82] All this is problematic because certain claims rank ahead of ordinary unsecured debts under insolvency laws, like bank depositors' claims, taxes, wages, and liquidation costs.

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[78] An equal treatment clause would require that, after actual insolvency, the debtor will pay all its debts pro rata, including trade debt and the milk bill. *Issue 79 – Pari Passu Clauses* (London: Financial Markets Law Committee/Bank of England, 2005), available online at http://www.fmlc.org/papers/fmlc79mar_2005.pdf (accessed on 28 April, 2008).

[79] 194 F. 3d 363 (2nd Cir. 1999).

[80] In 1983, the Republic of Peru guaranteed foreign bank borrowings of Banco de la Nacion and Banco Popular de Peru. Some years later, Peru and the two banks defaulted on this and much other external debt. Some years later still, in 1996, most of Peru's bank lenders agreed to a composition. Under this, the 1983 instruments were exchanged for "Brady Bonds," with the bonds either stating a reduced principal amount or paying a lower rate of interest. Elliott, a vulture fund specializing in obligations of distressed firms and countries, had purchased $20.7 million face amount of Peru's 1983 debt at the discounted price of $11.4 million from two international banks while the restructuring negotiations were ongoing. It held out from the composition, refusing to participate. Elliott brought an action to enforce the debt at face value.

[81] *Supra* n. 10, at 879.

[82] J.T. Gathii, "The Sanctity of Sovereign Loan Contracts and its Origins in Enforcement Litigation," 38 *George Washington International Law Review* 251 (2006) at 297.

Hence, while drafting this covenant, it should be qualified by an express exception for obligations mandatorily preferred by law applying to companies generally, and other customarily preferred creditors.

Events of Default

The default clause will contain a range of events which the lender is entitled to treat as a default. Significantly, an event of default will give remedies additional to those conferred by the general law:[83]

1. An event expressly permits the bank to accelerate outstanding loans.
2. An event expressly permits the bank to cancel its obligations to lend further loans.
3. An event expressly enables the bank to suspend further loans under the "conditions precedent" clause.
4. An event may constitute a default under other credit agreements of the borrower under a cross-default clause.

There are three types of defaults:[84]

1. actual—non-payment;
2. non-compliance with a non-financial clause because it might prejudice payment, for instance, breach of negative pledge, breach of warranty; and
3. early warning or anticipatory, the warning light, for example, cross-defaults.

The occurrence of the events set out in a default clause may not automatically constitute default; there may be requirements that notice be given to the borrower, grace periods, materiality tests, and other limitations built into the clause.[85]

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[83] Under the general law, default enables a bank to sue for its losses. A serious default means it can terminate the facility. It may also have the court appoint a receiver. P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 85.

[84] P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 85.

[85] L. Buchheit, *How to Negotiate Eurocurrency Loan Agreements* (2nd edn., London: Euromoney Publications, 2000) at 96–100.

The Cross-Default Clause

This provides that if the borrower fails to pay other financial debt when due, or other financial debt is accelerated, or a commitment to lend other financial debt is cancelled, or an event of default or pending event of default occurs in relation to any other financial debt, or collateral security for financial debt becomes enforceable or is enforced, this would constitute an event of default for this purpose of this loan.

Although this clause has sometimes been called a *lazy clause*, because the creditor absorbs the protections of other creditors without negotiating them itself,[86] in practice, the cross-default has an inertia effect—if everybody can accelerate, nobody can, since this spells bankruptcy.

A crucial aspect of the default case is how cross-default is defined. This can be extraordinarily wide or limited to actual acceleration of other loans; not to mere occurrences of a pending default. Or, the premature acceleration may be limited to those caused by actual defaults, and not, for example, mere events of default.[87] Cross-defaults are incredibly potent because of their ability to create domino effects. Hence, they must be carefully negotiated and applied.

Material Adverse Change

This clause provides that if any circumstances arise which, in the (reasonable) opinion of the majority banks, might/is likely to/will have a material adverse effect on the financial condition of the borrower or on the ability of the borrower to comply with its obligations under this agreement, it will constitute an event of default. The material adverse change clause is the fall-back clause for banks to suspend/cancel loans they know cannot be repaid but where other specific covenants aren't breached. However, the clause is vague and subjective and the use of the clause to suspend loan drawdown can be dangerous for banks because of a damages risk if the suspension was not justified.[88]

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[86] P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 103.

[87] In effect, all grace periods, materiality tests, and the like are removed because the other creditors may have a similar cross-default. P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 105.

[88] Borrowers commonly object that this clause converts a term loan into a demand loan and this removes the objective of term lending. Precise financial tests confer greater predictability for both sides. F. Julien et al., "Material Adverse Change and Syndicated Bank Financing: Part 2," 19(6) *Journal of International Banking Law and Regulation* 193 (2004) at 194.

Often, these clauses are drafted in such a way that there is a double test: "material adverse change" and "the change affects the ability of the borrower to perform." From a bank's point of view, the clause should apply to any significant deterioration, whether caused by external or internal events. If the change must also affect ability to pay, the clause is weakened because this could amount to proving potential insolvency or a liquidity crisis.[89]

Banks often seek discretion ("in the bank's reasonable opinion") because of the difficulty of proof and the absence of up-to-date information. Where a party has discretion, courts will not intervene unless the discretion is exercised *mala fide*/arbitrarily/unreasonably.[90] A UK Takeover Panel's ruling in November 2001 considered that availing oneself of a material adverse change clause should require a considerable change which went to the core of the transaction itself.[91]

The Remedies: Acceleration and Cancellation

The first issue with respect to the use of these remedies is *when* this remedy can be enforced, that is, whether the bank must act in good faith or whether it can act automatically after there's been a default. English law does not impose "good faith" duties on use of an event of default clause.[92]

The next issue is whether the right of cancellation and acceleration is frozen by reason of the opening of corporate insolvency reorganization proceedings. Several jurisdictions do this, for example, Chapter 11 in the

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[89] F. Julien et al., "Material Adverse Change and Syndicated Bank Financing: Part 1," 19(5) *Journal of International Banking Law and Regulation* 172 (2004) at 172–75.

[90] See, for example, *Abu Dhabi Tanker Company* v. *Product Star Shipping Company Ltd.*, [1993] 1 LR 397 at 404. In *Lewis* v. *Farin*, [1978] 2 All ER 1149, a sale and purchase agreement for a company contained a warranty that as between the balance sheet date and the completion date "there will have been no material adverse change in the overall net assets of the company allowing for normal trade fluctuations." There was an adverse change in net assets of $8,600. It was held that there had been a material adverse change. A drop of 20 percent in the net asset value in about four months was material.

[91] Another issue is whether a MAC clause be applied to circumstances which could have been predicted, or which the lenders should have suspected. This debate appears to be divisive among specialists, with some wishing a high test of foreseeability, and others claiming that this is a matter of interpreting the terms of a contract in order to determine whether the contracting parties had intended to remain bound by the terms of the contract or conversely, in the absence of any stipulation on this point, whether the theory of frustration has any applicability. F. Julien et al., "Material Adverse Change and Syndicated Bank Financing: Part 2," 19(6) *Journal of International Banking Law and Regulation* 193 (2004) at 194.

[92] P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 116.

US Bankruptcy Code. This is relevant because it will typically be decided not by the governing law of the credit agreement, but by the bankruptcy law of the place where the insolvency takes place.[93]

There are several limitations on the banks' acceleration powers. Acceleration is usually subject to a majority bank control; some agreements allow acceleration only if the event of default is "continuing," which probably means it has not been remedied or waived; some contain conclusiveness clauses.[94]

The Inter-creditor Relationship and Arrangements in a Syndicate

Nature of a Syndicate

In order to study the inter-creditor arrangements that are made in syndications, it is imperative to first understand the legal nature of a syndicate. Some writers have voiced the view that a syndicated lending agreement may amount to a partnership.[95] If a lending syndicate is considered to be a partnership, many impractical consequences would ensue. Member banks would have joint liability for individual actions; it would need to be registered; decision-making and representation of syndicate banks might be affected;[96] also, if the loans of syndicate banks are to be treated as shares in a partnership, the aggregate amount of the loan would constitute the "partnership capital"—and as, during the term of partnership, the partnership capital cannot be divided into individual partners' shares, it would prohibit the market practice where repayment of a loan comprises partly principal and partly interest, as it would mean the "partnership capital" is distributed before the end of its term.[97]

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[93] *Ibid.*, at 117.

[94] *Ibid.*

[95] G. Akhurst, "Syndicated Loans and the Polish Law of Partnership," 8(4) *Journal of International Banking Law* 151 (1993) at 151.

[96] For instance, because each partner can manage affairs that do not exceed the scope of the partnership's ordinary management without a previous resolution of the partners, in the absence of an express agreement, each bank would have the capacity to bind other members by its decisions. *Supra* n. 6, at 57; *Supra* n. 72, at 719.

[97] C. Gayle, "Acquisition Finance-Syndication Best Practice," 13(8) *International Company and Commercial Law Review* 300 (2002) at 151–52.

Therefore, generally, each bank's rights and obligations vis-à-vis the borrower are several and the documentation usually reflects this and states that no bank is responsible for the obligations of the other banks and that each bank can exercise its rights and pursue its remedies independently of the other banks. However, in 1985, an American case, *Crédit Français International S.A.* v. *Sociedad Financiera de Comercio C.A.*,[98] called into question the independent nature of a lender's obligations in a syndicate lending arrangement. It made any syndicate member reluctant in proceeding on his own against the borrower, on the basis that the court felt the arrangements constituted a joint venture.[99]

However, it is highly unlikely that such would be the case in India (or even England[100]) because under the Indian Partnership Act, 1932, the sharing of gross returns does not of itself create a partnership.[101] There is no sharing of net profit between the syndicate members.[102] Each bank bears its own expense of being in the syndicate, so that whether the interest payable under the syndicated loan constitutes a profit, and if so how much, varies for each bank. The sharing clause cannot affect this conclusion.[103] Notwithstanding all the criticism that this case has received, it has resulted in more attention being paid to provisions in the loan documentation which are designed to remove any opportunity to argue that the agreement is a partnership or joint venture.[104]

Severalty of Lending Commitments and Divided Rights

Syndicated loan agreements normally provide that the rights and obligations of each syndicate member are several; failure by any one bank to perform its

[98] 490 N.Y.S.2d 670 (Supr. Ct. 1985).

[99] P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 117.

[100] See generally, R. Cranston, *Principles of Banking Law* (2nd edn., Oxford: Oxford University Press, 2002) at 58.

[101] Section 4 of the Indian Partnership Act, 1932 defines a partnership as "the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all."

[102] E.P. Ellinger, *Ellinger's Modern Banking Law* (Oxford: Oxford University Press, 2006) at 719.

[103] R. Cranston, *Principles of Banking Law* (2nd edn., Oxford: Oxford University Press, 2002) at 58.

[104] J. Lehane, "The Role of Managing and Agents Banks: Duties, Liabilities, Disclaimer Clauses," 1 *International Financial Law Review* 235 (1982) at 236.

obligations does not absolve the other banks of theirs,[105] and each bank can separately enforce its rights as against the borrower (inasmuch as these are not relinquished in other parts of the agreement).[106]

Syndicate Democracy

Syndicated loan agreements normally require the unanimous consent of all the syndicate members for the amendment or waiver of important provisions in the agreement such as those relating to the financial terms of the loan, or the agent's role in administering the loan,[107] but different voting majorities can be used for waivers of provisions in the nature of covenants and/or other provisions in the agreement.[108]

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[105] P. Wood, *International Loans, Bonds, and Securities Regulation* (London: Sweet & Maxwell, 1995) at 94; *Supra* n. 6, at 56. This means that if one of the syndicate members cannot meet its lending obligations, the other members will not underwrite or guarantee to the borrower that the member will meet its obligations or otherwise remain solvent. The failure of a syndicate member to advance loan disbursements as per its lending commitment generally only entitles the borrower to file a suit against that member for its individual default. J.J. Norton, "International Syndicated Lending: The Legal Context for Economic Development in Latin America," 2 *NAFTA: Law and Business Review of the Americas* 21 (1996) at 48.

[106] R. Cranston, *Principles of Banking Law* (2nd edn., Oxford: Oxford University Press, 2002) at 56.

[107] D.L. Eaton, "Trouble with the Syndicate: Avoiding Disputes Over Syndicated Loan Documents and Participation Agreements in Insolvency," *Lender Liability News*, May 19, 1995 at 12. These would include, for instance, the release of collateral, deferral of principal or interest, change in amount of principal or rate of interest, release of guarantor, and changing agent authority.

[108] Syndicated loan agreements may contain provisions that enable the majority of syndicate members to (i) agree on a formula for the recalculation of interest rates following default; (ii) pre-empt negotiations with the borrower following default; (iii) require the prior written consent of a majority of syndicate members for consideration of an amendment to the loan agreement; (iv) direct the agent bank to initiate actions on behalf of the syndicate members that limit the agent bank's discretion; (v) waive breaches of covenants or consents to the relaxation of covenants such as the negative pledge clause; (vi) determining whether or not an incorrect representation or an adverse change in the borrower's financial condition is material for purposes of events of default; and (vii) direct the agent bank to accelerate the loan following an event of default. *Supra* n. 183, at 49; B.W. Semkow, "Syndicating and Rescheduling International Financial Transactions: A Survey of the Legal Issues Encountered by Commercial Banks," 18 *International Lawyer* 869 (1984) at 925.

Pro Rata Sharing Provisions

In a syndicated loan arrangement, the borrower makes payments to the agent bank, which then distributes them *pro rata* to the different banks forming the syndicate.[109] The borrower is discharged after paying the agent bank even if the agent bank fails to distribute the loan proceeds pro rata to the syndicate members. Hence, the syndicate members generally assume the risk of the agent bank's insolvency.[110] In order to protect the syndicate against insolvency or fraud or misappropriation of funds occasioned by an agent, all monies received in respect of the loan are often paid into a separate account in the name of the agent and held in trust for the participants.[111]

Conversely, if the agent bank distributes payments to the syndicate members without having received the funds from the borrower, the syndicate members will normally be required under the loan agreement to refund those payments back to the agent bank with accrued interest under what is known as the "claw-back" clause.[112]

In times of financial distress, the borrower may be pressured to make preferential payments to particular syndicate members and avoid making payments to other members. Concerns of such preferential payments are addressed by the so-called "sharing provisions." They stipulate that in the event any individual syndicate member is paid more than its pro rata share, such member must pay the excess difference to the agent bank, who then redistributes the excess to syndicate members pro rata. The paying member is then subrogated to the claims of the other members who are paid.[113] Sharing provisions thus discourage unilateral action by individual syndicate

[109] P. Wood, *International Loans, Bonds, and Securities Regulation* (London: Sweet & Maxwell, 1995) at 239.

[110] *Ibid.*, at 50.

[111] S.K. Chatterjee et al., "Legal Aspects of Syndicated Loan Agreements," 9(4) *Company Lawyer* 91 (1988) at 93.

[112] P. Wood, *International Loans, Bonds, and Securities Regulation* (London: Sweet & Maxwell, 1995) at 240.

[113] The sharing provision is also designed to ensure syndicate equality by the sharing of more indirect individual receipts of one syndicate member to the expense of other members. For instance, syndicate members may attempt to obtain disproportionate payments from the borrower by exercising a bank lien, set off, attachment, counterclaim, litigation judgments, guarantees, or any disproportionate payments of principal or interest on advances owed to syndicate members by the borrower or by the guarantor.

members because, upon receipt of direct or indirect payments, the member would only have to share the proceeds.[114]

Whether all aspects of this clause would be upheld in a court remains to be seen and would be largely dependent on the jurisdiction in which it is tried.[115] However, in practice, this clause has not always been successful. First, banks cannot be forced to exercise individual rights against the borrower and often choose not to. Second, banks tend to legalistically interpret and apply these clauses.[116] Accordingly, much emphasis is now placed on the precise wording of the sharing clause but this may not be of much assistance in a politically volatile situation.[117]

The Agent Bank: Appointment, Role, and Functions

Whereas a lead manager organizes the syndication, it is the role of an agent bank to administer and manage it after the agreement is signed.[118] In practice, the arranger is usually appointed as the agent bank.[119] Yet it is important to keep the roles of the arranging bank and the agent bank separate and distinct.

The agent bank's responsibility is largely for channeling payments and communications between the borrower and the syndicate.[120] It has to

[114] P. Wood, *Law and Practice of International Finance* (London: Sweet & Maxwell, 2006) at 189.

[115] *Ibid.*, at 187.

[116] One example of this occurred during the Iranian crisis. Chase Manhattan was the agent for a number of syndicated loans to Iran at the time. These loans contained sharing clauses which required banks to share payments by the borrower but not deposits against which a bank could exercise a right of set off. When the Iranian crisis started Chase Manhattan set off the large deposits which had been placed with it by the Iranian government. Chase refused to subject these deposits to the sharing clause despite much negative publicity. See, G. Penn et al., *The Law and Practice of International Banking* (London: Sweet & Maxwell, 1987) at 140.

[117] This was demonstrated in the Falklands crisis. The Argentines had loans from syndicates which included French and British banks. They refused to pay the British banks but continued to pay the French banks. The French banks refused to honor the sharing clause. Although legal arguments were put forward to justify their actions it soon became axiomatic that there were underlying political motivations. *Ibid.*, at 140–41.

[118] E.P. Ellinger, *Ellinger's Modern Banking Law* (Oxford: Oxford University Press, 2006) at 717.

[119] P. Wood, *International Loans, Bonds, and Securities Regulation* (London: Sweet & Maxwell, 1995) at 93.

[120] R. Slater, "Syndicated Bank Loans," 1 *Journal of Business Law* 173 (1982) at 177.

establish that all conditions precedents are met, then collect funds from the participants and pass them on to the borrower. It must keep records of those transactions and also determine the amount of interest due on the loan, collect the interest and repaid principal from the debtor, and apportion them among the participant banks.[121] Some of the borrower's activities that the agent monitors include the borrower's use of the collateral, delivery of routine required reports, and delivery of certificates of compliance with the loan covenants. The agent either distributes this information to the participants or advises them how to proceed based upon its view of this information.[122] It is for the agent bank to ensure that all documents received by it from the borrower are in order and accurately completed. It remains responsible for checking the documents, and for negligence thereto on its part.[123]

An agent bank has an implied right to be indemnified, and it is not uncommon for loan agreements to include express rights of indemnity of an agent. It may resign at any time by giving written notice to the participant banks and the borrower. It may be removed at any time without any explanation by the majority banks. Upon a notice of resignation by, or removal of the agent, the majority banks usually appoint a successor on behalf of the borrower and the banks. However, appointment of a successor must be based on the written consent of the borrower. All rights, powers, privileges, and duties of the original agent must be vested in the successor agent.[124]

An agent usually performs routine functions. It does not guarantee repayment of a loan. It may consult a legal counsel, including the counsel of the borrower and other professional experts selected by it, and cannot be held liable for any action taken or omitted in good faith by it in pursuance of the advice of such counsel or experts. It does not have any duty to ascertain whether a borrower is fulfilling the conditions of the loan; nor does it have any duty to initiate any legal action in connection with a loan agreement,[125]

[121] P. Wood, *International Loans, Bonds, and Securities Regulation* (London: Sweet & Maxwell, 1995) at 93; T.H. Donaldson, *International Lending by Commercial Banks* (New York: Wiley and Sons, 1979) at 73–74.

[122] T.H. Donaldson, *International Lending by Commercial Banks* (New York: Wiley and Sons, 1979) at 74; R. Cranston, *Principles of Banking Law* (2nd edn., Oxford: Oxford University Press, 2002) at 56.

[123] P. Wood, *International Loans, Bonds, and Securities Regulation* (London: Sweet & Maxwell, 1995) at 93.

[124] *Ibid.*

[125] C. Qu, "The Fiduciary Role of the Manager and the Agent in a Loan Syndicate," 12 *Bond Law Review* 86 (2000) at 100; P. Wood, *International Loans, Bonds, and Securities Regulation* (London: Sweet & Maxwell, 1995) at 93.

although it is believed that it has an implied duty to notify its participants as to any event of default by the borrower.[126]

The Applicability of the Law of Agency

Prima facie, an agency relationship exists between the agent bank and the participants by virtue of the agreement between them.[127] This has important ramifications. If the borrower reasonably believes that the agent bank possesses the power to act on behalf of the syndicate, the syndicate may become liable for the agent's actions, even though such actions were unwarranted under the terms of the loan agreement.[128]

Hence, while drafting, it is important to expressly specify the extent to which the borrower can rely upon the conduct of the agent bank. Otherwise, common law will normally find that the agent bank has sole control over loan management, collection, and enforcement, despite objections to the contrary.[129]

Duties and Liability of the Agent Bank to Syndicate Members

The precise scope of the duties of the agent bank depend upon the provisions of the particular loan agreement in question; nevertheless, there are certain implied duties, such as the duty to exercise due skill, care, and diligence in exercise of its powers and duties, the duty to avoid conflicts of interest with the syndicate members, the duty not to sub-delegate the authority imposed on it, the duty not to make secret profits out of agency, and the like.[130]

Inter-creditor liability issues have received extensive treatment in US courts over the last decade in the context of disputes between lead lenders and

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[126] R. Cranston, *Principles of Banking Law* (2nd edn., Oxford: Oxford University Press, 2002) at 56–57. The scope of liability of an agent in the event of a default seems to have remained unclear. On this point, see further, P. Wood, *International Loans, Bonds, and Securities Regulation* (London: Sweet & Maxwell, 1995) at 266–70.

[127] P.J. Cresswell et al., *Encyclopaedia of Banking Law* (London: Butterworths, 1992) at 535.

[128] This would arise principally under the concept of implied authority, which provides that the scope of an agent's authority to bind the principal is ascertained by determining what authority a reasonably prudent person who is familiar with the pertinent business practice might rightfully believe the agent possesses. P. Wood, *International Loans, Bonds, and Securities Regulation* (London: Sweet & Maxwell, 1995) at 39–40.

[129] See, for example, the Louisiana case of *Mansura State Bank* v. *Southwest National Bank*, 549 So.2d 1276 (La.Ct.App. 1989).

[130] P. Wood, *International Loans, Bonds, and Securities Regulation* (London: Sweet & Maxwell, 1995) at 93. For legal effect of liability disclaimers, see further, W. Crews Lott et al., "Structuring Multiple Lender Transactions," 112 *Banking Law Journal* 734, 735 (1995) at 742–45.

participating banks in loan participation agreements.[131] As the relationship between lead lenders and participating banks in loan participation arrangements is normally more akin to that of seller and purchaser, as opposed to that of co-lender between the agent bank and syndicate members, most of the lender liability issues arise in relation to the solicitation process when the participating bank sues the agent bank for (i) negligent or fraudulent affirmative misrepresentations, (ii) fraudulent omissions or concealment, and/or (iii) breach of fiduciary duty, in connection with its purchase of the loan participation interest.[132] These claims are normally brought only upon the borrower's default, insolvency, or other financial distress. The legal

[131] See generally, J.N. Brooks, "Participation and Syndicated Loans: Intercreditor Fiduciary Duties for Lead and Agent Banks under U.S. Law," 10(6) *Journal of International Banking and Financial Law* 275 (1995).

[132] In order to establish actionable fraud by the agent bank, as per the common law principles set out in *Derry* v. *Peek*, [1889] 14 AC 337, the syndicate member must prove that the agent bank made material misrepresentations in the form of false statements or omissions, knowing the statements to be false or having no honest belief in its truth, or where it makes a statement reckless as to whether it is true or false, or with the intent that the concealment or nondisclosure will mislead the syndicate member, and that the member or bank justifiably relied on the representation or omission and thereby suffered damages. See, for example, *Banco Urquijo, S.A.* v. *Signet Bank*, 861 F. Supp. 1220 (M.D. Pa. 1994).

Under the common law, the duty to disclose may arise where one party stands in a fiduciary or confidential relationship with respect to the other, or when one party possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge. Proving that the agent bank acted with the requisite knowledge in fraudulent concealment cases is an extremely difficult undertaking for the syndicate member, and as a consequence may be usually unsuccessful. Mere recklessness is not sufficient to constitute common law fraud claims. See generally, R.P. Austin, "Moulding the Content of Fiduciary Duties," in *Trends in Contemporary Trust Law* (A.J. Oakley ed., Oxford: Clarendon Press, 1996); G. Bhattarchya, "The Duties and Liabilities of Lead Managers in Syndicated Loans," 16(9) *Company Lawyer* 259 (1999) at 260.

An agent bank may find itself liable for negligent misrepresentation as per the rule laid down in *Hedley Byrne and Company Ltd.* v. *Heller and Partners Ltd.*, [1964] AC 465. In that case, the House of Lords held that the law would imply a duty of care upon one party making statements or giving information or advice to another where there was a special relationship between the parties, and where reliance on the misrepresentation was shown, that is, the innocent party must have entered the contract relying upon it. Thus, for claiming negligent misrepresentation in connection with syndicated loan or arrangements, there must exist a special relationship of trust or confidence between the parties. We have already shown (with respect to the arranger) that this is extremely difficult to prove in an arms length transaction.

Generally, regarding the fiduciary relationship, courts in the United States, however, have repeatedly refused to characterize the relationship between the agent bank or lead lender and the syndicate members or participating banks as that of a trust. See *Banque Arabe et Internationale d' Investissement* v. *Maryland National Bank*, 819 F Supp. 1282 (S.D.N.Y. 1993).

principles involved, however, are fully applicable in the syndicated loan context with inter-creditor disputes between agent banks and syndicate members.

Regulatory Framework in Indian Law

It is clear that the Indian legal system has no statute or legal framework that directly regulates syndicate lending. Moreover, India has no treaty obligations which stipulate a legal framework circumscribing international consortium lending. Syndicated lending in India is governed by piecemeal provisions in assorted laws which regulate various, different aspects.

First, much of consortium lending is regulated by the Indian Contract Act, under which the agreements between the agent bank, syndicate members, and borrower are made. Provisions relating to fraud, misrepresentation, etc. of the Indian Contract Act apply to contracts in consortium lending.[133]

Second, consortium lending is regulated by various equitable principles. The duties owed by the arranging and agent banks to participants in a consortium are based in equity; the fiduciary duties and the duty of care and skill are important examples of this. The severalty clause in loan syndicates is also based in equity, as is the pro rata sharing principle.

Third, consortium lending in India may also be influenced by case law in India and in other jurisdictions, especially England and the United States. The Indian financial and banking sector has not faced very many challenges with respect to consortium lending and therefore there has not been excessive judicial development in this area in India. Some principles may therefore be borrowed from cases in other jurisdictions, especially in situations which hitherto have not arisen in India.

W. Crews Lott et al., "Structuring Multiple Lender Transactions," 112 *Banking Law Journal* 734, 735 (1995) at 742–43. See, for example, *First Citizens Federal Savings and Loan Association* v. *Worthen Bank & Trust Company*, 919 F.2d 510 (9th Cir. 1990) at 514; *Banco Urquijo, S.A.* v. *Signet Bank*, 861 F. Supp. 1220 (M.D. Pa. 1994) at 1249; *Banque Arabe et Internationale d' Investissement* v. *Maryland National Bank*, 819 F. Supp. 1282 (S.D.N.Y. 1993) at 1290. *Banco Espanol de Credito* v. *Security Pacific National Bank and Security Pacific Merchant Ban*k, 763 F. Supp 36 (S.D.N.Y. 1991) was a case involving loan sales as opposed to syndicated loans, where it was held that fiduciary duties were not owed. A. Mugasha, "The Agent Bank's Possible Fiduciary Liability to Syndicated Banks," 27 *Sydney Business Law Journal* 403 (1996); S.F. Farrar et al., "Rights and Duties of Managing and Agent Banks in Syndicated Loans to Government Borrowers," 1 *University of Illinois Law Review* 229 (1982) at 244–49.

[133] See sections 15 to 19 of the Indian Contract Act.

Finally, the Indian regulatory regime also comprises guidelines and notifications by the Reserve Bank of India (RBI) in the context of consortium lending, as is evinced by the following.

In 1973, the RBI set up a study group to develop policy relating to the role of consortium lending in working capital. The Study Group suggested that consortium lending be accepted as a foundational principle of banking, and that the "evolution of consortium lending could lead to the pooling of expertise, geographical presence and a total upgradation of the lending and service capacity of the entire banking system."[134] Based on the report of the Study Group, the RBI put forward certain guidelines that banks could follow:

1. Large credit amounts to any borrower in the public or private sector, in excess of 1.5 percent of a bank's deposits, should be extended as a consortium loan.
2. Where multiple lenders exist, but there is no consortium arrangement, a procedure for the coordination between different lenders and an exchange of information should be evolved.
3. All consortium lending should try to fulfill all the credit needs of the borrower so as to prevent multiple consortiums being formed.
4. Food credit consortiums require special guidelines, and the involvement of the Food Corporation of India.
5. The bank with the maximum credit limit should act as the agent bank.

These guidelines were further elaborated on in 1979, when the RBI stated, *inter alia*, that:

1. The share of each bank in a consortium should not be less than 10 percent.
2. The lead bank must be given the responsibility for appraising the borrower's credit requirements.
3. The terms and conditions under the consortium should be the same for all members.
4. The formation of a consortium was obligatory where the credit limit sanctioned by many banks to a single borrower exceeded Rs 5 crores.
5. The total drawing from each of the banks in a consortium must be proportional to the ratio of sharing.[135]

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[134] Tannan, *Tannan's Banking Law and Practice in India* (New Delhi: India Law House, 1997) at 379.

[135] Master Circular on Income Recognition, Asset Classification, Provisioning and Other Related Matters–UCBs. RBI/2007–2008/83.

In 2007, the RBI recognized the importance of consortium lending in the context of regional rural banks (RRBs) and stated that "With a view of providing more business avenues and opportunities to RRBs for lending, it has been decided to permit them to participate in consortium lending, within the extant exposure limits, with their sponsor banks as also with other public sector banks and developmental financial institutions (DFIs), subject to the condition that the project to be financed is in the area of operation of the Regional Rural Bank concerned and guidance and appraisal of the project is provided by their sponsor bank."[136]

While discussing loan advances in the context of consortium lending, the RBI stated:

> Asset classification of accounts under consortium should be based on the record of recovery of the individual member banks and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account will be treated as not serviced in the books of the other member banks and therefore, be treated as Non Performing Asset. The banks participating in the consortium should, therefore, arrange to get their share of recovery transferred from the lead bank or get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.[137]

In the context of non-performing assets of banks, the RBI has stated that "(i) In respect of a borrower having more than one facility with a bank, all the facilities granted by the bank will have to be treated as Non Performing Asset and not the particular facility or part thereof which has become irregular. However, in respect of consortium advances or financing under multiple banking arrangements, each bank may classify the borrowal accounts according to its own record of recovery and other aspects having a bearing on the recoverability of the advances."[138]

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[136] RRBs—participation in consortium lending. RBI/2006–2007/440.

[137] Master Circular—Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances. RBI No.2007–2008/39.

[138] *Ibid.*

4

Licensing Intellectual Property Rights' Use

Suchita Saigal, *Parul Kumar*, and *Aditya Verma*

Introduction

In a contract for licensing the use of any property for any purpose enables the licensee to exploit the property in a manner he could not otherwise have legally done.[1] The consent of the proprietor is crucial to a license. It is different from assignment in that it does not involve a transfer of title to the property itself, but only provides a limited right of use. Permanence is a feature of assignment while a license is usually time bound.[2] A license also does not create an agency relationship, since it does not alter the licensor's legal position with respect to third parties through the actions of the licensee. It is also not a master–servant relationship, but falls in to a legally recognized category of its own.

With the growth in the diversity and commercial worth of intellectual property in global industry, licensing of intellectual property has become a multi-billion dollar business in itself. A key distinction between licensing of intellectual property vis-à-vis corporeal property is that while corporeal property can only be licensed to one licensee at a time due to physical factors, intellectual property can be replicated, licensed, and used by many parties at the same time. Thus, the parameters that govern licensing of intellectual property rights are different and unique.

This chapter analyzes licensing agreements for three kinds of intellectual property—patents, copyrights, and trade marks. Their distinctive characteristics

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[1] *Licensing and Intellectual Property Law Desk Reference* (M.D. Scott ed., New York: Aspen Publishers, 2004) at 468.

[2] P. Narayanan, *Law of Trade Marks and Passing Off* (6th edn., Kolkata: Eastern Law House, 2004) at 423.

within the realm of licensing of intellectual property are highlighted. To act as a useful tool for a legal and commercial practitioner, each section on the different kinds of intellectual property summarizes the legal framework governing such licensing agreements, with reference to Indian, American, and British jurisdictions. Reference is made to statutory provisions and judicial pronouncements as well. Areas of controversy are identified as well. Clauses in licensing agreements that are commonly found and those which must be kept in mind while drafting them are stated and discussed. Throughout an attempt has been made to highlight the practical perspective of licensing agreements in the context of intellectual property.

Patent Licensing Agreements

A patent is an exclusive right granted to an inventor by the state, allowing him to commercially exploit his patented invention. Under the Indian Patent Act, 1970, the patentee enjoys the exclusive rights to manufacture, use, and offer for sale the patented invention. However, in several cases the patentee is unable to effectively/optimally exploit or work the invention; in such situations he seeks to either assign or license his rights to third parties so as to allow them to commercially exploit or work the concerned invention. In return the patentee, as the assignee or licensor, gets royalty payments.[3]

With this background in mind it is important to note that in recent times the market for intangibles has increased substantially. This is evident from the fact that IBM earns more than 30 percent of its annual revenue through licensing its intangibles.[4] Specific to patent licensing, revenues (royalties) from patent licensing have increased in the United States from $15 billion in 1990 to more than $110 billion in 1999. Hence, it is safe to say that presently patent licensing is fast increasing in volume and expanding across economic sectors. Among the leading licensors are Intel, IBM, Hewlett-Packard, Monsanto, and DuPont, among several other companies.[5]

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[3] *Supra* n. 1, at 468.

[4] "IPR – A Corporate Strategy Tool," available online at http://www.tienewdelhi.org/Presentations/Jyoti%20Sagar_%20IPR. ppt (accessed on September 12, 2008).

[5] Gu, F., and B. Lev, "Markets in Intangibles: Patent Licensing," available online at http://ssrn.com/abstract=275948 or DOI: 10.2139/ssrn.10.2139/ssrn.275948 (accessed on September 10, 2008).

Patent Licensing: Statutory Provisions

In India patent licensing contracts are governed by the Indian Patent Act, 1970 (Patent Act) and the provisions relating to general contracts are under the Indian Contract Act, 1872.

The Patent Act contemplates various kinds of licenses. A broad categorization would be as follows:

1. Compulsory Licenses[6] and Other Licenses.
2. Exclusive and Non-exclusive Licenses.

It should be noted that these categorizations are not exclusive or watertight. For instance, as per sec. 90(1)(iv), a compulsory license granted under the Patent Act should be a non-exclusive license.

Other provisions related to licenses in the Patent Act are as follows:

As regards definitions, sec. 2(f) of the Patent Act defines an "exclusive license" as "a licence from a patentee which confers on the licensee, or on the licensee and persons authorized by him, to the exclusion of all other persons (including the patentee), any right in respect of the patented invention, and 'exclusive licensee' shall be construed accordingly." At this point it would be apt to distinguish between an assignment of a patent and a license of the same. To be precise, the difference is that by assigning the patent right to another party, the patentee transfers his legal title over the invention to the assignee. Thus, once assigned, the patentee no longer owns or has any control of the patent. On the contrary, in a license there is no transfer of proprietary interest.[7] By licensing an invention, the patentee retains ownership to the

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[6] The author would like to point out that compulsory licenses are more concerned with issues of public health and access to medicines. Thus, such licenses do not strictly fall within the category of a business contract and will not be examined in the present article. However, it is important to note that in recent times these Doha styled compulsory licenses have generated a lot of debate in India. It is pertinent to note that the Controller of Patents is yet to grant a single compulsory license. However, some time back, a Hyderabad-based Natco Pharma filed an application for grant of compulsory license in its favor under sec. 92A of the Patent Act, overriding patents owned by the Swiss company Roche on erlotinib and the US company Pfizer on sunitinib (both are anti-cancer drugs), in order to meet a public health situation in Nepal. The matter is yet to finally decided, however, the Delhi High Court has decided that Roche and Pfizer have the right to be heard prior to the grant of any such compulsory license. Please refer to S. Basheer, "Roche vs NATCO: India's First 'Doha Style' Compulsory License?" available online at http://spicyipindia.blogspot.com/2008/02/indias-first-doha-case-natco-pfizer-and.html (accessed on September 8, 2008).

[7] A.S. Gutterman, *Innovation & Competition Policies* (London: Kluwer Law International, 1997) at 121.

rights to that patent and thus retains control of who manufacture and who sells it.[8]

Further, in relation to grant of a license, as per the Patent Act, an owner of a patent can grant license. However, in case of joint ownership, a co-owner of a patent cannot grant license without the consent of the other owner. As regards validity of a license agreement, sec. 68 stipulates that a license is not valid unless all the terms and conditions between the parties in relation to the license have been reduced in writing and documented in the agreement, which should be duly executed.

The registration requirements are enunciated in sec. 69 of the Patent Act. As per the section, the licensee shall file an application for registration of his rights as a licensee under the concerned license agreement with the Controller of Patents within six months of the date of agreement. A similar application to register the transfer of interest shall also be filed by the licensor.

Moving on to address the substantive rights of the registered grantee, sec. 70 of the Patent Act enunciates the power of the registered grantee to deal with the patent and recognizes the right of the registered grantee to grant licenses under, or otherwise deal with the patent, subject to a contract to the contrary. More importantly, the proviso in sec. 70 deals with equitable considerations. Thus, if the license is not registered, but the parties have acted upon the covenants in the document, then in lieu of the proviso to sec. 70, equity will grant the licensee such rights as he would be entitled to if the license was registered.[9]

Lastly, the Act allows for the terms of license to be kept confidential by the Controller, if so requested by the patentee or licensee.

Patent Licensing: Case Law

The case law under patent licensing can be divided into two categories. First, case law relating to the licensing agreements as such and second, case law relating to licensing agreements and anti-competitive practices.

The landmark case in the first category is *Waterman* v. *Mackenzie*,[10] wherein the US Supreme Court stated that, "an agreement by which the

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[8] See the website of the Ministry of Information Technology, "Patents: General Information and National Perspectives," available online at http://www.mit.gov.in/default.aspx?id=787 (accessed on September 11, 2008).

[9] Refer to V.J. Taraporewala, *Law of Intellectual Property* (Mumbai: V.J. Taraporewala, 2005) at 78.

[10] 138 U.S. 252 (1891).

owner of a patent for an invention grants to another person the sole and exclusive right and license to manufacture and sell the patented article throughout the United States, not expressly authorizing him to use it, is not an assignment, but a license, and gives the licensee no right in his own name to sue a third person at law or in equity for an infringement of the patent." In this case the plaintiff had been granted a patent license to manufacture and sell fountain pens throughout the United States. Post this, the owner assigned the patent to another person and the assignment was recorded in the Patent Office, invalidating the license to manufacture and sell pens. The licensee went to court claiming that his right was prior in time and that he could sue the assignee for infringement of his rights. The court held that a license is a mere arrangement which is overridden by a subsequent assignment of the right, and the licensee cannot sue for violation of his rights under the license agreement.

The US Federal Court also decided on the boundary of a license by stating that a mere granting of a license to make, use, or sell a patented article does not confer upon the licensee the right to transfer his license unless the patentee has consented thereto.[11]

In India, these issues have been addressed in the Patent Act itself. The right of the licensee to further license, subject to a contract to the contrary, is found in sec. 70 of the Patent Act and has been discussed earlier. Further, as regards the right of the licensee to sue for infringement, sec. 109 of the Patent Act[12] allows the exclusive licensee to file an infringement suit for infringement committed post the grant of license. Moreover, the provision allows for compensation of the licensees' loss of business and revenue through the damages paid by the judgment debtor in the suit. However, it is important to note that the patentee (owner of the patent) needs to be a party to the suit, impleaded either as a defendant or as a plaintiff by the licensee.

[11] *Rock–Ola Mfg. Corp.* v. *Filben Mfg. Co.*, 168 F.2d 919.

[12] Section 109, Indian Patent Act reads as follows:

Section 109: **Rights of exclusive licensee to take proceedings against infringement:**

(1) The holder of an exclusive license shall have the like right as the patentee to institute a suit in respect of any infringement of the patent committed after the date of the license, and in awarding damages or an account of profits or granting any other relief in any such suit the court shall take into consideration any loss suffered or likely to be suffered by the exclusive licensee as such or, as the case may be, the profits carried by means of the infringement so far as it constitutes an infringement of the rights of the exclusive licensee as such.

(2) In any suit for infringement of a patent by the holder of an exclusive license under sub-section (1), the patentee shall, unless he has joined as a plaintiff in the suit, be added as a defendant, but a patentee so added as defendant shall not be liable for any costs unless he enters an appearance and takes part in the proceedings.

On a plain reading of the provision it is evident that in the absence of the patentee as a party the suit will be dismissed.

As regards disputes relating to patent licensing agreements in India, legal experts contend that the process of patent licensing is still in its infancy. They argue that presently the Indian industry is mostly serving multi-national companies (MNCs) to build their technology and indigenous creation of intellectual property right isn't the priority.[13] An obvious effect of this is that there is not much litigation on disputes relating to patent licenses. The only recent dispute which comes to mind is the dispute between the consumer electronics heavyweight, Royal Philips Electronics of Netherlands, and Indian music major T-Series over royalty payments and non-compliance issues for a couple of patent license agreements. The facts were that the companies had signed the patent agreements for VCDs and CDs in 2003 and for DVD players and DVD-ROM players in November 2005. However, later disputes arose, wherein Philips Netherlands charged T-Series of non-payment of royalty on all the three agreements; in response Super Cassettes Industries, which owns the T-Series brand, was planning to petition the Delhi High Court.[14] However, no subsequent record of any litigation between the concerned parties can be traced.

The second category of case law relates to patent licenses and anti-competitive agreements. There has been a lot of debate over whether exclusive licenses of technology create barriers in entry for new entrants into a market, thus, resulting in an anti-competitive set-up. At an international level, the Trade Related Intellectual Property Rights (TRIPS) Agreement includes provisions which recognize that intellectual property rights may be abused, and authorize members to regulate anti-competitive licensing practices and encourage cooperation in enforcement.[15] Further, anti-competitive agreements are also a serious issue in the United States. In fact, the US Supreme Court in *General Talking Pictures Corp* v. *Western Electronic Corp*.[16] stated that "the owner of the patent may grant licenses to manufacture, use, or sells upon conditions not inconsistent with the scope of monopoly."

[13] *Business Standard*, "India Inc yet to cash in on Patent Licensing: Expert," available online at http://www.business-standard.com/india/storypage.php?autono=156981 (accessed on September 24, 2008).

[14] R. Pratap et al., "Patent Tussle: Philips locks horns with T-Series," available online at http://economictimes.indiatimes.com/News/News_By_Company/Companies_A-Z/P_Companies_/PATENT_TUSSLE_Philips_locks_horns_with_T-Series/rssarticleshow/1937605.cms (accessed on September 18, 2008).

[15] See Articles 8.2, 31(k)-(l), 40 of the TRIPS Agreement.

[16] 304 US 175.

The US Supreme Court has further ruled that patent misuse is an equitable defense to the enforcement of patents. Subsequently, in 1995, the US Department of Justice/Federal Trade Commission released Antitrust Guidelines for the Licensing of Intellectual Property.[17] The latest case that created waves in the realm of intellectual property rights and anti-competition laws in both the United States and the European Union was the Microsoft case.

In India, though we have the Competition Act, 2002, a case of anti-competitive practices in relation to grant of exclusive licenses is yet to come up. However, there have been concerns in the past of certain license agreements being anti-competitive in nature. For instance, the license agreements between the American pharmaceutical giant Gilead and several Indian generic manufacturers in relation to a HIV drug created uproar as being "patent settlements as opposed to pure licensing agreements." These license agreements were attacked by civil society activists who argued that the aim of the licenses was to prevent these generic manufacturers from challenging Gilead's application for patent over the product in India. The license agreements were also opposed because they caused significant price hikes and caused artificial decrease in supplies of API's (Active Pharmaceutical Ingredient), thereby increasing their costs. Many argued that the voluntary licenses came with several restrictions on geographies, exports, and back-end supplies for the generic companies. Moreover, they were marred with lack of transparency. All of this resulted in the general opinion that such agreements should be examined for being anti-competitive.[18]

Patent Licensing: Contractual Clauses

It is pertinent to note that a patent license agreement can be a part of a complex business transaction or a stand-alone agreement. An example of a license agreement being a part of a more complex set-up could be Tata's acquisition of Jaguar. This acquisition would have several contracts ranging

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[17] Refer to F.M. Abbott, "Patent Licensing, Competition Law and the Draft Substantive Patent Law Treaty," available online at http://www.wipo.int/export/sites/www/meetings/en/2006/scp_of_ge_06/presentations/scp_of_ge_06_abbott.ppt. (accessed on September 7, 2008).

[18] S. Basheer, "HIV Patents in India: Will it Rain 'Rejections'?," available online at http://spicyipindia.blogspot.com/search?q=kei (accessed on September 20, 2008). See also B. Shrivastava, "Brazilian Health Group Opposes Gilead's Patent Plea in India," available online at http://www.livemint.com/2008/06/26231355/Brazilian-health-group-opposes.html (accessed on September 20, 2008).

from contracts in relation to the corporate aspects of the deal, to foreign investment aspects, and also addressing intellectual property aspects, amongst many others. Thus, assuming that Tata acquired Jaguar's intellectual property (including patent rights) through a license agreement, such an agreement would be one of the several agreements between the parties and a small part of a more complex transaction. However, one should not undermine the importance of such contracts; often because of their great strategic importance, such contracts are referred to as "turnkey contracts." However, on the other hand, a license agreement can also be a stand-alone agreement, which merely governs the sole license agreement relationship between the parties. Such a stand-alone agreement was seen in the Philips and T-Series case discussed earlier.

It is important to understand that prior to commencing negotiations in relation to such an agreement the parties normally enter into informal negotiations, carried out with due diligence in relation to the concerned patent rights to ensure that they are valid patents, and determine the evaluation of the patents, etc. Subsequently, normally the parties enter into a Memorandum of Understanding or Letter of Intent, which details upon the objectives of the parties in relation to the said license. In certain cases before embarking on a long-term technology licensing agreement the parties may prefer to get their feet wet through a distributorship agreement. Such an agreement enables the potential licensee to distribute a product of the potential licensor in a specified market under specified terms and conditions. A successful relationship built under the distribution agreement could well ease the way into a successful technology licensing agreement.[19]

Some of the standard clauses in a license agreement are as follows: clauses relating to the parties of the contract, the definition of the licensed technology, the permissible usage of the licensed subject matter, the nature of license (exclusive or non-exclusive), the consideration (royalty) to be paid, the performance obligations and rights of the parties to the contract, the warranties and guarantees in relation to the licensed subject matter, the confidentiality agreements, the technical assistance and commercial support responsibilities, the effect of breach of contractual clauses (inclusive of the effect of breach of warranty or incorrect representations), term and termination provisions (inclusive of grant back provisions), and the course

[19] "Exchanging Value: Negotiating Technology Licensing Agreements" (A Training Manual), available online at http://www.wipo.int/export/sites/www/sme/en/documents/pdf/technology_licensing.pdf (accessed on September 14, 2008).

of action to be adopted in case of infringement or misappropriation of the concerned technology by a third party.

The Parties to the Contract

Determining the parties is important as the nature of the license agreement will vary, for instance, a license agreement with a university will in all probability be modification license (to improve the patented product or process); on the other hand, a license agreement with a MNC would in all probability relate to manufacture and sale of licensed product or process. The parties enter into such a contract in keeping with their business strategy. Thus, it is from the nature of the parties, that the objective of the agreement would come through.

Definition of the Licensed Technology

The next important clause relates to the definition of the licensed technology and the permissible scope of usage. This clause is important and needs to be unambiguous to ensure that the licensee clearly knows his boundaries, because any usage outside those permitted by the contract would amount to being an infringement of the rights of the licensor.

Nature of License

Another important clause relates to the nature of the license, whether the license is an exclusive license, a non-exclusive license, or a sole license. The exclusivity may depend on the geographical extent of the licensee's right, the time factor, and/or the exclusivity to exercise the rights licensed.[20] It is pertinent to note that an exclusive license even excludes the licensor from exercising the licensed rights. On the other hand, a sole license allows only the licensor and the licensee to use the technology in the defined territory.[21]

The nature of the license is important as it affects the royalty the licensor is entitled. For instance, if it is a non-exclusive, given the fact that the licensee would have to compete with other licensees, the royalty payment to the patentee would be lower than that in an exclusive license. Further, in case of a non-exclusive license, a most-favored licensee clause may be included; that is, if the licensor grants more favorable terms to someone else, then those terms will become applicable to the present licensee.[22] This clause

[20] P. Ganguli, "Anatomy of Licensing Agreements," available online at www.wipo.int/export/sites/www/sme/en/activities/meetings/csir_india_05/licensing_agreement_ganguli.ppt (accessed on September 17, 2008).

[21] *Ibid.*

[22] *Supra* n. 20.

ties up with another clause often found in such agreements, wherein the licensee prohibits the licensor from granting a superior right to any third party in relation to the licensed technology. The aim of this provision is basically to prevent a *Waterman* case situation. In the event of breach of this clause the licensee is normally entitled to damages and to be treated at par with the third party which enjoys the superior right.

Payment of Royalty

The next important aspect of a patent licensing agreement is the clause relating to the payment of royalty to the licensor. Normally, the arrangement in the license is such that the payment of royalties is spread over the term of the agreement. The royalty can be based on the cost to manufacture, the profit, the units or volume produced, or the sales. The most common base being the sales, royalty being calculated either on the basis of units sold or the net sales.[23] The normal royalty rate in license agreement is 10 percent of the net sales.[24] Lastly, the failure to pay royalties will normally be a ground for breach of the license contract, and would entitle the licensor to terminate the license.[25]

Performance Obligations and Rights of the Parties

The next clause to consider is the clause relating to performance obligations and rights of the parties to the contract. In such agreements normally the obligation on the licensee is to work the licensed patent product or process. In case of an exclusive licensee the obligation to work the licensed invention is greater and penalties for non-performance may include termination of license, payment of minimum royalty, conversion of an exclusive license to a non-exclusive license, and other clauses in favor of the licensor.[26] Similarly, the obligation on the licensor would be to disclose all the necessary know-how to work the license and a violation of the same may include a clause for termination of the contract and payment of damages to the licensee. The rights of the parties relate to being capable to work the invention without

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[23] D. Bollella, "Wipo National Workshop on Negotiating Technology Licensing Agreements: Commercial and Financial Considerations in a Patent License," available online at http://www.wipo.int/export/sites/www/sme/en/activities/meetings/csir_india_05/financial_considerations_bollella.ppt (accessed on September 14, 2008).

[24] *Ibid.*

[25] P. Mendes, "To License a Patent – or, to Assign it: Factors Influencing the Choice," available online at http://www.wipo.int/export/sites/www/sme/en/documents/pdf/license_assign_patent.pdf (accessed on September 12, 2008).

[26] *Supra* n. 20.

undue interference of the licensor and in relation to the licensee the right to receive regular accounts and royalty as stipulated in the agreement. It should be noted that the clauses are much more detailed, tailored to the specific needs of the parties, and this article merely aims to give a brief overview of the clauses.

Warranties and Guarantees

The next important clause in the license agreement relates to the warranties and guarantees in relation to the licensed subject matter. According to Alan S. Gutterman, performance warranties and guarantees present the most difficult issues in the entire licensing area.[27] The warranties cover a number of business issues relating to the commercial utility of the technology, including warranties that the licensed product can be used to manufacture the specified products and that the process will be able to operate under specified conditions.[28] Other warranties on behalf of the licensor would be that the invention lives up to the standards promised by the licensor, that he would provide the relevant technical know-how and trade secrets in relation to the invention and also that the specified patent is valid and does not infringe any third parties' rights.

In contracts relating to license of patented products, an often included warranty would be that the product meets the standards prescribed by consumer protection laws. Moreover, the licensor would undertake the responsibility to indemnify the licensee in case the latter incurred any product liability. However, this is not to say that the licensor will be responsible in all circumstances, for instance, if the licensee manufactures the product, the licensee as a manufacturer would be typically responsible for product liability issues. Thus, in such cases product liability insurance should be purchased by licensee.[29]

The warranties on behalf of the licensee would be that he would supply the licensor with the financial statements in relation to the licensed technology at regular intervals and keep the licensor informed of any improvements in the said technology.

Confidentiality Clause

As regards the confidentiality clause, if the licensor provides the licensee with some confidential information, then it is the responsibility of the licensee

[27] *Supra* n. 7, at 136.

[28] *Supra* n. 7, at 136.

[29] *Supra* n. 23.

to maintain the secrecy of the confidential trade secrets and know-how. Normally, the licensee is granted the right to use such information and can also use it to improve the technology at hand. Breach of this clause would amount to the licensor being entitled to terminate the contract and also claim damages. It is pertinent to note that the confidentiality clauses can also be the subject matter of an independent agreement between the parties.

Technical Assistance and Commercial Support Responsibilities

The subject matter of the clause relating to technical assistance and commercial support responsibilities of the parties has been discussed earlier in the article. Largely the aim of this clause is to ensure that the licensee can successfully work the licensed technology. The license agreement must clearly define the documents and other information which are to be transferred to the licensee. Normally, the license agreements contain an annexure of a recital containing a list of documents which are to be transferred from the licensor to the licensee. However, such a clause does not merely contemplate transfer of information, for the initial part of the agreement it also contemplates situations where the licensee trains the employees of the licensor in working the licensed technology.[30]

Breach of Contractual Clauses: Term and Termination of the Contract

Moving on, we now address the clause dealing with the effect of breach of contractual clauses (inclusive of the effect of breach of warranty or incorrect representations). Often breach of contractual clauses in relation to working the invention or in relation to warranties and representations made by the parties would allow the party adversely affected to terminate the contract and claim damages. For example, if the licensee fails to pay the stipulated royalty to the licensor, the licensor under the contract may be entitled to terminate the contract after giving due notice. These would be cases of early termination of the contract. However, if the license runs its entire term then at the end of the term of the contract, unless the contract is renewed, the licensor cannot continue to use the licensed technology and the same reverts back to the licensor. It is pertinent to note that in licensing contracts, grant back provisions should be carefully drafted, because in some situations such clauses have been found to be anti-competitive, resulting in invalidating the

[30] *Supra* n. 5, at 138.

contract. For instance, in the European Union there is a per se prohibition against exclusive grant backs in patent licensing.[31]

Lastly, it is important to remember that a license agreement is a contract. This means that the legal requirements for a binding and enforceable contract are necessary. These include that the parties have the legal capacity and the intention to enter into a contract, that there is offer and acceptance and that there is valid consideration, such as a payment on signing.[32]

Patent Licensing: Safeguards while Drafting a License Agreement

We now move on to address the safeguards one should adhere to while drafting a patent licensing agreement. While drafting a patent licensing agreement one should be careful to ensure that the agreement is not invalidated by violation of statutory provisions (e.g., restrictive covenants) or otherwise by exceeding legal limits of licensing. For instance, in the European Union exclusive grant back provisions are per se anti-competitive. Hence, if the license agreement is to be worked in the European Union, an exclusive grant back provision in the same would result in invalidating the contract.[33]

Other licensing agreements which might fall foul of the law are tying agreements which basically include patented and unpatented products to increase term of license, exclusive dealing agreements (which are agreements between the parties under which they agree only to deal with patented product), and package licensing agreements (which are basically prerequisite conditions that license will be granted only as a package).[34]

Patent Licensing: Pharmaceutical Industry

In this section the author will briefly examine how pharmaceutical companies work patent licensing agreements to increase their revenue stream. The pharmaceutical industry constitutes ideal subject matter for studying the practical side of patent licensing because these companies essentially rely on the patent system to recover the costs incurred by them in research and development and manufacturing the drug.

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[31] *Supra* n. 17.

[32] *Supra* n. 19.

[33] *Supra* n. 20.

[34] *Supra* n. 20.

While the way in which the pharmaceutical company uses their intellectual property depends largely on its business strategy, its size, resources, innovative capacity, competitive arena, and field of expertise,[35] the most common business strategy in the sector is to innovate and thrive. The way this strategy works is that the inventor would try to improve blockbuster drugs patented by others (possibly by removing side effects). Then he would obtain patent on improvement. After which he would license the improvement to the owner of original drug patent and earn royalties. Some examples of blockbuster drugs improved following the above-mentioned business strategy are Prozac, Claritin, and Seldane.[36]

In India, the Council for Scientific and Industrial Research (CSIR) has been successful in effectively using patent licenses to commercially exploit its inventions. For instance, in a case study provided by CSIR itself, the organization elaborates upon its success in licensing the drug "Streptokinase." The case study is as follows: It was documented that increasing number of people were suffering from heart diseases worldwide and especially in India. The cause of death in such cases was the development of a blood clot causing vascular blockage. Death could be prevented by timely intravenous administration of a thrombolytic agent. However, the problem was non-availability of affordable thrombolytic agent within 6 hours of the onset of heart attack. The drugs commonly used are tissue plasminogen activator, urokinase, and streptokinase. The market surveys showed that the market demand for thrombolytics was one billion rupees. Streptokinase was demanded by 80 percent of the consumers and there was a 20 percent growth in demand annually.[37]

In response to the market demand, IMTECH (Institute of Microbial Technology, Chandigarh) developed the first indigenous clot buster drug "STPase" and it was launched in market in 2000 through Cadila Pharma. The impact of the drug was that the price of the thrombolytic agent crashed down from Rs 3,500 to Rs 2,000 per dose. As a result, milestone payments based on the demonstration of the technology, that is, 98 percent purity at 20/100 L scales. Moreover, the royalties started to flow in from the date of commercial production.[38]

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[35] R. Mishra and G.V.S.S. Kumar, "How Pharma Companies can Leverage Their IP Rights," available online at http://www.managingip.com/Article.aspx?ArticleID=2020358 (accessed on October 2, 2008).

[36] *Supra* n. 4.

[37] R.K. Gupta, "Management of Intellectual Property (IP) in CSIR Laboratories," available online at http://www.wipo.int/export/sites/www/sme/en/activities/meetings/csir_india_05/management_ip_csir.ppt. (accessed on October 2, 2008).

[38] *Ibid.*

It is interesting to note that CSIR has several more success stories to boast of in relation to successful commercial exploitation of patents through patent licensing. Hence, one can finally say that the Indian industries and commercial sectors are finally realizing the importance of patents and patent licensing as an effective revenue stream.

Copyright Licensing Agreements

Copyright protects intangible property, which has the potential of being utilized by a variety of different people at the same time: for example, a copyrighted sound recording can be played simultaneously in several public places, such as pubs, shops, and discos.[39] Copyright owners may license the property directly, for example, by way of selling software on a floppy disc which includes a license, or they may do so indirectly, through agencies that manage relationships between the copyright owner and the user of the copyright product.[40]

The significance of granting a license is that it permits the licensee or user to carry out activities that would otherwise be prohibited without the consent of the owner of the copyright, such that the licensed work can be used without leading to copyright infringement. Hence, the licensee is made immune from action by the copyright owner if the use of the licensed work falls within the scope of the agreed terms of the license.[41]

Copyright Licensing: The Legal Framework

Copyright represents a variety of an intellectual property right. A copyright is essentially an exclusive right that is held by the author of a particular work. Section 14 of the Copyright Act, 1957 in India defines copyright in the context of literary, dramatic, or musical works.[42] The rights vested in the copyright owner generally include the right to reproduce the copyright work, the right to perform such work in public, and the right to make

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[39] L. Bently and B. Sherman, *Intellectual Property* (Oxford: Oxford University Press, 2003) at 253.

[40] *Ibid.*, at 253–54.

[41] *Supra* n. 39, at 256.

[42] Section 14(1)(a), Copyright Act, 1957.

copies and translations.[43] Under law, copyright is treated as public property, and hence, the commercial exploitation of copyright involves assigning or licensing some of the rights held by the copyright owner.[44]

Section 30 of the Copyright Act authorizes the owner of copyright in any existing work or the prospective owner of the copyright in any future work the right to grant any interest in the copyright work by license. The mode of licensing under the Act is governed by sections 19 and 19A, which pertain to the mode of assignment of copyright.[45] This indicates a lacuna in the law, since the process of licensing, by virtue of differing from the process of assignment, should be governed by provisions that exclusively deal with licensing.

While copyright licensing agreements take many different forms in practice, legally copyright licenses may be classified into categories such as "exclusive," "non-exclusive," "voluntary," and "compulsory."

Exclusive versus Non-Exclusive Licenses

Copyright licenses may be categorized as "exclusive" and "non-exclusive" licenses. An exclusive license confers rights contained in the copyright of a particular work to the licensee, to the exclusion of all other persons, including the owner of the copyright.[46] If a comparison were to be made with the law relating to tangible property, an exclusive copyright license could be compared to a lease.[47] Since an exclusive license places the licensee in the shoes of the copyright owner, one of the most important rights that accrues to the licensee is the right to sue infringers of the copyright.[48] Owing to the fact that the rights and remedies of the exclusive licensee in relation to copyright infringement are concurrent with the owner of the copyright, the exclusive licensee is, in fact, put in the same position as an assignee, against all persons except the owner of the copyright.[49] A non-exclusive license differs from an exclusive license in that the rights granted are not to the exclusion of all other persons.

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[43] See sec. 14, Copyright Act, 1957.

[44] *Supra* n. 38, at 253.

[45] Section 30-A, Copyright Act, 1957.

[46] Section 2(j), Copyright Act, 1957.

[47] *Supra* n. 39, at 257.

[48] *Ibid.*

[49] H. Laddie, *The Modern Law of Copyright an Designs, Vol. I* (3rd edn., London: Butterworths, 2000) at 905.

Voluntary and Compulsory Licenses

Copyright licenses may be divided into two categories: voluntary licenses and compulsory licenses. Voluntary licenses are those that the copyright owner grants out of his/her free will, whereas compulsory licenses represent exceptional circumstances where the law intervenes to compel the owner of the copyright to license the work, and require the licensee to pay a fee.[50]

In *Entertainment Network (India) Ltd.* v. *Super Cassette Industries Ltd.*,[51] the Supreme Court observed that voluntary licenses represent the primary mode used by copyright owners for making the copyright work available to the public. It further noted that the Copyright Act enables the owner of the copyright to enter into voluntary agreements for licensing the copyright work on terms that are mutually acceptable to him/her as well as the licensee. In this manner, the Act provides the copyright owner the complete freedom to enjoy the fruits of his/her labor by earning the fee or royalty agreed through the issuance of licenses. However, the court emphasized that this right is not absolute, and is subject to the right of other individuals to obtain compulsory licenses.

Section 31 of the Copyright Act provides that if a complaint is made in respect of Indian copyright work in the form of artistic work, cinematograph films, or sound recordings,[52] which has been published or performed in public, the Copyright Board may grant a compulsory license to the complainant. The complaint must be based on the ground that the copyright owner has refused to allow the republication, performance, or communication of the work in public on terms considered reasonable by the complainant.[53] The Copyright Board has the discretion to grant a license to the complainant if it is found that the license has been denied on unreasonable grounds in the first place, such that the public has been deprived of the performance or reproduction of the work.[54] The compulsory license would be subject to the payment of compensation to the copyright owner, as well as compliance with terms and conditions determined by the Copyright Board.[55]

Section 31(2) provides that in a situation where two or more persons make a complaint in order to obtain a compulsory license for works withheld from the public, the license would be granted to the complainant who

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[50] *Supra* n. 39, at 261–62.

[51] *Entertainment Network (India) Ltd.* v. *Super Cassette Industries Ltd.*, 2008 (9) SCALE 69.

[52] Explanation to Section 31(1), Copyright Act, 1957.

[53] Section 31(1), Copyright Act, 1957.

[54] *Ibid.*

[55] Section 31(1)(b), Copyright Act, 1957.

would best serve the interests of the general public, in the opinion of the Copyright Board. However, it was recently held by the Supreme Court that the grant of compulsory license to one broadcaster would not preclude other broadcasters from approaching the Copyright Board for compulsory licenses.[56] In this manner, sec. 31(2) was interpreted in a liberal manner.

The Copyright Act also provides for compulsory licenses in unpublished Indian works, where the author of the work or the copyright owner is dead or cannot be traced. Any person can apply to the Copyright Board for a license to publish such a work or its translation[57] on meeting certain conditions, such as publishing the proposal to publish or translate the work in a daily newspaper.[58] If the Copyright Board approves the application, it can direct the Registrar of Copyrights to grant the applicant a license to publish the work or its translation on the basis of payment of royalty and other terms and conditions that are determined by the Copyright Board.

In the United Kingdom, compulsory licenses can be granted in situations where, *inter alia*, the copyright work consists of broadcast schedules that are sought to be reproduced, where the work is sought to be broadcast or included in a cable program, where the Secretary of State has made an order in relation to the lending of works, and where the work is of enemy origin.[59]

The European Union has recognized that compulsory licenses may be granted where it is found that a copyright owner has violated Article 82 of the Treaty of Rome, 1957 which deals with the abuse of a dominant position. In *RTE and Independent Television Publications* v. *Commission of the European Community*,[60] popularly known as "The Magill" case, an Irish broadcasting organization known as RTE owned copyright over its television (TV) schedules and refused to license the copyright to newspapers who wished to publish the schedules in their weekly TV listings. The practical effect of such a refusal was that broadcasting companies had the exclusive right to publish TV listings, and newspapers and magazines were unable to access this information to publish comprehensive weekly TV guides. The European Court of Justice found that the exercise of such an exclusive right by broadcasting companies may constitute abuse of dominant position on

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[56] *Entertainment Network (India) Ltd.* v. *Super Cassette Industries Ltd.*, 2008 (9) SCALE 69.

[57] Section 31A(1), Copyright Act, 1957.

[58] Section 31A(2), Copyright Act, 1957.

[59] Coppinger and S. James, *Copyright, Vol. I* (15th edn., London: Sweet & Maxwell, 2005) at 1589–90.

[60] *RTE and Independent Television Publications* v. *Commission of the European Community*, [1995] 4 CMLR 18.

the fulfillment of certain criteria: first, where the conduct of the broadcasting company results in a refusal to offer something for which there exists a potential consumer demand; second, where such refusal is not justified in the activity of TV broadcasting or that of publishing TV magazines; and third, where, through their conduct, the TV broadcasting companies deny access to basic information that constitutes indispensable raw material for the creation of a secondary market of weekly TV guides.[61] The *Magill* case reflects an instance of the grant of compulsory license in light of the abuse of dominant position by a copyright owner.

In the case of *IMS Health*,[62] a company known as IMS Health, a leading supplier of information on sales and prescriptions of pharmaceutical products, developed a model known as the "1860 brick structure," which divided pharmacies in Germany into small geographical units on the basis of which it provided information to its clients. Over time, the brick structure had become the standard in the industry, and other formats were far less acceptable. A company known as NDC requested a license from IMS Health to use the license to compete with it in Germany, but was denied the grant of a license. The European Court of Justice stated that the relevant factor to consider was whether refusal to license copyright to the 1860 brick structure by IMS Health would reserve the market for the supply of pharmaceutical sales data to IMS Health, thereby eliminating all competition in the market.

Since the jurisprudence on competition law has not yet developed to a great extent in India, the abusive practices of a copyright owner holding a dominant position in a market have not been viewed as a ground for the grant of compulsory license. An amendment to include the ground in the Copyright Act may prove to be a step in the right direction.

The Practical Application of Copyright Licensing

Publishing Agreements

An important application of copyright licensing is seen in publishing agreements. A copyright license for publishing may be granted orally,[63] though in practice they are usually entered into in writing. Often, a copyright license

[61] *RTE and Independent Television Publications* v. *Commission of the European Community*, [1995] 4 CMLR 18.

[62] *IMS Health GmbH & Co. OHG* v. *NDC Health GmbH & Co. KG*, [2004] E.C.R. I-5039 (ECJ (5th Chamber)).

[63] *Supra* n. 49, at 919.

may be inferred from the prevailing circumstances, such as when an author sends the manuscript of an article to the editor of a periodical without any mention of publication or payment, it could be argued that the publisher is justified in publishing the work subject to making payment to the author at the standard rate maintained by the publishing house.[64] However, the act of submitting the manuscript for a book to a publisher is generally interpreted to be a mere offer to enter into negotiations for publication.[65]

The duties conferred on the publisher by a publishing contract are usually personal in nature.[66] As a result, publishing contracts cannot be assigned to another publisher before obtaining the consent of the author, or unless the contract itself provides for assignment.[67] This would hold true in situations where the publishing company becomes bankrupt or goes into liquidation.[68]

Important Clauses in a Publishing Agreement

1. **Undertakings**
   In a publishing contract, the author is under an obligation to confirm that the manuscript sought to be published contains original, unpublished work. The author must be the copyright owner of the manuscript and the submission should not, in any way, violate the copyright of any individual or corporation. The author is required to state that the same manuscript is not under consideration by any other journal or publishing house, and in the event that it is, it must be immediately withdrawn. The author is under an obligation to have taken all reasonable care to ensure that the content of the manuscript is not libelous, obscene, or in violation of the rights of any other individual, including privacy rights.
2. **Editing and Proofreading**
   Publishing contracts generally require the author to grant unconditional permission to the publisher to carry out the process of editing and proofreading on the manuscript, and modify the manuscript in the process.

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[64] *Ibid.*
[65] *Supra* n. 49, at 919.
[66] *Fraser* v. *Berkeley*, (1836) 7 C & P 621.
[67] *Supra* n. 49, at 919–20.
[68] *Ibid.*, at 919–20.

3. **Retained Rights**
   Publishing contracts usually provide for certain rights that are retained by the author after the publication of the book or article. The copyright in the work usually vests in the author even after publication. After publication, the author is usually allowed to re-use excerpts from the article or book, though not the published work in its entirety. However, most publishing contracts require the author to acknowledge the publisher in case of such reproduction.
4. **Legal Action for Copyright Infringement**
   Publishing agreements contain a clause to the effect that the publisher is at liberty to take legal action in the event that the copyright is infringed. The publisher usually undertakes to do so at its own cost and expenses. The legal action may be taken in the name of the author, if necessary.

Software Licensing Agreements

Software license agreements facilitate an individual or corporation owning the copyright over a particular software to enable other users to utilize the software without such utilization constituting a copyright infringement. The licensee must comply with the terms and conditions set out in the agreement in order to make use of the software. Such agreements often mandate that the license is non-transferable, and hence, cannot be further sub-licensed by the licensee. Since the terms and conditions must be accepted prior to making use of the software, some of these agreements are popularly known as "clickwrap agreements," requiring the user to click "I Accept" in order to download the software that the license pertains to.

The Indian Copyright Act, 1957 does not make any mention of software licensing agreements. Section 30 of the Act states that copyright licenses may be granted in respect of work that is protected by copyright. Section 14 of the Act, while dealing with copyright, includes computer programs within the scope of "copyright."[69] However, Chapter VI, which deals with licenses, does not make a mention of computer programs, and appears to focus on licenses for literary, musical, artistic, and cinematographic works. It is submitted that in light of the growing importance of software licensing agreements, the Indian Copyright Act be amended to include such agreements within the scope of licensing. Such an inclusion would serve the purpose of clarifying the Indian legal position on software license agreements.

[69] Section 14(b), Copyright Act, 1957.

Important Clauses in a Software Licensing Agreement

1. **License to Use**
   The clause pertaining to license to use may differ from contract to contract. Some contracts strictly mandate that the license is granted for using the software for the internal use of the licensee, whereas some other software licensing agreements, particularly those pertaining to open source software, state that the copying and distribution of the software is permitted, provided it is done along with publication of the copyright notice and disclaimer of warranty.
   In non-open source software licensing agreements, the contract expressly provides that the copyright for the software vests in the company which created the software. Such contracts usually make restrictions on making copies of the software, or the installation of the software on more than a single device without express permission.
2. **Limitation of Liability**
   Many software licensing agreements contain a limitation of liability clause, which provides that the licensor company would not be liable for damages, loss of revenue, profit or data that result from the software failing to perform correctly. Further, they provide that the liability of the licensor company would not exceed the amount paid by the licensee for the software.
   Since the licensee does not have a choice but to accept all the conditions in a software licensing agreement in order to be able to use the software, it may be argued that clauses such as the limitation of liability clause reflect the unequal bargaining power in such contracts. Licensees may be left without recourse in cases where the software is found to be deficient after they have made the payment stipulated under the contract.
3. **Termination of License**
   Software license agreements generally provide that the failure to comply with any provision of the software licensing agreement would lead to an immediate termination of the license. Such termination may occur even without any notice from the licensor company.

Licensing of Creative Works through Copyright Societies

Creative works, such as music and sound recordings, are usually copyrighted by their performers. In order to commercially exploit such work, the copyright owners may enter into a contract with copyright societies, also known as collecting societies. Owing to technological innovation, there has been a proliferation in the number of channels for commercially exploiting creative

works; however, there is also a growing need to protect the copyright owners from the increased possibility of infringement of copyright.[70] As a result, individual control over creator's copyright has lost its relevance to some extent, and collective administration organizations, which administer the rights of its copyright owning members, have become extremely significant.[71] Copyright owners empower such copyright societies to authorize certain specified uses of their works, including the licensing of their works.

Under sec. 33(3) of the Copyright Act, the central government may register an association as a copyright society, in "the interest and convenience of the public and in particular of the groups of persons who are most likely to seek licences in respect of the relevant rights." A copyright owner may authorize a copyright society to be exclusively responsible to administer its rights through the issue of licenses and/or the collection of license fees.[72] Hence, copyright societies act as the agents of copyright owners by licensing their works; in return for this, these societies may deduct a percentage of the fees paid by the licensees for meeting their expenses.[73] One of the criticisms levied against the manner in which copyright societies carry out their activities is that the copyright owners ultimately become entitled to a very small proportion of the amount paid by the licensees.[74] However, copyright owners continue to have the right to grant licenses in their individual capacity, consistent with their obligations as members of a registered copyright society.

In India, some of the registered copyright societies are: the Society for Copyright Regulation of Indian Producers for Film and Television (SCRIPT) for cinematograph and television films, the Indian Performing Right Society Limited (IPRS) for musical works, the Phonographic Performance Limited (PPL) for sound recording, the Indian Reprographic Rights Organization (IRRO) for reprographic (photocopying works).[75] PPL negotiates licenses pertaining to sound recordings in a wide variety of users in several media, such as broadcasting, television, Internet, hotels, discotheques, restaurants, large-scale events, and public performances.[76] The revenue received from broadcast and public performance are distributed by PPL to its members annually.

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[70] A. Chawla, *Copyright and Related Rights: National and International Perspectives* (Delhi: Macmillan India Ltd., 2007) at 163.

[71] *Ibid.*, at 163–64.

[72] Section 34(1)(a), Copyright Act, 1957.

[73] See Section 34(3)(iii), Copyright Act, 1957.

[74] *Supra* n. 70, at 164.

[75] Source: Copyright Societies, http://www.copyright.gov.in/CRS-Web.pdf (accessed on October 4, 2008).

[76] *Supra* n. 70, at 172–73.

The case of *Bennett Coleman and Co. Ltd.* v. *Phonographic Performance Ltd.*[77] involved a dispute between a radio channel called Times FM and a copyright society, Phonographic Performance Ltd. As per the arrangement between the parties, the radio channel would have to pay Rs 1,500 per time slot per hour for broadcasting music to which the copyright society held copyright. Subsequently, the radio channel was allotted a complete FM channel throughout the day in 40 cities, for which it wanted to continue the arrangement with the copyright society at the same rate, that is, Rs 160 per needle hour. However, the copyright society demanded Rs 1,500 per needle hour. On a consideration of the balance of convenience, the Calcutta High Court granted an interim injunction to the radio channel for continuing to play music at the rate that was originally fixed. The judge also gave an order for expediting the hearing of the suit. It must be noted that in the United Kingdom, a report by the Monopolies and Mergers Commission has observed that the use of needle-time restrictions for radio licenses is an anti-competitive practice, which should be abandoned.[78]

Important Clauses in Contracts with Copyright Societies

1. **Subject Matter of License**
   The contract must clearly stipulate the subject matter that the copyright society is authorized to license. For example, the subject matter may relate to certain specified songs or video clippings, or the part thereof.
2. **Nature of License**
   The parties must pre-determine the nature of license that is sought to be covered by the contract between them. For example, the licensing of a particular sound recording may be in relation to television shows, radio programs, Internet websites, mobile ringtones, etc.
3. **Tariff and Distribution Scheme**
   Every copyright society must set out its tariff scheme, which would deal with the nature and quantum of fees or royalties that it proposes to collect in relation to copyright material administered by it. The distribution of royalties to the copyright owners would be governed by certain criteria, which must be clearly mentioned in the contract. While copyright societies in some countries pay fixed rates of royalty to different authors of copyright work, which does not depend on the

[77] *Bennett Coleman and Co. Ltd.* v. *Phonographic Performance Ltd.*, [2004] 2 CHN 595.
[78] *Supra* n. 59, at 1604.

usage of such work, most copyright societies stipulate that the rate at which copyright owners are remunerated would be based on the actual use of their works.[79] Contracts with copyright societies also usually stipulate that the payment of royalty would be done on an installment basis, with the first installment of payment often becoming payable on the execution of the agreement.

Trade Mark Licensing Agreements

The term "trade mark licensing" is a creature of commercial taxonomy that refers to a contractual relationship between the proprietor of a trade mark and another in which the former consents to the use of its trade mark by the latter under certain terms and conditions.[80] These terms and conditions are stipulated by a trade mark licensing agreement, subject to the law. Trade mark licensing has gained great significance as a multi-billion dollar commercial phenomenon, acting as a tool for marketing, distribution, and advertizing across the world. In this context the creation of trade mark licensing agreements attains considerable importance since it governs the rights of the proprietor of the trade mark (the licensor) and the user of the trade mark (the licensee). It also impacts consumers of goods and services since a trade mark acts as a signifier of certain attributes in those goods and services.[81] In some cases a trade mark license might also function as a component of a larger commercial transaction, or may be granted along with a patent license as well.

Different legal systems use different terminologies to describe and govern the commercial relationship in a trade mark license. In this section the statutory provisions that govern trade mark licensing in Indian legal system are discussed first. Next, the law relating to trade mark licensing developed through judicial case pronouncements is examined, drawing on American and English jurisdictions as well. Lastly, the practical aspects of a trade mark license are highlighted with an overview of the kinds of clauses a practitioner should look out for in a trade mark license.

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[79] *Supra* n. 70, at 174.

[80] N.J. Wilkof and D. Burkitt, *Trade Mark Licensing* (London: Sweet and Maxwell, 2004) at 1.

[81] Section 2(1)(zb), Trade Marks Act, 1999 defines states that *"trade mark" means a mark capable of being represented graphically and which is capable of distinguishing the goods or services of one person from those of others and may include shape of goods, their packaging, and combination of colors.*

Legislative Attitude

The relevant statute in India relating to trade mark licensing agreements is the Trade Marks Act, 1999.[82] It has significantly amended the law as it stood under the Trade and Merchandise Marks Act, 1958, reflecting changes in modern commerce and in laws in other jurisdictions like the United Kingdom and E.E.C [83] (European Economic Community). It does not use the terms license, licensor, or licensee in relation to the authorization of use of a trade mark by a proprietor to another.[84] The concept of "permitted use" finds place in the TMA.[85] Permitted use can be by a registered user of the trade mark[86] or by a person other than the registered proprietor and registered user as well.[87] A person other than the registered proprietor of a trade mark may be a registered user of the same, and use by the latter inures to the former.[88] Since a trade mark functions as an indicator of the source or quality of a good or service, a trade mark license cannot be given for use outside of the scope of the trade mark itself.[89]

A registered user can be only in respect of a registered trade mark, and not in respect of an unregistered trade mark. The procedure for registration as a registered user of a trade mark is by application as provided in the TMA.[90] An agreement in writing between the registered proprietor and the proposed registered user with respect to the permitted use of the trade mark by the latter is necessary for registration.[91] Other particulars including the degree of control exercised by the registered proprietor over the permitted use of the trade mark, the subject matter of permitted use, the duration,

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[82] Hereinafter referred to as the TMA.

[83] K.C. Kailasam and R. Vedaraman, *Law of Trade Marks and Geographical Indications: Law, Practice and Procedure* (2nd ed., Nagpur: Wadhwa and Co., 2005) at 601.

[84] It may be noted, however, that the term licensee is used in sec. 29(7), TMA, in the context of infringement. It states that a *registered trade mark is infringed by a person who applies such registered trade mark to a material intended to be used for labelling or packaging goods, as a business paper, or for advertising goods or services, provided such person, when he applied the mark, knew or had reason to believe, that the application of the mark was not duly authorized by the proprietor or a licensee.*

[85] Section 2(1)(r), TMA.

[86] Section 2(1)(r)(i), TMA.

[87] Section 2(1)(r)(ii), TMA.

[88] Section 48, TMA.

[89] P. Narayanan, *Law of Trade Marks and Passing Off* (6th edn., Kolkata: Eastern Law House, 2004) at 424.

[90] Section 49, TMA.

[91] Section 49(1)(a), TMA.

the mode of use, and any other restrictions or conditions that are placed by virtue of the agreement need also have to be filed.[92] As will be elaborated upon subsequently, the requirement that the licensor of a trade mark must maintain quality control over its use by the licensee has been a foundational principle in trade mark licensing elsewhere, including in the British and American legal systems.[93]

Registration as a registered user may be varied or cancelled on various grounds stipulated in the Act.[94] The grounds for cancellation may be that such use is not in accordance with the agreement under sec. 49, TMA, or if it is likely to cause deception or confusion.[95] Cancellation may also occur if any stipulation in the agreement between the registered proprietor and the registered user regarding the quality of the goods or services in relation to which the trade mark is to be used is either not being enforced or is not being complied with.[96]

A registered user can sue for infringement of the trade mark as if he were the registered proprietor of the trade mark, unless an agreement between them specifies otherwise.[97] No rights of assignment or transmission of the trade mark are transferred to a registered user.[98] This emphasizes that a trade mark license agreement is contractual in nature as distinguished from being proprietary.

As mentioned before, permitted use need not necessarily be by a registered user. Registration as a permitted user of a trade mark is not mandatory under sec. 48, TMA.[99] A person can be an unregistered permitted user of a trade mark by virtue of a written agreement to that effect.[100] However, an unregistered permitted user of a trade mark does not have the right to sue for infringement of the trade mark, unlike a registered user.[101] There is nothing in the statute that prohibits licensing an unregistered trade mark.[102]

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[92] Section 49(1)(b), TMA.

[93] See E. Horwitz, *World Trademark Law and Practice, Vol. 5* (2nd edn., New York: Lexis Nexis, 2002).

[94] Section 50, TMA.

[95] Section 50(1)(c), TMA.

[96] Section 50(1)(d), TMA.

[97] Section 52, TMA.

[98] Section 54, TMA.

[99] *Gujarat Bottling Co. Ltd.* v. *Coca Cola Company*, AIR [1995] SC 2372.

[100] Section 2(1)(r)(ii)(c), TMA.

[101] Section 53, TMA.

[102] *Supra* n. 2, at 430.

Judicial Approaches

Cases relating to trade mark licensing can broadly be described under two heads:

QUALITY CONTROL

Initially at common law and in American law the concept of licensing itself was perceived to be antithetical to the function of a trade mark. If a trade mark should indicate a particular source, licensing meant using that trade mark in relation to a different source, theoretically defeating the purpose of a trade mark in the first place.[103] The source could be an anonymous source as well.[104] Over time, this became the basis for the function of a trade mark as an indicator of quality of a good or service. If a licensor exercised sufficient control over the use of its trade mark by the licensee the quality of the good or service could be made uniform notwithstanding different physical sources, thereby granting the purchaser a fair perspective if he chose to rely on the trade mark. Some early cases hinted at adopting this approach, if there was no evidence of deceptive intent on the part of the parties.[105] In American law, if the licensor had control over the main ingredient or it exercised financial control over the licensee, licensing of a trade mark would be valid.[106]

Subsequently the requirement of quality control was entrenched in legislations and judgments in the American, British, and Indian jurisdictions. It has since been reinforced in the American and Indian jurisdictions,[107] while the position of law in England has become uncertain after apparent judicial countenance of naked licensing practices.[108] Naked licensing or uncontrolled licensing takes place when the licensor is not controlling the quality of the good or service represented by the trade mark at all. This has been held to

[103] *Bowden Wire* v. *Bowden Brake*, [1914] 31 R.P.C. 385 (HL); *Macmahan Pharmacal Co.* v. *Denver Chemical Manufacturing Co.*, 113 F. 468 (8th Cir., 1908).

[104] *Birmingham Vinegar Brewery Co. Ltd.* v. *Powell*, [1897] A.C. 710.

[105] *Re: Radiation*, (1930) 47 R.P.C. 37; *J.H. Coles Proprietary Ltd.* v. *Need*, [1934] 50 R.P.C. 379.

[106] *Coca Cola Bottling Co.* v. *Coca Cola Co.*, 269 F. 796; *Keebler Weyl Baking Co.* v. *J.S. Ivins' Son*, 7 F. Supp. 211.

[107] *Dawn Donut Co. Inc.* v. *Hart's Food Stores Inc.*, 267 F.2d 358; *Alligator Co.* v. *Robert Bruce Inc.*, 167 F. Supp. 377; *Bostitch TM*, [1963] R.P.C. 183 (Ch D); *Cycle Corporation of India* v. *TI Raleigh Industries Pvt. Ltd.*, [1996] SCALE (4) 528.

[108] *Supra* n. 80, at 224.

be an inherently deceptive practice elsewhere.[109] However, the House of Lords stated that an inherently imprecise standard of quality control was not needed since customers would not be unfairly prejudiced even if the licensor did not exercise control at all times.[110]

Breach of License

A rich set of cases has arisen with respect to the fulfillment of the rights and obligations of the licensor and licensee under a trade mark license agreement. A trade mark license only creates contractual rights and not proprietary rights in favor of the licensee.[111] The licensor, on the other hand, can assert both contractual and proprietary rights from the same subject matter. Thus, under American law, use of a trade mark by a licensee after termination of the license enables a claim for liquidated damages under the contract and an additional claim for infringement as well.[112] Under English law, the licensor's right to pursue a proprietary or contractual claim depending on which provides a higher measure of damages has been recognized.[113] Enforceable terms in a license need not be expressed and can be implied as well.[114] Proprietary rights in a license for an unregistered trade mark can also be asserted.[115] The distinction between proprietary and contractual rights has been sought to have been drawn in numerous cases by courts. Clauses stipulating particular expenditure or procedures are contractual,[116] while those entailing quality control are proprietary.[117]

A licensee's independent proprietary claim to a trade mark is foregone by the act of entering into a license agreement with the licensor since this acknowledges the latter is the proprietor of the trade mark.[118] A licensee can sue the licensor for non-payment of dues under the license for advertisement and promotion, for instance.[119] Non-financial contractual obligations can

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[109] *First Interstate Bancorp* v. *Stenquist*, 16 U.S.P.Q.2d (BNA) 1704. See, *Licensing and Intellectual Property Law Desk Reference* (M.D. Scott ed., New York: Aspen Publishers, 2004) at 527.

[110] *Scandecor Development AB* v. *Scandecor Marketing AB*, [2002] F.S.R. 122 (HL).

[111] *Crittal Windows* v. *Stormseal*, [1991] R.P.C. 265; *Northern and Shell Plc* v. *Conde Nast and National Magazines Distributors Ltd.*, [1995] R.P.C. 117.

[112] *Ramada Inns Inc.* v. *Gadsden Motel Co.*, 1 U.S.P.Q. 2d.

[113] *Sport International Bussum B.V.* v. *Hi-Tec Sports Ltd.*, [1988] R.P.C. 329.

[114] *Ibid.*

[115] *Mirage Studios* v. *Counter-Feat Clothing Company Ltd.*, [1991] F.S.R. 312.

[116] *Terry* v. *International Dairy Queen Inc.*, 218 U.S.P.Q. 905.

[117] *Franchised Stores of New York Inc* v. *Winter*, 159 U.S.P.Q. 221.

[118] *Bunn-O-Matic Corporation* v. *Bunn Coffee Service Inc.*, 88 F.Supp.2d.; *J.K. Jain* v. *Ziff-Davies Inc.*, 2000 PTC 244 (Del) (DB).

[119] *Actomin Products Ltd.'s Application*, [1953] 70 R.P.C. 201.

also be enforced.[120] If a licensee stalls payment of royalties due to a pending claim against the licensor and yet continues to use the trade mark, it would constitute infringement, even if the licensee succeeds in the pending claim.[121] If the licensee is in breach due to non-payment of royalties, the licensor subsequently terminates the license and the licensee continues to use the trade mark thereafter, the licensor can claim contractual damages under the agreement until the date of termination, and proprietary damages for infringement after that.[122] Even if the proprietary aspect of a license is invalid, the licensee's contractual rights against the licensor under the agreement subsist.[123] However, the licensee has no right to continue using the trade mark if the license has been terminated.[124]

An exclusive license authorizes the licensee to use the trade mark with certain limitations to the exclusion of all other parties including its proprietor. This is distinct from a sole license which does not exclude the proprietor itself. In a controversial decision, an exclusive license for a particular product in a particular area has been interpreted to imply that the licensor cannot utilize the trade mark for any other product in that area.[125] This has serious repercussions for the drafting of exclusive licenses since the licensor's right to use the trade mark with respect to a good or service outside the purview of the license will have to be specifically stipulated. Though generally the exclusivity of a license must be expressly stated,[126] in certain cases exclusivity can be implied if the circumstances so warrant.[127] Indian courts, however, have interpreted the term exclusively dependent on the specific provisions of the contract.[128]

Practical Aspects

As an aid to a legal practitioner in the commercial field of trade mark licensing, certain concerns that would commonly be addressed in such a license are listed as follows:[129]

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[120] *Pantone* v. *Letraset*, 11 U.S.P.Q. 2d. 1454.

[121] *Burger King Corp.* v. *Hall*, 770 F. Supp. 633.

[122] *Dairy Queen* v. *Wood*, 133 U.S.P.Q. 294.

[123] *Proriver Inc.* v. *Red River Grill LLC*, 27 F. Supp. 1.

[124] *Pepsi Foods* v. *Jai Drinks*, [1996] PTC 181 Del.

[125] *Shoney's Inc.* v. *Shoenbaun*, 13 U.S.P.Q. 2d. 1643.

[126] *Pacific Supply Cooperative* v. *Farmers Exchange*, 137 U.S.P.Q. 835.

[127] *Huber Baking Co.* v. *Stroehmann Brothers Co.*, 116 U.S.P.Q. 348.

[128] *Shubhmangal Mercantile (P) Ltd.* v. *Tricon Restaurants (India) Pvt. Ltd.*, [1999] PTC 529 (Del).

[129] See generally, A. Michaels, *A Practical Guide to Trademark Law* (3rd edn., London: Sweet and Maxwell, 2002) at 210–12.

1. Parties to the agreement should be clearly identified. It should be ascertained whether the licensor has the right to license the trade mark, and what conditions must be abided by in case the licensor assigns the trade mark to a third party.
2. The rights that are being licensed should be specifically laid out.
3. The territorial limits of the license should be present.
4. The goods or services in respect of which the license is being given should be clear. Mechanisms for quality control and conditions for sub-licensing should also be known.
5. If required, royalties and the method of their calculation should be mentioned.
6. The duration of the license must be mentioned. If the trade mark license is given along with a patent license it should be clear whether the former would continue to subsist after the latter expires by law. Conditions for renewal, if any, must also be made clear.
7. Conditions and procedures for termination of the license must be laid out.
8. Jurisdictional and choice of law clauses should find a place in the license if there is a significant foreign character to the transaction. Different clauses may govern the jurisdiction and choice of law in respect of proprietary and contractual rights under the license.

Often, there exists a memorandum that is a draft proposal for a license agreement. It is important that such a memorandum be clearly stated to be one without legal effect to avoid any confusion. A licensee should try and ensure that the licensor indeed has the right to license the trade mark, in order to mitigate any claims that a third party claiming proprietorship over the trade mark may have.[130]

Nowadays franchise operations have grown across the world, including in India, and these involve detailed trade mark licensing agreements.[131] Quality control is a primary component of such arrangements. Crucially, restrictive covenants commonly find a place in such transactions. These covenants limit the freedom of the franchisee-licensee to enter into a competing business or franchise agreement for a limited period after the termination of the franchise. This raises important issues regarding the restraint of trade and care must be taken that these restrictions are reasonable in order that

[130] *Supra* n. 80, at 242.
[131] *Supra* n. 83, at 603.

they are upheld by law.[132] A restriction that the franchisee would not carry on a similar business after termination under any name was held to be void.[133] A restrictive covenant in a franchise agreement needs to satisfy a less stringent test than that necessary for an employment contract.[134]

Conclusion

This chapter has aimed to effectively analyze the existing licensing regime for intellectual property rights. As is evident from the chapter, there is no one kind of licensing agreement. In fact the licensing contracts and the clauses of such intangibles are tailor made to satisfy the need of a particular contract or business transaction.

The question which then arises is, whether we should look at any statutory regime to govern such licensing contracts? It is pertinent to note that in India these contracts are regulated by several laws. For instance, in the case of patent licensing both the Indian Contract Act and the Indian Patent Act become relevant. However, they govern the bare essentials such as the validity of such a contract and the registration requirements, issues like the percentage of royalty payments and anti-competition are not legislated upon.

The answer to this question is obviously tricky and the same is evident from the expansive scope of material covered in this article. Thus, the large and complex variety of agreements is the first road block faced by a legislator when aiming to legislate on such agreements. Hence, the only possible answer to this question is that, like the Contract Act and the Patent Act, the government should release very basic notifications on issues like royalty and anti-competition. A working example for such notifications could be articles 81 and 82 of the EC (European Commission) treaty, which in very general terms lay down the law relating to anti-competition for the European Union, and leave interpretation and decisions in specific cases to the courts.

According to the researchers such an approach would also aid the commercial aspects of trading in intangibles, given the varied nature of agreements, trade, and business relations in the concerned area; too much and too specific regulation may end up adversely affecting the business and go against the legislative intent of ensuring free flow of trade.

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[132] *Gujarat Bottling Co. Ltd.* v. *Coca Cola Company*, AIR [1995] SC 2372.

[133] *IEC School of Art and Fashion* v. *Gursharan Goyal*, [1998] PTC 493.

[134] *Dyno-Rod Plc.* v. *Reeve*, [1999] FSR 148 (Ch D).

5

Joint Venture Agreements

Ankur Narain Saxena and *Debeleena Das*

Introduction

Today for business expansion or entry into new markets corporations are entering into joint ventures. Such ventures give parties opportunities to access capital, skills, and new markets while ensuring independence of the parties. Liberalization coupled with rapid economic development in India has led to increasing number of alliances between foreign and Indian companies.

However, in India there is no particular law governing joint venture agreements to deal with the various legal issues which parties face in a joint venture. This paper highlights the important legal issues which the parties need to be aware of while drafting such an agreement. A well-drafted joint venture agreement can go a long way in making it successful.

Part I of the chapter lays down the approach that parties can adopt in drafting an agreement, while laying down the options of equity and contractual legal structure for a joint venture agreement. However, while entering into a joint venture the provisions of the Competition Act or Antitrust may be invoked which the paper wishes to highlight. Part II details the legal issues, except for tax and standard clauses, in such an agreement.

Part I: The Approach

The drafting of a joint venture agreement is a complex process which involves promoting coordination and flexibility by adopting a conflict-resolution and governance approaches.[1] The wording of the clauses can depend on the

approach that the joint venture parties adopt. Theoretically there are three contractual approaches: *classical*, *neoclassical*, and *relational*.[2]

Classical contracts maximize emphasis on coordination in effect compromising on flexibility, with their scope being limited to an individual transaction, and are characteristically "*presentiated*," that is, they "*fix at the time of contracting precise expectations for future performance and the remedies available in the event of breach.*" *Neoclassical contracts* focus on governance structures and are not much perpetuated. *Relational contracts* permit growth of joint venture and expansion in new markets thus allowing parties to respond to change in circumstances while still being governed by the agreement.[3] Under this approach contracts are drafted in a manner to allow modification rather than trying to provide remedies to all possible situations upfront.[4]

The authors suggest that owing to unpredictability of business environment relational contracts approach would help in building an organic relationship between parties.

Definition

There is no precise definition of joint venture; rather, it is contextual, with the definition depending on the type of structure, durations, form, and scope.[5]

In *New Horizons Ltd* v. *Union of India*[6] the Supreme Court of India defined joint venture as:

> *The expression "joint venture".... connotes a legal entity in the nature of a partnership engaged in the joint undertaking of a particular transaction for mutual profit or an association of persons or companies jointly undertaking some commercial enterprise wherein all contribute assets and share risks. It requires a community of interest in the*

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[1] J. Taylor, "Drafting Intellectual Property Joint Venture Agreements with an Eye Toward Termination," 4 *University of Pittsburgh Journal of Technology Law and Policy* 1 (2004), available online at www.westlaw.com (accessed on September 26, 2008).

[2] S.R. Salbu and R.A. Brahm, "Strategic Considerations in Designing Joint Venture Contracts," *Columbia Business Law Review* 253 (1992), available online at www.westlaw.com (accessed on September 26, 2008).

[3] *Supra* n. 1.

[4] *Supra* n. 2.

[5] J.P. McGrath, "Antitrust Problems in Negotiating a Joint Venture Agreement," 54 *Antitrust Law Journal*, 971 (1985), available online at www.westlaw.com (accessed on September 27, 2008).

[6] MANU/SC/0564/1995.

> *performance of the subject matter, a right to direct and govern the policy in connection therewith, and duty, which may be altered by agreement, to share both in profit and losses. [Black's Law Dictionary; Sixth Edition, p. 839]. According to Words and Phrases, Permanent Edition, a joint venture is an association of two or more persons to carry out a single business enterprise for profit [P.117, Vol. 23].*

Black's Law Dictionary (7th edition, p. 843) defines "joint venture" as: "*A business undertaking by two or more persons engaged in a single defined project. The necessary elements are: (1) an express or implied agreement; (2) a common purpose that the group intends to carry out; (3) shared profits and losses; and (4) each member's equal voice in controlling the project.*"[7]

Joint ventures may result in anti-competition practices. Thus, around the world, countries like the United States[8] and Australia[9] have defined "joint venture" for the purposes of competition law. However, the definition under the European competition law is the most comprehensive as it categorizes joint ventures into different types, thus aiding analysis of procedural aspects.[10]

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[7] See *Faqir Chand Gulati* v. *Uppal Agencies* MANU/SC/3133/2008. Here the Hon'ble Supreme Court explained "joint venture" in the context of owner of land and a builder, by way of an example wherein they enter into an agreement for sale of apartments, then in the agreement indicates that both parties shall exercise joint control over the construction/development and be accountable to each other as regard their respective acts, then it will constitute a joint venture. Further, the court pointed it out that there is "*a requirement of each joint venturer being the principal as well as the agent of the other party.*"

[8] **The US Collaboration Guidelines define these arrangements in the following terms:**

> *A 'competitor collaboration' comprises a set of one or more agreements, other than merger agreements, between or among competitors to engage in economic activity, and the economic activity resulting there from. 'Competitors' encompasses both actual and potential competitors. Competitor collaborations involve one or more business activities, such as research and development ('R & D'), production, marketing, distribution, sales or purchasing.*

Federal Trade Commission and US Department of Justice, Antitrust Guidelines for Collaborations Among Competitors, April 2000, at 2. Taken from J.P. McGrath, "Antitrust Problems in Negotiating a Joint Venture Agreement," 54 *Antitrust Law Journal*, 971 (1985), available online at www.westlaw.com (accessed on September 27, 2008).

[9] The High Court of Australia in *United Dominions* v. *Brian Pty Ltd* (1985) 60 ALR 741.

"*The term 'joint venture' is not a technical one with a settled common law meaning. As a matter of ordinary language it connotes an association of persons for the purpose of a particular trading, commercial, mining or other financial undertaking or endeavour with a view to mutual profit, with each participant (usually but not necessary), contributing money, property or skill.*"

[10] The European Community competition law classifies joint venture into three categories:

> *(a) Concentrative "full-function" joint ventures: Joint ventures that perform on a lasting basis all the functions of an autonomous economic entity. Typically, such a joint venture is a separate*

Conflict of Interest and Disclosure Problems

A joint venture, unlike a closely held corporation, is a complex model where there are interlocking directors who represent the interest of both the parent as well as joint venture resulting in duplicity of interest.[11] Hence, the agreement should ensure that the directors do not prioritize the interest of the parent company over the joint venture.

To begin with, the conflict of interest could be of three categories: (i) self-dealing, where conflicts may occur when a joint venture transacts with one of its parent companies;[12] (ii) corporate opportunity conflicts, where both the joint venture and the parent compete to take the same business

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corporate entity from its parent co-venturers, and has sufficient management, finance, staff, and other resources to conduct business on a long-term basis. These are often referred to as "merger-type" joint ventures that have a Community dimension because their "turnovers" exceed certain thresholds established under the relevant provision;

(b) Cooperative "full-function" joint ventures: Joint ventures which perform on a lasting basis all the functions of an autonomous economic entity, but do not have a "Community dimension", i.e., their turnovers do not exceed the established thresholds;

(c) Cooperative "partial-function" joint ventures: Joint ventures that perform only limited, specific functions (eg research and development, production, joint distribution, or joint purchasing activities for their parents) and have no access to a market. Also, joint ventures which are established for a short duration, eg those designed to construct a specific project, will be classified under this heading, because they are considered as not operating on a lasting basis. These joint ventures will be treated as merely auxiliary to their parents. These may or may not have a Community dimension.

R.J. Hoskins, "Antitrust Analysis of Joint Ventures and Competitor Collaborations: A Primer for the Corporate Lawyer," 10 *University of Miami Business Law Review* 119 (2002), available online at www.westlaw.com (accessed on September 26, 2008).

Under the categorization in EU competition law, the concentrative "full function" joint ventures regulated by Merger Regulation EC Merger Regulation, 20/1/04, O J L 24/1 and the cooperative "full function" and the cooperative "partial-function" joint ventures are the subject of art. 81 (which controls restrictive agreements affecting trade between member states) of the Treaty Establishing the European Community.

J.P. McGrath, "Antitrust Problems in Negotiating a Joint Venture Agreement," 54 *Antitrust Law Journal*, 971 (1985), available online at www.westlaw.com (accessed on September 27, 2008).

[11] Z. Shishido, "Conflict of Interest and Fiduciary Duties in the Operation of a Joint Venture," (39) *Hastings Law Journal* 63 (1987) available online at www.westlaw.com (accessed on September 22, 2008).

[12] An example of a self-dealing conflict is when a parent company supplies materials to a joint venture. This is more common in a new joint venture where to save initial cost of capital, the parent company supplies initial capital goods. In such a case, the interest of the parent company is to sell these materials at the highest price possible, whereas the interest of the joint venture is to purchase them at the lowest price possible. *Supra* n. 11.

opportunity; and (iii) disclosure conflicts which arise when a director or an officer of a joint venture has information about either the joint venture or a parent company or in situations when a parent company has sole access to information that is necessary for operating the joint venture.[13]

As a remedy to these conflicts, there is a school of thought which argues that the conflict of interest is through the "Theory of Implied Agreement and Estoppel." What this theory essentially says is that a dissenting parent company should be estopped from undertaking direct action against a joint venture director for breach of fiduciary duties. However, this argument might not always work since it presupposes that certain directors are straw men and that most joint ventures agree on giving some amount of discretion to the directors which cannot be impliedly restricted in a contract.[14]

Thus, there is a need for alternative solutions to this. Zenichi Shishido has suggested some model remedies to the afore-mentioned conflict scenarios. In case of self-dealing transactions, a way out of it is ratification by non-interested parent companies or independent directors to avoid conflict. Thus, a joint venture agreement should essentially include that criterion. When ratification is not possible, then the courts should look at the "fairness argument"[15] as to whether it was fair on behalf of one party not have disadvantaged the joint venture. Different standards could be adopted for accepting fairness. For example, it would be best to use market price or arm's length standard as the criterion.[16] A second alternative for determination of fairness is to use a full disclosure and ratification process for all self-dealing

[13] An interesting example to further elaborate this issue would be that of the GM–Toyota joint venture to manufacture and sell subcompact cars. Toyota has the know-how to manufacture subcompact cars and GM has a distribution network. Toyota already has a product, the Corolla which is similar to the joint venture product Nova. Thus, to determine the price of Nova, it would be in the best interest of the joint venture to know about the cost and price of the Corolla though it would be contrary to Toyota's interest. Thus, the moot issue is whether directors of Toyota could be held responsible for breach of fiduciary duty if they do not disclose information about the Corolla. *Supra* n. 11.

[14] *Supra* n. 11.

[15] The "fairness test" has been adopted in some legislation also. For example, sec. 310 of the California Corporations Code did not require that a self-dealing transaction be "just and reasonable" when the proper procedures for shareholder ratification were followed. However, an amendment was introduced in 1975 and the revised law requires that a self-dealing transaction be "just and reasonable" when the transaction is approved only by the board of directors, or when no proper procedure for ratification is followed. *Supra* n. 11.

[16] *Supra* n. 11.

transactions.[17] This however creates problems in case of high-information joint ventures which will be dealt with later in this article.

Now coming to a possible remedy for corporate opportunity conflicts of interest, a parent company can obtain any business opportunity without violating its fiduciary duty toward a joint venture in certain instances where it is very clear that the opportunity does not belong to the joint venture. This brings us to the moot question as to which opportunity belongs to the joint venture and which belongs to the parent company and if there could be an objective standard to determine that. A possible remedy is to look at how a business opportunity arose (using the fairness standard) and which enterprise will derive a higher relative value from a business opportunity (using the efficiency standard).[18]

Lastly, coming to problems that arise out of disclosure of information,[19] it could easily be said that this is by far the most complex of all the problems that arise in a joint venture. Essentially, it arises when disclosure of information benefits only one party and harms the other. This is more prominent in joint ventures involving high technology where information confidentiality is of utmost importance and one party must make sure that as a value of entering into the agreement, it does not divulge so much information which will allow the other party to accomplish its goal without the joint venture.[20] Thus, there is thin line between need for disclosure and the urge to guard information.

Disclosure of information not only lets out the technical know-how of the technical skills, it also could help parent companies in diverting business opportunity. The classic example of the genre is *Meinhard* v. *Salmon*,[21] which involved the diversion of a joint venture opportunity in a real estate joint venture using the information it had access to.

Zenichi Shishido suggests that to resolve the disclosure problem, it is necessary to balance the conflicting interests. Three factors should be

[17] *Supra* n. 11.

[18] *Supra* n. 11.

[19] In this regard, the information can be categorized into those that are proprietary to the joint ventures and those that are proprietary to the individual participants.

A. Vestal, "'Ask Me No Questions and I'll Tell You No Lies': Statutory and Common-Law Disclosure Requirements within High-Tech Joint Ventures," 65 *Tulane Law Review* (1991), available online at www.westlaw.com (accessed on September 22, 2008).

[20] *Ibid.*

[21] *Meinhard* v. *Salmon*, 249 N.Y. 458, 164 N.E. 545 [1928].

considered for balancing, namely, (i) the characteristics of the information,[22] (ii) the other parent companies' interest in the information, and (iii) the degree of disclosure that is required in each fact situation. He further elaborates the test by imposing a duty on the court to consider whether the interested parent company obtains benefit to the detriment of other joint venture and in doing so should use the fairness test.[23]

The disclosure requirement is also made part of some statutes. In the United Kingdom, the Uniform Partnership Act (UPA) provides for the same. This includes two categories of obligations: (i) routine disclosures[24] and (ii) extraordinary and remedial disclosures.[25]

Common law also has some disclosure requirements. Joint venture parties, like co-partners, owe to one another the duty of the fiduciary duty to act in good faith. Common law also imposes the obligation specifically on "pre-partnership transactions" and self-dealing transactions. However, courts have clarified the position that such a disclosure requirement is not effective after the terms of the sale are agreed.[26]

In India, the Partnership Act provides, in sec. 11(2) and sec. 16, that partners cannot compete with their partnership firm while they are partners. The Press Note 1 (2005 Series) issued by the Government of India has also issued the protection of joint venture interest. It provides that the joint venture agreement "may contain a 'conflict of interest' clause to safeguard the interests of joint venture partners in the event of one of the partners desiring to set up another joint venture or a wholly owned subsidiary in the 'same' field of activity." However, the Press Note 1 (2005 Series) or even

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[22] This category has significance only when the joint venture and the parent company compete or, in other words, are in a horizontal relationship. Information critical to competition may include information about technology, know-how, design, price, cost, and output of the parent company's product. *Supra* n. 20.

[23] *Supra* n. 20.

[24] Obligation to make routine disclosures is implied in sec. 18 of the UPA. Professor Melvin Eisenberg concludes that "*the effect of Section 18(e) 'is to require that, absent contrary agreement, every partner be provided on an ongoing basis with information concerning the partnership business, and be consulted in partnership decisions.*" *Supra* n. 20.

[25] The requirements in the second category, the extraordinary and remedial disclosures, are explicitly set forth in the UPA. The primary extraordinary and remedial disclosure requirement is sec. 20, which provides that "*[p]artners shall render on demand true and full information of all things affecting the partnership to any partner or the legal representative of any deceased partner or partner under legal disability.*"

[26] See *Talbot* v. *James*, 259 S.C. 73, 190 S.E.2d 759 [1972]; *Lynch* v. *Vickers Energy Corp.*, 383 A.2d 278 (Del. 1977).

the Partnership Act does not provide disclosure requirements, neither does it provide guidelines for prevention of conflict of interest between parent companies and the joint venture partners.

Antitrust and Joint Venture

Joint ventures may also threaten competition by distorting competitive incentives among joint venture participants. Basically, it poses three types of anti-competitive risks: collusion, loss of potential competition, and market exclusion. Collusion threat is the most important one in the context of joint ventures since a joint venture can essentially provide the tools for cartelization.[27]

In the United States, sec. 1 of the Sherman Act and sec. 3 of the Clayton Act regulate joint ventures from an antitrust perspective. Section 1 of the Sherman Act provides that *"every contract, or combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations to be illegal."* Whereas sec. 3 of the Clayton Act makes it illegal for *"any person engaged in commerce, in the course of such commerce, to lease or make a sale or contract for sale of goods ... or fix a price charged ... where the effect of such lease, sale, or contract for sale or such condition, agreement, or understanding may be to substantially lessen competition or tend to create a monopoly in any line of commerce."*

However, instead of the deciding cases under the statutory provisions, US courts have more often than not dealt with the issue under the "rule of reason" test to determine the competitive effect of joint ventures.[28] Under the "rule of reason" approach, courts generally look at the structure of the joint venture, the conduct and intent of the participants, and finally analyzes the competitive effects of the joint venture as a whole to determine the illegality of it. There have been plethora of cases which have used this test and the general principles that the courts have laid down in these cases include disallowing an unlawful cartel from using the guise of a joint venture. Moreover, courts tend to closely scrutinize joint ventures between competitors which have a high market share as also, those joint ventures that restrain the marketing or output decisions of the participating firms. Finally,

[27] J.F. Brodley, "Joint Ventures and Antitrust Policy," 95 *Harvard Law Review* 1521 (1982), available online at www.westlaw.com (accessed on September 22, 2008).

[28] A. Lear, "Joint Ventures: Treatment under New Zealand, United States and European Competition Law," 11 *New Zealand Business Law Quarterly* 187 (2005), available online at www.westlaw.com (accessed on September 27, 2008).

courts are also careful when it comes to a joint venture wherein the legitimate business purposes cannot be achieved by less restrictive means and if non-participants in the joint venture are given access on non-discriminatory terms.[29]

Under the Clayton Act, however, the test that is used is the test that was adopted by the courts in the case of *United States* v. *Penn-Olin Chemical Co.*,[30] where the court came up with a two-stage test to test the legality of a joint venture agreement. The first stage requires a determination whether each of the two parents are potential competitors in the joint venture's market. If the answer is in the affirmative, then courts will look at whether the joint entry might foreclose the competitive benefits of individual entry. Only if both of the parties are found to be potential competitors in joint market, then in the second stage, courts will determine whether the joint venture is likely to injure competition.

To add to this, FTC (Federal Trade Commission) and DoJ (Department of Justice)—the Agencies—have jointly issued the US Collaboration Guidelines on how they approach and analyze collaborations among competitors. This guideline adopts a two-step approach wherein first, it sees if there are hard-core cartel elements that affect price and output, market sharing, etc. Next step involves a framework whereby the Agencies will consider justifications as to why these are per se illegal agreements. Some of the justifications given in the guidelines are that it is "an efficiency-enhancing integration of economic activity" or that it is "reasonably related to the integration and reasonably necessary to achieve the pro-competitive benefits."[31]

In India, sec. 3 of the Competition Act is likely to have some impact on the joint venture agreements. Section 3 provides that agreements in respect of production, supply, distribution, storage, acquisition or control of goods, or provision of services which causes an appreciable adverse effect on competition within India are void. However, it must be noted that the proviso of sec. 3(3) provides that the provisions of anti-competitive agreements are not applicable to joint venture agreements, provided that such agreement increases efficiency in production, supply, distribution, storage, acquisition or control of goods, or the provisions of services.[32]

[29] *Supra* n. 27.
[30] 97 F.Supp. 952 (D. Md. 1951).
[31] *Supra* n. 28.
[32] Competition Act, s.3(3) Proviso.

Types of Joint Venture

In India parties can enter into equity/incorporated joint venture or a contractual joint venture according to which the laws and regulations will apply.

1. **Companies or Equity Joint Ventures**[33]
   Under the Indian law, a corporate vehicle is regulated by the Companies Act, 1956. It enjoys the advantage of limited liability, and is supported by the company law which is highly adaptable[34] giving parties various categories of joint venture companies to choose from and the option of forming a private limited company or a public limited company. Further, parties to the joint ventures may wish to form a separate joint venture company or invest a share capital of an existing company. A new entity allows the flexibility of structuring the documents of incorporation, that is, the Memorandum of Association and Articles of Association to reflect the rights, and obligations of the parties as understood between them. However, when a joint venture partner invests in shares of an existing company the documents of incorporation will have to be amended in accordance with the joint venture agreement and in the manner specified in the Companies Act.[35]
2. **Partnerships or Contractual Joint Ventures**[36]
   Parties may wish not to have any formal legal structure or vehicle like the ones outlined earlier; rather, they may carry out a joint venture

[33] Many insurance companies are operating in India by way of joint venture companies. Recently, the Tata group and American International Group (AIG), entered into a joint venture forming a company Tata AIG Life. http://www.tata-aig-life.com/(accessed on August 13, 2009).

[34] S. Dua and Associates, *Joint Ventures & Mergers and Acquisition in India – Legal and Tax Aspects* (New Delhi: Butterworths, 2006) at 2.

[35] *Ibid.*, at 2.

[36] Jet Airways and Kingfisher Airlines on October 13, 2008 announced an agreement regarding the formation of an alliance of wide-ranging proportions; the scope of the alliance will include the following areas: Code-shares on both domestic and international flights subject to DGCA approval, Interline/Special Prorate agreements to leverage the joint network, deploying 189 aircraft offering 927 domestic and 82 international flights daily, joint fuel management to reduce fuel expenses, common ground handling of the highest quality, cross-selling of flight inventories using the common global distribution system platform, joint network rationalization and synergies, cross-utilization of crew on similar aircraft types, and commonality of training

based purely on contractual arrangements. Based on the incident of time or purpose for which the parties want to establish the venture, parties may enter into consortium/collaboration agreements, etc. like submitting a joint venture bid for a construction contract.[37]

Limited Liability Partnerships

In United Kingdom, the Limited Liability Partnership Act, 2000 has introduced a new legal structure under which parties can incorporate limited liability, LLP is liable to the full extent of its assets but the members have limited liability, while retaining the benefits of tax status, appearance, and the flexibility of a partnership under the traditional partnership. There is no limitation on the number of members of the LLP, and professionals or even two or more persons, including companies, carrying on any trade or profession can enter into such a legal arrangement. However, the Act imposes public filing requirements similar to those of a company like annual accounts, annual returns, and any change to registered office.[38]

Similarly in India, the Limited Liability Partnership Bill, 2006 proposes a LLP which would be a hybrid between a partnership firm and a limited liability company. The LLPs would enjoy the status of a body corporate which will have distinct identity from its partners with perpetual existence. While the Bill stipulates a minimum of two partners for constituting a firm it proposes to raise the maximum number of partners from the current limit of 20 to 100 partners. The partners will only have limited liability in the LLP to the extent of investment made by them in the LLP, besides not being liable for each other except in certain cases.[39]

However, the utility of such a limited partnership involving corporate partners have been questioned on the basis that joint venture partners will

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as also of the technical resources, subject to DGCA approval, and reciprocity in Jet Privilege and King Club frequent flier programs.

The agreement is a very good example of a contractual joint venture. http://www.jetairways.com/MSIB21/Templates/JetTPLPressReleasePosting.aspx?NRMODE=Published&NRORIGINALURL=%2fcultures%2fen-US%2fKuwait%2fabout%2520us%2fpress%2520room%2fpress%2520releases%2f9w_it&NRNODEGUID={A609C31E-3568-4A53-AADE-95A3B8C79B77}&NRCACHEHINT=Guest (accessed on August 15, 2009).

[37] *Supra* n. 34, at 3.

[38] I. Hewitt, *Joint Ventures* (2nd edn., London: Sweet & Thomson, 2001) at 99.

[39] P.V. Sahad, "Legal Guest Column: Limited Liability Partnership Bill 2006 in Line with International Practices," available online at http://www.vccircle.com/2007/01/22/legal-guest-column-limited-liability-partnership-bill-2006-in-line-with-international-practices/(accessed on September 26, 2008).

usually wish to have some control over the management beyond what is permissible for a limited partner.[40]

Part II: Contents of a Joint Venture Agreement

The various provisions of a joint venture agreement and their enforceability would depend upon the legal structure. This part of the paper highlights the typical provisions of joint venture agreements. The readers would be made aware of the relevance of a particular clause in an incorporated and a contractual joint venture.

As regards incorporated joint venture it is pertinent for the parties to be aware of the provisions of the company law as the same would override any provision contrary to the company law or the articles of association.

Condition Precedent

Conditions precedent are stipulations which the parties have to fulfill in order for the joint venture to come into existence, which may be of the nature of:

1. **Regulatory compliances**
   In the form of licenses, approvals, etc., which are statutory.[41] While partners will be aware of the statutory regulations since they form the law of the land, statutory regulations may be changed to conditions independent to the actions of the parties. Thus, joint venture agreements should be drafted in a manner such that the venture is capable of accommodating to statutory changes.

   In case of international joint ventures parties may be subject to statutory regulations of the jurisdiction where the venture is incorporated or located and also of the place of incorporation or location of the partners to the venture. In India, foreign direct investment policy is formulated by the Department of Industrial Policy and Promotion, which is announced by the Secretariat for Industrial

[40] *Supra* n. 38, at 84.
[41] *Supra* n. 34, at 100.

Assistance, and is subsequently notified by Reserve Bank of India under the Foreign Exchange Management Act, 1999 (FEMA). The policy provides for investment by the "automatic route,"[42] "non-automatic route,"[43] and "inbound and outbound investment."[44, 45]

2. **Contractual conditions precedent**
   Parties may require certain condition precedent among themselves in order to enter into a joint venture. However, in order to give force to such condition precedent it is suggested that parties enter into agreements to make them legally enforceable.

Ownership/Governance/Management Structure

Incorporated joint venture allows the parties the scope of range of four possibilities (i) majority ownership by one party, (ii) fifty/fifty ownership, (iii) forty-nine/forty-nine shareholding with the controlling shareholding held by a third party, and (iv) one hundred ownership vested in one party with the other parties having the option to acquire some or all of those shares.[46]

In case of an incorporated joint venture the control over the venture is exercised by the board of directors of companies incorporated in India.

[42] "'**Automatic Route'**–Foreign Investor need not obtain the prior approval from the Government of India (GOI), or the Reserve Bank of India (RBI)" taken from *Supra* n. 34, at 4.

[43] "'**Non-Automatic Route'**–Imposed on certain regulated sectors, Foreign Investment can be carried out with the prior permission of the Foreign Investment Promotion Board (FIPB) under SIA. While Indian companies getting foreign investment under this particular route, do not require any clearance from the RBI for the purposes of inward remittance, and issue of shares to the foreign investors. However, companies are required to notify the concerned regional offices of the RBI about the receipt of inward remittances within 30 days of such receipt, and to file the required documents with the concerned regional officers of the RBI within 30 days of issue of shares to the foreign investors or NRIs." *Supra* n. 34, at 4.

[44] "'**Inbound and Outbound Investment'**–The FDI policy and FEMA regulate such investment with the policy giving the broad outline of the Indian position on foreign investment while all the inbound and outbound investment regulated by FEMA. Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations 2000, regulates inbound investment while. Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations 2000 regulates outbound investment." R.R. Iyer, "Joint Ventures and Wholly Owned Subsidiaries Abroad," 49(9) *Company Law Cases* 446 (2006) at 446.

[45] M. Ladwa and V. Shukla, *Establishing a Joint Venture in India*, available online at http://www.scribd.com/doc/2954632/Establishing-A-Joint-Venture-In-India (accessed on September 22, 2008).

[46] N.K. Jain, *Manual of Indian Investments Abroad*, (New Delhi: Nabhi Publication, 1995) at 69.

In order to accommodate the interest of various parties to a joint venture, Hewitt points out that, unlike in German law, under the UK Companies Act there is no scope for differentiating management and supervisor responsibilities; the UK law provides scope of variety of arrangements for the management of the joint venture company.[47] In India the position is same as the United Kingdom.

The authors here underline the approaches given by Hewitt, which can be incorporated in the joint venture agreement for a company incorporated in India.[48]

1. Parties can enter into an agreement whereby each shareholder can appoint a certain number of directors to represent their interest in the board. However, in light of sec. 255 of the Companies Act it is subject to a maximum of one-third the total directors.
2. As long as parties do not violate the provisions of the Companies Act, 1956, parties can have clauses stipulating that certain decisions will be made not by the board, contractually subject to the approval or decision of the shareholders before they can be implemented.

As regard an unincorporated joint venture, parties enjoy the flexibility of deciding upon the management structure of the venture. However, in case of a partnership the partners will have a joint liability and there can be a maximum of 20 partners only. It is advisable that parties clearly lay down the management structure in the agreement to dispel any chance of conflict.

Intellectual Property Rights

Joint venture might lead to the creation of intellectual property. However, owing to the uncertainty surrounding a venture involving different parties, it is essential that partners to a joint venture should clearly lay down in the agreement the mechanism by which the value of the joint venture's intellectual property will be secured post joint venture and any related conditions.[49] In case of a collaborative joint venture agreements parties typically prefer to draft clauses which state that the collaboration will not be deemed a "joint

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[47] I. Hewitt and G. Picot, "Structuring the Joint Venture," *Joint Ventures in English & German Law* (E. Micheller and D.D. Prentia eds., Oxford: Hart Publishing, 2000) 13, at 25.

[48] *Ibid.*

[49] *Supra* n. 1.

work," rather permitting the parties to "contract out" in case of a defined default by a joint venture party.[50]

Duties of the Directors/Management

The Companies Act, 1956 clearly outlines the fiduciary duties and duties of care and skill of the directors which are non-derogable and in fact parties cannot even contract out of the same. In case of partnership joint ventures, the Indian Partnership Act, 1932 lays down the duties of the partners to the partnership and third parties.

Confidentiality

1. **Pre-contractual confidentiality**
   The need of a confidentiality agreement in negotiation stage becomes imminent since there is a likelihood that the negotiations might fail. Thus, parties need to sign a clearly worded agreement prohibiting each one of them from using a confidential information disclosed by one to the other for any purpose other than in connection to the joint venture, non-disclosure to third parties, an undertaking to keep the information confidential, and in case of break down of negotiations, to return all material relating to such information to each other.[51]
2. **Confidentiality clause under the agreement**
   The agreement should provide safeguards to prevent unauthorized use of the confidential agreement. The agreement should clearly identify what constitutes confidential information and accordingly give an undertaking that the information received by the partners in the course of the venture is a confidential information, setting out the probable use of the con-fidential information, non-disclosure to third parties, and possible measures in case of breach.[52]

[50] M.B. Wiles, "Do Theatrical Collaboration Agreements Create a Joint Venture?," 25 *Columbia Journal of Law & Arts* 219 (2002), available online at www.westlaw.com (accessed on September 22, 2008).

[51] *Supra* n. 34, at 22–23. See *Seager* v. *Copydex Ltd* [1967] 1 W.L.R. 923 where the court awarded damages to the plaintiff when the defendant produced a product based on the information disclosed by the plaintiff as regard an invention during the course of negotiation for a joint venture which failed. The court held that the defendant had used the confidential information to gain a springboard.

[52] *Supra* n. 34, at 118.

Restrictions on Shareholders/Parents

In order to safeguard the interest of the joint venture, parties need to put mutual restrictions like putting non-compete clause, territorial scope of the venture, lay down exceptions if any for any existing venture of a party, obligations on the parties to refer to the joint venture any orders/business which they get within the field of the joint venture, putting anti-poaching clauses as regard employees, duration of restrictions whether during the period of the existence of the joint venture or their scope of application subsequent to the agreement, and putting obligations by way of guarantee on the parties as regards performance.[53]

Profit/Revenue Sharing

The joint venture agreement should deal with issues regarding profit sharing, the dividend policy, and minimum level of disbursement or retaining of profits each year, and scope of change in profit distribution.[54]

Termination Clause

Paradoxically, while the parties strive to draft the agreement in a manner so as to prevent termination yet they are also to account for it.[55] In case of conflict, parties have the choice of amendment to the agreement, recession of the agreement, termination of the agreement which leaves the joint venture intact with the continuation of certain obligations, or termination of the joint venture bringing it to an end. The difference between recession and termination can be pointed from the contract, with recession being either unilateral or mutual[56] while termination happens by "discharge of duties by exercise of powers granted by the agreement."[57]

In case of default in India, sec.39 of the Contract Act provides that if there is breach of an agreement by a party then the contract becomes voidable at the option of the aggrieved party. However, in case of an incorporated

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[53] *Supra* n. 38, at 591.
[54] *Supra* n. 38, at 590.
[55] *Supra* n. 1.
[56] Section 62 of the Indian Contract Act.
[57] *Supra* n. 1.

joint venture, in order to bring an end to the a joint venture company the winding up provisions under the Companies Act will have to be adhered to by the parties.

However, in order to avoid termination the agreement should provide parties with options in case of a breach. Thus, as regard incorporated joint ventures, parties may put a clause in the agreement defining "non-defaulting party" and "defaulting party," giving the latter greater rights, such as in case of default arising because a party goes bankrupt or has materially breached its covenants, then the non-defaulting party might have an option to purchase the defaulting party's shares at a formula price.[58]

Further, parties can include clauses allowing right of first refusal to each other in case one party wishes to withdraw from the venture, or facilitate financing by the other party by giving options like easy term of payment for withdrawing party's share including long term, low on interest, and a long period of grace.[59]

Standard Clauses

There are various clauses in joint venture agreements which are standard and thus the authors feel that they do not require a detailed examination but need to be put in an agreement: (i) force majeure, (ii) notices, (iii) amendments, (iv) assignment of rights/obligations, (v) severability, (vi) entire agreement, (vii) public announcements, (viii) governing law, and (ix) dispute resolution.

Conclusion

Successful joint ventures require utmost harmony, understanding, and confidence between parties. The various issues as raised in the paper, ranging from the approach to the integrities in various clauses, if addressed by the parties during the drafting of a joint venture agreement can make the agreement a facilitator rather than an impediment in the continuation and growth of the joint venture.

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[58] M.E. Hooton, "Structuring and Negotiating International Joint Ventures," 27 *Creighton Law Review* 1013 (1994), available online at www.westlaw.com (accessed on September 26, 2008).

[59] *Supra* n. 46, at 115.

6

Shareholders' Agreements

Raghvendra Kishore Singh

Introduction

The desire to arrange the mutual participation of the shareholders within a company by contract has been there for long. Over time, this desire has become rooted in the commercial world and shareholders' agreements are a common feature of most companies today. The wide usage of shareholders' agreements can be gauged from the fact that almost all joint venture companies have a shareholders' agreement to run the joint venture apart from the Memorandum of Association and the Articles of Association of the joint venture company. In fact the shareholders of every closely held company with two or more shareholders should give serious consideration to having a shareholders' agreement.

What is a Shareholders' Agreement?

A shareholders' agreement is a contract as between the members (or prospective members) of a company. If the company is in existence, it too is often considered as a party to the agreement. Thus, there can be three kinds of shareholders' agreements, namely, (i) an agreement between the company and the members collateral and supplementary to the articles of association (hereinafter referred to as the Articles); (ii) an agreement between all the shareholders' *inter se*; (iii) an agreement between some of the shareholders.[1]

[1] John Farrar and Brenda Hannigan, *Farrar's Company Law* (4th edn., London: Butterworths, 2000) at 136.

Among the commonest terms to be found in shareholders' agreements are provisions concerning the right to be represented on the board of the company; minority protection, and the transferability of shares.

Why have a Shareholders' Agreement?

The shareholders' agreement performs a very similar function to the company's Articles. It is a useful supplement to the articles because the latter are subject to a number of limitations. These include:

1. the fact that the Articles only come into effect on incorporation. A shareholders' agreement may deal with events relating to a period prior to incorporation;[2]
2. it is not every type of right which is enforceable by virtue of sec. 36 (1) of the Companies Act, 1956. The terms of the articles are only enforceable insofar as they relate to the rights of members qua members.[3] By contrast, any type of right is enforceable in contract in the usual way if it is contained in a shareholders' agreement;[4]
3. protection of minority rights conferred by the articles. Generally speaking shareholders' rights which are incorporated in the articles (and which are not class rights) are only effective provided the shareholders in question can block a special resolution. Shareholders' agreements can be used to confer on the minority a power of veto over alterations to the articles without creating a separate class of shares;[5]
4. the need to deliver the Articles to the registrar of companies and their subsequent availability for inspection. On the other hand, there should be no need to deliver a copy of the shareholders' agreement to the registrar of companies;[6]

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[2] Michael Lower, "Shareholders' Agreements," 15(8) *Company Lawyer* (1994) at 241.

[3] *Beattie* v. *E & F Beattie Ltd*, [1938] 3 All ER 214.

[4] *Supra* n. 2, at 241.

[5] Graham Stedman and Janet Jones, *Shareholders' Agreements* (3rd edn., London: Sweet & Maxwell, 2001) at 57. For more on minority rights vis-à-vis shareholders' agreements, see Rita Cheung, "The Use of Statutory Unanimous Shareholder Agreements and Entrenched Articles in Reserving Minority Shareholders' Rights: A Comparative Analysis," 29(8) *Company Lawyer* (2008).

[6] *Ibid.*

5. the fact that the Articles can be altered by special resolution. Members' rights can be protected from alteration by being placed in a shareholders' agreement;[7] and
6. the fact that a shareholders' agreement is a contractual obligation and hence is purely personal and binds only the individual shareholder who has become party to the contract, and cannot be made to run with the shares as appurtenant thereto in the hands of successive owners.[8]

But there are certain disadvantages of a shareholders' agreement. The most obvious disadvantage is the need to enter into a fresh agreement with the new shareholder every time there is a sale of shares. This further agreement will renew the contractual bond of the members *inter se* (including the new member) and, if appropriate, the company itself. There may well also be release of the outgoing shareholder from its obligations.[9]

Thus, a shareholders' agreement creates legally binding contractual rights enforceable irrespective of the Articles thereby improving the legal position of, and protecting the shareholder. However, as will be discussed subsequently, making the company a party to the shareholders' agreement may cause problems of enforceability as against the company itself.

Shareholders' Agreement and Joint Venture Agreements

Joint venture agreements are one of the most practical uses of a shareholders' agreement. A joint venture may be formed between two or more persons or entities, and is used when the intended project is beyond the resources of the individual venturers, or where strategic alliances or cross-border arrangements are anticipated.[10] Among other ways, joint ventures can be implemented by the incorporation of a limited liability company or the creation of a partnership. The corporate structure is often favored by joint venturers but the partnership or the contractual routes may be more appropriate for

[7] *Supra* n. 2, at 242.

[8] *Shalfoon* v. *Cheddar Valley Co-operative Dairy Co. Ltd.*, [1924] NZLR 561.

[9] *Supra* n. 2, at 242.

[10] Katherine Reece and Thomas Christopher, *The Law and Practice of Shareholders' Agreements* (London: Butterworths, 1999) at 13.

smaller ventures, those ventures with a limited life span or where tax considerations dictate.[11] Therefore in the context of shareholders' agreements, joint venture agreements may be defined to mean those shareholders' agreements used in the connection with a joint venture which actually effects a combination of existing businesses or the creation of a new business by existing venturers and adopts a corporate route to do so. Thus, where a limited liability company is the chosen vehicle, the parties will most often enter into a shareholders' agreement (the joint venture agreement) to regulate the venture and their relationship as shareholders in that company. The joint venture agreement will contain issues such as (i) the ongoing relationship between the parties and income distribution; (ii) specified eventualities involving share transfers and withdrawal; (iii) management and control of the board; (iv) employee rights of participation; (v) intellectual property issue; and (vi) termination of the venture.[12]

Nature of Shareholders' Agreements

Lord Bridge in *Scally* v. *Southern Health and Social Services Board*[13] referred to shareholders' agreements as a "definable category of contractual relationship." However, this particular characteristic of a shareholders' agreement has not received much elucidation as cases which have focussed on shareholders' agreements have more often focussed on matters more properly falling in the domain of company law. Academics are of the view that while much has been written about the significance of the need to analyze the so-called statutory contract created by the memorandum and the Articles, shareholders' agreements have not received similar analysis.[14] Nevertheless a shareholders' agreement, being in essence a contract, must be in accordance with the contract law. Hence, the provisions of the Indian Contract Act, 1886 on issues, such offer and acceptance, and consideration, that apply to a contract also apply to a shareholders' agreement. One issue that requires consideration is the form in which a shareholders' agreement should be entered into. Shareholders' agreements can be oral as Indian law does not

[11] *Ibid*, at 14.

[12] *Ibid.*

[13] [1992] 1 AC 294.

[14] *Supra* n. 10, at 21.

require writing for the creation of binding contractual obligations. Though there are a number of specific exceptions to this rule, notable in the contracts for the sale of land, shareholders' agreements have been expressed to confer rights of a proprietary nature on shareholders but they are not in interest of law for the purposes of the law relating to formalities.[15] However, in the interest of certainty and to avoid any arguments of proof, anyone setting out to form a shareholders' agreement is advised to put the agreement in writing.

Enforceability of Shareholders' Agreement

Although shareholders' agreements are legally enforceable, their enforceability in company law has been a matter of controversy. At the heart of the controversy is the issue whether these agreements, to which a company is a party, to exercise voting rights by the shareholders or to regulate the activities of the company, in a particular manner is enforceable.[16] The issue can be framed in the following manner.

Whether a shareholders' agreement, to which a company is a party, to exercise voting rights by the shareholders or to regulate the activities of the company, in a particular manner is enforceable?

The enforceability of such an agreement has to be analyzed in two separate ways depending on whether the agreement is being enforced against the company or the shareholders, because the consequences are different.

Since shareholders' agreement is governed by the principles of contract law, if the company is not a party to the agreement, it cannot be bound by it.[17] The freedom of the company is unfettered even if the company has taken note of the agreement or even if the company has acted thereon.[18]

On the other hand, if the company is party to the agreement, ordinary principles of contract law would dictate that the company should be bound by the agreement. However, this is not the case under company law. Indian courts have held that the provision in an agreement that puts *a fetter on the management of the affairs of the company* is not binding on the company, unless

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[15] *Supra* n. 10, at 22

[16] See Audax Peter Rutabanzibwa, "Shareholders' Agreements in Corporate Joint Ventures and the Law," 17(7) *Company Lawyer* (1996).

[17] *S.P. Jain* v. *Kalinga Tubes*, AIR [1965] SC 1535.

[18] *Rolta India Ltd.* v. *Venire Industries Ltd.*, [2000] 100 Comp Cas 19 (Bom).

those provisions have been incorporated into the articles of association.[19] Thus, a provision in the agreement entered into by a shareholder director, stipulating not to exceed the minimum number of three directors, cannot be enforced against the company even though it did not violate the Articles. It is non-enforceable because "the agreement cannot be used to supersede the statutory rights given to the Board of Directors to manage the company."[20] The law on this point has been more clearly expressed by the English courts. The House of Lords in *Russell* v. *Northern Bank Development Corporation Ltd*[21] held that a provision in a shareholders' agreement to which the company is a party is not enforceable against the company if it puts *a fetter on the exercise of statutory powers of the company*. The precise scope of "statutory powers" is not clear, though in *Russel*, the impugned provision related to restriction on the increase of the share capital of the company. It has been proposed by academics that "statutory powers" would presumably include any matter which is required to be resolved upon by shareholders in general meeting in order to be effective, such as increasing its authorized share capital; consolidating, sub-dividing, converting, and cancelling its shares; reducing its share capital, changing its memorandum or articles of association; removing its directors or auditors; changing its name or winding up the company.[22]

The next issue that arises is the enforceability of the agreement against the shareholders only. The answer to the question poses considerable difficulty due to inconsistencies in judicial decisions. The Supreme Court in *V.B. Rangaraj* v. *V.B. Gopalakrishnan*,[23] which has been held to be applicable to public companies as well,[24] held that "a restriction which is not specified in the articles of association is not binding either on the company or *on the shareholders*." The decision has been affirmed by the Supreme Court and applied by various High Courts. It has been interpreted to mean that the provision of the agreement is not only unenforceable against the company, but also unenforceable against the individual shareholders who are party to

[19] *IL and FS Trust Company Ltd.* v. *Birla Perucchini Ltd.*, [2004] 121 Comp Cas 335 (Bom).

[20] *Supra* n. 18.

[21] [1992] 1 WLR 588 (HL). For a detailed analysis of the *Russel* decision, see Tamasin B. Little, "How Far Does Shareholder's Freedom of Contract Extend?-Russell v. Northern Bank Corporation Limited and other Recent Cases," 3(10) *International Company and Commercial Law Review* (1992).

[22] John Cadman, *Shareholders' Agreements* (London: Sweet and Maxwell, 2004) at 10.

[23] AIR [1992] SC 453.

[24] See *Gujarat Bottling Company Ltd.* v. *Coca Cola Company*, AIR [1995] SC 2372.

the agreement. Such an interpretation is in direct conflict with the well established proposition and which has been upheld by the Indian courts time and again, that in a shareholders' agreement the agreement among the shareholders to vote for a specific person, or in a certain way, is valid and enforceable because the right to vote is a proprietary right. The right to vote may be aided and effectuated by a contract and, in a shareholders' agreement, it may be utilized in connection with the election of directors and shareholders' resolutions where shareholders have a right to vote.[25] Hence, the shareholders' agreement, though unenforceable against the company, must be enforceable against the individual shareholder and if specific performance cannot be obtained, the individual shareholder must be held liable to pay damages.

The correct statement of law on this point seems to have been stated by the House of Lords in the *Russel* case. The court held that individual shareholders may deal with their own interests by contract in such way as they may think fit and such contracts, whether made by all or some of the shareholders only, would create personal obligations. The validity of such contracts would be independent of the Articles and thus while a provision in a company's articles which restricts its statutory power to alter those articles is invalid, an agreement dehors the articles between shareholders as to how they shall exercise their voting rights on a resolution to alter the articles is not necessarily so. Shareholders can enter into agreements to regulate the relationship between the shareholders with regard to the management and control of the company and it will be valid. There is no reason why the agreement should not be enforceable by the shareholders *inter se* as a personal agreement, which in no way fetters the company in the exercise of its statutory powers. However, an important point to remember is that the undertaking of the shareholders to restrict their rights must be *independent of and severable from* that of the company's undertaking. Otherwise the invalidity of the company's undertaking would apply to the shareholder's undertaking as well.

The foregoing analysis shows that the decision of the Supreme Court in *Rangaraj* case, insofar as it relates to the enforceability of the shareholders' agreement against the individual shareholders who are party to the agreement, requires reconsideration. If *Rangaraj* is to be read as an accurate statement of the law, it will lead to havoc and utmost confusion in the commercial world. Innumerable corporate financing documents, such as loan agreements, loan stock, or bond, contain promises to produce the effect

[25] *Supra* n. 18.

that the shareholders' rights are restricted even though such a restriction is not contained in the Articles. These and similar promises in other forms of financing agreements are regarded as essential protection for those providing the finance.

An important lesson for the drafters of shareholders' agreement that emerges from the foregoing analysis is that undertakings of the individual shareholders and the company must be kept as severable as possible. Further an attempt must be made to not impose obligations on the company that puts a restriction on the exercise of its statutory powers.

Restriction on Transferability of Shares in a Shareholders' Agreement

From the general issue of the enforceability of shareholders' agreements, one can study the particular issue of restriction on transferability of shares in a shareholders' agreement since it is one of the most common terms in shareholders' agreements. The issue assumes importance because transferability of shares is also one of the most common activities in the commercial world. Two prominent issues arise when studying the above issue which are as follows:

Issue One: Whether a public company limited by shares can refuse to register shares on an application made by the transferee, upon transfer from the transferor, despite a provision contained in a binding agreement among the two contracting parties?

Section 82 of the Companies Act, 1956 (Act), which applies to both private as well as public companies limited by shares, describes the legal characteristics of shares. It states that the shares in a company shall be movable property, transferable in the manner provided by the articles of the company. Hence, one of the fundamental characteristics of shares is that, unless the articles otherwise provide, a shareholder has a free right to transfer his shares to anyone he chooses. It is not necessary to seek in the articles for a power to transfer, for the Act gives that. It is only necessary to look to the articles to ascertain the mode of transfer and the restrictions upon it. Thus, a member has a right to transfer his shares to another member unless this right is clearly restricted by the articles.[26] A restriction which is not specified

[26] *Sadasiv Shanker Dandige* v. *Gandhi Sewa Samaj Ltd.*, [1958]28CompCas137(Bom), at para 10.

in the Articles is, therefore, not binding either on the company or on the shareholders. The vendee of the shares cannot be denied the registration of the shares purchased by him on a ground other than that stated in the Articles.[27] Further in determining the extent of any restriction on transfer contained in the Articles, a strict construction is adopted. The restriction must be set out expressly or must arise by necessary implication and any ambiguous provision is construed in favor of the shareholder wishing to transfer.[28]

Similarly an agreement between shareholders or an agreement between shareholder(s) and non-shareholder(s) restricting the right to transfer shares is not binding on the company. Unless such an agreement is incorporated in the Articles, the company can register the shares in the name of the transferee as the company is guided solely by the articles when it comes to the non-registration of shares.[29]

An important issue that arises at this juncture is whether a public company can amend its articles subsequent to the agreement to transfer or actual transfer and then rely on it for its refusal to register the shares in the name of the transferee. The said resolution altering the articles cannot be challenged by the transferees because, so far as the transferees are concerned, they are not entitled to challenge the resolution at all because at the time the resolution was passed their names had not been entered on the register and as such for all practical purposes the transferors continue to be the shareholders. The transferors can at best contend that the resolution is a fraud played on the minority shareholders and, if that be the position, in order to invalidate the said resolution the transferors at best can have recourse either to sec. 397 or to sec. 398 read with sec. 399.[30]

However, despite the foregoing proposition, the transferee does have a right to get the shares registered in his name in one situation, when the transfer between the transferor and the transferee becomes effectual between the transferee and the company. This happens when the deed of transfer is not only lodged, but accepted by the company as properly lodged,

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[27] *V. B. Rangaraj* v. *V. B. Gopalakrishnan*, AIR [1992] SC 453, at para 6. Though the case dealt with the transfer of shares of a private company limited by shares, the ratio is applicable to public companies as well, since the court interpreted sec. 82 of the Act which is applicable to both public as well as private companies.

[28] *Ibid.*

[29] *S. P. Jain* v. *Kalinga Tubes Ltd.*, AIR [1965] SC 1535; *Mafatlal Industries Ltd.* v. *Gujarat Gas Co. Ltd.*, (1998) 4 ComLJ 112.

[30] *Matrubhumi Printing and Publishing Co. Ltd.* v. *Vardhaman Publishing Limited*, [1992] 73 Comp Cas 80 (Ker) at para 22.

because if the company finds that it does not comply with the provisions of the Act, it is its duty to refuse to receive. Thus, once the transferee does everything that he is required to do under law, to get his name entered on the register by proper lodgment of the instruments of transfer and no other obstacles remain in enforcement of the said right, the transfer becomes effective as against the company also. Thereafter, the company cannot unilaterally alter its articles affecting the aforesaid right of the transferee. Mere delay in the actual registration of the name of the transferee on the register, provided there is a proper lodgment of the instrument of transfer, cannot affect the above right of the transferee. Thus, the right of the transferee to get his name entered on the register gets crystallized when proper lodgment is affected and the transfer from the date of the proper lodgment becomes effective as against the company also, and such rights cannot be affected by subsequent actions of the company like amendment of articles.[31]

Issue Two: Whether a public company limited by shares can refuse to register shares on an application made by the transferee, despite there being an agreement between the company (the transferor) and the transferee, to transfer the shares?

It follows from the law stated under issue one that the company can refuse to register shares on an application made by the transferee, despite there being an agreement between the company and the transferee. However, such a refusal must be based on a provision contained in the Articles. Similarly an agreement entered into between the company and one group of shareholders restricting the right to transfer any of the shares of the company will not be binding on other shareholders. Such an agreement governs the relationship between parties to the contract and cannot be construed as placing a restraint on the right of the shareholders to transfer their shares.[32] In the absence of a restrictive provision under the Articles, an agreement to sell shares is capable of being specifically enforced.[33]

Another issue to be considered is whether the company can alter its articles subsequent to entering into an agreement to transfer shares, and then rely on it to refuse registration of the shares in the name of the transferee. The company can do so. It should, however, be borne in mind that the company will always be liable to damages in case the alteration of the article results in a breach of the contract the company had entered into with any persons. To put it differently, by effecting alterations in its articles a company cannot

[31] *Howrah Trading Co. Ltd.* v. *CIT*, AIR [1959] SC 775.

[32] *Gujarat Bottling Company Ltd.* v. *Coca-cola Co.*, (1995) 84 Com Cases 618 (SC), at para 43.

[33] *Brooke Bond India Ltd.* v. *U. B. Ltd.*, [1994] 79 Com Cases 346 (Bom).

defeat or escape from its contractual obligation with any person. The power to alter the articles subject to the provisions of the Act and the memorandum is indisputably very wide, but the articles cannot be altered to deprive the minority shareholders of their rights. That means that no majority of shareholders can, by altering the articles retrospectively, affect, to the prejudice of the non-consenting owners of shares, the right already existing under a contract, nor take away the right already accrued, for example, after a transfer of shares is lodged, the company cannot have a right of lien so as to defeat the transfer.[34]

Remedies Available under a Shareholders' Agreement

Under Indian law, a failure by one party to perform a contract in accordance with its terms is a breach of contract which will normally entitle the other party to a remedy. Whether or not the breach has occurred is a matter of construction of the contract and it is for party alleging the breach to prove it. Since a shareholders' agreement is essentially a contract, the contractual remedies originate from the statute and equity which are damages, specific performance, and injunction. These standard remedies are available to parties to a shareholders' agreement in the appropriate circumstances as they will be to any party as the provisions of the Indian Contract Act, the Specific Relief Act, etc.

Conclusion

With a growth in corporate transactions, the need for documents such as shareholders' agreements will continue to grow. However, one cannot allow the simultaneous growth of legal uncertainty around shareholders' agreements. The primary burden to ensure efficiency of the commercial world would thus be on two important actors, namely, the courts and the drafters of shareholders' agreements. The courts should be a lot more careful when analyzing the law relating to shareholders' agreement as any loophole

[34] *Supra* n. 30, at para 29.

or unexplained areas or an outright error can wreak havoc in the world of business. Further the drafters of shareholders' agreements should be very cautious while choosing what terms to include and what term to omit. The foregoing analysis and many other factors should be considered in preparing the draft of a shareholder-type agreement. A useful advice is that, based on the foregoing analysis, terms which cannot be enforced against the company by inserting them into the shareholders' agreement should be made a part of the articles through suitable amendments. But the best advice is to first sit down with your clients to better understand their personalities, business, and expectations.

7

Escrow Agreements

Lakshmi Prakash, *Kota Chandan*, and *Sandeep Uberoi*

Introduction

An escrow is a legal device by virtue of which a third party is entrusted with an asset, who holds it until the conditions or contingencies in the contract are met, and then proceeds to deliver the asset to the party prescribed in the contract.[1] The contract that sets into place this legal mechanism is called an escrow agreement. This kind of legal arrangement helps parties to secure satisfactory performance and avoid legal battles.[2] Escrow agreement has three parties: (i) depositor, (ii) escrow agent, and (iii) beneficiary.[3]

As a legal device, escrow agreements were developed in the United States primarily as a tool of safeguarding party interests in real-estate transactions.[4]

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[1] One of the most comprehensive definitions of an escrow is found s.17003 of the California Financial Code. It defines an escrow 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*. Many other jurisdictions also use a similar or broadly similar definition of an escrow. See, for example, R.C.W. 18.44.011(4).

[2] See for a brief outline of the benefits of using an escrow arrangement, Frederick Miller, "Know Your Escrow Rights: The Lawyer's Edition," 62-April *New York State Bar Journal* (1988) at 71.

[3] See generally, Joan MacLeod Heminway and Timothy M. McLemore, "Acquisition Escrows in Tennessee: Annotated Model Tennessee Acquisition Escrow Agreement," 7 *Transactions: Tennessee Journal of Business Law* (2006) at 273.

[4] Historically speaking, cases that have defined and laid down the rights and liabilities of escrow agents have all been in the context of real-estate transactions. See *Malta* v. *Phoenix*

Overview of Escrow Agreements

Practical Application of Escrow Agreement

Escrow agreements came into vogue in India in 1991, post the privatization of power sector. Escrow agreements have become standard operational practice to militate against the risk of a State Electricity Board not paying dues under the agreed tariff structure.[5] The Information Technology industry boom also led to the frequent application of escrow agreement,[6] mostly called software agreements. Most businesses that rely on third party's software for their functioning seek to ensure business continuity by providing for software escrow agreements which require owners of the software to place source code of the software with an escrow agent.[7] Escrow agreements are also used in joint development agreements to ensure that the Escrow agent steps in to decide the rights of either party in case of default by the other.

Laws Governing Escrow Agreement

Escrow is a contractual arrangement between the parties. However, it is governed and regulated by specific laws in United States.[8] In India, this legal instrument is still in a nascent stage and is mostly self-regulated, that is, governed by the terms of the contract. However, the provisions of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 apply to different kinds of escrows in India. Further, the Securities Escrow is partly governed by Reserve Bank of India, which has issued a notification[9] permitting non-residents, subject to

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Title and Trust Co., 76 Ariz. 116, 120, 259 P.2d 554, 557 (1953); *Higgins* v. *Kittleson*, I Ariz. App. 244, 249, 401 P.2d 412, 417 (1965); *Tucson Title Ins. Co.* v. *D'Ascoli*, 94 Ariz. 230, 234, 383 P.2d 119, 121 (1963); *Brean* v. *North Campbell Professional Bldg.*, 26 Ariz. App. 381, 384, 548 P.2d 1193, 1196 (1976).

[5] See generally, Kalpana Unadkat, "Power Liberalisation in India," 2 *I.E.L.T.R (International Energy Law and Taxation Review)* (2000) at 49–51.

[6] Jonathan L. Mezrich, "Source Code Escrow: An Exercise in Futility?" 5 *Marquette Intellectual Property Law Review* (2001) at 117.

[7] *Ibid.*

[8] See for example, Chapter 18.44 R.C.W.

[9] See RBI/2006–2007/413.

certain terms and conditions,[10] to hold and maintain escrow accounts and special accounts with authorized dealers in India without prior approval of the Reserve Bank for acquisition/transfer of shares/convertible debentures through open offers/delisting/exit offers.

This chapter is an attempt to map the creation of an effective escrow agreement.[11] The first section highlights the advantages an escrow agreement confers on the parties. The second section describes and analyzes the essential terms of an escrow agreement. The final section focuses on the unique role and duty of an escrow agent. Further, the jurisprudential characterization of his role has a substantial impact in the rules governing escrow agreements.

Advantages of Using an Escrow Agreement

Business Expediency

The primary advantage of escrow agreement is the security provided by the instrument for all parties concerned. This facilitates smooth transaction in

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[10] These terms and conditions are specified in Schedule 8 of the Foreign Exchange Management (Deposit) Regulations, 2000. These terms and condition are: (i) Acquisition/transfer of shares shall be strictly in accordance with the provisions of Notification No. FEMA 20/2000-RB dated May 3, 2000 as amended from time to time and Security Exchange Board of India (Substantial Acquisition of Shares and Takeover) Regulations, 1997 [SEBI (SAST) Regulations] or any other SEBI Regulations as applicable. (ii) The accounts shall be non-interest bearing. (iii) Escrow account may be opened in Indian rupees, jointly and severally for the purpose, with the following permitted credits and debits: Permitted credits: Foreign Inward Remittance through normal banking channels. Permitted debits: as per SEBI (SAST) Regulations or any other SEBI Regulations, as applicable. (iv) Special account may be opened in rupees, jointly and severally for the purpose, with the credit and debits as per SEBI (SAST) Regulations or any other SEBI Regulations, as applicable. (v) The resident mandatee, empowered by the overseas acquirer for this purpose, may operate the escrow account in accordance with SEBI (SAST) Regulations or any other SEBI Regulations, as applicable and with the specific approval of the authorized dealer with whom the account is opened. (vi) No fund-based/non-fund-based facilities shall be permitted against the balance in the accounts. (vii) Requirement of compliance with KYC (Know Your Customer) guidelines issued by the Reserve Bank shall rest with the authorized dealer. (viii) Balance in the escrow account, if any, may be repatriated at the then prevailing exchange rate (i.e., the exchange rate risk will be borne by the overseas company acquiring the shares), after all the formalities in respect of the said acquisition are completed (ix) In the event, the proposal under the said acquisition/transfer does not materialize, the authorized dealer may allow repatriation of the entire amount lying to the credit of the escrow account on being satisfied with the *bona fides* of such remittances. (x) The accounts shall be closed immediately after completing the requirements as outlined above.

[11] The authors have, in their analysis, relied primarily on real estate and software escrow agreements. However, depending on the nature of the asset or the thing deposited with the escrow agent, further instructions may be added to the agreement in order to construct a full-serving escrow agreement.

business which is essential for any economy. The seller of a property is usually protected against bad cheques, non-sufficient funds, scams, fraud, etc.[12] The purchaser is secure that the money can be safely returned, if the seller fails to meet the obligations[13] like clearance of a title[14] or other obligation[15] of the seller. Escrow serves as a tool to ensure completion of obligations undertaken by the seller and at the same time demonstrate his interest and willingness in the transaction.

This is possible because of the neutrality and objective approach of the escrow agent who is trusted by both the parties.[16]

Pre-empts Legal Dispute

Escrow agreement ensures more or less equal bargaining power and secures the position of the parties. This view is supported by Joan MacLeod Heminway and Timothy M. McLemore.[17] This is effective in pre-emptively settling disputes between parties in a sale transaction.[18] It is a pre-determined structure which functions on already agreed upon markers and that makes it effective.

In a typical software escrow agreement the owner of the software provides a copy of the database content, website, support manuals, other intellectual property, and source code[19] to an escrow agent. The escrow agreement sets outs certain events under which the above can be released to a licensed

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[12] See, R.L. Narayanan, "Escrow Agreements," available online at http://www.hindu.com/pp/2006/09/30/stories/2006093000240600.htm (accessed on September 26, 2008).

[13] See Antonios Dimitracopoulos, "Escrow," *A.T. Law Update* 154 (2004) at 22–24.

[14] The buyer may, for example, when buying property from a Hindu undivided family, require the *Karta*, with whom they are dealing with, to obtain consent forms from all the shareholders.

[15] Conditions may also include the seller completing and paying for certain repairs or changes to the property.

[16] See R.L. Narayanan, "Escrow Agreements," available online at http://www.hindu.com/pp/2006/09/30/stories/2006093000240600.htm (accessed on September 26, 2008).

[17] Joan MacLeod Heminway and Timothy M. McLemore, "Acquisition Escrows in Tennessee: Annotated Model Tennessee Acquisition Escrow Agreement," 7 *Transactions: Tennessee Journal of Business Law* (2006) at 273.

[18] It has been reported that in India there is a practice of appointing an escrow agent as an arbitrator when a dispute arises within the framework of the escrow agreement. See R.L. Narayanan, "Escrow Agreements," available online at http://www.hindu.com/pp/2006/09/30/stories/2006093000240600.htm (accessed on September 26, 2008).

[19] Instructions or statements written in eye-readable form in programmer's language and capable of being compiled into object code, and an object code being a computer code that a computer can understand.

user of the software like bankruptcy or liquidation, a merger or acquisition takes place, or fails to properly maintain the software or perform under the License Agreement.[20]

Thus, a business that relies on third party software to run some of its critical processes can ensure business continuity by using an escrow arrangement. Such an arrangement would also work better than a normal performance guarantee as the latter would involve loss of time, in creating software from scratch. Placing the source in escrow will also help the licensor market her services better. The licensee will gain confidence in the business and will feel safe in the knowledge that if one of the events discussed earlier occurs then he will be safe.[21]

Terms and Conditions of an Escrow Agreement

Agreement

The foundation of any escrow service is the agreement. A typical escrow is a tripartite one[22] signed between the seller, purchaser, and the escrow agent, thereby enmeshing the parties into the framework created under the agreement. The depositor is required to entrust money with the escrow agent. The escrow agent holds the escrow deposit until it can be released to the beneficiary upon the happening of some future event, or the performance of certain contractual conditions. If any or both the parties withdraw their obligations under the agreement, the escrow agent is required to return the down payment to the purchaser.

The main clauses of an escrow agent are the following:

1. it would specify who the escrow agent is;
2. it would describe the asset or thing that is to be put in escrow;
3. it would detail the events which would trigger the release of the "thing" held in escrow;

[20] See Risa Lynn Wolf-Smith and Erin L. Connor, "Bankruptcy Considerations in Technology Transactions," *American Bankruptcy Institute Journal* (2004) at 32.

[21] G. Moorthy, "Three to Tango: Software Escrow Arrangement," available online at http://www.thehindubusinessline.com/ew/2006/05/22/stories/2006052200230400.htm (accessed on September 26, 2008).

[22] In the context of software escrow agreements, many escrow agents are now offering bipartite escrow services which are structured to ensure that the benefits of using an escrow would flow to all licenses/uses of a software. However, the authors are not looking into such agreements in this paper.

4. it will contain a clause indemnifying the escrow agent;
5. it will contain a confidentiality clause; and
6. it will specify the governing law.

Some of the important clauses are explained hereunder.

Preamble of the Agreement

The parties and the type of the escrow agreement are laid down. The name of the escrow agent is also stated in the agreement and the specialized nature of subject matter is specified.

Materials Deposited in Escrow

An escrow agreement, we have already pointed out, varies in its structure according to the nature of the item/thing/money being deposited into escrow. This factum, however, also impacts the extent and nature of the obligation imposed on the escrow agent. These obligations can be contractually stipulated and modified.[23]

The escrow agent is responsible for safeguarding the escrow amount and specific documents deposited in the escrow, as per the agreement, for example, title documents in a real estate transaction. Source code or any material required to enable a reasonably skilled programmer to understand and maintain the current software in case of software agreements. Thus, in case of a real estate transaction where an escrow agent is entrusted with title documents, he would be under an obligation to protect them. In most software escrow agreements, verification services are also sought from a software escrow agent.[24]

In cases where the escrow agent is entrusted with money, such money must be deposited in a special bank account separate from the escrow agent's personal and business accounts.[25]

Time Period of the Escrow Agreement

The time period for completing an escrow is generally set out in the sale and purchase agreement, or agreed upon by the seller and purchaser. Generally, the date should be mutually convenient for both parties. In some instances it

[23] See Antonios Dimitracopoulos, "Escrow," *A.T. Law Update* 154 (2004) at 22–24.

[24] See G. Moorthy, "Three to Tango:Software Escrow Arrangement," available online at http://www.thehindubusinessline.com/ew/2006/05/22/stories/2006052200230400.htm (accessed on September 26, 2008).

[25] *Ibid.*

might take some time for the purchaser's loan to be processed and approved by the bank. In other instances, when the purchaser is purchasing off-plan, there is a time delay while the building is being constructed. In these instances payment will only be made after a period of time has lapsed.[26]

In a real estate escrow the terms usually provide that in case the acquisition transaction is completed with fulfillment of all conditions agreed upon[27] the escrow agent must deliver the entire remaining fund to the seller.[28] In the case of software escrow agreements the trigger clauses include contingencies like the software vendor going bankrupt or otherwise being unable or unwilling to service the software.[29]

Further, any mutually agreed upon event could serve as a trigger for a claim. For example, the breach of any of the representations and warranties under the purchase agreement may act as a trigger for the release of the escrow monies.[30]

Appointment of Escrow Agent

As mentioned earlier, an escrow agent has to be appointed. The authors believe that a third, neutral party is the best choice to appoint as an escrow agent.[31] However, in practical life it is seen that the parties may agree to appoint the lawyer of one of the parties or a real estate broker as an escrow agent. Indeed in many real estate transactions it is the lawyer of the seller who is usually appointed as the escrow agent.[32] It can be said that the validity of the escrow arrangement depends on what the parties agreed to see the arrangement as.[33]

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[26] B. Cohen, "The Doctrine of Escrow," 12(7), *Competition Law* (1991) at 149.

[27] Usually the parties agree upon a time limit for the performance of conditions they agree upon for the sale transaction. This date is known as the termination date for the escrow agreement.

[28] See Antonios Dimitracopoulos, "Escrow," *A.T. Law Update* 154 (2004) at 22–24.

[29] See, Risa Lynn Wolf-Smith and Erin L. Connor, "Bankruptcy Considerations in Technology Transactions," 23 *APR American Bankruptcy Institute Journal* (2004) at 32.

[30] See *Manor Healthcare Corp*. v. *Tolbert*, [1986] Del. Ch. LEXIS 419.

[31] See for example, *Rajala* v. *The Holland Corp (In re Chesapeake Assoc. Ltd.)*, 141 B.R. 737 where the court held an escrow to be ineffective because the escrow agent was an agent of a party and not a neutral third party.

[32] See R.L. Narayanan, "Escrow Agreements," available online at http://www.hindu.com/pp/2006/09/30/stories/2006093000240600.htm (accessed on September 26, 2008).

[33] The Supreme Court in the *Siddhivinayak Realities* Case held that "*…when both the parties were aware that one of the Joint Escrow Agents was representing a 3rd party whose interests were adverse to theirs, they cannot later contend that said Joint Escrow Agent would be biased…*" See *Siddhivinayak Realities Pvt. Ltd.* v. *Tulip Hospitality Services Ltd.*, [2007] 4 MLJ 772 (SC).

The obligations of the escrow agent will be discussed in the next section of this chapter. Escrow agents are generally not compensated.[34] In case of compensation, the matter of fees and reimbursement of expenses should be clearly set forth in the escrow agreement.[35] This fee may be paid in a lump sum or in case of more lengthy escrows, over one year in duration are arranged, the parties may agree that one or the other will pay the escrow agent's fees on a periodic (often quarterly) basis.

However, an escrow agent cannot be compensated through the interest of the escrow property as it would be against the fiduciary duty.

Notice on Breach of the Agreement

If any party has a claim to the escrow amount/deposits, due to a contractual breach by the other party, he should notify it to the escrow agent—within a certain time. This time period is stipulated and known as notice period. It is in this context that some parties include a definition of business day in their agreement. This helps them avoid dealing with questions regarding differences in holidays under corporate policies, state laws, and national laws. The authors believe that this should be definitely incorporated in escrow agreements as it diminishes the scope of litigation.

The notice also ensures the defaulting party to contest the claim. A form of claims notice can be appended to an escrow agreement. This will be of great use to the parties for they can then use the form of notice as a means of assuring clarity in the escrow triggers and claims procedures.[36]

In most agreements that the authors have seen a seller's failure to object is deemed as an acceptance of the validity of the buyer's claim. Unfortunately, often the parties are unaware of the specifics of their obligations under the agreement. Hence, it might be advisable to include a deeming clause, where the buyer is deemed to have objected to the claim.[37]

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[34] See Frederick Miller, "Know Your Escrow Rights: The Lawyer's Edition," 62 *APR New York State Bar Journal* (1995) at 71.

[35] See Joan MacLeod Heminway and Timothy M. McLemore, "Acquisition Escrows in Tennessee: Annotated Model Tennessee Acquisition Escrow Agreement," *7 Transactions: Tennessee Journal of Business Law* (2006) at 273.

[36] See for a model claims notice, *ibid.*

[37] For use of such a clause, see *ibid.*

Dispute Resolution

In case of a dispute on the notice period or otherwise, the procedure for mediation/arbitration should be clearly laid down,[38] including the governing law and place of arbitration. Litigation is another option which is generally not preferred as it is time consuming.

The authors suggest that the agreement should incorporate determination by an independent expert as the mechanism to settle disputes arising out of a trigger claim. If properly set up, such a mechanism would be outside the framework of the Arbitration and Conciliation Act, 1996, and, hence, would avoid the delays and expense a court or arbitration process would involve. In the United States escrow agents usually insist that the governing law of the state in which her office is located be chosen, and also that jurisdiction be conferred exclusively on courts in her state.[39] This would ensure that the agent would not be put to any undue trouble or expense in settling disputes arising under the agreement. In software escrow agreements such clauses are more common as they usually are standard from ones provided by the agents.

The seller should, we suggest, insist on a contractual term providing that if the amount claimed is less than the total in the escrow fund, the excess should promptly be released to the seller at the end of the fixed escrow period. This would ensure that he secures access to the part of the purchase money that is not being disputed.

Specific stipulations according to the nature of the escrow should also be provided. In the case of a software escrow agreement a concern arises as to the use that the licensee of the software can put the source code to in the event it is released to him by the agent. It is highly recommended that the agreement set out clearly that the source code can be used only for maintaining and enhancing the software for the purposes of the licensee's business and that the licensee may not put the code to commercial use.[40]

Indemnification

Indemnification clauses are usually insisted upon by escrow agents in order to limit their liability for actions under the escrow agreement. Agreements

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[38] See R.L. Narayanan, "Escrow Agreements," available online at http://www.hindu.com/pp/2006/09/30/stories/2006093000240600.htm (accessed on September 26, 2008).

[39] See for a model claims notice, Joan MacLeod Heminway and Timothy M. McLemore, "Acquisition Escrows in Tennessee: Annotated Model Tennessee Acquisition Escrow Agreement," *7 Transactions: Tennessee Journal of Business Law* (2006) at 273.

[40] See Graham Smith, Software-Source Code-Escrow Agreement, E.I.P.R. 2002, 24(12), N196-197.

usually contain a clause that the buyer and seller shall jointly indemnify the agent for any loss or expense incurred due to a claim relating to his actions under the escrow agreement. The justification for providing this sort of immunity to the agent is that he performs a limited function under the agreement, usually limited to safekeeping of the escrowed property in accordance with the terms of the agreement. However, care must be taken to ensure that the indemnification clause is narrowly worded and excludes indemnity in cases of the agent's own negligence or fault.[41]

It is recommended that it should be incorporated that if the loss is suffered due to the fault of one party, that stated party is liable to make good the loss.

Confidentiality

Most escrow agreements do not contain a confidentiality clause. However, in the case of software escrow agreements it might be advisable to the developers of the source code to put into place a clause positively obligating an escrow agent to keep confidential. The very fact that the software licensor did not want to give the code to a customer reflects the value that is attached to the code.

The need for an explicit confidentiality clause is especially important in cases where a source code escrow agent provides technical verification services of the source code for the benefit of the beneficiary. Care must also be taken to ensure the agent does not make unlimited number of copies of the software, in the interests of safekeeping.

If the liability occurs due to the *negligence* of the escrow agent, which party would bear the loss?[42] In the United States this question has come to be addressed by the entitlement rule.[43] Simply put the rule mandates that in case of a loss due to the actions of the agent, the loss must, as between the parties to the escrow transaction, be borne by the one who, at the time of its occurrence, was lawfully entitled to the right or property affected.[44]

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[41] As escrow agreements, especially in the context of software escrow agreements, are usually standard form contracts given by agents to the parties. See Jonathan L. Mezrich, "Source Code Escrow: An Exercise in Futility?," 5 *Marquette Intellectual Property Law Review* (2001) at 117.

[42] A remedy would of course lie against the agent, but it would usually be difficult to trace her or if traced she might have become insolvent, leaving the parties to battle between themselves over the missing property.

[43] See for a detailed discussion of the manner in which this rule has been developed and applied, Leigh M. Koehn, "Allocating the Risks of Embezzlement by an Escrow Holder," 84 *Nebraska Law Review* (2006) at 1266.

[44] *Ibid.*

The inevitable result of this analysis is that one blameless party will suffer a substantial loss while the other will still reap the benefits of the escrow. It is advisable thus that the parties keep in mind such a contingency and contractually evolve a mechanism to deal with such issues.

Putting into place such measures assumes a whole new significance in light of the limited liability the agent assumes under escrow agreements.

Impartiality

An escrow officer must remain completely impartial throughout the entire escrow process. He or she will normally adopt a courteous but rather formal manner when dealing with parties to the escrow, keeping conversations to the matters at hand in the escrow. This formal behavior is meant for the benefit of all concerned, since the escrow officer must follow the instructions of both parties without bias.

Escrow Agent

An escrow agent has a vital function in this tripartiate agreement of escrow. Some of the key characteristics which define the duty and importance of this post/role are detailed in the following.

Fiduciary Duty of an Escrow Agent

Escrow agents cannot use the funds in escrow account for their own use. Its duty lies in ensuring timely payment of all taxes due on the property.[45] In such an arrangement the escrow agent makes timely payments of tax dues and other payments from the sum held in escrow according to instructions.

The escrow agent is supposed to ensure the safety of the escrow property. When the funds in escrow were originally payable to and endorsed by the contractor on their way into the escrow, the bank's duties as an escrow agent do not terminate just because the bank's self-interest in the mortgage has ended. The bank's function of fiduciary duty to the remaining claimants to the insurance proceeds escrow continues unabated by the release of the mortgage.[46]

[45] See for example, s. 5-601 of the New York General Business Law.

[46] McBride, 101 Ill. App. 3d at 762.

The escrow agent has to be completely unbiased. This was discussed in *Siddhivinayak Realities Pvt. Ltd* v. *Tulip Hospitality Services Ltd*,[47] where it was held that in case of scope of bias because of affiliation or relation, it should be pointed while entering into contract, unless some circumstance *actually* comes about after entering into the agreement, unless some later event takes place. The authors feel that it is the correct interpretation.

Escrow Agent—Agent or Trustee?

As reiterated earlier the escrow agent is the one who ensures the smooth transaction of the escrow. There is a jurisprudential debate on the actual nature of duty of escrow agent. It is not clear if he is an agent or a trustee or a combination of both. The law of escrow does not fall neatly within the established rules of contract, agency, or trust. The law of escrow is complicated primarily by the fact that the escrow agent or depository provides a service to at least two parties with potential or actual adverse interests. The law has struggled to place a reasonable and predictable duty upon the third party who is elected to perform this difficult task with its inherent potential for conflict.

In United States, many cases have held escrow agent to be both a trustee and an agent.[48] The escrow agent's agency title pertains to the obligation and loyalty he owes to both parties, while the trustee title refers to the "performance of an express trust" with which he has been deposited. However, another view taken is that because of the adverse interests involved, it is unrealistic to compare this duty to that of a trustee where multiple compatible interests exist or an agent where a single interest exists.

This question was discussed in *Lovell Construction Ltd* v. *Independent Estates plc* (in liquidation)(unreported, June 25, 1992). In this case, the question was whether escrow property is a charge or a trust, as that would impact the winding up process. The courts held that it is a trust and hence this property could not be utilized by creditors.

As stated earlier, this view is not consistent. In fact, many authors believe that in normal circumstances, however, escrow agent is considered as an agent. This is most evident when he/she embezzles the money. This happened in *Bio-Electronics* v. *C and J Partnership*.[49] The court based its holding on the theory of agency, stating that the escrow holder is the agent of the buyer with

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[47] AIR [1991] SC 540.

[48] For more, see In re Copeland, 531 F.2d 1195 (3d Cir. 1976).

[49] 268 Neb. 252, 682 N.W.2d 248 (2004).

respect to the money, and the agent of the seller with respect to the deed or other documents. The escrow holder's role does not change until each party has become completely entitled to the item that is to be transferred to him under the agreement.

The researcher believes that the best conclusion is that the answer lies in the fluctuating role vis-à-vis the property interests. Prior to closing, he acts both as a trustee and dual agent. However, once the escrow holder fulfills these duties and the transaction closes, he is no longer a dual agent but merely a trustee, holding property interests on behalf of his clients—depositors.

Who can Act as Escrow Agents?

Escrow agents could be either a person or an artificial legal personality. Usually, the escrow agent has fair knowledge of the subject matter of transaction. For example, in a real estate, mortgage lenders might require the maintenance of an escrow account by the mortgagor to ensure timely payment of all taxes due on the property.[50] In such an arrangement the escrow agent makes timely payments of tax dues and other payments from the sum held in escrow according to instructions. In the United States in the real estate scenario escrow services are widely provided by title insurance companies. These companies in addition to their escrow services also provide title search and title insurance services.[51]

Laws Governing Escrow Agents

In United States, there are various rules of conduct, responsibilities, and liabilities imposed on escrow agents, which have developed over time. For example, in California, escrow law provides that the commissioner of corporations should license certain escrow agents before they may be appointed as such. Exemptions to this rule include banks, savings and loan associations, title insurance companies, trust companies, attorneys, and so on. The escrow agents, the various exempted bodies, and professionals are all bound by specific rules of conduct, which impose various obligations and responsibilities on them.[52]

However, this is not the case in India. The authors believe that apart from common law contractual terms, such specific laws should be enacted to govern escrow agents in India.

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[50] See for example, s. 5-601 of the New York General Business Law.

[51] See for example, The First American Corporation Annual Report, available online at: http://www.firstam.com/title-wa/spokane/services/escrow.html (accessed on September 26, 2008).

[52] Antonios Dimitracopoulos, "Escrow," *A.T. Law Update* 154 (2004) at 22–24.

Conclusion

The authors believe that escrow agreement is a necessary tool in today's day and age. Its advantages are many, the most important one being that it encourages business expediency. The authors believe that the primary problem in India is that there is no law governing escrow agreements, especially escrow agents, and this should be rectified. Moreover, the wording of the clauses, especially in relation to damages caused by the negligence of escrow agent, should be worded carefully, and should be fair to both the parties.

8

Law of Outsourcing Contracts

Uttara Gharpure and *Aditya Bandyopadhyay*

Introduction

Outsourcing involves the conducting of one or more organizational activities, traditionally "in house," by external agents. The primary motivation behind outsourcing, especially offshore outsourcing, is cost reduction which is made possible by the significantly lower per capita costs of labor in most offshore destinations. Taking up such practices also allows companies to improve their own operations and compete better with other firms—in terms of having better logistics, more rationalized inventories, quicker time to market, etc.

The present wave of outsourcing transactions has transformed the way many corporations look at business. Companies that have multiple operations are often found struggling against smaller, more agile companies that have cut their costs and are pricing products and/or services lower. In a sense, the concept of growth itself has been redefined, since the new mantra for companies situated in developed economies is to focus on their "core competencies" and allow other processes to be outsourced to India and China, essentially reducing the size of their operations!

In this background, it becomes clear that the importance of outsourcing contracts can scarcely be overstated. The decision arrived at, and expressed via the contract, plays the single most-important role in ensuring that the transaction itself goes through in a manner that is beneficial for all parties involved. As with any new industry, outsourcing contracts too have developed several peculiar features over the course of the last decade. Interestingly however, not many outsourcing relationships have, as yet, ended up in courts—hence, the quantum of expressed judicial opinion is scarce.

In addition to these self-evident reasons for studying outsourcing contracts in detail, we also note that the recent economic climate across the world provides further impetus to this study. The fast-changing economic scenario will undoubtedly force several companies, who are currently engaged in outsourcing transactions, to attempt to renegotiate or, failing that, to re-engage on their terms. As a result of these developments, contractual terms associated with outsourcing transactions will undoubtedly receive greater judicial scrutiny in the near future.

What is an Outsourcing Contract?

For the purposes of this paper, we have taken the expression "outsourcing" to refer to the act of transferring responsibility for existing or new business activities to external, third-party service providers. The party which was earlier performing the said business activity in-house is referred to as the "customer" and the party providing the contractual services as the "supplier." In most cases the decision to enter into an outsourcing contract is driven either by the customer's desire to lower costs or to focus on its core competencies or to benefit from the expertise of the supplier or to spread risks associated with that activity, or some combination thereof.[1] Studies have also found that such contracts can lead to more efficient use of resources like labor, land, technology, and capital.[2]

Outsourcing first gained popularity as a business method in the late 1980s when Kodak outsourced the management of its information technology systems. This led to a trend where managers re-conceptualized their businesses and concentrated on developing strategic partnerships, outsourcing certain aspects of their business.[3] Today, outsourcing is increasingly coupled with *offshoring*, where services are outsourced overseas, to countries like India, China, and other countries in eastern Europe, since costs are much lower in these locations.[4] Before outsourcing came into vogue, companies

[1] R. M. Weiss, and A. Azaran, "Outward Bound: Considering the Business and Legal Implications of International Outsourcing," 38 *Georgetown Journal of International Law* 735 (2007) at 737–738.

[2] See J. Barthelemy, "The Seven Deadly Sins of Outsourcing," 17(2) *Academy of Management Executive* 87 (2003).

[3] R. Handfield, "A Brief History of Outsourcing," available online at http://scm.ncsu.edu/public/facts/facs060531.html (accessed on October 5, 2008).

[4] *Ibid.*

regularly sub-contracted processes to external service providers. However, the distinction between the two types of contracts is in the strategic importance of the business processes that are outsourced and also in the nature of the relationship between the parties, which is discussed in greater detail in the next section of this note.

Characterizing Outsourcing Contracts

It is impossible to classify outsourcing contracts in an exhaustive manner. Contracts to outsource may be entered into for any service that is capable of being strategically shifted out of the company. Some popular types are those involving business process outsourcing, software development and IT services, research and development, drug investigation for approval, legal process outsourcing, hospital services and manufacturing, especially "finishing" of products, and other ancillary services.

The nature of the contractual relationship between the parties in an outsourcing contract is largely dependent on the terms of the contract and the services outsourced. An outsourcing contract cannot usually be classified as a master–servant relationship since, in such a relationship, the master must have the power or right to control and direct the servant with respect to the material details of how the work is to be performed.[5] This level of direct control over actions and performance of services is almost always missing in an outsourcing relationship. Further, the outsourcing contract may also not be said to create a principal–agent relationship, if it does not give the supplier authority to act on behalf of the customer.[6] However, certain outsourcing contracts, such as those involving the outsourcing of customer services, may give such authority to the supplier and hence create a principal–agent relationship. In a recent case, the Karnataka High Court observed that a contractual relationship between a person (who had been hired to load and unload goods) and the owner of some transport vehicles, wherein wages were to be paid by the consignor and not by the owner, was an "ingenious" attempt to outsource the loading and unloading process. However, since the employee was acting under the authorization of the owner, it went on

[5] *Black's Law Dictionary* (B.A. Garner ed., 8th edn., Minnesota: West Publishing Co., 2004).

[6] See G. Geis, "Business Outsourcing and the Agency Cost Problem," 82 *Notre Dame Law Review* 955 (2007) at 974–975.

to hold that this still amounted to a contract of employment, so as to make the owner liable to pay compensation for the employee's death.[7]

Models of Outsourcing

Outsourcing today is mainly carried out through complex corporate structures that attempt to build a relationship between the customer and the supplier. Some commonly used models are the formation of a captive entity, formation of joint venture company, use of the Build, Operate, and Transfer ("BOT") model, and use of a third-party supplier. We shall examine each of these briefly.

An expensive option, used by certain large companies, is the creation of a *captive entity*. General Electric, Microsoft, and Dell are some companies which have set up wholly-owned subsidiaries in India that function as their captive centers and provide service support to the parent company and its global affiliates. The staff and assets in the captive entity are owned by the customer and the subsidiary carries out functions solely for the parent group of companies. This model reduces the risk of over-dependence and allows the customer to exercise better control over the services. However, the costs associated with setting up a subsidiary in another country may be quite high and the tax implications of the same may not be favorable to the customer.[8]

Another popular method of global outsourcing is the setting up of a *joint venture company* where the customer and supplier share the management and control of the new company. This structure allows the customer to micro-manage services that are outsourced while leaving the daily functioning of the business to the supplier, who is physically present in the country where the joint venture has been set up. However, entry costs in this model are also high and exit options are certain to be constrained, as both parties are equal partners in the company.[9]

The *BOT model* is a hybrid model which allows the customer to outsource the initial formulation and operation of the service to a third-party service provider and acquire the ownership rights for the entity at a later date.

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[7] *United India Insurance* v. *Shivabasavva*, [2008] (3) Kar. L.J. 71.

[8] S. Agarwal, S. Khaitan, S. Shrivastava, and M. Banks, "Destination India: Offshore Outsourcing and its Implications," 11(8) *Computer and Telecommunications Law Review* 246 (2005) at 248–249.

[9] *Ibid.*

This model, which first gained popularity in infrastructure and construction projects, allows the service provider to build the service according to the requirements of the customer and operate the same till the customer is ready to acquire it. This model requires a long-term relationship to be successful. Thus, in addition to the usual terms, it is essential that the contract also contains provisions detailing how the supplier is supposed to manage the service as well as regarding how the transition process is to be effectuated.[10]

In a *third-party contract*, the customer contracts with an independent service provider for a specific set of business processes. Unlike in earlier models, here there is no investment or capital participation in the business run by the external service provider. The supplier may exclusively serve the customer or may have several customers availing of his outsourcing services. Such contracts are relatively quick to execute but leave the customer with lesser control over the services that are to be provided. In such contracts, service levels and performance indicators should be given adequate importance.[11]

Finally, coming to the structure of the agreement itself, most outsourcing transactions include more than one document. There is, of course, the main contract itself, which lays down the principal terms and conditions upon which the service is to be provided. However, unlike in other areas, these contracts usually do not provide many details relating to the service. These are most often located in a separate document, called the Service Level Agreement ("SLA"), which governs day-to-day operations. The SLA is usually considered a flexible document[12] and particular terms can be changed relatively easily to reflect the parties' needs. Key-performance indicators and benchmarks are sometimes used to provide standards against which it is possible to measure the quality of service delivered by the supplier.[13] It is of legal significance as a breach of contract would most likely need to be established vis-à-vis the agreed service levels provided for in the SLA. In practice, due to the significant investments made by both parties and in the interests of

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[10] See A. Vashistha, and A. Vashistha, *The Offshore Nation: The Rise of Services Globalisation* (Delhi: Tata McGraw-Hill, 2005). Excerpt available online at http://www.neoit.com/gen/knowledgecenter/articles/Oct_04_Excerpt_from_The_Offshore_Nation-Determining_an_Offshore_Model.pdf (accessed on October 3, 2008).

[11] *Supra* n. 8.

[12] M. Kobayashi-Hillary, *Outsourcing to India: The Offshore Advantage* (2nd edn., Berlin: Springer, 2005) at 197–201.

[13] *Ibid.*

maintaining their long-term relationship, minor violations of the SLA are almost considered as amounting to a breach of the contract itself.

Specific Issues Arising in Outsourcing Contracts

Though outsourcing contracts must be drafted according to the requirements of the parties and the specific project, certain common legal issues that may arise in drafting of such contracts are discussed in the following.

Maintaining Data Confidentiality

Most outsourcing relationships, especially those involving outsourcing of business processes, require a high degree of cooperation between the parties and involve the disclosure of large amounts of confidential data by the customer to the supplier (and occasionally vice versa). This issue becomes especially important in the case of offshore outsourcing, since there may be significant differences between data protection laws in both countries. Just because a company is engaging in offshore activity will not, unless specifically provided, exempt it from meeting the standards set by its country's laws. Thus, a customer situated in the United States will be bound by the data privacy provisions of the Gramm-Leach-Bliley Act[14] (if it is in the financial services industry) or the Health Insurance Portability and Accountability Act[15] (if it is in the health care industry) or other, sector-specific legislation. Similarly, a customer situated in the United Kingdom would be subject to the relevant European Union Council Directive, which strictly limits the processing and transfer of all personal information.[16]

India does not have a comprehensive law on data protection. The closest we have come toward creating a legal regime is the Information Technology

[14] Gramm-Leach-Bliley Act, 1999, Pub. L. 106–102, 113 Stat. 1338.

[15] Health Insurance Portability and Accountability Act, 1996, Pub. L. 104–191, 110 Stat. 1936.

[16] See EU Data Protection Directive, Council Directive 95/46, 1995, which takes the view that privacy is a fundamental human right, and establishes a comprehensive legal framework that is aimed at protecting individuals when there is processing of personal data. The directive is based on a set of data protection principles, data confidentiality, data subjects' rights of access, restrictions on onwards transfers, additional protection where special categories of data and direct marketing are involved, and a prohibition on automated individual decisions.

Act, 2000, which addresses computer crimes, including hacking, damage to computer source code, and breach of confidentiality provisions, while simultaneously setting up a tribunal to hear matters relating to the Act. Important sections, for the purposes of outsourcing contracts, include those dealing with the definition of data,[17] mandating standards for the authentication and retention of that data,[18] and providing penalties for violations of these provisions.[19] However, the existing provisions are almost universally acknowledged as providing indirect, inadequate protection and there is presently an amendment to this Act that is pending.[20]

Keeping in mind the higher degree of protection demanded under the laws of most other countries and the relative weakness of the Indian legal system in this regard, customers often take to drafting stringent data-protection terms into the outsourcing contract, so as not to incur any liability for loss or theft of data. These typically include requiring the supplier to implement a range of security measures, such as technological protection of data systems, physically controlled access to the premises, and policies preventing employees from bringing potential data-stealing devices to work. They also require the supplier to indemnify the customer from any loss caused to the latter as a result of mishandling of data by the former.[21]

Rights Relating to Intellectual Property

Intellectual property (IP) forms an important part of most software and business process outsourcing contracts, since these typically involve either developing new products or using existing ones over which IP rights are already subsisting. In outsourcing contracts, IP issues may broadly be categorized into three types, viz., relating to the protection of value of existing IP, relating to the usage of existing IP, and relating to ownership rights over new IP developed through the course of the contract.

With respect to the first issue, the threat is that the value of IP rights can be eroded significantly if not carefully managed. It is extremely important for both parties to ensure that no such reduction takes place since *post facto*

[17] Section 4, Information Technology Act, 2000.

[18] Sections 5 and 7, Information Technology Act, 2000.

[19] Section 79, Information Technology Act, 2000.

[20] This amendment, approved by the government in 2007, expressly provides for data protection and privacy measures and provides for imposition of liability on organizations when they are negligent in implementing "reasonable security practices" to safeguard sensitive personal data within their control.

[21] *Supra* n. 1, at 742.

legal remedies are largely ineffective and the loss in value of the IP cannot be undone this way.[22] Closely linked to this is the second issue—parties often need to share business methods, software, trade secrets, etc., and this results in a situation where the right to use certain products must be assigned or licensed to the other party. Not only must the contract clearly lay out the terms of use regarding the said IP, it must also specify the penalties in case of a breach by either party of the terms and conditions. Sometimes the customer is not the owner but merely the licensee of existing IP, in which case it must obtain permission from the supplier to also use the said products.[23] With respect to the third issue, which relates to the ownership of IP that is developed during the outsourcing relationship, a supplier can typically claim ownership, unless there is an agreement to the contrary, and the customer can use the new IP under a license. Further, problems can occur when third parties or subcontractors are used by the supplier, since the ownership of IP usually rests with the creator, unless it is created within the scope of employment terms.[24] It is hence desirable to clarify these issues in the contract, so that any IP that is developed by the supplier at the customer's request belongs to the customer and any other IP may be licensed to the customer in an agreed manner.

Tax Implications

The quantum of tax liability depends on the structure of outsourcing that is adopted in the contract. Each of the outsourcing structures discussed earlier have different tax liability. Tax liability in international transactions, between parties from different jurisdictions, is determined by Double Taxation Avoidance Agreements (DTAAs) that are signed between the concerned states.

In case of a BOT arrangement or a joint venture company, the Indian Income Tax Act, 1961 prescribes that income arising from an international transaction between associated enterprises shall be computed having regard to the arm's length principle.[25] According to this principle, the income earned

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[22] P. Chothani, "Intellectual Property Considerations in the Outsourcing Industry," 80 *New York State Bar Journal* 30 (2008) at 34.

[23] *Supra* n. 1, at 744.

[24] *Supra* n. 22, at 35.

[25] Sections 92A–92F, Income Tax Act, 1961.

by the associate enterprise in India is assessed as if the transaction is between two unrelated parties. Therefore, any special discounts on the basis of the relationship between the two parties are not deducted for the purposes of assessing total income.[26]

Moreover, transfer-pricing provisions are also included in the DTAAs India has signed with different countries. Article 5 of the standard DTAA states that a non-resident or a foreign company is treated as having a permanent establishment in India if the said non-resident or foreign company carries on business in India through a branch, sales office, or through an agent (other than an independent agent) who habitually exercises an authority to conclude contracts or regularly delivers goods or merchandise or habitually secures orders on behalf of the non-resident principal. In such a case, the profits of the non-resident or foreign company attributable to the business activities carried out in India by the permanent establishment becomes taxable in India.[27]

Subsidiary companies and captive entities will be taxed according to the corporate tax slab for Indian companies. In case of a third-party service agreement, the income earned by the supplier will be taxed according to the provisions of the Income Tax Act, 1961 applicable to residents in India and the corporate rate of tax will apply. However, setting up of subsidiary companies in export promotion zones, software technology parks, and electronic hardware technology parks will lead to tax exemption at least till 2009.[28] A brief period of confusion was created by promulgation of Circular No. 1/2004 stating profits of foreign entities having a permanent establishment in India would be taxed if the service outsourced was a "core activity."[29] However, this circular was soon withdrawn due to widespread criticism.[30]

[26] Section 92C, Income Tax Act, 1961 gives various options for computation of income using the arm's length method.

[27] Article 7, DTAA.

[28] Circular No. 142/49/2000, Central Board of Direct Taxes, available online at http://www.taxlawsonline.com/news/article/business.asp (accessed on October 1, 2008).

[29] Circular No. 1/2004, Central Board of Direct Taxes, January 2, 2004, available online at finmin.nic.in/the_ministry/dept_revenue/revenue_headquarters/cbdt/circulars/circularno1.PDF, accessed on October 1, 2008.

[30] Circular No. 5/2004, Central Board of Direct Taxes, September 28, 2004, available online at http://finmin.nic.in/the_ministry/dept_revenue/revenue_headquarters/cbdt/circulars/IT-bpo.pdf; see V.J. Mehta, "CBDT's BPO Circular: Creating Confusion?" available online at http://www.algindia.com/publication/article1400.pdf, accessed on October 1, 2008.

The Indian income tax authorities are providing enough tax incentives for foreign companies to move their business processes to India. This will continue if the rate of growth of such business remains consistently high. However, in the future businesses will have to take into account increased costs due to tax liabilities on income generated from outsourcing transactions. It is therefore important, especially in the case of long-term outsourcing contracts, to provide for sufficient flexibility to absorb the impact of such regulatory changes.

Managing Labor Requirements

Certain outsourcing contracts, such as those where services existing in a company are outsourced, involve the transfer of staff from the customer to the supplier. Moreover, in cases where there is a BOT arrangement, the transfer of the undertaking will involve transfer of staff from the supplier to the customer. Provisions for the same should hence be included within the outsourcing contract itself.

India has no specific laws regarding protection of employees during transfer as part of an outsourcing transaction. The Industrial Disputes Act, 1947 provides that in the case of transfer of an undertaking, compensation must be paid to all employees who have been in service for a minimum period of one year.[31] Retrenchment under the Act is also regulated and the Act does not advocate a hire-and-fire policy.[32] The Indian judiciary has been giving a progressive interpretation to labor regulations and very recently, keeping in mind the trends toward globalization and increase in outsourcing transactions, held that in case of wrongful termination of employment, the employer may pay compensation instead of reinstating the employee back with wages.[33] Most of the individuals employed by companies engaging in an outsourcing transaction are excluded from the purview of the Act due to the nature of their employment and salary.[34] Since Indian law does not regulate the transfer of employees, this must be done so by way of contract and adequate protection must be provided to the employees with regard to salary level, conditions of service, and termination of employment.

[31] Section 25FF, Industrial Disputes Act, 1947.

[32] Section 25F, Industrial Disputes Act, 1947.

[33] *U.P. State Electricity Board* v. *Laxmi Kant Gupta*, Civil Appeal No. 5863 of 2008, decided on September 26, 2008; see also *U.P. State Brassware Corporation* v. *Uday Narain Pandey*, AIR [2006] SC 586.

[34] Section 2(s) of the Industrial Disputes Act, 1947 defines the term "workman."

In the United Kingdom, protection for employees in case of transfer of an undertaking is provided under the Transfer of Undertaking (Protection of Employment) Regulations, 1981.[35] As per these regulations, on the transfer of an undertaking from one party to another, unions or employee representatives must be consulted before the transfer takes place. Moreover, on transfer there is an automatic novation of the employment contract from one employer to another and the transferring employee's existing contractual entitlements are preserved. If the employment of any individual is seen to be terminated as a result of the transfer, there is an automatic finding of unfair dismissal.[36] It may be desirable for the contract to reflect these regulatory requirements, especially in cases where one of the parties is ordinarily subject to these regulations.

Companies staffing persons in India must also take into account the stringent labor laws in India, especially relating to working conditions for minority groups like women. Certain state legislations prohibit women from working in night shifts. However, keeping in mind the outsourcing boom, certain states like Karnataka have allowed IT firms to claim an exemption.[37]

Regulatory Considerations

With the increasing popularity of the outsourcing model, certain functions like legal processes, medical care, and drug investigation for trial purposes are also being outsourced. For these types of outsourcing, certain regulatory and ethical considerations must be taken into account.

Legal outsourcing has gained currency in recent years as basic legal matters, research, documentation, regulatory compliance matters, and legal planning are increasingly being handed over to legal process outsourcing companies

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[35] These regulations were promulgated to enforce the Acquired Rights Directive (1977/187/EEC). The consolidated EC Directive on employment protection was promulgated in 2001. See, Council Directive 2001/23/EC, available online at http://eur-lex.europa.eu/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc= 32001L0023&model=guichett accessed on October 1, 2008).

[36] P. Allery, *Effective Outsourcing: Practice and Procedures* (Croydon: LexisNexis, 2004) at 71–73.

[37] Section 25, Karnataka Shops and Commercial Establishments Act, 1961. Section 66(1)(b) of the Factories Act, 1948 also prohibits women from working in night shifts, see "30,000 Bangalore Women Work in Night Shifts," *Deccan Herald*, March 20, 2008, available online at http://www.deccanherald.com/content/Mar202008/scroll2008032058463.asp?section=frontpagenews (accessed on October 8, 2008).

(LPOs) in India.[38] The Indian government has also encouraged such strategic legal outsourcing relationships by granting multiple-year tax breaks and attempting to streamline legal and administrative processes in India.[39] However, US lawyers outsourcing legal work to India or any other jurisdiction must take into account the model code of conduct imposed on them which requires them to have proper legal knowledge and skill as regards the matter they are looking into, supervize the delegation of tasks to subordinate lawyers and non-lawyers, act with reasonable diligence and promptness while representing a client, and communicate with the client.[40] It is important that considerations as regards minimum qualification of lawyers, performance levels, and diligence be included in a legal process outsourcing contract. Much of the strategic relationship depends on trust and confidence between the parties, including specific performance indicators relating to the conduct to be followed by lawyers which may be of significant utility to both parties.[41]

Similarly, compliance with regulations has been debated in the context of outsourcing clinical trials for drugs to India. The outsourcing of clinical trials to India from other jurisdictions like the United States has become possible due to changes in the intellectual property regime and the Indian Drugs and Cosmetic Rules, 1945.[42] Trials that are conducted in India do not need to follow the rules laid down by the Food and Drug Administration,[43] but have to follow Indian rules and the Declaration of Helsinki, which governs regulation of clinical testing of drugs on human beings.[44] In spite of this, such contracts may still reflect many additional requirements and safeguards, since most customers wish to avoid public criticism in their home countries (and around the world) for failing to meet perceived ethical standards of testing.

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[38] A.R. Harmon, "The Ethics of Legal Process Outsourcing," 13 *Journal of Technology Law and Policy* 41 (2008) at 54–58.

[39] J. Krishnan, "Outsourcing and the Globalising Legal Profession," 48 *William and Mary Law Review* 2189 (2007) at 2209.

[40] *Supra* n. 38, at 67–78, discussing the US Model Rules of Professional Conduct and the American Bar Association's Formal Opinion on these issues.

[41] See J. Bachrach, "Offshore Legal Outsourcing and Risk Management," 21 *Georgetown Journal of Legal Ethics* 631 (2008).

[42] J. Cekola, "Outsourcing Drug Investigations to India: A Comment on U.S., Indian and International Regulation of Clinical Trials in Cross-Border, Pharmaceutical Research," 28 *Northwestern Journal of International Law and Business* 125 (2007) at 130–131.

[43] U.S. Federal Food, Drug and Cosmetic Act, 21 U.S.C. 301 (2005).

[44] World Medical Association, Declaration of Helsinki: Ethical Principles for Medical Research Involving Human Subjects, 1964, available online at http://www.wma.net/e/policy/pdf/17c.pdf (accessed on October 6, 2008).

Dispute Resolution

Private dispute resolution is a popular choice in outsourcing contracts. Parties rarely wish to resort to the courts, as this is a time consuming and expensive process and it takes them away from the strategic relationship that both parties have invested in. Moreover court proceedings are public, and the subject-matter of many contracts involves information that companies would prefer to keep confidential, which is the norm in private dispute settlements. However, certain types of disputes, such as those arising from the renegotiation of a long-term outsourcing relationship, may lead to situations where the court is required to pass an order, as was done in the case of *Vertex Data Science* v. *Powergen Retail*.[45] In this case the plaintiff, who was the supplier, argued that a mandatory injunction must be awarded against the defendant and that the supplier must be allowed to perform its obligations under the contract. However, the court decided that the UK law did not allow for the granting of mandatory injunctions and only allowed parties to claim compensation. This case shows that the renegotiation of outsourcing contracts may increasingly lead to disputes for which parties may have to resort to the judicial system.

When opting for private dispute resolution, many parties prefer a "multi-tier" dispute resolution clause, wherein the parties are first required to attempt to resolve disputes by means of negotiation and/or mediation, and only upon failure of these attempts can the provisions for compulsory arbitration be triggered. While such clauses have ordinarily been upheld,[46] it ought to be noted that in some cases courts have held that "'first-tier" provisions are not compulsory and that parties can resort directly to arbitration.[47] To avoid such an outcome, the contract should be drafted to clearly indicate that adhering to the negotiation and/or mediation clause(s) is a necessary prerequisite for invoking the arbitration provisions in the contract. Moreover, including provisions for determining the proper law of the contract, the judicial system that will have jurisdiction over the dispute and the seat and rules of arbitration will further assist the parties.[48]

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[45] [2006] 2 Lloyd's Rep. 591. See R. Hawtin, "No One Ever Sues on an Outsourcing Contract: A Case Comment," 13 *Computer and Telecommunications Law Review* 88 (2007).

[46] See *HIM Portland* v. *DeVito Builders*, [2003] 317 F.3d 41.

[47] *Halifax Financial Services* v. *Intuitive Systems*, [1999] 1 All E.R. 303.

[48] *Supra* n. 36, at 148–49.

Concluding Remarks

Through the course of this chapter, we have examined various aspects of outsourcing contracts, from their proper characterization to the models commonly employed in such transactions to the major issues that arise in these contracts. On the basis of our study, we have arrived at the following conclusions, some of which relate to legal aspects of outsourcing contracts and some of which apply to the outsourcing industry in general.

First, offshore outsourcing has grown at a hectic pace over the past decade and more, mostly due to the fact that properly executed outsourcing transactions can lead to cost savings—which is increasingly important in a globalized world—but also partly due to the quality of outsourcing services offered, especially in destinations like India.[49]

Second, the spread of outsourcing transactions is wide and there is no one accurate characterization of all such transactions—the exact nature of the legal relationship between the customer and the supplier will almost completely depend upon the specific terms and conditions of their contract. Thus, close attention must be paid at the drafting stage to ensure that unwanted and unexpected liabilities are not read into the contract at a later date.

Third, we conclude that the model of using "third-party contracts" has been the preferred choice for customer companies when transacting in India, since investment risks are minimized in such situations and the perceived shortcomings—lesser control over the service and hence risk of lower quality—have not actually taken place in most cases. In other words, Indian suppliers are enjoying the benefits of having built a reputation of, by and large, delivering high quality services.

Fourth, it would appear that the growth enjoyed by the Indian outsourcing industry has been in spite of several severe shortcomings with India as a destination for offshore outsourcing. Customers had initially hesitated due to the lack of robust legal infrastructure in several key areas—such as data protection, confidentiality, labor restrictions on employment, long delays in and uncertainties regarding court outcomes—but over a short period of time seemed to be willing to accept the risks of doing business in India. However, it is our conclusion that the present scenario is unlikely to continue along the same path in the long term, without serious efforts by both

[49] R. Dossani, and M. Kenny, "Went for Cost, Stayed for Quality?: Moving the Back Office to India," available online at http://iis-db.stanford.edu/pubs/20337/dossani_kenney_09_2003.pdf (accessed on October 8, 2008).

the government and the industry. It is necessary to further strengthen our laws in some areas, such as data confidentiality, and to better implement existing ones. Moreover, when the tax breaks and other concessions are eventually withdrawn, suppliers in India need to be able to continue to deliver, both in terms of quality as well as costs, and to compete with fast emerging challengers like China—which seems unlikely in the present scenario.

Finally, with the changing market conditions around the world and the falling value of the rupee to the US dollar, it is likely that many suppliers will find it harder to continue with business as usual. Again, what is required is innovation on their part, along with a re-structuring of their businesses to make them less dependent on one or two types of customers, viz., those from the United States and the United Kingdom.

9

Standard Form of Contracts

Mallika Abidi and *Shreya Aren*

Introduction

In today's world, it is very common to receive printed receipts, bills, etc., which have certain terms and conditions. Even offers provided in advertisements come with a small super-scribed asterisk and the phrase "terms and conditions apply." All these conditions might be said to form part of the package if the main offer is accepted. A number of questions relating to consent, suitability, etc., arise because of this. All these contracts which are drafted by a single party and apply indiscriminately to those who have entered into transactions can be termed standard form of contracts.

There are several attributes of a standard form contract—it consists of a printed form containing several terms in the form of a contract, the contract is drafted by one of the contracting parties to the agreement, the drafting party engages in a volume of the same types of transactions on a regular basis, the party further imposes the form on the consumer on a "take-it-or-leave-it" basis, the other party will usually sign the contract after minimal, if any, negotiation, the other party does not similarly engage in a volume of the type of transaction at issue and lastly, the primary obligation of the other party is usually to pay money.[1]

Corporations or other business concerns use these generally to exclude their liability in one form or the other and thus reducing their risk. This helps them to lower their price and increase their profit. The prevalence of standard form of contracts bears evidence of their indispensability in

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[1] Todd D. Rakoff, "Contracts of Adhesion: An Essay in Reconstruction," 96 *Harvard Law Review* 1173 (1983) at 1177.

today's commercial world. Further, through the usage of these standard contracts, the costs of attorney and drafting different contracts for different transactions is drastically reduced.

The problem arises, however, when the other party does not take note of the terms of these standard form contracts for one reason or another[2] while the system assumes that they have read the contracts. The standard principles of contract law assume that both sides are consenting to the contract and agree to the terms and conditions which are presented before them. Thus, there exists a difference in the paradigm and reality of standard form contracts.

The courts have thus viewed standard form contracts differently from other forms of contract keeping in mind the unique predicaments which come with them. The first consideration to be kept in mind is the nature of the document. If the document is of such a nature that it can be regarded as an integral part of the contract, it must be seen if it has been signed by the party against whom the excluding term is to be pleaded. If it is unsigned, the question to be judged is of reasonable notice of the term.[3] If the contractual document has been signed, on the other hand, there are various rules which have been evolved by the courts to be kept into consideration while interpreting the various clauses.

Nature of Document

Contract law has evolved to consider the nature of the document on which the terms and conditions are printed. It has to be a document which can be reasonably considered to be a contractual document and not just a printed receipt.

The first case in which the question arose as to the nature of the document was the case of *Chapelton* v. *Barry Urban District Council.*[4] In this case, the plaintiff had wished to hire a deck chair on a beach. He went to a pile of deck chairs belonging to the defendant council which had the following notice: "Barry Urban District Council. Cold Knap. Hire of chairs 2d. per session of 3 hours." The notice went on to say that the public was requested

[2] *Ibid.*, at 1229.

[3] Micheal Furmston, *Cheshire, Fifoot & Furmston's Law of Contract* (15th edn., Delhi: Oxford University Press, 2007) at 205.

[4] [1940] 1 KB 532.

to obtain tickets for their chairs from the chair attendants which were to be retained for inspection. The plaintiff obtained two chairs and paid for them and received two tickets. The tickets on the front side said "Barry Urban District Council. Cold Knap. Chair Ticket 2d. Not transferable." On the other side, it said, "Available for three hours. Time expires where indicated by cut-off and should be retained and shown on request. The council will not be liable for any accident or damage arising from the hire of the chair." The plaintiff sat down on a chair which gave way. Due to this, the plaintiff was injured. The court held that the ticket was a mere voucher or receipt for the money paid for the hire of the chair, and that since the notice contained no limitation of liability for any accident or damage arising from the hire of the chairs, the local authority was liable.

Slesser L.J. said that the contractual terms which composed an offer could only be those which were found on the notice and could not include those which were on the ticket which was intended as a mere receipt showing how long a person hiring a chair is entitled to use that chair.[5] Since the notice had nothing about exclusion of liability, it was not considered part of the contract.

Till this point, only the sufficiency of notice had been considered by the court for document containing standard terms for exclusion etc. However, this case also put into consideration whether the document could be assumed by a reasonable person to be one containing contractual terms. In this regard, a passage from *Parker* v. *South Eastern Railway Company*[6] was cited.

The judgment of the *Chapelton* case was followed in the case of *Burnett* v. *Westminster Bank Ltd.*[7] The plaintiff had issued a crossed cheque made out to cash for £2300. The cheque had been taken from a cheque book which had been issued to the plaintiff in connection with the Borough account, and bearing along the bottom three figures representing cheque number, the bank and branch, and account number. It was first cheque book of this new type to be issued to the plaintiff. Unlike the previous cheque book, it had the following words on its cover—"The cheques and credit slips in this book will be applied to the account for which they have been prepared. Customers must not therefore permit their use on any other account."

[5] [1940] 1 KB 532.

[6] 2 CPD 416—"For instance, if a person driving through a turnpike-gate received a ticket upon paying the toll, he might reasonably assume that the object of the ticket was that by producing it he might be free from paying toll at some other turnpike-gate, and might put it in his pocket unread."

[7] [1965] 3 WLR 863.

The plaintiff, however, wishing to draw the cheque on his other account deleted with pen and ink the name of the other account and substituted it. Nevertheless, the cheque found its way magnetically sorted out to the branch for which the cheque book was intended. The plaintiff brought an action against the defendant for acting without his authority. The court held that since the covers of cheque books had never previously been used for the purpose of containing contractual terms, the plaintiff could have reasonably assumed that the cover contained no conditions if no notice had been given of such terms being there. Mocatta, J. said that if the new cheque book had been the first issued to the plaintiff on his opening the account, then it would be a different situation. In the present case, the mere presence of the two sentences on the new cover is inadequate to affect the pre-existing contractual relationship. The case of *Chapelton* was also followed in *Olley* v. *Marlborough Court Ltd.*[8] where a bedroom door inside a residential hotel room which led to the washstand was not held to be a reasonable place for contractual documents.

In the recent Indian case of *Jaswant Raj Soni* v. *Prakash Mal*,[9] the court held that the conditions printed on the back of a rent receipt cannot be assumed to be resulting from a conscious decision by both the parties as a receipt and is only to acknowledge the payment of rent by the landlord. It has also been held by the Indian courts that an ouster of jurisdiction merely on the top of a bill does not get incorporated into the contract. However, if the clause was part of a contract, it would have been a different situation.[10]

If the document can be reasonably assumed to be one which can contain contractual terms, then the issue that arises is of adequacy of notice.

Adequacy of Notice

The test of adequacy of notice was first formulated in the case of *Parker* v. *South Eastern Railway Company.*[11] The question here was of deposit of articles at the cloak room of a railway station. The ticket had the words

[8] [1948] 1 All ER 955 (KBD).

[9] [2005] (8) SCC 38.

[10] *S. Manuel Raj* v. *J. Manilal,* AIR [1963] Guj 148; *C. Satyanarayana* v. *Kanumarlapudi Lakshmi Narasimham*, AIR [1968] AP 330.

[11] 2 CPD 416.

"See back" written on it. At the back, it was written that the company will not be responsible for any package exceeding a certain value. The jury had been asked to judge the question of deciding whether the plaintiff had read the special condition upon which the article was deposited and whether he was under any obligation in the exercise of reasonable and proper caution. The court in this case held that it cannot be decided whether the plaintiff had an obligation etc. The question which needed to be considered was whether the company had done whatever was reasonably sufficient to give the plaintiff notice of the condition.[12] In *Thornton* v. *Shoe Lane Parking Ltd.*[13] as well, the court affirmed that if the defendants had not done reasonably enough to bring to the notice of the plaintiff that the ticket had contained certain conditions, those conditions did not form part of the contract. Denning, L.J. went to the extent of saying in *Spurling* v. *Bradshaw*[14] that some clauses would require to be printed in red ink with a red hand pointing to it before the notice could be held to be sufficient.

Along with this, another principle which has been laid down is related to the factor of *when* a condition is brought to the notice of the party. This is derived from the principle of consent of the parties. Thus, any term which is supposed to form part of the contract has to come to the notice of the party before the agreement has been entered into. This was taken into consideration by the court in *Chapelton* v. *Barry Urban District Council*[15]and *Olley* v. *Marlborough Court Ltd.*[16] In both these cases, the clause relating to exclusion or limitation of liability was brought to the notice of the party after they had entered into the contract. In the first case, the question was of a ticket which was received as a receipt, and in the second case, of a notice given behind a bedroom door which had been given to the plaintiff as a result of the contract. It has been noticed by the court that if the ticket is

[12] Further, a three-pronged test was laid down. First, if the person receiving the ticket did not see or know that there was any writing on the ticket, then he is not bound by the conditions. Second, if he knew there was writing, and he knew or believed that the writing contained conditions, then he is bound by the conditions, even though he did not read them and did not know what they were. Third, if he knew that there was writing on the ticket, but did not know or believe that the writing contained conditions, nevertheless he will be bound if the party delivering the ticket has done all that can reasonably be considered necessary to give notice of the terms to persons of the class to which he belongs. (Taken from *Burnett* v. *Westminster Bank Ltd.*, [1965] 3 WLR 863.)

[13] [1971] 2 WLR 585.

[14] [1956] 1 WLR 461.

[15] [1940] 1 KB 532.

[16] [1949] 1 KB 532.

to form an integral part of the contract, it has to be passed at or about the time of the contract.[17]

In the case of *R.S. Deboo* v. *Dr. M.V. Hindlekar*,[18] the question that arose was of whether the limitation of liability of a dry-cleaner through a term at the back of a laundry receipt formed part of the contractual term. The court held that the terms and conditions printed on the reverse of a receipt do not *necessarily* form part of the contract in the absence of the signature of the other party. In the absence of such a signature, the burden of proof was on the party that had issued the document to prove that the attention of the other party had been sufficiently drawn to the alleged conditions *before* the contract was concluded. In the case of *Mukul Dutta Gupta* v. *Indian Airlines Corporation*,[19] the issue related to an airline ticket. The court held that the notice—with the conditions of carriage which was displayed at the counter where the ticket was bought—along with a statement at the cover page of the ticket saying "subject to the conditions of carriage" was enough to show that the airline had taken reasonable steps to bring the conditions to the notice of those who were buying the tickets.

Principles of Interpretation

Standard form contracts require a form of interpretation which is separate from that which is applied to general contracts. This is because general contracts are entered into after negotiation between parties having an equitable semblance of bargaining power, primarily to protect the weaker party, and they also ensure that unfair terms that were not consented to or are extremely unconscionable are not enforced. The main issue with pre-determined standard form contracts which are usually prepared by the party with the greater bargaining power for repetitive use is the question of consent. Is the consent given by the parties real?

There is a tendency to assess general contracts from a somewhat traditional approach of "objective assent" wherein if both parties have given consent to the contract, then the terms even if unfair would be enforceable to a great extent. This is primarily because great weightage is given to the fact that the parties knowingly entered into a contract and agreed to the terms.

[17] *Thornton* v. *Shoe Lane Parking Ltd.*, [1971] 2 WLR 585.
[18] AIR [1995] Bom 68.
[19] AIR [1967] Cal 311.

Hence, the court would not go into the unconscionability of every term and see the question of enforceability.[20]

Standard form contracts also attract a stricter form of review because of the past experience of increased burden on the weaker party. The traditional duty to read before entering into an agreement does not seem to apply to these contracts. They are in the form of "take-it-or-leave-it" contracts and it is a very well accepted practice that majority of the participants do not read all the terms prior to consenting. It has to be understood that it is because of the nature of the transaction and the characterization of assent at the formation stage of contract that over time the courts have become more aware of the need to protect the rights of the weaker participants and yet ensure commercial freedom.[21]

One of the most famous scholars Friedrich Kessler has done some great foundational work on standard form contracts and their enforceability. He makes a very important distinction between the consent to be contractually bound and consenting to all the terms, which is critical to the interpretation of such contracts.[22] Many courts have not taken a signature to be a sign of complete consent to all terms unless they were known and in many cases legible. Hence, one the most important rule of interpreting the fairness of the terms would depend on the manner these terms were presented to the contracting parties, be it consumers or other participants. The courts have felt that the intention of the offeror to bring due notice to all the terms is very important in determining enforceability. Hence, the style of writing, the language,[23] the positioning of the terms,[24] etc., become important indicators of manifestation of consent.[25]

The doctrine of unconscionability has also been used popularly in the interpretation of such contracts. This is to invalidate the contract after it has been formed on the basis of evaluating individual terms while looking at the overall impact on the parties and also considering if the agreement is a

[20] Edith R. Warkentine, "Beyond Unconscionability: The Case for Using 'Knowing Assent' as the Basis for Analyzing Unbargained-For-Terms in Standard Form of Contracts," 31 *Seattle University Law Review* 469 (Spring, 2008).

[21] Wayne R. Barnes, "Towards a Fairer Model of Consumer Assent to Standard Form of Contracts: In Defense of Restatement Subsection 211(3)," 82 *Washington Law Review* 227 (May, 2007).

[22] *Supra* n. 20.

[23] *Richardson* v. *Rowntree*, [1894] AC 217.

[24] *Henderson* v. *Stevenson,* [1875] LR 2 Sc.

[25] See generally, Richard A. Lord, *Williston on Contracts Volume 2* (4th edn., New York: Lawyers Co–op Publishing, 1991).

fair one. Here, the test of reasonability comes into play and the question to be answered is whether a careful person would have reasonably agreed to such terms. The drawback to this approach has been that it is very fact-sensitive and depends on subjectivity of the judges. It also becomes a case of extremity because only those terms which are *prima facie* completely unreasonable are usually struck down.[26] It is almost similar to the test of fairness[27] wherein the inquiry is into studying the actual impact of a particular term on the parties with its inclusion as well as its exclusion and more importantly, an effort is to see the core importance of the term to the substance of the entire contract.

What seems to have developed particularly in recent scholarship in these areas is the need to take an assent or consent-based approach to evaluate the enforceability of such contracts. As has been emphasized before, people generally do not read the terms of standard form contracts and do not have the ability to negotiate the terms. The key concern is whether the consent given applies to all the terms included in the contract. The judges, at times, fall in a dilemma because of the economic viability of such contracts and the need to strike a balance between the market and the individual.

According to the consent-based approach each unbargained term is judged on the basis of whether the term was conspicuously placed, the importance and impact made clear to the parties, and whether assent was given to the term in an outwardly clear manner separate from assent to the main contract. In fact all these approaches are a manifestation of the same basic formula which aims to protect the weaker bargaining power.[28]

Another test now evolving especially in the European Union and in particular seen in case of consumer contracts is the circumstantial test. Under this test, the scrutiny is moved away from the unfair terms and unconscionability, but judges are encouraged to take a comprehensive picture of the contract. Certain unconscionable terms may be protected if the study of market conditions are favorable to the overall contract or if some terms give some extra advantage to the consumers, they balance the negative effect and the contract is allowed to remain in force.[29]

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[26] *Supra* n. 20.

[27] *Director General of Fair Trading* v. *First National Bank plc*, [2001] UKHL 52.

[28] *Supra* n. 20, at 475.

[29] Leone Niglia, "The 'Rules Dilemma' – the Court of Justice and the Regulation of Standard Form of Consumer Contract in Europe," 13 *Columbia Journal of European Law* 125 (Winter, 2006–2007).

Fundamental Breach in Standard Form Contracts

Fundamental breach of a contract is when a person who, as promised to perform a duty or make a delivery, fails to perform or delivers something else altogether. The breach is so fundamental that the contract is deemed to have not been performed in entirety in most cases and this puts an end to the said contract.[30] It becomes a critical issue in standard form contracts primarily because majority of such contracts have exclusion of liability clauses which are then used as a defense. But the courts have made it clear that clauses excluding or limiting liability fail to have their protective cover once there is a fundamental breach of the contract. However, the decision of fundamental breach itself, particularly in standard form contract, has been very fact sensitive because such contracts are used for a large number of participants like in the form of insurance policies and, hence, a fundamental breach has to be studied on a case-to-case basis.[31]

This is a very common defense used by insurance companies to avoid liability and the response of the Indian judiciary is evaluated by two landmark judgments in this regard. In *Skandia Insurance Co. Ltd.* v. *Kokilaben Chandravadan*,[32] the licensed driver left the truck with running engine with the key in the ignition to get snacks and meanwhile a cleaner, not licensed or authorized to drive the truck started driving and lost control causing an accident. Due to the gross negligence of the driver the master and the insurance company were held liable. However, the insurance company claimed exemption as at the point of time when the accident occurred the person who had been driving the vehicle was not a duly licensed person to drive the vehicle and such exemption was statutorily provided by certain provisions of the Motor Vehicles Act. The Supreme Court after reviewing important precedents upheld that the exclusion clause has to be "read down" in order that it is not conflicting with the "main purpose" of the provisions enacted for the protection of victims of accidents so that the promisor is exempt when he does everything in his power to keep the promise. It was highlighted that it is not the contract of insurance which is being interpreted rather it is the statutory provision defining the conditions of exemption which is being interpreted. It was held that the insurer will not be exonerated because the main aim of the Motor Vehicles Act is to protect the persons and compensate adequately victims of accidents for injuries sustained.

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[30] *Nichols* v. *Godts,* (1854) 10 Exch. 191; *Alexander* v. *Railway Executive,* [1951] 2 KB 882.

[31] *Supra* n. 3, at 227.

[32] *Skandia Insurance Co. Ltd.* v. *Kokilaben Chandravadan*, [1987] 2 SCC 654.

In *B.V. Nagaraju* v. *M/s. Oriental Insurance Co. Ltd., Divisional Officer, Hassan*,[33] the main question that arose before the Supreme Court was whether the alleged breach of carrying humans in a goods vehicle, more than the number permitted in terms of the insurance policy, is so fundamental a breach so as to afford ground to the insurer to avoid liability altogether? The insurance policy had clearly written that the maximum number of persons to be carried in any vehicle was six excluding the driver and no more should be allowed. They claimed complete exemption because the vehicle carried nine persons and claimed it was a fundamental breach of the contract. The court, however, clearly denied that it was fundamental breach because the accident was a result of the driver's negligence and the added persons could not be the sole reason for the accident. The court said it was an "irregular" use of the vehicle but would not exempt the insurers from paying the due amount.

Legislative Efforts by the United Kingdom and the United States

The Unfair Contract Terms Act, 1977 (UCTA) has been enacted by the British parliament with an aim to deal with the unfair exemption clauses. It provides for a control of fairness founded upon consideration of certain particular circumstances. The Act either completely makes a term unfair or introduces a test of reasonability.[34] For example, Sections 2, 4, 6, and 7 clearly provide for situations wherein exclusion of liability is not allowed like cases of personal injury or death (sec. 2(1)), cases of breach by the person exempting liability (sec. 3(2)(a)), and unreasonable indemnity clauses (sec. 4).

Section 11 deals with the test of reasonability and the circumstances as provided for in Section 11(2) of the UCTA were intended to be a technique to be employed by courts to protect weak contractual parties against powerful dealers by automatically declaring certain terms to be unfair and unenforceable. Preserving this legislative intent, courts have tended to strike down exemption clauses burdensome on consumer contractors.[35]

[33] *B.V. Nagaraju* v. *M/s. Oriental Insurance Co. Ltd., Divisional Officer, Hassan*, AIR [1996] SC 2054.

[34] *Supra* n. 3, at 234–35.

[35] *Supra* n. 3, at 235.

For guidelines for assessing reasonability of a term in the particular circumstances, regard is to be given to the following that appear to be relevant:

1. The strength of the bargaining positions of the parties relative to each other, taking into account alternative means by which the customer's requirements could have been met, etc.
2. Whether the customer received an inducement to agree to the term or, in accepting it, had an opportunity of entering into a similar contract with other persons but without having to accept a similar term.
3. Whether the customer knew or ought reasonably to have known of the existence and extent of the term (having regard, among other things, to any custom of the trade and any previous course of dealing between the parties).
4. Whether the term excludes or restricts any relevant liability if some condition is not complied with; whether it was reasonable, at the time of the contract to expect that compliance with that condition would be practicable.
5. Whether the goods were manufactured, processed, or adapted to the special order of the customer.[36]

In the American legislature, the intent to regulate such unfair terms and conditions has also manifested itself in legislations enacted from time to time. There are special provisions concerning such contracts in Restatement of Law of Contracts and the Uniform Commercial Code. The Uniform Commercial Code deals with such unfair terms in sec. 2.302 which provides:

1. If the court finds a contract or any clause of the contract to have been unconscionable at the time it was made, the court may refuse to enforce the contract or it may enforce the remainder of the contract without the unconscionable clause or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.
2. When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable, the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose and effect, to aid the court in making the determination.[37]

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[36] Section 11(2) of the Unfair Contracts Terms Act, 1977.

[37] Law Commission of India, *199th Report on Unfair (Procedural and Substantive) Terms in Contract,* available online at http://lawcommissionofindia.nic.in/reports/rep199.pdf (accessed on October 26, 2008).

Another important effort has been through the Restatement (Second) of Contracts. Section 211 provides as follows:

1. Except as stated in subsection (3), where a party to an agreement signs or otherwise manifests assent to a writing and has reason to believe that like writings are regularly used to embody terms of agreements of the same type, he adopts the writing as an integrated agreement with respect to the terms included in the writing.
2. Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement.

India has remained far behind in terms of an effective legislation for encompassing the wide range of standard form contracts and the concept of unfair terms. It becomes important to study certain Sections of the Indian Contract Act which may be applicable to standard form contracts.

Section 16(3) provides that "where a person who is in a position to dominate the will of another, enters into a contract with him, and the transaction appears, on the face of it or on the evidence adduced, to be unconscionable, the burden of proving that such contract was not induced by undue influence shall lie upon the person in a position to dominate the will of the other." This particular provision is facilitative but will not be very helpful in providing effective and speedy remedy in cases of standard form contracts primarily because in most cases as we have studied the stronger party is able to put up a good defense because of the large financial resources available to them.

Another important section that can be used is sec. 23, which talks about lawful and unlawful considerations.

> 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.

However, this section has been rejected by high courts on several occasions.[38] Here, it becomes important to understand that the judges have a responsibility to ensure a commercial-friendly environment and since most of these contracts are in the field of business, like insurance, the public interest is

[38] *Sheikh Mohd. Ravuther* v. *B. I. S. N. Co.*, [1909] ILR 32 Mad 95.

not violated to such an extent by exemption clauses or exclusion of liability to be in a position to use this Section.[39]

Conclusion

It becomes important to realize that the Indian Contract Act is not adequate enough to meet the needs of the changing business environment, with new forms of contracts emerging which are more complicated and those provisions which relate to general contracts being insufficient to deal with standard form contracts. Further, although there are a few certain and uniform principles that have been evolved through the case laws, they have been applied with a great factor of subjectivity.

Further, increasingly popular in the sphere of e-commerce and now a very common phenomenon relates to the standard form contracts on the Internet called "shrink-wrap" and "click-wrap."

The "shrink-wrap" agreements are those that contain the terms and conditions to the contract in the packaging of the product itself as in the case of many software programs that usually come in clear plastic packages.[40] This unsigned license agreement comes into effect when the consumer opens the package, since the act of opening or tearing or any such outward manifestation implies consent to the terms and conditions enclosed therein. It is clear that shrink-wrap contracts do not allow the contracting parties to read the terms and conditions prior to accepting them.[41]

Click-wrap contracts are generally online contracts where the user is supposed to click the "I Agree" or "I Accept" icon to indicate his assent (much like a handshake or a signature) to the standard terms and conditions, and only then has access to the software.[42] Therefore the term "click-wrap" originates from the fact that assent to the online contract is demonstrated with the click of a mouse on an on-screen icon.

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[39] See generally, *Supra* n. 37.

[40] Richard G. Kunkel, "Recent Developments in Shrinkwrap, Clickwrap and Browsewrap Licenses in the United States," 9(03) *Murdoch University Electronic Journal of Law* (September, 2002).

[41] Adam Snukal, "The 21st Century Contract: Packaging Your Protection," available online at http://www.internetindustry.com/Interviews/archives/ss00/package_snukal.shtml (accessed on October 26, 2008).

[42] Craig Horrocks and Chihaya Natusch, "Legal Holes may Exist in Click-Wrap Trap," available online at http://www.idg .net.nz/webhome.nsf/0/CC256A87000C5F2FCC256834 007ACC1Aopendocument (accessed on October 26, 2008).

Such new variants of standard form contracts create problems in applying contract law. The traditional form of consent, duty to read and consider, is no longer applicable to such new variants. The courts are themselves unsure of the extent of enforceability, and the entire concept of consent is undergoing a severe change. The courts pay utmost importance to the positioning of the terms and whether they were conspicuous enough for the participants or whether the access was difficult.

However, it becomes essential for the Indian legislature to realize that due to their unique nature, principles of general contract law cannot be applied to standard form contracts. Taking from the extensive jurisprudence of the United Kingdom and the United States, including the experience of the Indian judiciary, certain legislations should be enacted which crystallize the position of law and also take into account the problems generated by the new forms of contracts.

10

E-Contracts

Abhishek Krishnan and *Rakshithaa*

On E-Contracts in General

Over a relatively short period of time, E-contracts have risen to ubiquity and the average computer user enters into several binding E-contracts during numerous transactions, sometimes unwittingly. This chapter is devoted to demystifying three main aspects of E-Contracting:

1. Kinds of E-Contracts and their enforceability.
2. The formation of an E-Contracts and the application of the mailbox rule.
3. The relevance of the Information Technology Act, 2000.

Kinds of E-Contracts: Shrink-, Click-, and Browse-wrap Contracts

Shrink-wrap licenses are so called because of the clear plastic wrapping that encloses many software packages. They contain a notice that by tearing open the shrink-wrap, the user assents to the software terms enclosed within. In the context of software applications, the typical shrink-wrap agreement is a software license that dictates a seller's terms to a buyer, and includes a conspicuous notice of agreement, title retention in the seller, restrictions on transfer and modification, prohibition of reverse engineering, and limited copying provisions.

The case of *Step-Saver Data Sys., Inc.* v. *Wyse Tech*[1] was the first time that a shrink-wrap agreement was contested. The Step-Saver had purchased a

[1] 939 F.2d 91 (3d Cir. 1991).

software program from the defendants by placing an order for 20 copies over the telephone, and had resold it to end-users. These customers brought a suit against the plaintiffs for the software's defects and they in turn sued the defendants in this case. Wyse Tech raised the disclaimer and limitation of remedies contained in the shrink-wrap license as its defense.

The Court of Appeals for the 3rd Circuit accepted the plaintiff's argument that the contract had been formed during the telephone conversation in which an offer to purchase had been made, and was accepted. The additional terms of the shrink-wrap license were construed as proposals for addition to the contract, and were not enforceable because Step-Saver had not assented to them. Hence, the liability for the defective software was placed on its manufacturer, rather than a reseller.

ProCD, Inc. v. *Zeidenberg*[2] was a watershed for the enforceability of shrink-wrap contracts. ProCD had compiled data from 3,000 telephone directories into a searchable database at considerable expense. They sold this database to consumers on CD-ROM disks, and on the outside of the box stated that use of the software was restricted to the terms of the enclosed license. However, the user's manual contained the license and the license appeared on the user's screen every time the program was run. Zeidenberg purchased this package and uploaded the database onto the Internet in contravention of the license.

In the action brought by ProCD, the district court relied on Step-Saver, and concluded that the shrink-wrap license was not part of the contract between ProCD and Zeidenberg. On appeal, the 7th Circuit Court noted that it would be impossible to print the entire license terms on the exterior of the box to be viewed before sale, and that having a notice on the outside with a right to return the software if the terms are unacceptable may be a means of doing business.[3] The court held the shrink-wrap license enforceable, and Zeidenberg liable for having violated the license terms. Cases subsequent to ProCD have uniformly upheld the validity of shrink-wrap agreements when there is a notice and a right to return, since it was open to consumers to request a copy of the terms before purchase.[4] This is only subject to the standard rules that govern contracts of adhesion, such as *contra preferentum*.

Click-wrap agreements are an electronic form of contracting that are deployed when a product is distributed by means other than disks, such as

[2] 86 F.3d 1447 (7th Cir. 1996).

[3] *Ibid.*

[4] *Hill* v. *Gateway 2000, Inc.*, 105 F. 3d 1147 (7th Cir. 1997).

when software is downloaded over the Internet. On installation or first use, a window containing the terms of the license opens for the user to read. The user is presented with a choice of clicking on either "I agree" or "I do not agree" which accepts or declines the terms. If the user does not agree, the process is terminated. Unlike shrink-wraps, these agreements do not require a court to consider whether the user had adequate notice of the terms since they are displayed at the very start of the contract formation process (although the user may have to scroll down the window to read all of the terms).

In *Caspi* v. *Microsoft Network*,[5] the plaintiff, a subscriber to Microsoft's MSN network, assented to MSN's membership agreement which appeared in a scrollable window. It was alleged that Microsoft engaged in "unilateral negative option billing" by making subscribers agree to more expensive plans without their actual consent. The court ruled that customers had adequate notice of the clause because they were free to scroll through the terms before agreeing. The agreement also contained a forum selection clause which the court enforced by ruling that there was no fraud or unfair bargaining power, it did not violate public policy, and that it did not seriously inconvenience trial.[6] Another notable case on click-wrap agreements is *Forrest* v. *Verizon Communications, Inc.*,[7] in which the plaintiff argued that the forum selection clause affected only contractual rights, and not consumer protection claims. The court rejected the plea and ruled that the forum selection clause that was broad enough to encompass all claims related to the service. However, click-wrap agreements cannot operate in respect of damage caused before the contract was entered into.[8]

Browse-wrap agreements are frequently used on websites and do not appear on the screen until a user accesses the terms by clicking on a hyperlink. These agreements are susceptible to challenge for lack of notice and assent to terms. There are a few significant aspects that define browse-wrap agreements—unlike click-wraps there is no actual or constructive notice, a product can be used without ever viewing the terms of the agreement, and users may not even realize that a contract is being formed.[9]

The leading case on browse-wrap agreements is *Specht* v. *Netscape Communications Corp.*,[10] where free downloads of Netscape's software obtained

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[5] 732 A.2d 528 (N.J. App. Div. 1999).

[6] *Ibid.*

[7] District of Columbia Court of Appeals, (CA-405-01, decided August 29, 2002).

[8] *Williams* v. *America Online, Inc.*, [2001] Mass. Super. LEXIS 11.

[9] K.M. Das, "Forum-Selection Clauses in Consumer Click-wrap and Browse-wrap Agreements and the Reasonably Communicated Test," 77 *Washington Law Review* 481 (2002).

[10] 150 F. Supp. 2d 585 (S.D.N.Y. 2001).

web-usage information from its users, presenting privacy concerns. The browse-wrap terms included an arbitration clause. Upon installation, users were merely told to "*please review and agree to the terms of the Netscape Smart Download software license agreement before downloading and using the software*." The court ruled that this was an invitation and not a condition, and could not constitute assent. Providers of online services and software have the option of click-wrap agreements, and have to bear with the consequences of failing to use it.[11] However, it appears that terms on a browse-wrap agreement would bind competing businesses.[12]

Based on the foregoing cases, businesses would do well to keep some best practices in mind while deploying E-Contracts:

1. Online agreements should be as conspicuous as possible.
2. Whenever possible, use click-wrap rather than browse-wrap and the viewing of the terms should be mandatory. This could be accomplished by graying out Accept until the user has scrolled to the bottom on the agreement.
3. A notice should be included near the Accept button to make the user grasp the significance of his actions, such as "By clicking Accept, you are entering into a legally binding agreement."
4. Keep a record of the moment that the user clicked Accept.

Formation of a Contract and the Mailbox Rule

A contract is formed when acceptance is communicated to the offeree. This presents few problems in face-to-face negotiations, but when communicating over distances, it is often the case that the offeree has dispatched an acceptance which is not received by the offeror or arrives after the expiry of the offer. Does acceptance take effect when it was sent or when it arrives? Under sec. 4 of the Indian Contract Act, the communication of acceptance is complete:

1. As against the Proposer, when it is put in the course of transmission to him, so as to be out of power of the Acceptor.
2. As against the Acceptor when it comes to the knowledge of the Proposer.

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[11] *Ibid.*

[12] *Register.com* v. *Verio, Inc.*, 126 F. Supp. 2d 238 (S.D.N.Y. 2000).

This mirrors early common law cases on the mailbox rule, wherein acceptance is deemed to be communicated to the offeree when it enters the postal system. Case law also tends to distinguish between delayed forms of communication and instantaneous forms of communication, such as the telephone, telex, and fax machine. Acceptances communicated using such mediums are formed when the offeror receives the acceptance because they are functionally equivalent to face-to-face communications.

In *Entores Ltd.* v. *Miles Far Eastern Corporation*,[13] the plaintiffs made an offer to the defendant corporation in Holland. This was accepted by a telex, which was received on the plaintiff's machine in London. Denning, L.J. observed:

> When a contract is made by post ... acceptance is complete as soon as the letter is put into the post box, and that is the place where the contract is made. But there is no clear rule about contracts made by telephone or by telex... My conclusion is that the contract is only complete when the acceptance is received by the offeror: and the contract is made at the place where the acceptance is received.[14]

Similarly, in *B.G. Kedia* v. *G. Parshottamdas and Co.*,[15] the Supreme Court ruled that contracts concluded over the telephone, being an instantaneous mode of communication, would not be subject to the mailbox rule.

Is it possible to extend the analogy to emails and other forms of computer-mediated communication? Acceptances would be formed when the offeror receives the acceptance, and the transmitting party bears the risk of broken communications. The problem in adopting this is that most email systems use mail servers operated by third parties, and the recipient has to login to the mail server before he has a chance to read the communication. In such cases, the communication being instantaneous is of little practical use. In the context of telex, the House of Lords has stated:

> The message may not reach, or be intended to reach, the designated recipient immediately: messages may be sent out of office hours, or at night, with the intention, or on the assumption, that they will be read at a later time. There may be some error or default at the recipient's end which prevents receipt at the time contemplated and believed in by the sender. The message may have been sent and/or received through machines operated by third persons. And many other variations may occur. No universal rule can cover all such cases; they must be

[13] [(1955)2 QB 326].

[14] *Ibid.*

[15] AIR [1966] SC 543.

resolved by reference to the intentions of the parties, by sound business practice and in some cases by a judgment where the risks should lie.[16]

Selected Provisions of the Information Technology Act, 2000

There is no special law of E-Contracts. E-Contracting is a method of forming agreements, not a subset based upon any specialized subject matter. Accordingly, the Information Technology Act, 2000 has not amended the law of contracts in any way, and only clarifies several aspects of E-Contracting that have already been alluded to. First, the Act identifies three parties to the electronic transmission process—the originator, the intermediary, and the addressee.

The originator, as defined under sec. 2(1)(za), means a person who sends, generates, stores, or transmits any electronic message; or causes any of these actions. But this does not include an intermediary (who, according to sec. 2(1)(w), is any person who on behalf of another person receives, stores, or transmits that message or provides any service with respect to that message). The addressee is defined in sec. 2(1)(b) as a person who is intended by the originator to receive the electronic record but does not include an intermediary. It must be understood that these categories are not the same as the promisor and promisee under the Contract Act, and are only meant to give meaning to the communication process.

The IT Act also contains provisions regarding attribution, acknowledgment, dispatch, and receipt of electronic records. Section 11 lays down certain conditions as to when an electronic record shall be attributed to the originator. The conditions are: the record be sent by the originator himself, sent by an authorized person on behalf of the originator, or sent by an information system programmed by or on behalf of the originator to operate automatically. This addresses the interesting issue of electronic agents—contract law requires a meeting of the minds, and the involvement of two parties negotiating is an underlying assumption. What of situations where the only minds that meet are programmed computer systems (such as an automated inventory system at an online store)? Humans assent to the system, not specific transactions. Even so, the transaction can be attributed to the originator by virtue of sec. 11.

Section 12 of the Act addresses legal issues arising from the use of acknowledgment of receipt (which is not to be confused with acceptance).

[16] Lord Wilberforce in *Brinkibon Ltd.* v. *Stahag Stahl*, [1982] 1 All E.R. 293 (HL).

The first clause provides for a situation where the originator has not agreed with the addressee that the acknowledgment be given in a particular form or by a particular method. Here, the acknowledgment may be by any means sufficient to indicate to the originator that the electronic record has been received. However, if the originator has specified to the addressee that the electronic record shall be binding only on receipt of an acknowledgment, unless acknowledgment has been received, the electronic record shall be deemed to have been never sent by the originator (clause 2). Clause 3 lays down an optional procedure to be adopted by the originator in case of non-receipt of acknowledgment—the originator may give notice to the addressee and specify a reasonable time for acknowledgment.

Section 13 of the IT Act deals with the time and place of dispatch and receipt of an electronic record, and clause (1) provides that the dispatch of an electronic record occurs when it enters a computer resource outside the control of the originator. With respect to receipt of the record, the law distinguishes between whether the originator has sent the message to a computer resource designated by the recipient to receive communications or a non-designated computer resource. Receipt occurs at the time the electronic record enters the designated computer resource unless the record was sent to a non-designated computer resource, in which case it occurs at the time when the electronic record is retrieved by the addressee. Thus, it would seem that when the acceptance of an offer is emailed to a computer system designated by the offeror, the mailbox rule would not apply. Finally, the location of the computer resource is irrelevant. Section 13(3) provides that an electronic record is deemed to be dispatched from the place where the originator has his place of business, and is deemed to be received at the place where the addressee has his place of business.

Software Contracts

> A software program is essentially a series of command issued to a computer, or to be specific, to the hardware of the computer, that enables the computer to perform in a particular manner, so as to achieve a desired result.[17]

In today's digital world, the breadth of software applications is broader than one's imagination could reach. Far beyond the traditional applications, such

[17] R. Matthan, *The Law Relating to Computer and the Internet* (New Delhi: Butterworths, 2000) at 2.

as word processors and spreadsheets, software components have become critical parts of various applications and day-to-day activities in numerous industries and businesses.

In such a scenario, the mode of supply of the software to the consumers and the contract between the software manufacturer/owner and the end-user assumes great significance. This is so not only because of the academic value attached to it, but also the practical implications of the same in determining the rights and liabilities of the parties to the contract, and for the purposes of resolution of any dispute that might arise subsequent to the contract. Also, the rapidly changing needs and preferences of both the inventors/owners of the software and the end-users as reflected in the contract necessitates a good understanding of the features of the software contracts, and the nature of software per se.

Understanding Software and Software Contracts

Computer programs, comprising a set of instructions, are generally stored and transferred as compact/floppy disks, purchased off the shelf, over the counter, or directly from the owner of the program as downloads from the Internet. Whatever be the mode of purchase, the end-user's primary interest lies in the software and its legitimate use, for which he pays the consideration, with the medium of transaction being merely incidental. The same has also been the view taken by the Indian courts while dealing with cases concerning the value of software per se, and software as stored in hard drives.[18]

Moving on to software contracts, excluding any contract that may exist between a retailer (in the case of off-the-shelf purchases) and the purchaser, the contractual relationship that may exists between the end-user and the owner of the software has been quite contentious. With the law being silent on the legal nature of such contracts, and case-law on the subject still in a nascent stage, the only alternative is to look at the terms of the contract in the light of the general principles of contract law applicable to them, as discussed in the previous section.

Software contracts often include restrictive terms regarding the copyright protection of the software and non-transferability of the copy of the software by the purchaser which limit the rights of the purchaser. Such limitations

[18] *MS. Sprint RPG India* v. *Commissioner of Customs-I, Delhi*, AIR [2000] SC 749; *Tata Consultancy Services* v. *State of Andhra Pradesh*, [2005] 1 SCC 308; *Commissioner of Customs Chennai* v. *Hewlett Packard India Sales (P) Ltd.*, [2007] 8 SCC 404.

of use and the rights of the purchaser leads one to the burning question of whether a software contract is to be treated as a sale, or as a mere license to the end-user to a legitimate use of the software. This section of the article is devoted to addressing this issue, and its implications.

Software Contracts: Contracts of Sale or a Mere License?

Software contracts simultaneously confer rights of exclusive possession upon the purchaser, and also impose certain restrictive terms and conditions. While the former feature points toward the contract being one of sale, the latter can exist only in the case of a license, especially since the purchaser is denied the right to transfer or assign his own copy to a third party.

One widely prevailing, and radical, approach is to disaggregate the purchase of software into two separate contracts—the sale of software (a copy of it), between the retailer and the purchaser, and a license to use the software, without copyright infringement, between the software owner and the end-user.[19] Examining two separate contracts, and thereby the application of two different standards of rights and duties, though simple, is flawed to the extent that it is restricted only to off-the-shelf contracts and excludes instances of software purchase by downloading. To make an artificial distinction between off the shelf and software directly downloaded via the Internet on the basis of the mode of transmission unjustly prejudices the customers who choose to download their software. Furthermore, making this artificial distinction leads to a further problem of classifying the incidents of the transaction between the two contracts. For instance, in a purchase of defective software off the shelf, who would be liable—the retailer or the entity that coded the software? These theoretical flaws and practical difficulties make this line of thought unappealing. However, arriving at a definite conclusion of whether a software contract is a sale or a license is also not without its attendant complexities and divergences. This section elucidates arguments from both sides of the fence.

Contracts of Sale

If softwares are to be *sold*, it needs to be examined if they can be described as tangible goods (to be possessed to the exclusion of others), and if they can

[19] J.N. Adams, *Atiyah's Sale of Goods* (9th edn., New Delhi: Butterworths Publications, 1995) at 48.

be easily transferable. Tangibility has traditionally entailed having a physical form or being capable of perception by the senses, and some argued that software was mere information enjoying no physical form, except that of magnetic notation on a tape or a disk, and hence clearly intangible.[20] However, this argument has been strongly refuted, as the software is information only to the computer, and is in effect the actual input that produces a desired result by functioning on the computer. Taking a computer program to be a mere information makes an artificial characterization of a program in its atomic form, analogical to defining a book as a collection of words, ignoring the fact that the book, as such, has an identity of its own, though its major value lies in the words printed on the pages.

Legal notions of tangibility have been long updated to accommodate the digital age. To quote from one of the decisions of the Court of Louisiana on the nature of software, by far considered the best definition of software,

> [T]he software itself, is not merely a right or an idea to be comprehended by the understanding. The purchaser of computer software neither desires nor received mere knowledge, but rather receives a certain arrangement of matter that will make his or her computer perform a desired function, and this arrangement of matter constitutes a corporeal body.[21]

The position under Indian law is similar, as various decisions of the Supreme Court indicate that softwares, by whichever form they exist, and by whichever mode they may be transmitted, are tangible goods, if they are capable of abstraction, consumption, and use and can be transferred, delivered, stored, and possessed.[22]

However, although considered tangible, software is not freely transferable—not due to technological constraints or legal prohibitions, but because of the terms and conditions that are laid down on the purchaser or end-user of the software. This is apart from the copyright protection that the software owner enjoys, and extends to prohibition of even the sale or

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[20] G. Smith, *Software Contracts* (3rd edn., New York: West Group, 2002) at 54.

[21] *South Central Bell Telephone* v. *Sidney J. Barthelemy*, 643 So. 2d 1240 at 1246. To explain further, software as it exists as source codes is always a corporeal body, taking the form of massive strings of bits. If a program is stored permanently on a CD-ROM, each bit is represented by either the presence or absence of a pit on the disk's surface. When the same is stored in a less permanent form, such as on a computer hard disk, it takes the form of a series of magnetic switches positioned at either I or O. Even in the case of an electronic transfer or download, when a program is in its most transient state, it still has a corporeal form because it exists as a series of electrical pulses that is transferred from one computer to another. Sarah, 166.

[22] See *Tata Consultancy Services* v. *State of Andhra Pradesh,* [2005] 1 SCC 308.

transfer of a particular copy of the software that the purchaser possesses. It is here that software contracts stand unique from other copyrighted works that are sold. To illustrate by means of an analogy, proponents of software contracts as sale compare it with copyrighted books that are sold off the shelf, or sometimes even downloaded from the Internet. However, the key difference between the purchase of the book and the purchase of software is that while the owner of the book can sell or gift it to a third party, a software purchaser cannot. In other words, the software contracts invariably impose an exception to the first sale doctrine.[23] In effect, what this boils down to is to see the purchase of the software as a sheer purchase of the right to use it for oneself within the permitted domain.

Contracts of License

With software contracts clearly not being contracts of sale, the obvious answer is for them to be taken as licenses to the end-user for the legitimate use of the software. When software was initially invented, the copyright regime had still not fully developed, and software developers licensed its use for a fixed subscription to its end-users to have the exclusive rights of distribution, copy, and reproduction and modification. Now, with copyright laws fully developed and extending to protect software inventions, software developers still license their software since copyright law tends to be notoriously porous. While the law allows the developer to proceed against any person who attempts to copy the software, this protection is restricted only to the exact lines of code defined under the license agreement, and offers little protection against minor alterations of the code sufficient to satisfy copyright law's "originality" threshold. This necessitates additional and supplementary protection, in the form of contracts entered with end-users and the terms and conditions imposed with regard to de-compilation, reverse engineering, and modifying the code contained in the software, in addition to choice of governing law, and other standard contractual provisions.[24]

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[23] The first sale doctrine, connected to copyright protection, acts as a limitation on the rights of a copyright owner. According to the doctrine, notwithstanding a copyright owner's exclusive right to distribute, the owner of a particular copy is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy. However, the software contracts impose restriction on the application of this doctrine, by way of the terms and conditions that are imposed on the end-user through shrink and click-wrap licenses, giving the contract the color of a license.

[24] N. Kamath, *Law Relating to Computers, Internet and E-Commerce: A Guide to Cyber Laws* (Delhi: Universal Law Publishing Co. Pvt. Ltd., 2000).

Moreover, contracting for licensing the software to the end-user addresses the considerations of defeating the first sale doctrine, effecting price discrimination, and imposing liability-limiting contract terms,[25] since these licenses obtained through the purchase of the software usually restrict users to the installation of only one copy of the software (with every installation onto a different computer requiring a fresh registration or agreement and a separate pay), helping the owners to preserve their market share, and providing a higher return on their investment, while also safeguarding their intellectual property rights.[26] Software licenses also enable the software owners to play with price discrimination, charging large corporations and commercial users more than home users (sometimes, even producing two versions of the same software), while ensuring that the users are subject to its limitation of liability provisions.[27]

Indian Position

Indian law does not make any express statutory mention of software contracts to make a blanket classification of the contract as a sale or a license, and the issue is left entirely to contract law, which gives complete autonomy to the parties to a contract to frame the terms of a contract subject to public policy. The judiciary has, in a few cases, delved into the nature of software by itself and vis-à-vis hardware, though not the contract formed during the software transaction.[28] These cases, though based mostly on the law of taxation, have help in a limited way to show that software has been recognized in India as

[25] C.H. Nadan, "Software Licensing in the 21st Century: Àre Software Licenses Really Sale?" 32 *American Intellectual Property Law Association Quarterly Review* 555 (2004). Under the American legal regime, the issue of typically what restrictions would make a contract a license, and whether software contracts reach the threshold was discussed in the Californian cases, popularly known as the Adobe cases—Stargate, 216 F. Supp. 2d at 1058; One Stop Micro, 84 F. Supp. 2d at 1091, 53 U.S.P.Q.2d (BNA) at 2006. The court, in both the cases, held that the typical restrictions in a software distribution are sufficient to make the transaction a license. These cases, though decided by the Federal Courts of California, have been accepted as the law in other states of the United States as well.

[26] GP. Ferrera, R. Gerald, Lchtenstein and D. Stephen. *Cyber Law: Text and Cases* (2nd edn., Australia: Thomson Publications, 2004).

[27] *Ibid.*

[28] In *MS. Sprint RPG India* v. *Commissioner of Customs- I, Delhi*, AIR [2000] SC 749, the question before the court was whether a software loaded on a hard disk would remain to be a hard disk drive on which software was loaded, or would still be considered a software. The question mainly arose because the percentage of the customs tax was greater on the hard disk than on the software. The court examined the price of the imported consignment (the software loaded in

having a value on its own, and being tangible enough to be imported and sold by itself (except when in-built as a part of a computer system).[29]

However, these cases did not go beyond this sphere, to decide on whether the contract formed would amount to a sale or a license. The recent *Tata Consultancy Services* v. *State of Andhra Pradesh*[30] came very close to determine that the software when sold in a tangible form as an off-the-shelf transaction was subject to sales tax. The case concerned the Tata Consultancy Services (TCS) that was dealing with loading of canned and uncanned software on customers' computers. The question that came up before the court was whether the loading of these softwares onto the computers would subject the softwares to sales tax. The main contention of TCS was on the issue of (in)tangibility of software, and hence that it cannot be subject to sales tax. The court, however, relied on various authorities, and referred to the decisions of other jurisdictions to hold that software was a tangible good, hence validating the taxation imposed. This court, although seems to have decided on the question of software contracts being a sale or license by subjecting software to sales tax, is to be importantly noted, did not directly address the contract anywhere in its decision which was primarily based on the tangibility of the subject matter, here, the software. Moreover, the court had imposed the tax only on canned software and had excluded uncanned or downloaded software from the discussion. For these reasons, this decision is to be read in its limited context of sales tax, and not in the broader context of the nature of the contract concluded, and the implied rights and liabilities of the parties.

Consumer Disputes and E-Contracting

Having seen the law on E-Contracts in general, discussing the intricate issues relating to Business to Business, Business to Consumer Contracts, and specific issues on software transactions, this part of the paper looks at the

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the CD), which was approximately Rs 68 lakhs as against the value of hard disk drives without the software that was roughly Rs 60,000, to determine the essential character of the imported goods, which it held was the software. Also see *Commissioner of Central Excise, Pondicherry* v. *ACER India Ltd.*, [2004] 8 SCC 173. The court in this case upheld the exemption from the levy of excise duty on software, even when it was implanted in a hardware that could be subjected to assessment of central excise under a different head.

[29] *Commissioner of Customs Chennai* v. *Hewlett Packard India Sales (P) Ltd.*, [2007] 8 SCC 404.

[30] [2005] 1 SCC 308.

more practical legal aspects of E-Contracts. The enforceability of the software contracts made through shrink-wrap and click-wrap formulae, and the issues on private international law, be it the jurisdiction of any dispute arising, or the choice of law applicable to the dispute, etc., are matters of utmost importance.

As seen in Part A, the two most common forms of contract entered with consumers, the shrink-wrap and click-wrap contracts, are contracts of adhesion, where the end-user of the software or service does not have any negotiating power with the software developer and is bound to take it as given. In such cases, it is only imperative to see if the law gives an absolute contractual autonomy to the software developers in imposing any obligations and limitations on the purchasers' rights, especially in light of the Consumer Protection Act and other similar laws of the country.

Next, another equally important aspect of these online contracts is the conflict of laws issues. As hard as it is to determine the extent of the transboundary jurisdiction of the courts over traditional disputes, it is much harder to ascertain jurisdictional issues in the context of an essentially non-demarcable entity like the Internet that is insensitive to any locational constraints. Also, the laws on traditional contracts relating to simple concepts, such as the formation, performance, and payment, are not applicable to contracts formed over the Internet, significantly affecting the question of choice of law.[31] To provide a simple example, a website advertising a particular product, and selling it via the Internet may be located in Florida. However, having a dot com existence enables it to be accessed across the globe, and have a worldwide market. Now, if a consumer in India purchases the product, and finds a defect with it, where should he file the suit? And which law would govern the liability of the product manufacturer? To further complicate the given case, if the product sold via the Internet is not a tangible good that has to be physically delivered to the purchaser (and hence to make the law of the place of delivery the applicable law), and is, instead, a software that is downloaded by the purchaser, thence having no correlation whatsoever with the *situs* of the purchaser, how would one determine the *forum conveniens* and the applicable law?

While most online contracts that are entered into nowadays provide expressly for the jurisdiction in case of a subsequent dispute, and the law that would govern the contract, confusion still exists in the few where either the jurisdiction clause is absent, or where it is unclear. Even in cases where the

[31] *Supra* n. 17, at 5.

choice of law and jurisdiction is provided, the courts at times overlook its express words and act for the cause of reasonability and fairness, especially in consumer contracts to favor the disadvantaged consumer and to offset the implications of a contract of adhesion.

Conflict of Laws in the Internet Era

The Internet age and the very many transactions between parties across the globe, while having an impact on several areas of law, have also led to the (need of) evolution of a new brand of jurisdictional jurisprudence as mentioned earlier. The two major factors that need to be considered vis-à-vis a court extending its jurisdiction over E-business, that have in fact acted as the twin reasons for the various case laws on this point, and the evolution of the law, are first, the chief reason behind corporates choosing business over the Internet is precisely because of its cost effectiveness, and to now factor in the potential costs of defending against litigation in every place where they could be accessed would be a major dent in their cost planning, making the Web-based business more expensive. Second, on the other hand, to allow the business and service providers to insulate themselves against the jurisdiction in every state, except the place where they are physically located, would be troublesome and unreasonable to the consumers situated across the globe, who have a much lesser bargaining power and resources to litigate in a foreign country.[32]

To achieve a balance between these two diverse considerations, American courts have applied the principles of minimum contact, effective functions, and the theory of long arm statutes, generally used in traditional contracts, with necessary adaptations to E-Contracts. The courts, in most cases, assume jurisdiction where it is proved that the corporate on his own volition marketed and contracted with the other party belonging to the forum state, with the cause of action arising out of his actions.[33]

An important case on this point is the *Compu Serve, Inc* v. *Petterson*,[34] where the US Court of Appeal extended the doctrine of minimum contact to the contracts of an electronic nature. The case concerned an electronic

[32] *Supra* n. 19, at 165.

[33] Irini A.S. Matandi et al., *Perspectives on Intellectual Property in the New Digital Environment-8* (London: Sweet and Maxwell, 2000) at 270.

[34] 1996 US Appp LEXIS 17837 (6th Cir, July 22, 1996).

shareware registration agreement between Richard Petterson, from Texas, and Compuserve that permitted the use by Petterson of the services of Compuserve, for the marketing and sale of his Internet navigation product. However, when Compuserve later marketed and sold its own Internet navigation software, a dispute arose between the two parties and Compuserve filed a suit before the Ohio Court. In regard to the question of jurisdiction, the Ohio Court looked at various aspects of the contract to conclude favorably on its jurisdiction based on the minimum contact that existed between Mr Petterson and the State of Ohio. Although, the contract between the parties had itself previously stated that it would be governed by the Ohio law, the court took this clause on the choice of law as only one of the considerations of jurisdiction and looked at other facets such as targeted customers of Mr Petterson in Ohio, the mode of payment, etc. Another similar case on jurisdiction, that reiterated the fact on minimum contact and restricted the courts from assuming jurisdiction in all cases where a website could be merely accessed, was the case of *McDonough* v. *Fallin McElligott*.[35] The court in this case distinguished between the mere existence of a website that could be accessed from within the jurisdiction of the forum state and certain express actions on the part of a contracting party to invoke the jurisdiction of a court.

The law laid down in these cases appears to be a rational approach to the concept of jurisdiction over the Internet. In its essence, the Internet is a storehouse of information created by the individual contributions of innumerable people from various corners of the world and from various legal systems that can be accessed anywhere in the world. To ensure that the Internet retains its nature of universal access, it is necessary that the courts hold restraint before invoking jurisdiction over activities that may be reasonably construed to have occurred outside the territorial confines of its borders.

Indian law, on the assumption of jurisdiction in Internet disputes, though not enough case laws to prove the point, is theoretically similar to the position in the United States. Section 20 of the Civil Procedure Code (CPC) deals with jurisdictional aspects and provides that a court may assume jurisdiction in a case, when the cause of action arises within its sphere. The section, though more relevant to domestic courts, can be interpreted to apply to transnational issues as well as private international law; although it has an international character, it is essentially the domestic law of a country. This provision for jurisdiction based on the cause of action is quite wide in its

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[35] No 95 Civ 4037 (S D Ca August 15, 1996).

ambit, enabling the court to assume jurisdiction over a dispute regardless of where the principles are resident or the *situs* of the business, so long as a portion of the cause of action took place within the local jurisdiction, while still having an implied standard set, in a way similar to the US long-arm jurisdiction provisions.

Further, the Indian procedural law also provides for the recognition and enforcement of such decisions—its own as well as the enforcement of foreign decisions—since a mere assumption of jurisdiction, and passing a judgment without it being recognized and enforceable in another country would have no effect. Section 13 of the CPC spells out the effect of foreign judgments on Indian courts, providing for their enforcement in all cases except under a few circumstances, in which case the courts would delve into the issues of jurisdiction of the court, the public policy, and morality of the decision to be enforced, keeping the merits of the case as off-limits.[36] Under sec. 44A of the code, the decrees of the Indian courts are enforceable in countries which the central government has declared by notification under the Section, and those which have entered into reciprocal agreements with the Government of India, in respect of the enforcement of their decrees in the Indian courts. Such agreements and reciprocal relationships are of essence especially in Internet contracts, where the parties have an international existence, needing a mutual cooperation between countries in effecting the valid judgments of each other.

However, in case of a country that does not have a reciprocal agreement with India, any judgment that has to be enforced there can be done only by commencing a new action for enforcement in that court, which might often be complicated since the foreign court may wish to re-assess the merits of the case or re-assess the Indian court's assumption of jurisdiction before giving effect to the decisions. This difficulty in the recognition and enforcement of judgments in other countries exists not only for the Indian courts, but for other jurisdictions as well, and mainly occurs because of the possibility of multiple jurisdictions hearing a particular matter arising over the Internet, and the wide range of laws that may govern the dispute. A Uniform Code, as it exists in the United States, dealing with interstate jurisdictions providing for the jurisdictional questions and choice of law if enacted for international jurisdiction in E-Contracts,[37] similar to the CISG (Conventional

[36] *Govindan* v. *Sankaran*, AIR [1958] Ker 203; *Rajarathnam* v. *Muthuswami*, AIR [1958] 203.

[37] T. Ramappaa, *Legal Issues in Electronic Commerce* (New Delhi: Macmillan India Ltd., 2003) at 65.

International Sales of Goods) for the sale of goods would bring in a legal certainty, solving most of the controversies and confusion regarding jurisdictional matters.

The same is also the case with the determination of the law that would govern the contract. Under traditional contracts, the governing law would be the law of the state where the transaction occurred, unless agreed otherwise by the parties to the contract, for which the rules of private international law were used in case of transnational contracts. However, moving over to E-Contracts, where the parties belong to different countries, and where there is no specific factor to determine the place of consummation of the contract, there is no mention of what the proper law is, in the rules of most of the domestic legislations. This pushes the courts to apply the law of the country that has the closest connection to the country, with the courts again differing in the factors that they take to arrive at this decision.

Nevertheless, most contracts entered online, be it Business to Business or Business to Consumer, specify both the jurisdiction, as well as the governing law of any subsequent dispute. In such cases, the courts generally uphold the contract between the parties, giving way to contractual autonomy, albeit with certain limitations especially for Business to Consumer contracts that are contracts of adhesion, hence requiring the intervention of the courts to induce reasonability of the terms and fairness. This is simply because the issue of consumer protection is closely intertwined with public policy, and legislatures the world over have realized the unequal bargaining power of the consumers in determining the jurisdiction and governing law of the contract, similar to the determination of the other relevant terms of the contract, giving a significant scope for forum shopping by the corporate.[38]

Additionally, the legislations of various countries and international conventions themselves provide for the consumer protection in such contracts of adhesion and prohibit the exclusion of their jurisdiction and consumer favorable laws by the contractual terms. For instance, sec. 28 of the Indian Contract Act and Section 11(2) of the Consumer Protection Act provide for the protection of the rights and remedies that the Indian law provides to its consumers, and allows the court to disregard the agreement between the consumer and the vendor as far as the choice of forum and the governing law is concerned.

At the International level, the Hague Convention provides for the prerogatives of the consumer as a party deserving special treatment. Article 7 provides that a consumer may bring suit in the courts of the state in

[38] *Supra* n. 19, at 279.

which he is habitually resident, if the consumer's claim relates to trade or professional activities that the defendant has engaged in or has directed to that state irrespective of the terms of the contract.

Even the Brussels Convention restricts the freedom of contract in online transactions, limiting the recognition of jurisdiction clauses only to non-consumer contracts. Article 5 of the convention prohibits the choice of law made by the E-Contracts from depriving the consumer of the protection afforded to him by the mandatory rules of the law of his country, including the consumer's right to sue and to be sued in his or her domicile.[39]

There has been an ongoing effort to form new rules that would apply to the online environment reflecting a growing consensus to accord appropriate respect to the freedom of contract of the parties, while providing some protection to the consumers in terms of reasonability for facilitating the development of electronic commerce.[40] However, there are no strong and pervasive laws as such for E-Contracts at present at the international level, both for determining the governing law of the contract, as well as the establishment of the *forum conveniens*, and the recognition and compulsory enforcement of such decisions in other jurisdictions. What could be done at best is to frame an international convention for the recognition, enforcement, and determination of the substantive laws of a contract that would solve various problems relating to E-Contracts at a practical level.

Conclusion

A separate law on E-Contracts would be redundant. Addressing the challenges presented by technology to contract law merely involves refashioning existing principles—a case of old wine in new bottles. This paper has addressed an entire gamut of legal issues that arise in the context of E-contracts—from breaking down its myriad forms to a few archetypes, to a note on consumer protection in international transactions. As there is little to add in terms of substantive arguments, the authors would like to emphasize certain findings and summarize them by way of a conclusion.

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[39] M. Chissick and J. Radler, *Electronic Commerce: Law and Practice* (London: Sweet and Maxwell, London, 1999).

[40] J.A.E. Faria, "The United Nations Convention on the Use of Electronic Communications in International Contracts - An Introductory Note," 55(1) *International and Comparative Law Quarterly* (2006) at 689.

First, all forms of E-Contracts ought to be made as conspicuous as possible to satisfy legal standards of notice of terms. Its binding legal nature ought to be impressed upon the end-user, and browse-wrap notices must ideally only be supplemental to a contract that the user has already manifested his assent to. The instantaneous nature of electronic transactions also invites a re-conceptualization of the mailbox rule of contract formation, and this is reflected in both case-law as well as provisions of the IT Act, 2000.

With respect to the status of software contracts, it has been noted that rights such as perpetual possession cannot be treated as dispositive. Given the fact that software tends to be heavily encumbered by restrictions that detracts from ownership as it is conventionally understood, software contracts ought to be treated as licenses. Finally, E-Contracting greatly reduces geographical barriers and increases the probability of consumers entering into transnational contracts. This raises several issues of private international law, and the legal regime here is quite obscure. There is no clarity or uniformity since countries tend to apply their own domestic laws on jurisdiction, recognition and enforcement, and determination of the applicable law. The need of the hour is an International Convention that would provide a holistic basis for the development of substantive and procedural aspects of E-Contracts.

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Hospital Contracts

Ganeev Kaur Dhillon,
Shivani Singhal, and *Srijoni Sen*

This chapter is concerned with consent forms, which generally take the form of a contract between a doctor and a patient. However, depending upon the nature of the relationship between the doctor and the hospital, the hospital may also be held liable if the doctor fails to obtain the requisite consent. In the first section, the authors delineate the contours of this patient–doctor–hospital relationship. The second section specifically looks at the consent requirements in India, while the third section attempts a comparative analysis of what constitutes informed consent in the United States, the United Kingdom, and India. Finally, in Section Four the authors propose certain amendments in the current legal regime governing consent forms.

The Legal Relationship between a Doctor, a Patient, and a Hospital

The Doctor–Patient Relationship

It was held in the case of *Indian Medical Association* v. *V.P. Shantha*[1] that a doctor–patient relationship is legally a contract for professional services. Therefore, the doctor–patient relationship is contractual. According to the Indian Contract Act,[2] a contract is valid only if it is entered into with the

[1] 1995 (6) SCC 651.

[2] Section 10 read with sec. 13, Indian Contract Act, 1872.

free consent of the parties concerned.[3] However, in the case of *Parmananda Katara* v. *Union of India*,[4] the Supreme Court held that every doctor is required to provide medical aid, especially in case of an emergency. The court additionally held that the right to medical treatment was part of the Article 21 rights. Therefore, a doctor may be compelled under law to provide treatment, which goes against the doctrine of freedom of contract.

Further, medical practitioners are governed by the Indian Medical Council Act, 1956 and the Code of Medical Ethics[5] made by the Medical Council of India, which regulates their professional conduct and relationship with patients, and also provides for disciplinary action by the Medical Council of India for professional misconduct. Also, since the medical profession has been regarded as a part of "service" as defined in sec. 2(1)(o) of the Consumer Protection Act, 1986,[6] a doctor may also be held liable for deficiency in service.

A contract for medical treatment may be expressed or implied. Apart from consent forms, most doctor–patient contracts are implied contracts. It has also been held by the Supreme Court that a doctor who offers medical treatment implicitly undertakes that he is possessed of the necessary skill and knowledge. He owes the patient certain duties: a duty of care in deciding whether to undertake the case, in deciding the nature of the treatment, and a duty in the administration of that treatment.[7] It is further implied that the doctor will not divulge information about the patient except in certain circumstances such as where required by law.[8]

The Hospital–Patient Relationship

As far as treatment in a nursing home or private hospital is concerned, the same is treated as a service under the Consumer Protection Act. This means that a patient may sue a doctor or a privately-owned hospital in the Consumer Protection Forum. The same, however, is not true of government hospitals, which are seen as being charitable institutions, and therefore not a "service" for which is a fee is paid, as required by the Consumer Protection

[3] Section 10, Indian Contract Act, 1872.

[4] AIR 1986 SC 2039.

[5] Indian Medical Council (Professional Conduct, Etiquette and Ethics) Regulations, 2002 (hereinafter "the Code of Medical Ethics").

[6] *Supra* n. 1.

[7] *Supra* n. 1.

[8] Purosottam Behera, *Medical Law and Ethics* (New Delhi: Mittal Publications, 2007) at 8.

Act. The case of *V.P. Shantha* held that only those hospitals and medical practitioners who offer free service would be exempted from the Consumer Protection Act.

The next question that arises is the extent of liability of a hospital where it is not its own negligence that is in question, but the negligence of one of its doctors. This had been the subject of significant debate in the United States. It is clear that a hospital is liable for the negligence of its employees while they are acting within the scope of their employment, due to the application of the doctrine of respondent superior which holds a hospital vicariously liable for the negligent acts of its employees.[9]

The question, however, still remains of whether, in a specific situation, a doctor is the employee of the hospital, or merely an independent contractor, and if the latter, whether the hospital is still liable. This is a debate that continued for quite some time in different jurisdictions, where courts would look at the level of control exercised by the hospital to determine whether the doctor could be characterized as an employee.[10] Ultimately, even where no actual employer–employee relationship exists between the doctor and the hospital, and the relationship is that of an independent contractor, the hospital may still be held liable under the doctrine of ostensible agency or apparent authority, where it appears to the patient or to an outsider that the hospital has authority over the actions of the medical practitioner, as happens in most cases.[11]

The Concept of Consent

A doctor must obtain the consent of the patient. Consent is defined in sec. 13 of the Indian Contract Act as when "two or more persons agree on the same thing in the same sense." Consent particularly in the case of medical

[9] Mark A. Hall, Mary Anne Bobinski and David Orentlicher, *Health Care Law and Ethics* (New York: Aspen Publishers, 2003) at 163.

[10] In determining the degree of control, courts have considered questions such as who bills the patient for services provided, whether the physician is free to practice elsewhere, who determines the physician's fees and who is the custodian of the medical records.Yoquinto, William D. and Mackenzie C. Monaco, "Must Hospital Vicarious Liability for Non-employee Physicians Continue in the 21st Century?" 13(1) *Health Law Journal* 19 (2008).

[11] In Australia, it is now well established that a hospital is vicariously liable for the negligence of those who provide health-care services in its name, regardless of whether the provider is an employee or an independent contractor of the hospital. See, Cowdrey, Michael L. and Melinda Drew, *Basic Law for the Allied Health Professions* (Boston: Jones & Bartlett Publishers, 1995).

treatment is further required under the Code of Medical Ethics. Regulation 7.16 requires that consent be obtained in writing from the husband or wife, or the patient, or the parent in case of a minor, as the case may be, before performing an operation. It also states that for an operation that results in sterility, the consent of both the husband and wife would be needed. The failure to obtain such consent is deemed "professional misconduct" under the regulations.[12] In English law, failure to obtain consent may result in a possible tort action of assault or battery.[13] In India, however, such action is rare and the relationship between a doctor and a patient is not as litigious, barring actual negligence. Nevertheless, obtaining consent, either oral, or in hospitals, through a consent form, particularly for any operative procedures, remains a standard practice.

The next question that arises is who is capable of giving consent. While this will be discussed in some detail in the next section, in brief, in case of minors or the mentally ill, a guardian is legally recognized as capable of giving consent, in all other cases, it is the patient whose consent must be obtained. However, it has been recognized that in cases of emergency where the treatment is necessary and cannot be postponed, where the patient is in no condition to give consent, the consent of a family member may be obtained.[14]

Consent Forms

The first question that arises, when it comes to a consent form signed at a hospital, is whether it is contractual in nature. It is argued that since a contract usually contains undertakings from both parties to perform certain duties, a consent form is not a contract since it contains only the undertaking of the patient. The form usually states that the procedures to be performed have been explained to the patient, who agrees to have the treatment administered to him. It may state that the patient agrees to do anything required by the doctor before, after, or during the treatment. Therefore, a consent

[12] Chapter 7, Code of Medical Ethics Regulations.

[13] Neil C. Manson, "Consent and Informed Consent," *Principles of Health Care Ethics* (Richard E. Ashcroft, Angus Dawson, Heather Draper and John R. McMillan eds, Chichester: John Wiley and Sons, 2007) at 301.

[14] Monique F. Jonas, "Competence to Consent," *Principles of Health Care Ethics* (Richard E. Ashcroft, Angus Dawson, Heather Draper and John R. McMillan eds, Chichester: John Wiley and Sons, 2007) at 255.

form is more in the nature of a "unilateral commitment" or undertaking like a power of attorney handed over to a doctor.[15]

Judicially, the concept of consent has been expanded to require that the consent obtained must be *informed consent*,[16] and it must be obtained for the *specific* procedure in question. Therefore, it is not sufficient for the form to mention that the patient consents to all treatments administered—instead, the specific procedures must be mentioned. Further, the procedure must be explained, preferably in the local language, in comprehensible, non-medical terms, and must include details of the diagnosis, nature of treatment, risks and benefits, and chances of success and failure. The consent form must be accurately and unambiguously worded.[17] A consent form does not shield a medical practitioner or hospital from any alleged negligence. Insertion of a clause in a standard consent form exonerating the hospital or its staff from any liability arising out of negligence is not valid, as it goes against public policy as per sec. 23 of the Indian Contract Act.

A Comparative Analysis of what Constitutes "Informed Consent"

As mentioned earlier, in order to be valid the consent must be an *informed* consent. In other words, the doctor must have obtained the patient's consent after making adequate disclosures regarding the proposed treatment. While absence of consent renders a doctor liable for assault or battery, obtaining consent without disclosure of all material information may render him liable for negligence since it amounts to a breach of duty of care.[18] Consequently, it is important to establish what constitutes informed consent, that is, the standard of disclosure that a doctor is required to comply with.

Courts in different jurisdictions have expressed varying opinions regarding the standard of disclosure. They have been influenced either by the specific socio-economic conditions prevailing within their jurisdiction, or practical considerations. The US courts by and large seem to have adopted a patient-centric approach. In *Salgo* v. *Leland Stanford Jr. University Board of*

[15] S.V. Joga Rao, *Medical Ethics – A Ready Referencer* (Bangalore: Legalaxy Publications, 2004) at 84.

[16] *Samira Kohli* v. *Dr. Prabha Manchanda*, (2008) 2 SCC 1.

[17] *Supra* n. 8.

[18] R. Gatter, "The Mysterious Survival of the Policy against Informed Consent Liability for Hospitals," 81 *Notre Dame Law Review* 1203 (2006).

Trustees,[19] the first US case which dealt with the issue of informed consent, it was held that a doctor is under an obligation to disclose all the facts which are necessary to form the basis of an "intelligent consent" to the proposed treatment. This standard which favored full and absolute disclosure of all risks, subject to the patient's mental and emotional condition, was replaced by that of reasonable disclosure in *Natanson* v. *Kline*.[20] The doctor was required to disclose only those consequences of treatment which a reasonable doctor would disclose in similar circumstances.

However, in *Cantebury* v. *Spence*,[21] the older standard favoring a higher level of disclosure was partially revived. It was held that the doctor must disclose all facts and risks which would be *material* to a patient's decision to undergo the treatment. But this standard is slightly lower than that in *Salgo* because it is an objective one. The doctor is required to disclose only those facts that a hypothetical reasonable patient would consider material.[22] He is under no obligation to consider the individual needs of a patient in deciding what constitutes material information. Hence, *Cantebury* has replaced the "reasonable doctor test" with the "reasonably prudent patient test." While most US courts continue to abide by this objective test, some of them have shown an inclination toward a more subjective standard.[23]

The UK courts have declined to impose such a high standard of disclosure on doctors on the ground of practical considerations. In *Sidaway* v. *Board of Governors of Bethlem Royal and the Maudsley Hospital*,[24] the House of Lords applied the professional standard, popularly known as the *Bolam's* test,[25] in determining the standard of disclosure required for informed consent. It held that deciding which risks should be disclosed is as much an exercise of professional skill and judgment as any other part of the doctor's duty of care toward an individual patient. As such, a doctor's duty of disclosure is satisfied if he discloses as much information as would be considered proper by a responsible and respectable body of medical opinion. Hence, full disclosure is not necessary as long as the doctor acts in accordance with accepted practice.

[19] 317 P. 2d 170 (1957).

[20] 350 P. 2d 1093 (1960).

[21] 464 F 2d. 772 (1972).

[22] R.A. Heinemann, "Pushing the Limits of Informed Consent: Johnson v. Kokemoor and Physician-Specific Disclosure," *Wisconsin Law Review* 1079 (1997).

[23] *Ibid.*

[24] [1985] 1 All E.R. 643 (HL).

[25] It was laid down in *Bolam* v. *Friern Hospital Management Committee*, [1957] 2 All E.R. 118 (QBD).

Though the majority in *Sidaway* appreciated the underlying rationale of the *Cantebury* approach, yet it was discarded as being impractical since a doctor cannot be expected to educate the patient to his own standard of medical knowledge encompassing all the relevant factors. Sometimes if a doctor discloses a remote risk, it may assume a disproportionate significance in the patient's decision making. Also, the *Cantebury* test is rather imprecise because it leaves it to the judge to decide what a reasonable patient would consider a material factor, thereby giving rise to unpredictability in litigation.

The *Sidaway* decision, which reflects the principle of medical paternalism, has been criticized on the ground that it gives too much leeway to the doctors, and hence undermines the significance of the concept of informed consent. A doctor can escape liability for non-disclosure by either pleading an error in judgment, or proving that there exists a respectable *minority* opinion against such a disclosure.[26] Further, exercise of clinical judgment in deciding the best method of treatment is not the same as deciding whether the patient should undergo treatment at all as the latter entails consideration of several non-medical factors as well.

In spite of the above shortcomings, the Indian judiciary has followed the UK approach. In *Samira Kohli* v. *Dr. Prabha Manchanda*,[27] the Supreme Court applied the *Bolam's* test, which had previously been accepted by Indian courts,[28] to informed consent as well. It held that consent should be real consent, based on "adequate information," implying that there is no obligation to disclose remote risks. The information should allow the patient to make a balanced decision, without being deterred from agreeing to a necessary treatment on account of remote risks. In endorsing the *Sidaway* approach, the Supreme Court was strongly influenced by the ground realities of health care in India. Introducing the American standard of disclosure would have entailed a hike in the cost structure, which the people of India may have been unable to afford. In addition, a large majority of the population being illiterate and poor, informed consent had little significance for them. The court also took into account the nature of the doctor–patient relationship in India. It found that the relationship was based on trust and implicit faith in the advice given by the doctor. In order to foster this relationship the reasonable doctor standard should be adopted.

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[26] B.S. Venugopal, "Informed Consent to Medical Treatment," 46(3) *Journal of the Indian Law Institute* 393 (2004).

[27] *Supra* n. 16.

[28] See, *Supra* n. 1; *Achutrao Haribhau Khodwa* v. *State of Maharashtra*, MANU/SC/0600/1996; *Vinitha Ashok* v. *Lakshmi Hospital*, MANU/SC/0583/2001.

This judgment also reaffirmed that the informed consent must be for the particular treatment. Consent given for a specific treatment will not be valid for another treatment, or for any additional surgery to which the patient has not specifically consented, even if it is beneficial for the patient, or would save him considerable time and expense. The only exception is where there is imminent danger to his life. Here surgery without consent can be justified using the principle of necessity. In this case there was no consent to the surgery and the court held that it amounted to assault and battery. However, since the doctor had acted in good faith and for the benefit of the patient, she was not held liable for it.

The foregoing case indicates that even where there is *no* consent, it is possible for the doctor to escape tortious liability because of the strong presumption of validity in favor of exercise of clinical judgment. This trend is discernible in other judgments as well. For example, in *J.N. Srivastava* v. *Rambiharilal*,[29] the doctor removed the patient's diseased gall bladder in the course of an appendicitis operation. The patient died because she could not withstand the trauma of surgery. The court upheld the doctor's decision to remove the gall bladder without obtaining specific consent since he had acted with reasonable care, and in good faith. Though it might be difficult to establish tortious liability in such cases, yet under Regulation 7.16 of the Code of Medical Ethics, it would amount to professional misconduct, and the doctor could be subjected to disciplinary action by the Medical Council of India.

The fact that courts do not attach enough importance to consent forms is evident in *Dr. T.T. Thomas* v. *Elisa* as well.[30] Here the doctor did not operate on a patient who had refused to sign the consent form even though he was in need of immediate surgery. The court disapproved of the insistence on consent forms. It observed that the purpose of a consent form was only to protect the doctor. Hence, Indian courts do not view consent forms as a necessary means of upholding bodily self-determination, and protection against unauthorized treatments.

Requirements of Special Consent Forms

The basic custom of consent forms that is followed across the country in most hospitals is what may be termed as the "standard practice." It falls far

[29] AIR [1982] MP 132.

[30] AIR [1987] Ker 52.

short of the "ideal practice" guidelines enunciated by various international agencies and experts in the field. Not only is it deficient vis-à-vis international standards, the standard practice is often not in consonance with the existing legal framework in India either. This section will deal with the requirements of the special consent forms and the manner in which legislation can contribute toward a regularization of the consent forms.

Consent forms can be of two types: general consent forms and special consent forms. General consent forms shield the hospital against claims of battery. The patient, by signing the form, indicates that he has consented to the administration of treatment and performance of medical examinations and investigations by the hospital. The form is of no use to the patient as it gives no details of the procedure or the treatment that will be given. Therefore, it is a unilateral agreement which protects the interests of the hospital.[31]

Special consent forms, on the other hand, while protecting the hospital from liability as in the case of the general consent forms, also include detailed descriptions of the patient's medical condition, proposed treatment, and risks. They manifest informed consent on the part of the patient. Though in some cases special consent forms are compulsory under law,[32] yet in many areas their procurement is left completely to the discretion of the hospitals and medical practitioners.[33]

Special consent forms are essential when the treatment is not run-of-the-mill. Special consent forms may include the following information:

1. The chances of success or failure of the given treatment.
2. The known side-effects of the treatment.
3. The circumstances under which the treatment will be cancelled.
4. The use of samples taken from the individuals in future tests or for the purposes of research, albeit anonymously.
5. The language of the form would be the language that the patient is most comfortable in.

The Transplantation of Human Organs Act, 1994

This Act deals with all the necessary forms and prerequisites for the authorization of organ transplantation. Chapter II of this Act comprehensively

[31] W.H. Roach, Jr, Robert G. Hoban, Bernadette M. Broccolo and Timothy P. Blanchard, *Medical Records & the Law* (Maryland: Aspen Publishers Inc., 1998) at 83.

[32] Such as in the case of federally funded sterilizations and research involving human subjects. *Ibid.*

[33] *Ibid.*

deals with the authority required for the removal of human organs and looks at the various situations that may arise.[34] It also provides the proforma for consent forms required under Transplantation of Human Organs Rules, 1995.[35]

General consent will obviously not be sufficient for the removal of organs from one person for the purpose of transplanting them in the body of another, but what the legislation achieves is more than that. The Act prevents any confusion in the matter and lays down unambiguously the conditions that the donor has to comply with. At the same time, it protects the hospital from any liability, if the consent has been received as per the provisions of the Act.

The law, however, is not always so unequivocal. Often, different legislations as well as the prevalent practice may be in direct contradiction to each other.

Medical Termination of Pregnancy

The medical termination of pregnancy, commonly known as abortion, is a sensitive issue for various reasons. As per the Medical Termination of Pregnancy Act, 1971, for a woman above the age of 18 years, only the express consent of the woman concerned is required. Similarly, the consent form given by the Ministry of Health and Family Welfare Guidelines for medical termination of pregnancy requires only the signature of the woman. International instruments too only require the consent of the person undergoing treatment.

The practice in India is, however, quite different. For abortion in particular (and other reproductive rights in general), the woman is often required to show the express consent of her husband or her family. The Code of Medical Ethics too is ambiguous on this point. Regulation 7.16[36] can be read to mean that the consent of the husband is required before carrying out any operation on the wife. Further, a reading of the recent judgment *Samar*

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[34] For instance, signing of consent form before the death of a person to donate, after the death of the person, in case of brain-stem death.

[35] http://www.medindia.net/indian_health_act/the-transplantation-of-human-organs-act-1994-authority-for-removal-of-human-organs.htm

[36] Regulation 7.16-"Before performing an operation the physician should obtain in writing the consent from the husband or wife, parent or guardian in the case of minor, or the patient himself as the case may be. In an operation which may result in sterility the consent of both husband and wife is needed."

Ghosh v. *Jaya Ghosh*[37] shows that the consent of the husband is essential for the medical termination of pregnancy to be legally valid.

Such contradictory requirements lead to confusion and chaos, not just for person undergoing the treatment, but also for the medical personnel concerned. The medical termination of pregnancy is only one instance of the prevailing ambiguity with respect to the requirement of consent.

Innovative Treatment

Special consent forms have an important role to play, even beyond properly informing the patient of the risks and benefits, where innovative treatments are being attempted in treating a patient. Laws regulating human experimentation and protection of research on human subjects entail strict and extensive requirements for obtaining patient consent. Apart from informed consent, standards for documentation and record retention also have to be regulated.[38] The explicit requirements for consent will of course vary depending on the specifics of the treatment, the health-care facilities, etc.[39]

For instance, even though there is no known cure for cancer, certain treatments seem to be more successful than others. These may be unorthodox or recent developments in the medical field and may not have been tested sufficiently for all possible side-effects. In such a scenario, it is of utmost importance that the patient understands all the nuances of the treatment and all the possible effects that it may have on him as well as the legal status of the treatment before deciding to proceed.

Suggestions and Conclusions

A study of the legal nature of the hospital–patient relationship in India reveals that although it is contractual in nature, an additional duty is also placed on the provider of medical care due to the right to medical treatment embodied in Article 21. Therefore, while the freedom of contract does exist between a doctor and a patient, it may be curtailed in cases of emergency. The next question that arises is the extent of legal liability of a hospital for

[37] [2007] 4 SCC 511.

[38] *Supra* n. 31, at 71.

[39] *Supra* n. 31, at 71.

the negligent acts of a doctor. Although in India this question has not been debated extensively, it is clear that a hospital will always be liable for the acts of those who are its employees, while in case of independent contractors the hospital may still be held liable under the principle of ostensible authority.

Since the relationship is contractual in nature, the concept of consent is very important. While consent may be implied, hospitals prefer to have it in writing through consent forms, which are supposed to outline specific procedures in clear language. However, a study of judicial pronouncements shows that while legally a consent form is protection against a tort of assault, such legal action is comparatively rare in India, where it is believed that there is a greater trust relationship with the doctor. Cases have shown that, even where there is no consent, tortious liability may not be established if it is proved that the doctor acted in good faith. Consent forms also are not considered very significant in India and courts have gone as far as to deny the need for signing forms where treatment is clearly for the benefit of the patient.

As of now, there are no clear guidelines as to the form or language of consent forms. The consent form is looked at largely as a formality and a nuisance on the part of the patients as well the medical personnel. But in light of the facts that consent forms can and do play an important role in the understanding of the treatment being provided to the patient, consent forms need to fulfill the role expected of them. It is suggested that a clear demarcation needs to be given between the cases requiring general and special consent. In certain situations, such as unauthorized additional surgery where there is danger to life, consent can of course be implied. It is indeed necessary for the consent to be assumed in such cases. While general forms can continue to be used for the most mundane of treatments carried out by the hospital, it is more constructive to all concerned that the consent form gives more information of the treatment being handed out. It gives the patient greater knowledge of the procedures and medical examinations facing him. At the same time, informed consent on the part of the patient exempts the hospital from any chance of liability being slapped on them later during or after the treatment. One method that can be employed for improving the regulation of consent forms is to lay down comprehensive and detailed rules for various aspects such as the standard of disclosure for informed consent, the specifications of the treatment to be administered, the language and the format requirements as well as clarifications on who can give valid consent.

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Entertainment Contracts

Ananya Chandra, Cuddapah Nanda Gopal, and *Poongkhulali B.*

Introduction

Entertainment, across the world as a source of enjoyment, has undergone a sea change with it no longer being just a pleasurable distraction. It now involves many multi-billion dollar industries dedicated to making huge profits through the delivery of various forms of entertainment to the consumer. The Indian entertainment industry itself was estimated to be more than Rs 20,000 crore 2 years ago and was estimated to grow at 18 percent by 2009.[1] As the stakes involved are huge, with the budgets of many of the entertainment products running into hundreds of millions of dollars, the clauses in the various contracts assumes importance and so a need to analyze these clauses arises.

Analysis of entertainment contract clauses cannot begin without first looking at what is an entertainment contract. This is where the first challenge arises. The word entertainment is quite generic with it including industries like music, film, theatre, live stage performances, videogames, sports, adult films, and casinos, among many other things.[2] Under each industry, there are a number of contracts that are entered into, behind the entertainment product. For example, in the making of a film, the producer

[1] Deepak Kapoor, "The Indian Entertainment Industry: An Unfolding Opportunity," *Media and Entertainment Insights* (May 2005).

[2] Entertainment is defined as something affording pleasure, diversion, or amusement. Source: www.dictionary.com. With such a wide definition, all the above-mentioned industries will come under the ambit of entertainment.

will enter into different contracts with the scriptwriter, actors, music director, director, etc. All of these will come under the ambit of entertainment law as they are contracts entered into for the creation and distribution and broadcast of the entertainment product. Defining an entertainment contract in this scenario is no easy task. For the purposes of this chapter, however, the authors have attempted a generalized definition of an entertainment contract.

An entertainment contract can be defined as a contract entered into by the various players of the entertainment industry. Though there are different types of contracts within the entertainment industry, many of them have certain clauses that are common among them and are unique to the entertainment field. Almost invariably, entertainment contracts will have clauses pertaining to intellectual property rights, restraint of trade and exclusivity, finances and payments, breach and dispute resolution. The equation changes when one of the parties involved is a minor. In India, generally contracts with minors are considered to be void except in the case of necessity.[3]

In India, entertainment contracts are generally governed by the Indian Contract Act, 1872, The Specific Relief Act, 1963, Indian Copyright Act, Telecom Regulation Authority of India Act, Broadcasting Regulations under the TRAI Act apart from various committee recommendations. As such there is no one regulation of entertainment contracts in India.

Through the analysis of the above-mentioned clauses, it is intended to show that entertainment contracts are highly specific to the industry and a lot depends on the factors affecting the industry.

Copyright Issues in Entertainment Contracts

Creativity may well be at the heart of entertainment, but its economic exploitation is the driving force behind the entertainment industry. One of the most crucial aspects of entertainment law is protection and acquisition of copyright, or to put it simply, "the right to copy" (though copyright in fact offers a bundle of rights). The industry places immense reliance on contractual relations to protect the perceived copyright interests of its various constituents, to name a few—artists, producers, writers, and directors. However, in the game of who gets to exploit how much, there are some

[3] Section 11 of the Indian Contract Act, 1872.

clear winners. Unequal bargaining power and asymmetries of information, coupled with a copyright law that favors dominant financial interests, enable producers and record companies to garner the various copyrights that subsist in the underlying works that form parts of the composite whole such as a film or music record.

Copyright in Entertainment Law

Indian copyright law follows common law tradition and is largely modeled on the UK Copyright Act, 1956. Accordingly, sec. 13(1) of the Indian Copyright Act, 1957 ("the Act") offers copyright protection *inter alia* to musical works, sound recordings, and cinematograph films. Notably, separate copyrights subsist in the musical work and its fixation in a recording, as well as other underlying works such as the lyrics (which would qualify as a "literary work"). Cinematograph films require greater scrutiny. The Act defines a "cinematograph film" as a "visual recording on any medium produced through a process from which a moving image may be produced by any means and includes a sound recording accompanying such visual recording."[4] Thus, the distinction between the film as an original work of expression and its fixation in a recording is blurred; the Act makes only the latter amenable for copyright protection and the former is even excluded from the scope of "dramatic work."[5] Other underlying works such as the film script and musical works used for the film score continue to receive independent copyright protection.

The first owner of the copyright is always the author, except when the work is made in the course of employment under a contract of service, in which case the employer becomes the first owner.[6] The use of the term "author" suggests that the actual creator of the work is sought to be protected and is thus anomalous when used in relation to cinematograph films and sound recordings, for which the Act bestows the copyright ownership on the producers. The dual justification that is often given for making the producers the author is that it is their capital and skill that leads to the

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[4] Section 2(f) of the Act.

[5] Section 2(h) of the Act. Under the new UK Copyright, Designs and Patents Act, 1988, the position has changed and the specific exclusion of cinematograph films from the definition of dramatic works has been removed. Whether this amounts to an acceptance that the original cinematograph work can amount to a dramatic work was discussed and accepted in the landmark decision of *Norowzian* v. *Arks Ltd (No 2)*, [2000] FSR 363.

[6] Section 17(c) of the Act.

production and distribution of the recording, and that it is practically unfeasible to offer copyright protection to the host of actual creators that participated in the process of production. There also exists a historical justification, as copyright law originated as a demand made by publishers, booksellers, and printers to protect their business investment, rather than from authors. Consequently, common law tradition generally viewed copyright as little more than the right to copy.[7]

Indian copyright law has undergone two positive developments signifying indirect recognition of the contribution of actual creators. First, a 1984 amendment to the Act introduced the concept of "moral rights," as a result of India's obligations under Article 6b is of the Berne Convention, 1886.[8] Section 57 of the Act confers upon the author the rights of paternity (to claim authorship of a work) and of integrity (to protect his honor and reputation and prevent distortion, mutilation, or other alterations of his work). Additionally, the author retains these rights even after assignment of the copyright to the work.

Second, following India becoming a signatory to the Rome Convention, 1961,[9] an amendment in 1994 to the Act introduced the neighboring right of performers under sec. 38 (defined to include an actor, singer, or musician[10]) to protect them against certain acts they have not consented to, such as broadcast and other communication to the public of their live performance or its fixation or reproduction. Since protection is contingent on the lack of consent of the performer, once consent has been given by a film performer to incorporation of the performance in a cinematograph film, sec. 38(4) takes away the operation of the right. Moreover, India continues to shy away from signing the World Intellectual Property

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[7] Jeremy J. Phillips, Robyn Durie, and Ian Karet, *Whale on Copyright* (4th edn., London: Sweet & Maxwell, 1993) at 5. This reductive view of copyright law has been sharply criticized in literature. See Fionna Macmillan, "The Cruel ©: Copyright and Film," 24(10) *European Intellectual Property Review* 483 (2002); A. Barron, "The Legal Properties of Film," 67 *Modern Law Review* (2004). Civil law countries follow an alternative conception of copyright protection, and view the actual creators as the intended recipients of protection. While a string of European Union directives have attempted to harmonize the two approaches to copyright protection, the conceptual confusion surrounding the source of copyright still exists. See Pascal Kamina, *Film Copyright in the European Union* (Cambridge: Cambridge University Press, 2002).

[8] Berne Convention for the Protection of Literary and Artistic Works, September 9, 1886, Berne.

[9] International Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organizations, October 26, 1961, Rome.

[10] Section 2(qq) of the Act.

Organization (WIPO) Performances and Phonograms Treaty, 1996 which sought to replace the Rome Convention and offers greater protection to performers.[11]

Securing Copyright through an Entertainment Contract

Whatever be the misgivings against concentrating copyright protection of the recording in the hands of the producer, it is perhaps best to see this as a necessary evil. Taking the film industry as the template, a complex web of negotiations and contractual relations assist the producer in ensuring that the film project is not plagued by copyright claims from all those who assist and/or participate in the production.

The underlying works have to be secured, either by assignment, license, or a release. Assignment of copyright is the industry practice, except when published music is being used for a film, in which case it is more common for the record company to give a non-exclusive license to the film producer.[12] Section 18 of the Act allows the owner of the copyright to assign the copyright, wholly or partially and for the entire term of the copyright or less. A salient feature of most scriptwriter or songwriter agreements in the film and music industries respectively is the transfer of full copyright, and all rights subsisting therein, to the producer. Songwriter contracts differ by often extending the transfer of rights to future compositions as well. The proviso to sec. 18(1) states that in such a case, the assignment takes effect only when the work comes into existence.

Depending upon the bargaining power of the original creator, they may be able to bargain with the producer to retain certain rights (for example, the right to dramatize on the stage). The producer must, however, insist on certain ancillary rights, such as multimedia and merchandizing rights, as these are likely to be demanded by distributors at the time the distribution agreement is negotiated.[13] Also, the standard practice is to engage writers on

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[11] Interestingly, at the time of negotiation of this treaty, India and the United States (due to powerful lobbying by Hollywood and Bollywood) ensured that the treaty did not apply to audio-visual performances, thus denying film performers of its protection. Macmillan, "The Cruel ©: Copyright and Film," 24(10) *European Intellectual Property Review* 483 (2002) at 492.

[12] *Film Business: A Handbook for Producers* (Tom Jeffrey ed., Australia: Allen & Unwin, 1995) at 98.

[13] "Filmmaking and Copyright Law: Negotiations, Rights and Releases in Film Contracts," available online at www.gibson-henlin.com/articles/film_making_and_copyright_law.pdf (accessed on October 2, 2008).

a work-for-hire basis—in which case the producer becomes the first owner. Such a contract of services then provides for the benefits that will accrue to the writer, including credit and compensation.[14]

Section 19 of the Act requires that the assignment be in writing to be valid, but courts usually do not insist on a full-fledged contract.[15] Subsection (2) directs that the assignment deed should clearly identify the work in question, and should specify the exact nature of rights assigned and the duration and territorial extent of such assignment. Subsection (4) imposes a duty on the assignee to exercise the rights assigned within 1 year from the date of assignment, or else the assignment is deemed to lapse, except if specified otherwise in the deed. If the deed does not provide for a period of assignment, then Subsection (5) deems that the assignment is for 5 years. Similarly, Subsection (6) states that in the absence of specified territorial extent of assignment, it will be deemed to be within India.

As an alternative to transfer of ownership, creators may choose to transfer only an interest. This, however, would not usually be acceptable to producers as later on distributors, investors, and film finance bodies insist on establishing a chain of title to all the underlying works.[16] License under Section 30 of the Act is again required, to be in writing.

If the film is based on another literary work (called an "adaptation") or the record producer plans to sample an earlier piece of music in the making of a new record, it is common to enter into an option/purchase agreement with the author of that work. Under the agreement, the author grants an exclusive option to the producer to purchase at any time before a specified period, for a further sum, the exclusive rights to the work in the form of an assignment. The author also undertakes not to dispose or deal with the rights in the work in a way that would prevent such rights to be transferred to the producer within the option period. If the producer fails to exercise the rights within the option period, the right reverts back to the author. It is also beneficial for the producer to incorporate a clause in the agreement allowing him to make modifications to the work, to prevent a claim based on moral rights.[17]

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[14] See Rabin, Susan and Christopher Q. Pham, "Authorship Issues in Entertainment Contracts," 29 *Los Angeles Lawyer* (10) (2006) at 10.

[15] As was held in *Effects Assocs., Inc.* v. *Cohen*, 908 F. 2d 555, 557 (9th Cir. 1990), "[T]he writing in question doesn't have to be the Magna Carta; a one-line pro forma statement will do."

[16] *Supra* n. 12, at 98.

[17] *Supra* n. 13.

The producer must next obtain releases to obtain consent to use a person's property. The most important release is with performers, whose release is usually part of their contract of services. The release agreement would bestow upon the producer the right to exhibit, advertise, or exploit the performer's appearance in the film, as well as any photographs taken or voice recordings.[18]

Obtaining music releases for the music used in the film is more omplicated. Usually, songwriters and composers transfer their ownership in copyright to the publisher, who then becomes the owner. So the producer must seek consent depending on who owns the rights. If a sound recording is used, then permission must be given by the record company that owns the copyright under a Master Use License agreement. This agreement is always signed in conjunction with a Synchronization License agreement, under which permission is given to use a song when synchronized with visual pictures in the film. Additionally, the producer must also obtain a Theatrical Performance License agreement, for performance of the music in cinema halls.

If the producer plans to have a sound-track album released along with the film, he should enter into a separate agreement with the record company that will be producing and distributing the music, as well as with any foreign record distributors to whom the record company has given an exclusive license to distribute in a particular territory. Often, artistes signed on by record companies other than the film's distributing record label are used in the sound-track, in which case the producer must get a release from those other record labels seeking permission to use their artistes.[19]

Clauses in Restraint of Trade

One of the essential elements of the success of any entertainment production is the fact that it is "one of a kind." It is also highly essential that the actors concerned are available for the shooting and related aspects of the production and are not pre-occupied with too many other commitments. These are some of the reasons why certain clauses which ensure such exclusivity find place in entertainment contracts between actors and producers, music artistes and the recording company, and so on. These clauses usually ensure

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[18] See http://www.dependentfilms.net/download/performerrelease.txt (accessed on October 2, 2008) for a sample performer release form.

[19] *Supra* n. 13.

that the actor is present for all the shootings of the production and does not sign any other contract which will conflict with the existing contract and its terms. These clauses may also say that the actor will not enter into any other contract where he would perform a similar role or perform with the same crew for a specified period of time. There could also be clauses which restrict his right to endorse certain products or undertake certain activities, or which may be in conflict with his image in the upcoming production. The main issue is that these clauses are all considered to be clauses in restraint of trade and hence is void under sec. 27 of the Indian Contract Act, 1872.[20] The conflict, which requires settlement, is whether such clauses will fall under the reasonable restrictions on the restraint of trade, which the courts have allowed time and again.

Position in the United Kingdom

Under the Common Law, a contract in restraint of trade is void. But this doctrine is not applied to contracts, which are of exclusive nature unless it is such that the enforcement of the same will have to be done in an oppressive manner.[21] This happens if the enforcement of the clause would mean that the artiste is prevented from earning a living. Typically an artiste's recording contract will commit the artiste to the record company for an initial period, which may be extended for a number of option periods. In each period there is usually a product-delivery requirement. The payments are arranged in such a manner that after an initial payment, the remaining payments depend on the sale proceeds and the royalty from the same. Sometimes the recording company will not release the same and hence there will be no payment. At the same time they might seek to enforce the exclusivity clause. It is under these circumstances that the unreasonability of the clause is brought to the notice of the court and the court strikes it down since there is no obligation on the recording company to publish the same and hence it is an unfair term.[22]

The Nordenfelt test is usually used to test whether a particular term is in restraint of trade. A restriction is allowed only if it is reasonable between

[20] Section 27, Indian Contract Act, 1872.

[21] Andrew Evans, "Doctrine of Restraint of Trade with Respect to Music Industry Agreements," (March 2003).

[22] *Schroeder Music Publishing Company Limited* v. *Macaulay (formerly Instone)*, [1974] 1 WLR.

the parties and also if it does not offend public policy. Usually the burden of proof that the restriction is reasonable will fall on the manager, publisher, or record company. The aim is to balance the parties' interests—the artiste will wish to obtain the benefit of the contract without restricting himself unduly, while the manager, publisher, or record company in question will want to maximize its own benefit under the contract.[23] The case of *Esso* v. *Harper*[24] formulated a two-stage test to determine whether a situation attracted the doctrine. First, what are the legitimate interests of the party seeking to enforce the contract, which it is entitled to protect? Second, are the restrictions more than adequate for that purpose?

These are questions of fact depending on the business and circumstances of the case in question. It is established that restrictions are examined, as they would have applied to both parties at the date of formation of the contract. The court should consider it from the viewpoint of what may happen under the contract rather than looking at what actually has happened. The courts in England have also struck down what are known as "leaving member clauses" which essentially prevents a member of group of singers from leaving the group and entering into an agreement with another recording company.[25] Thus, the common law framework intervenes whenever there is any unfair term, which goes against the freedom of trade and public policy.

Position in India

The Indian courts so far have also played a pro-active role with respect to cases which involve contractual terms, which are unreasonable. But the Indian entertainment industry faces a different sort of a problem wherein cases with respect to restrictive covenants are rarely ever taken to the court. Interviews with some lawyers in the entertainment sector revealed that the extent of restrictive covenants in a contract was directly interlinked with the seniority and the popularity and position of the artiste in the industry.[26] While younger and newer actors with low bargaining power are often made to enter into contracts with extremely restrictive covenants, the more established artistes do not allow such terms to be dictated to them. The only

[23] *Nordenfelt* v. *Maxim Nordenfelt Guns and Ammunition Co. Ltd.,* [1894] AC 535.

[24] *Esso Petroleum Co. Ltd.*, v. *Harper's Garage (Stourport) Ltd.*, [1968] AC 269.

[25] *ZTT* v. *Johnson* (1990) EIRP 175.

[26] Interview with Mr. Kiran Desai of KAD Legal Consultants, Mumbai. Mr. Desai is one of the leading entertainment lawyers in Mumbai.

cases where these clauses are widely accepted and used is to ensure efficiency with respect to the shooting, etc., wherein the producer or the director ensures that his film gets the first priority among the different commitments which the actor might have.[27]

Thus, we find that the legal framework in this regard is not inadequate. There is protection available both in contract law and in constitutional law. The problem lies in the larger issue of the unorganized nature of the entertainment industry in India and the ad-hoc nature of many of the dealings, the high influence wielded by power and money, and the overall ignorance of the artistes to understand their rights.

Entertainment Contracts with Minors

The presence of child stars in the entertainment industry has been increasing in leaps and bounds in recent times. The trend of using child artistes in the entertainment industry is not uncommon and has been present world over and India is no exception to this trend. The contracts with minors are those agreements which are entered into between producers of entertainment and the legal representatives of the minor entertainer for the purpose of defining the terms, and conditions of the entertainment contract. The salient contractual principle that is involved in these contracts is the *capacity to contract*. This is because, under Indian law, contracts with minors are considered to be void unless the same is for necessities.[28] Hence, there is no possibility for the producer entering into a contract directly with the minor for the provision of entertainment. The main reason behind this is because minors are considered to be immature and incapable of understanding the full import of the agreement, which they are entering into.[29] The second issue arising out of such contracts is the ability of the producer to enforce such contracts in cases of breach.[30]

In India, the governing law with respect to these contracts, as with all other kinds of entertainment contracts, is the Indian Contract Act, 1872. Some of the other countries in the world have made some special provisions to

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[27] *Ibid.*

[28] *Mohiri Bibi* v. *Dharmodas Ghosh*, [1903] 30 Cal 539.

[29] *Ibid.*

[30] These clauses are void *ab-initio* according to Section 11 of the Indian Contract Act, 1872.

protect minors and govern such contracts. One of the most important legislations, which require examination in this regard, is the law enacted in the State of California in the United States.[31] In India, this is a huge lacuna in the law since it leads to problems to both sides. On one hand, there are instances where the minors are exploited since their bargaining power is really low, and they are exploited excessively. On the other hand, such contracts do not give the producers the legal right to enforceability since they are considered void in the first place and hence not valid in law. Hence, production houses and recording companies are sometimes left with huge losses in these cases since a lot of investment goes into the minor with respect to publicity, etc.[32] Thus, the production house loses out on the competitive edge that it has when minors pull out of contracts and do not honor them.

Law in the United States

In the United States, the minors have the right to disaffirm the contract at any point of time. This is based on what is known as the infancy doctrine.[33] This led to a lot of cases where the producers faced a lot of loss because the minors withdrew from their commitments midway through a particular venture. Hence, the State of California took the lead and enacted a law which specially governed entertainment contracts in which a minor is party to the contract.[34] This was followed by New York, Massachusetts, and Florida. According to this law, the courts have the power to approve the contract with a minor and once the same is approved, there is no scope of the same being disaffirmed by the minor.[35] This ensures that the entertainment industry does not lose out on their end of the bargain. The courts have clear guidelines as to the factors which must be looked into while approving the contract. The first and foremost principle that has to be checked is whether the contract is fair and reasonable; second, whether the educational and financial interests of the minor are adequately protected; third, whether the contracts provides enough opportunities for the development of the talent

[31] See Cal. Fam. Code 6750–53 (West 1994).

[32] T. Hardin, "The Regulation of Minor's Entertainment Contracts: Effective Californian Law or Hollywood Grandeur?"19 *Journal of Juvenile Law* (1998) at 376.

[33] Larry A. DiMatteo, "Deconstructing the Myth of the 'Infancy Law Doctrine': From Infancy to Accountability," 21 *Ohio National University Law Review* (1994) at 481.

[34] *Ibid.*

[35] *Supra* n. 31.

of the minor artiste; and lastly, if the chances of professional success of the minor are maintained and the same is not jeopardized in any manner by the terms of the contract.[36]

These contracts also ensure that the parents of these child artistes set some part of the earnings aside. This clause came into the legal framework since there have been several instances where the parents and the guardians of the minors have exploited the minors and their earnings leaving very little for their enjoyment and benefit. In fact it was the famous *Coogan* case[37] which brought the entire lacuna in the law to the fore and currently the courts while approving these contracts ensure that there are clear terms which lay down the percentage of the earnings which are to be set aside for the minor's benefit.

Indian Position

In India, there is no special law dealing with minors in the entertainment industry and the provisions of the Indian Contract Act are applicable. The industry practice is that the producer/production house enters into an agreement with the parents/guardians of the minor and through these agreements, the parents/guardians undertake to ensure that the minor performs all the terms and conditions of the contract. The parents sign what is called a "Minor release agreement." Through this agreement the parents grant permission for the recording of the minor's voice or to allow the minor to act in a particular production. This agreement also has clauses by which the parents agree to indemnify the production house in case of a loss arising due to non-performance and there is also an undertaking to the effect that the minor will not disaffirm the contract.[38]

Entertainment lawyers who deal with Bollywood agreements revealed that the industry practice favors those with money and in a bargaining position.[39] Most of the contracts are entered into with the parents.

It is highly recommended that India should have a legal framework which is broadly in the same lines as the basic principles in the Californian legislation. The Indian regulatory framework should ensure that every contract which is entered into with a minor should require the approval of the

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[36] *Supra* n. 32.

[37] This was the Charlie Chaplin case where the minor's entire earnings were used up by the parents leaving him in debt on attaining majority.

[38] Minor release agreement.

[39] *Supra* n. 26.

court and the courts while granting approval should take into consideration issues of justice, fairness, and the paramount interest of the minor and his professional career into account. Adequate provisions should be made to ensure their education and financial security. It is the duty of the law to protect the weaker parties and it is absolutely essential that the Parliament and the Judiciary take a pro-active role in this regard to prevent exploitation of minors, at the same time protecting the commercial viability of ventures which feature them.

Breach, Remedies, Dispute Resolution, and Guilds Clauses

To understand what constitutes breach and the remedies available one must understand the nature of the industry as the terms of the contract are dependant on the factors specific to an industry. In order to understand the factors an interview was conducted with two film producers, one from the Hindi film industry and the other from the Telugu film industry in South India. Both the producers noted that until a decade ago, most of the contracts entered into in India, and especially in the film industry, were oral contracts.[40] The effect of this was that in case of breach of terms, the remedy would not be enforceable by the court. As the stakes grew over the years, the producers started insisting on written contracts with the terms and conditions being tightly drafted. Both the producers noted that even though written contracts are insisted upon in the industry, it still plays a second fiddle to oral contracts and the trust that exists between the parties.

Just like in any other contract, breach of terms of entertainment contract will have certain consequences. However, what sets apart a breach of terms in entertainment contracts from a breach in other contracts are first, what is considered to be a breach and second, what sort of remedies is available for the breach.

According to K.L. Narayana, a producer in the Telugu film industry, the most important clauses in the contract between, say, an actor and producer, or a producer and the scriptwriter, are those pertaining to dates and

[40] K.L. Narayana is a producer in Telugu film industry and is also the President of the Telugu Film Producers Council for the sixth year in running. Anuj Saxena is a Television actor, and is also involved in the production of Hindi films, animation, and South Indian films.

exclusivity. In the case of an actor, the contract will specifically mention the starting and the ending dates between which the actor should be available for the project of the producer. Most of the time, the producer will ensure that the actor cannot enter into any other project without the prior consent of the producer during the period the actor is associated with the producer. In the case of the scriptwriter, the main clauses are those that concern delivering the script on time, to the satisfaction of the producer, and ensuring that the script is solely used for this film and not for any other project. While these are the major reasons for breach even in the Hindi film industry, another major constituent of breach is that of remuneration. According to Anuj Saxena, a producer in the Hindi film industry, non-payment of consideration is one of the major issues that causes dispute. The foregoing are a few examples of the types of breach of terms that generally occur in the film industry. Apart from these other types of breach could pertain to copyright infringement and licensing issues.

The question then shifts to the remedies that are available to the parties. As noted earlier, even though written contracts are insisted upon, most of them are based on mutual trust of the parties and generally the contract does not get drafted until the project is finished indicating that written contract is not of much importance.[41] Both the producers noted that breach of terms would generally not result in the parties going to court for remedy as first, the process is extremely long and second, given the fickle nature of the industry where anyone can become an overnight star, nobody would want to get on bad terms with the people involved and third, given the amount of money involved in the project, it is in no one's interest to go to the court of law to enforce remedies.[42]

On the other hand, assuming that the contract is valid and the aggrieved party seeks redressal, the possible remedies that are available to the aggrieved party is either damages or compensation or specific performance. Most of the actor–producer or scriptwriter–producer contracts are contracts for hire or contracts for personal service. Under the Specific Relief Act, 1963, sec. 14(1) provides that contracts which are dependent on the personal qualifications of one of the parties cannot be specifically enforced.[43] Thus, as most of the contracts are contracts of personal service, specific performance cannot be sought. The only other remedy then would be payment of certain amount of damages to the aggrieved party. It must be noted that most of the contracts will have clauses of exclusivity and restraint of

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[41] *Ibid.*

[42] *Supra* n. 4.

[43] Section 14 (1) (b) of the Specific Relief Act, 1963.

trade to ensure that the artiste or performer will adhere to the terms of the contract. These have already been dealt within the previous section.

On the subject of remedies available to the aggrieved, Anuj Saxena was of the opinion that as hardly any dispute ever goes to the court of law, hence whatever remedy is available to the aggrieved party is through private settlement. He noted that when a dispute arises, then a third person who is well known to both the parties acts as a mediator and tries to achieve an amicable solution. Nine times out of ten, a settlement is reached at this stage itself. The essential idea is to reach a settlement amicably and to avoid any conventional means of dispute resolution like arbitration or adjudication. K.L. Narayana said that the method of dispute resolution in the South film industry is different from that in the Hindi film industry but he asserted that whatever problems arise, they are to be kept in the industry itself to the extent that no lawyers are allowed to be a part of the dispute resolution.

In dispute resolution, another major factor that comes into play is that of the influence of the guilds or unions. Through the use of collective bargaining techniques, the guilds can safeguard the interests of its members much more effectively than a single party. In Hollywood, there are specific guilds that take care of the interests of the particular group. Unlike in India, guilds like Writers Guild of America and the Screen Actors Guild are quite powerful and take active part in negotiations with the studio houses in representing its members in the case of any dispute. These guilds negotiate a basic agreement with the production houses which are applicable to all its members. This agreement serves as the minimum terms and conditions which the production houses cannot contract without.[44] In case of any breach in terms of the Basic Agreement, either the guild or the writer can initiate court proceedings and in such an event both the guild and the writer will be bound by the court's decision.[45]

In India, however, the guilds or unions do not take such active part in negotiations with the production houses.[46] Associations like The Film Writers Association do not take an active part in negotiations or dispute resolution despite it being in the mandate of the association.[47] In South

[44] 2004 Writers Guild of America and the Alliance of Motion Pictures and Television Producers—Theatrical and Television Basic Agreement. This has articles pertaining to minimum compensation, credit acknowledgment, dispute resolution among many other things. Source: www.wga.org/content/default/aspx?id=1610.

[45] Article 12 of the Theatrical and Television Basic Agreement.

[46] *Supra* n. 4.

[47] The constitution of this association holds that one of the objectives of the association is to safeguard the interests of the writers in employment and living conditions.

Source: http://www.thefilmwritersassociationindia.com.

film industry, there is more active involvement of the unions in dispute resolution. According to K.L. Narayana, there is a federation consisting of all the associations in the film industry pertaining to each field. The governing body is the AP Telugu Film Producers Council which adjudicates any disputes that arises between the parties. If the party is aggrieved by the decision of the council then he can appeal to a Higher Committee within the Producers Council itself and the decision of the committee is final and binding.[48] While the decision of the council may not have any legal authority, it is generally followed as the consequence of not following it would be boycott of that party within the film industry.

While the legal validity of these methods of dispute resolution can be debated, this is the method that is followed at present in India. The dispute resolution mechanism in the South film industry is very organized although it leaves a lot more to be desired in terms of the part unions play in negotiations of the terms of the contract. In the Hindi film industry the existence of the guilds seems to have no practical utility with the production houses invariably having the upper hand. An ideal situation would be like the one in Hollywood, where there are written contracts that are enforceable and the minimum terms of which are negotiated by the guilds ensuring that there is no unequal bargaining power.

Conclusion

This chapter has sought to highlight the legal complexities encountered in negotiating an entertainment contract. The issues addressed here are just a few reminders that is mandatory to be kept in mind by the various parties while entering into such a contract. The challenge lies not only in the successful negotiation of the contract but also in avoiding the legal complications that can arise. Securing the various intellectual property rights requires a degree of thoroughness on the part of the producer. Allegations of unequal bargaining power often arise in this context, an issue that is addressed under the restraint of trade provisions of law. Certain protection to the weaker party may also be provided in the dispute resolution clauses. Nonetheless, it is imperative that the entertainment industry gears up for an age where artistes can no longer rely on their star power to protect their interests. There is a pressing need for model agreements drafted as per acceptable industry standards.

[48] *Supra* n. 4.

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Sports Contracts: Standard Players Contract

Dhruv Nath, *Krishna Hariani*, and *Rohini Kharkar*

Introduction

Over the centuries, sporting activities have achieved a significance of global proportions, involving not only the media and multi-million dollar corporations, but even states, governments, and the judiciary. Apart from the commercialization and commodification of sports, most club sports are now handled by professional leagues. In such a situation, sports contracts have assumed an increasing significance and form the founding block of club relationships.

Sports contracts define the rights and responsibilities of the various participants in the business of professional sports. The International Convention against Apartheid in Sports, 1985 defines a sports contract in the following manner:

> The expression "sports contracts" shall mean any contract concluded for the organization, promotion, performance or derivative rights, including servicing, of any sports activity.

Sports contracts are of several types, covering different aspects of the business that sports have now become. The following are some of the commonly used sports contracts:

1. The professional services/standard player contract
2. Endorsement contracts
3. Arena lease agreements
4. Student-athlete university scholarship agreements
5. Coaching contracts

6. Agent – player contracts
7. Appearance contracts

In this chapter, the researchers focus on the professional services or the standard player contract, which defines the relationship between the professional athlete and the employing club. Such a contract basically states the unique skills of the player, and the manner in which the club will control the activities of the player, while at the same time specifying the rights of both parties.

At the outset, it must be pointed out that sports law in India is, as yet, at an extremely undeveloped stage, with very little in the way of either scholarship or jurisprudence. This article attempts to highlight the legal issues that are likely to arise in the case of a standard player contract, bringing to light areas where greater judicial thought, and a possible revision of attitudes in the judiciary and the legislature, may be required.

The Salient Features of a Standard Player Contract

The standard player contract generally found across sports contains certain terms which are discussed hereinafter. It must be remembered that the source of the standard player contract is the Collective Bargaining Agreement (CBA) entered into between players' associations on one side, and the club and league management on the other. It not only provides for the contract, but also governs the application of a set of rules to the players and the clubs. Thus, the contract would refer to the CBA for a variety of reasons, including references to the CBA for certain rules, for example, drug use. However, as will be shown in the course of this chapter, due to the weaker bargaining position of the athletes, the CBA is hardly an accurate representation of the players' interests. Moreover, in the context of India, the researchers have been unable to find any similar agreement.

Title: As mentioned before, a sports contract could be of different types, making it important to signify the type of contractual agreement sought to be entered into. Thus, the agreement should be titled, in such cases, "Standard Player Agreement" or "Standard Player Contract."

Parties and Term: As in any other agreement, it becomes important to specify clearly the club and the player between whom this agreement is entered into. The duration for which this contract has been entered into between the player and the club/franchise is also significant.

Duty and Obligations: This clause specifies the duties and the obligations of the player, agreed to by both parties, and imposed consequently. This, usually first and foremost, obligation on the player signifies that the player has agreed to render his services and to play the particular sport for a particular franchise to the best of his ability.

Compensation: This clause lays down the compensation that the player receives for the duration of the contract. This clause also provides for the bonus, etc., that a player is entitled to, such as performance bonus. In the United States, the base compensation payable is equivalent but variable according to age/experience in the respective leagues, and the compensation tables can be found in the CBAs.

Deductions: This clause provides for the deductions to be made from the player's compensation package in case of certain fines imposed on him by the league or by the club for misconduct, etc.

Expenses: This clause discusses the expenses of the player to be borne by the club for games played outside of the home arena, and the nature of such expenses, including a cap on the expenses borne by the club.

Conduct: This clause provides that the player shall agree to be bound by the rules laid down by the club, and agrees to such other terms, including the duty to report to the club's training camp at the time and place fixed by the club in good physical condition; the duty to keep himself in good physical condition throughout the season; give his best services; participate in all promotional activities which in the opinion of the club promote the welfare of the club and the promotion of the league and the sport generally;[1] conduct himself on and off the field in accordance with the highest standards of morality, honesty, fair play, and sportsmanship; and any other obligation the club may impose on the player.

This clause also provides the penalty/fine, suspension, etc., that may be imposed on a player for the violation of club rules, or for any conduct impairing the faithful and thorough discharge of the duties incumbent upon the player. The player's conduct on and off the field must be differentiated—the player's conduct off the field, though may be punished, should not amount to termination unless it is of a very grave nature (such as the commission of crimes like rape or murder, and for offensive or racist words

[1] This is usually provided for in the CBA. There may also be a provision for allotting the rights over a player's attributes, name, nickname, photographs, pictures, playing skills, etc., to be used by the league.

spoken to the media or otherwise).[2] The player's conduct on the field also may be punishable in ways other than mere termination, such as through disciplinary proceedings.

Two important provisions that have been incorporated into such clauses have been those to prevent the payment to the player (otherwise then by the club) of any sum of money for the outcome of a particular match (to prevent betting, match-fixing, and other such evils); and for preventing the player from enticing, inducing, persuading or attempting to entice, induce, or persuade any player or coach to negotiate for or contract for such services as player or coach, or from negotiating on his behalf or on behalf of any such player or coach, except without the previous permission of the club.

Physical Condition: This clause deals with the physical condition of the player throughout the season. The player, under this clause, agrees and stipulates that he shall remain in good physical condition when he reports to the training camp, for matches, and throughout the season generally. If the player fails to remain in good condition, he may be suspended and the compensation due to him may be suitably deducted. Such clauses also provide for the situation where a player gets injured while working for the club, and the mode of repayment of expenses, etc. This clause also provides for the player being subjected to medical tests in case of likelihood of injury, etc.

Prohibited Substances: This clause prohibits the use of certain substances by the players in accordance with the CBA, and provides for the consequences in case a player is found to be abusing this policy. Often, the club may terminate the player's contract, or suspend him for a certain period, and in certain cases, even provide for rehabilitation of the player, and pending such rehabilitation, the suspension of the player. The Indian Premier League, for example, provides for termination, and National Basketball Association (America) has termination of the contract as one of the options. The Major League Baseball, however, has adopted a more lenient approach, and talks about rehabilitation. Possibly, a middle path could be found where a first-time offender is allowed to rehabilitate, while repeated offences would attract a more severe stricture, such as termination. However, judging by the rampant drug use by athletes in India, it may be advisable to maintain a

[2] Such as Allen Iverson who came out with a rap song with offensive lyrics, or an interview given by a baseball player to *Sports Illustrated*, which was very controversial for its contents—it had racist remarks, and other derogatory remarks against groups of people. Such remarks may be punished, and the level of offensiveness may determine the severity of the conduct.

strict law relating to use of prohibited substances by the players, and possibly, termination offers the best solution.

Unique Skills: This clause states that the player possesses unique knowledge, ability, and skill as a player, and the loss of such services rendered by him cannot be replaced or adequately compensated, and that on breach of this contract by the player, the player will cause irreparable damage to the club and the league.

Image Rights: This clause will typically include some provision necessitating the obtaining of permission from a player for use of his image for endorsements by the club and a provision preventing the player from taking on any outside endorsements without the permission of the club, to prevent any conflict in endorsement obligations undertaken by the player and those undertaken by the club.

Other Activities: Under this clause, the player undertakes to refrain from undertaking certain activities which are deemed by the club, and indeed, by the players themselves, to be dangerous, with the capacity to endanger the performance of the player. Reasonable restraints on the freedom of the player are permitted, and in certain cases, permission may be sought from the club to participate in a particular activity. Such clauses empower the clubs to discipline the player. However, the courts have been hesitant in interpreting this provision broadly to allow *all* types of activities to be prohibited. Thus, a clause seeking to prevent a player in the National Hockey League (America) from playing competitive basketball, or even sky-diving, bungee-jumping, para-sailing, etc., may be justified in protecting the clubs' as well as the individuals' interests. However, seeking to prevent the player from playing basketball at home with his family would be unreasonable. It can be ensured by way of collective bargaining that such clauses are not unduly restrictive.

Assignment/Licensing: This clause allows a club to assign or license the contract out to any other club, and provides for the procedure to be followed in case of such assignment. The clause usually also provides for the expenses borne by the player in moving to the territory to which he has been assigned. Further, the clause also provides for the punishment in case the player being assigned does not report to the assignee club. It is possible to have no-trade provisions in the contract, or even the CBA, to limit the application of this provision.

Default by Club: This clause provides for the remedy available to the player in case the club defaults in the payment of the compensation agreed upon between the club and the player.

Termination: This clause provides for the methods by which such agreements may be terminated by either party. Termination may arise from the player's conduct, in case of injury to the player, by his failure to conform his personal conduct to the standards laid down earlier, failure to remain in the agreed-upon good physical condition, misconduct such as an attack on players/officials, ceasing to exhibit the unique skills to qualify as a member of the club, or any other way of breaching the provisions of the contract by either party. In all cases, the termination must be "for cause." Sometimes, a contract may also have a "no-cut" clause, which primarily restricts the grounds on which a player can be removed from the club.

Option: Another controversial clause has been the option clause. The option clause allows the club to bind the player to the club for another year at a percentage of the previous year's salary. Usually, this clause is softened through collective bargaining.

Dispute Resolution: There usually exists a dispute resolution clause in the standard player contract, indicating how disputes between the player and the club/league are to be resolved, usually in accordance with the procedure laid down in the CBA.

In addition to these clauses, a player who possesses more skill or popularity (possesses "more juice"), may negotiate the terms of the contract to incorporate certain other clauses which are beneficial to him. One of the premier examples of this is the signing bonus clause, which provides that the player may be given a certain amount of money as a bonus when he signs on with the club; such amount is not returnable even if the player is subsequently "cut" from the club.

Issues Relating to Standard Player Contracts

Are Sports Contracts Fair?

The standard player contract, as the name suggests, is a uniform contract to be signed by all players. The widespread use of standard forms to govern contractual relationships is an expedient response to the needs of our dynamic commercial society. However, often, they are "contracts of adhesion"—a form proposed by one of the contracting parties to the other as the definitive form of the contract which is intended to be unalterable except for minor details. The party to whom this type of contract is offered may "take it or

leave it" but cannot negotiate its terms and conditions.[3] Thus, the party with relatively weak bargaining power adheres to the terms of a mass form which has incorporated limitations on the liability of the drafting party, with very little room for negotiation.[4] Consequently, the essence of a contract—the expression of free will of the parties—is not reflected in such contracts. In fact, the scope for negotiation depends on the unique skills or the popularity of the player. Therefore, while it may be possible for the "stars" of the game to negotiate terms beneficial to them, the majority of the players get very little say regarding the terms of the contract they are party to.

A key feature in most such contracts is the "option clause" by which the club/league reserves the right to sign the player for another year. It would appear that the contract is thus for one year, with an option of renewal for another year, and players are free to deal with any other club after that. The fact, however, is that they do not shift because they sign a new contract containing the foregoing clause each year, effectively curtailing their freedom to change clubs. Another clause which is patently unfair is the termination clause. Generally, the termination clause gives the club the right to terminate the athlete's contract "for cause." However, this "for cause" is not defined, and could simply be that the employee no longer fits the club's needs, thus enabling a club to cut a player whenever it likes.

Further, the option clause is ultimately enforceable against uncooperative players by boycott, a technique that has been termed illegal per se.[5] In *Silver* v. *New York Stock Exchange*,[6] however, the court suggested that a boycott may be removed from the per se category by a "justification derived from the policy of another statute or otherwise." It has been suggested that where collective action is inherent in the structure of the industry, as it is in sports leagues, the "or otherwise" justification is present,[7] further weakening the position of players.

Because there is normally only one league in each sport, the two devices of reserve and player draft taken together mean that a player must come to terms with the club which holds "rights" to him or not play the sport. The crippling

[3] C.M. Schimtthoff, "The Unification or Harmonisation of Law by Means of Standard Contracts and General Conditions," 17(3) *International and Comparative Law Quarterly* 551 (1968) at 552.

[4] A.W. Meyer, "Contracts of Adhesion and Doctrine of Fundamental Breach," 50(7) *Virginia Law Review* 1178 (1964) at 1180.

[5] *Klor's, Inc.* v. *Broadway-Hale Stores, Inc.*, 359 U.S. 207 (1959); *Fashion Originators' Guild of America* v. *FTC*, 312 U.S. 457 (1941).

[6] 373 U.S. 341 (1963).

[7] See "Trade Association Exclusionary Practices: An Affirmative Role for the Rule of Reason," 66 *Columbia Law Review* 1486 (1966).

effect these controls have on a player's bargaining power is dramatically illustrated by the case of *Harrelson*, who was released unconditionally by his club and was left free to bargain with all the other clubs, finally signing for an estimated $75,000 per year, while previously he had been receiving only an average salary. The effect of these restraints is further illustrated by a comparison of the salary levels and role in management accorded to athletes with those of other entertainers, who also have unique skills in performing for the public. In America, even athletes with outstanding skills rarely earn more than $100,000 per year, and have no say in management; in contrast, movie stars have salaries many times those of sports stars and almost unlimited management control.[8]

Moreover, a trend that has been noticed in some countries, especially the United States, is that "everyone recognizes everyone else's contracts" with players. Thus, even if a player were to repudiate his contract, it is very unlikely that he would be able to play for any other club, unless a rebel club decides to challenge the system. The result is a complete absence of equality in bargaining position.[9]

Breach

A situation might arise where the player who has signed a contract with a particular club wishes to join another club midway through his contract. This amounts to breach of contract in the form of repudiation, which can usually be remedied by either paying for damages, restitution, or specific performance.

In the case of standard player contracts, courts have been reluctant to force an athlete to play against his will. Since the English case of *Lumley* v. *Wagner*,[10] where the court held that contracts for personal services cannot be specifically enforced, courts both in England and America have been willing to enjoin a breach of a negative covenant not to render services of a unique type for other parties, so long as it could be proved that the services were unique and that money damages were inadequate.[11] The use of this injunctive remedy in professional sports was established in the landmark

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[8] "The Super Bowl and the Sherman Act: Professional Club Sports and the Antitrust Laws," 81(2) *Harvard Law Review* 418 (1967) at 421.

[9] J.H. Topkis, " Monopoly in Professional Sports," 58(5) *The Yale Law Journal* 691 (1949) at 697–99.

[10] 42 Eng. Rep. 687.

[11] G. Youngman, "Negotiation of Personal Service Contracts," 42(1) *California Law Review* 2 (1954) at 9–10.

American judgment of *Philadelphia Ball Club* v. *Lajoie*,[12] where the court held that the club did not have a right to demand performance of a player for a player's non-performance as exhibited by his jumping to another club. However, it could obtain equitable performance by way of injunctive relief through a contractual clause. In the case of *Central New York Basketball, Inc.* v. *Barnett*[13] the court came close to articulating a "per se" rule that professional athletes would be considered employed under a personal services contract and subject to the Lumley rule.

It is submitted that although a standard player contract is a contract for personal services, there are sufficient differences between this and other contracts for personal service to justify a different approach for the enforcement of these contracts.[14] The primary argument, that the performer will be recalcitrant if compelled to comply with the contract, does not hold in the case of sports. In this field, the future of a player depends on his ability to perform, and it is highly unlikely that he will deliberately sabotage his career and earning potential by delivering substandard performances for a club he has been compelled to play for.[15] Second, the behavioral norms and incentives prevailing in a professional sports setting are not generally present in other personal services relationships. Unlike a performer, who has no one but herself to answer to, a professional sports player who is perceived to be intentionally performing below his ability has several parties to answer to, including the co-members of his club. A further factor that would influence professional athletes to compete is the simple fact that by the time they reach the professional level, they have internalized norms of extreme competitiveness. These norms might motivate them to try to win even if they were upset about their contractual arrangements.

Again, concerns about judicial monitoring of obligations are not very compelling because information pertaining to player performance is easily available in the media. Moreover, unlike other performances which cannot be judged objectively, an athlete's career is meticulously documented using statistics. A sudden drop in performance post-relief would be easily proved,

[12] 202 Pa 280, 51 A 973 (1902).

[13] 181 N.E.2d 506 (Ohio C.P. Cuyahoga County 1961).

[14] G.C. Rapp, "Affirmative Injunctions in Athletic Employment Contracts: Rethinking the Place of the Lumley Rule in American Sports Law," 16 *Marquette Sports Law Review* 261 (2006) at 263.

[15] R. Cloete, "The Enforceability of Sports Contracts," available online at http://web.up.ac.za/sitefiles/File/hpc/The%20Enforceability%20Of%20Sports%20Contracts.pdf (accessed on September 17, 2008). See also T. Davis, "What is Sports Law," 11 *Marquette Sports Law Review* 211 (2001) at 221.

and while there might be other explanations for a downturn, proceedings would be far simpler than in other contexts.[16]

A final objection to affirmative injunctions arises as a function of transaction costs and market imperfections that may exist in typical employment or personal services contracts. After the issuance of a decree, whether the injunction is negative or affirmative, a performer who is unhappy with the court's order will offer to pay off the club, based on how much the player values being free of the injunction and how much the club values preventing that player from escaping his contractual obligations. In an ordinary employment or personal services arrangement, however, transaction costs impede this Coasian bargaining. A typical employee lacks the financial assets to make offers employers are likely to accept, nor can he access sufficient credit for the same. Moreover, once the injunction has been issued, a typical employee cannot bear the costs of a lengthy negotiation because he must service personal and consumer debt, thus compromising his bargaining position. However, things are different in professional athletics because most players have personal net worth of millions of dollars. Not only do they have resources and the access to credit markets to make an appropriate side payment to their clubs, but they have enough money to sustain a comfortable lifestyle for as long as it takes to reach an agreement without having to compromise their bargaining position. Thus, transaction costs and market failures are not present in the context of professional athletic employment arrangements.[17]

In fact, there are several judgments which have recognized an exception in the case of sports contracts. In the case of *Santos Professional Football Club (Pty) Ltd* v. *Igesund*,[18] the court observed that the only person who was likely to suffer from the lackluster performance of a player performing under compulsion was the plaintiff himself, who had already chosen to take that risk by bringing a suit for specific performance. In *Roberts & Another* v. *Martin*[19] the Cape High Court reaffirmed the court's willingness to order specific performance of contracts in the realm of professional sport.

These judgments reflect the modern-day commercial reality in the professional sports world and rebut a number of arguments raised against the granting of specific performance which have no place in professional sport contracts. Lastly, to contend that an order of specific performance would amount to forced labor is completely erroneous. The player who concluded the contract in question receives a large sum of money for abiding by it.

[16] *Supra* n. 14, at 275.

[17] *Supra* n. 14, at 280.

[18] [2002] 5 SA 697 (C).

[19] [2005] 4 SA 163 (C).

He cannot then argue that fulfilling the contractual obligations, and benefiting from the same amounts to forced labor, any more than a party to any other type of contract can.

Another situation that could arise is that of "player holdouts," where a player refuses to perform unless the club agrees to an upward revision of his salary. Apart from the argument for specific performance, which may or may not be accepted, the only meaningful remedy available in courts of law is contract damages.[20] Of late, a new remedy that has emerged is that of self-help specific performance where the party may initially and deceptively agree to demands to modify an existing contract in order to obtain contractual performance instead of, and as they should, pursuing contract damages when faced with illegal demands for modification. Following such performance, the consenting party can repudiate his agreement and seek to enforce the terms of the original contract, suing on grounds of duress. It has been suggested that the use of self-help specific performance is exactly the type of behavior courts should encourage when the law fails to provide a viable remedy in situations involving opportunistic threats to renegotiate contracts.[21]

However, the researchers wish to point out that the use of such remedies would only increase the mistrust between players and their clubs, and what is needed today is to bridge the gap between the two through collective bargaining mechanisms so that such underhanded remedies would not be required at all.

In India, while sec. 38 of the Specific Relief Act, 1963 permits injunctions against players changing clubs in breach of their contracts, sec. 14(b) of the Specific Relief Act, 1963 expressly provides that a contract is not enforceable if it is dependent on the personal qualifications or volition of the parties. Owing to the lack of sports-oriented decisions, it is very difficult to predict whether Indian courts will recognize an exception to sec. 14(b) in the case of players' contracts.

Since before Independence, it has been the position in India that the court would never make an order the effect of which would be to compel specific performance of a contract of personal service.[22] Despite adequate opportunity to create a reasonable exception to the bar against specific performance of personal service contracts, the court has consistently refrained

[20] *Lumley* v. *Wagner*, 42 Eng. Rep. 687, 693 (Ch. 1852); *De Fracesco* v. *Barnum*, [1890] 45 Ch. 430.

[21] A.M. Johnson, "The Argument for Self-Help Specific Performance: Opportunistic Renegotiation of Player Contracts," 22 *Connecticut Law Review* 61 (1989) at 63.

[22] *Ramkumar Potdar* v. *The Sholapur Spinning and Weaving Co. Ltd.*, (1934) 36 Bom.L.R. 907.

from doing so.[23] In *Vaish Degree College* v. *Lakshmi Narain*,[24] Bhagwati, J. had expressed the view that it is "not possible to doggedly hold fast to these doctrines which correspond to the social realities of an earlier generation, far removed from ours." It was observed that it is necessary to rid the law of these anachronistic doctrines and bring it in accord "with the felt necessities of the times." This seems to set the stage for bringing in exceptions to the law today. However, as of now, the only exception to this rule exists when the breach of employment contract is violative of art.311 of the Constitution of India, 1950, or of statutes, and when the employees are public servants.[25]

However, it must be remembered that the continued lack of an effective remedy to enforce long-term personal service contracts may presage judicial, and hence societal, disenchantment with such contracts. Therefore, in light of the foregoing arguments, and the forward-thinking depicted by courts in the United States, an exception should be made in the case of sports contracts, allowing for orders for enforcement of specific performance.

Lastly, there are certain defenses that players can invoke in a suit for breach of contract. One of the most commonly used defenses is that of "unclean hands." Players have successfully used the doctrine of unclean hands in defending against suits by management for negative injunctions. A court of equity will not grant injunctive relief to a plaintiff who has acted in bad faith as regards the problem to be litigated.[26] Another defense could be that the contract was illegal or unfair. A court, for example, will not permit equitable enforcement if the terms of the contract are too harsh and one-sided.[27] Another defense to a club's suit for a negative injunction is the lack of mutuality. That is, either inequality between the player's obligation of many years and the club's obligation for a minimal amount of time or the fact that the club can avail itself of an opportunity to obtain the specific performance of an athlete's negative promise, whereas, specific performance is unavailable to a player.

Restraint of Trade

An important issue that could arise with respect to a player contract is the issue of restraint of trade. A restraint of trade is a restraint placed by a

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[23] *Raj Krishan Chopra* v. *National Mineral Development Corporation Ltd. and Ors.*, ILR [1981] Delhi 308.

[24] [1976] 2 SCR 1006.

[25] *Saumyendra Nath Mookerjea* v. *Anz Grindlays Bank, Bombay*, [1991] 93 Bom.L.R. 502.

[26] *New York Football Giants, Inc.* v. *Los Angeles Chargers Football Club, Inc*, 291 F.2d 471 [5th Cir. 1961].

[27] *Connecticut Professional Sports Corp.* v. *Heyman,* 276 F. Supp. 618 (1967).

contract (or otherwise) on a person's ability to practice any profession or occupation of his choice. In order to be enforceable, a contract, or a clause in a contract, must not be a restraint of trade.

Different clauses in the standard player contract may be read as being restraints of trade by a court; both clauses barring a player for playing for any other club and clauses placing conditions precedent on the player's employment by the club in the first place could operate as restraints of trade. Conditions precedent such as mandatory genetic or medical testing for diseases such as HIV and hepatitis could mean that players are barred from participating if the test results are unsatisfactory.[28] Such conditions precedent, though, have only recently been introduced into a few contracts, and their validity has not as yet been tested before any court.[29] Restraints on players in the nature of clauses preventing players from playing for competitors of the club, on the other hand, are routine, both in India and abroad.

In most jurisdictions, whether British, American, Canadian, Australian, or New Zealander,[30] restraints of trade of this nature are permissible only when they are reasonable. This reasonableness of restraint is required by contract law principles as well as by specific antitrust legislations in the different jurisdictions.[31] Even in the case of sports contracts, courts look into whether the restraint imposed by the player contract serves a legitimate interest and whether the restraint is reasonably necessary or overbroad.[32] Courts have been especially reluctant to uphold the reasonableness of restraints in players' contracts, privileging instead the players' right to freedom of contract.[33]

The prohibition on the restraint of trade is the strongest in India. In India, sec. 27 of the Indian Contract Act, 1872 states that *all* contracts in restraint of trade are void, and makes no exception for the reasonableness of the restraints. Courts have therefore refused to read this exception into

[28] Magnusson, R. and Hayden Opie, "HIV and Hepatitis in Sports: An Australian Legal Framework for Resolving Hard Cases," 5 *Seton Hall Journal of Sport Law* 69 (1995).

[29] Not only could the validity of such conditions be legally challenged on the basis of restraint of trade, but also on the basis of the contract being an unconscionable contract of adhesion, as also on the grounds of discrimination.

[30] S. Ross, "Player Restraints and Competition Law Throughout the World," 15 *Marquette Sports Law Review* 49 (2004).

[31] J. Scura, "The Time has Come: Ending the Antitrust Non-enforcement Policy in Professional Sports," 2 *Seton Hall Journal of Sports Law* 151 (1992).

[32] *Blackler* v. *New Zealand Rugby Football League*, [1968] NZLR 547 (CA).

[33] *Supra* n. 30. See, for instance, *Cincinnati Bengals, Inc.* v. *Bergey*, 453 F Supp 129 (SD Ohio 1974); *American League Baseball Club of Chicago* v. *Chase*, 149 NYS 7 (1914); *Continental Basketball Association, Inc.* v. *Ellenstein Enterprises, Inc.*, 669 NE2d 134 (Ind 1996).

the Act.[34] So, any clause imposing a restraint of trade is invalid in India,[35] and any such clause in a players' contract would not be upheld by the court. The antipathy of the courts to any enforcement against sportspersons of restraint of trade clauses was stressed by the recent decision of the Bombay High Court in *Percept Talent Management Pvt. Ltd.* v. *Yuvraj Singh*,[36] following the Supreme Court decision in *Percept D'Mark* v. *Zaheer Khan*.[37] While these cases involved post-contractual restraints in sponsorship contracts, the refusal by the courts to enforce them clearly illustrates that courts will not enforce restraints of trade on sportspersons.

However, this does not mean that no conditions can be imposed on the player. Restrictions imposed on players not to compete with the club, or not play for any other club, during the term of employment, if properly bounded in time and space, have been held to be valid as not being restraints of trade at all. In such cases, it is possible to obtain a permanent injunction against the player, enjoining him from competing with the club, or playing for another club, as the case may be.[38] An injunction, under sec. 41 of the Act though, may only be granted when no equally efficacious relief can be obtained by any other mode of proceeding.

Thus, although certain restrictive terms in a standard player contract may be enforced in India, any clauses in restraint of trade operating after termination of the contract will be void and unenforceable, no matter how reasonable.

Image Rights

Players' contracts generally contain a clause regarding the vesting of player image rights, or player publicity rights, usually assigning them, to an extent, to the club. This clause is a significant one in a player contract because the

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[34] *Gujarat Bottling Co. Ltd.* v. *Coca Cola Co.*, [1995] 5 SCC 545.

[35] The competition law regime of India (The Monopolistic and Restrictive Trade Practices Act, 1969, The Indian Competition Act, 2002) could possibly also be invoked to prevent restraint of trade through contract.

[36] *Percept Talent Management Pvt. Ltd.* v. *Yuvraj Singh*, MANU/MH/1040/2007.

[37] *Percept D'Mark* v. *Zaheer Khan*, AIR [2006] SC 3426.

[38] As explained previously, specific performance of player contracts may or may not be allowed under Indian law. Under Section 41 of the Specific Relief Act, a permanent injunction will be refused if it is sought to prevent the breach of a contract the performance of which would not be specifically enforced. However, Section 42 clarifies that such an injunction may be granted where it only seeks to enforce negative obligations under such a contract and not indirectly bring about the specific performance of any positive obligations. Therefore, an injunction may be granted to enforce a restrictive clause.

recognition of a celebrity or well-known sportsperson's right to publicity is only a recent development of law.

The concept of image rights found its earliest roots, in the United States, United Kingdom, and other commonwealth countries, in the recognition of the right to privacy. However, the right to publicity was later distinguished from the inherent right to privacy as being a commercial right, closer to an intellectual property right than to a personal liberty right.[39] While the right to publicity or image has often been overridden in courts by the right to free expression, courts have also implemented this right on various occasions against such unauthorized use.[40]

The publicity rights of famous sportspersons have been recognized time and again, including even their right to identity in terms of jersey number and racing car number.[41] The Delhi High Court too, in *ICC Development (International) Ltd.* v. *Arvee Enterprises*[42] case, stated in passing that if any entity were to use Kapil Dev or Sachin Tendulkar's name or persona in connection with the World Cup without their authorization, they would have a valid and enforceable cause of action.

Player contracts in India and abroad recognize the publicity rights of players.[43] Even after the players join a club, image rights remain with the players, unless the rights are assigned or sold to the club by the contract.[44] However, whether such a clause will stand the test of an Indian court of law is uncertain. Given that the right to publicity has been recognized in India only as a corollary to the right to privacy, the assignment of such a right may not be legally possible.[45] Even if this transfer of publicity rights is recognized, a clause preventing the player from entering into an endorsement agreement without the permission of the club may be challenged as a restraint of trade. Further, since the assignment of image rights in an SPK (Standard Player Contract) usually does not entitle the player to any separate substantial

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[39] See H. Carty, "Advertising, Publicity Rights and English Law," [2004] IPQ 109; B. Rowland, "An Athlete's Right of Publicity," 76 *Florida Bar Journal* 45 (2002).

[40] *Haelan Laboratories* v. *Topps Chewing Gum*, 202 F2d 866 (2d Cir 1953); S. Smith, "The Changing Face of Image Protection in Sport," 2 *International Sports Law Review* 37 (2004).

[41] *Irvine* v. *Talksport Ltd.*, [2003] FSR 619, CA; *Motschenbacher* v. *R.J. Reynolds Tobacco Co.*, 498 F2d 821 (9th Cir 1974).

[42] (2003) 26 PTC 245 (Del). V. Matthews, "Personality Rights Principle", http://www.hubyou.info/article/127584/advice–Will-RSS-Replace-Email-.html (accessed on September 24, 2008).

[43] P. Edwards, "What's the Score? Does the Right of Publicity Protect Professional Sports Leagues?," 62 *Alberta Law Reports* 579 (1998).

[44] *Shamsky* v. *Garan, Inc.*, 632 NYS2d 930 (Sup Ct 1995).

[45] http://www.legalserviceindia.com/article/l139-Celebrity-Rights.html (accessed on September 28, 2008).

emolument, the case could be made out that the clause transferring image rights is unconscionable and liable to be struck down.[46]

Morality Clause

This clause brings in a lot of subjectivity, and hence has been criticized. The primary criticism has been that the morality is set by the club, is not uniform, can often vary over time, and does not even set broadly what would fall within immoral conduct. Hence, it leaves far too much discretion in the hands of the club to terminate a player's services, often for a minor infringement of rules, and occasionally, even without such infringements. Another frequent criticism of such clauses is that they may often be invoked by a club against a player whose contract they wish to terminate, even for a slight infraction. Thus, such clauses provide an easy escape route for the clubs. One important case is that of Latrell Spreewell, a basketball player who represented Golden State Warriors, where after constant berating from the coach, Don Nelson, he physically attacked the coach one day. His contract was terminated, and he was handed a severe suspension, one of the longest served in basketball history at the time. He challenged the suspension and the termination, and though the termination was upheld, the case does indicate the willingness with which the player's contract was terminated could prove to be troublesome.[47]

Tortious Liability of the Club

Two questions of tortious liability in the context of a player–club relationship could arise—first, where the club is sought to be held vicariously liable for the conduct of the player, and second, where the club itself can be held liable for negligence against a player, with particular reference to injuries suffered by the player while representing the club.

Generally speaking, the club (employers) can be held vicariously liable for the sportsperson's actions where they have encouraged the act in question

[46] P. Sadler, "The 2003 Rugby World Cup: Player Image as Intellectual Property," available online at http://espace.lis.curtin.edu.au/archive/00001033/01/Pages_from_JCIBG_Interim_PDF_220404_rugby_IP.pdf (accessed on September 24, 2008); S. Hanlon, "'J.J. Morrison' and his Right of Publicity Lawsuit against the NCAA," 15 *Villanova Sports and Entertainment Law Journal* 241 (2008).

[47] When Ron Artest attacked a fan in the crowd a few years later, merely a suspension was handed out to him. This shows the subjectivity in the incorporation of this clause as well.

or it is regarded as part of the ordinary course of the employment. Thus, causing injury due to negligent or absolute recklessness and disregard may be punishable, and the club can be held vicariously liable for such conduct of the player. The standard of care owed in certain sports may be higher than in others, as the objectives of such sports, and the inherent dangers present in the sport, may raise the level of duty of care required. Thus, in the case of *Caldwell* v. *Maguire and Fitzgerald*,[48] the court laid down that in certain sports, the threshold of liability will be high, and the proof required should be one of reckless disregard in causing the injury. However, this should not be mistaken to be an assertion that "reckless disregard" is the standard of care required in sports injury cases. Once the negligence is established, the question of vicarious liability is not difficult to prove, as the contract usually establishes the relationship required. In certain cases, the employer can be held liable for encouraging the player to conduct himself in a particular manner, and thus, liability could be imposed on the club in such cases.[49] It must be remembered, however, that the club will be held liable only if the player caused the injury in furtherance of the employment, and not in any other circumstances.

The other aspect of tortious liability of the club, which has rarely been considered, is that of the liability of the club toward the player if its conduct results in an injury or an aggravation of injury. This principle was broadly recognized in the case of *Bayless* v. *Philadelphia National League Club*,[50] where the player sustained severe injuries as a result of the pain-killers administered to him by the club doctors, and encouraged him to take further part in the game. Such doctors and the club owe a duty of care to the player, and if they err by forcing an injured or unfit player to play, or when they administer wrong or excessive drugs, resulting in an injury, or even death of the player, the club must be held liable for its actions. It cannot be allowed to waive its liability in the standard player contract, and indeed, such references are not always found in standard player contracts. The interests and the well being

[48] [2001] EWCA (Civ) 1054.

[49] *Budgen* v. *Rogers*, (1993) Aust Tort Reports 81., where the coach of the club had encouraged the player to make a dangerous tackle. There are other cases on this point as well; if a player is known to be violent or dangerous on the field, encouraging him to perform a dangerous tackle, etc., would invoke the liability of the club. *Tomjanovich* v. *California Sports, Inc.* is the leading American case on the point of vicarious liability as it recognizes the principle to be applicable in sports—the Los Angeles Lakers were held vicariously liable for the injuries caused to the coach of the opposing club when a fight erupted between players, and the coach, Rudy Tomjanovich, was trying to break up the fight.

[50] *Bayless* v. *Philadelphia National League Club*, 579 F. 2d 37 (3rd Cir.).

of the player himself must be considered. To avoid potential legal liability, the club physician should refuse clearance of an athlete if she believes there is a significant medical risk of harm from participation, irrespective of the club's need for the player or the player's personal motivations. In addition to tortious claims, the player may also seek compensation under Workman Compensation laws.

Conclusion

Sports law remains an unknown entity in India, with practically no development, while in the United States and the United Kingdom, the law has evolved from general law. Indian sports contracts are treated on par with any other contract in India—in fact, many of the clauses mentioned earlier do not find even a mention in the contracts in India, which tend toward uncompromising contracts of adhesion. The only development in this regard has been the developments relating to promotional activities or advertizing activities by sportspersons, and this is the source of law for the purpose of discussion in this chapter.

The development of CBAs in the United States has greatly improved the conditions that the "fringe" players are offered, affording players a chance to negotiate on their own behalf with the teams to prescribe a threshold for certain conditions higher than what would otherwise have been adopted. An examination of such CBAs, found in every professional sports league in the United States, shows the comprehensiveness of such agreements, and indeed, the standard player contracts used in such sports are derived from and found in such CBAs. Such agreements, discussed between the teams and the league on the one hand, and the players on the other, provide for the complete regulation of the relations between the team, the player, and the league. Thus, provisions relating to drugs, conduct, promotional activities, the compensation package (including salary caps, and bonus) found in the standard player contracts can all be traced to the CBA.

In light of the floundering sports laws (particularly relating to sports contracts) in India, it is relevant to consider the possibility of including such CBAs in India. Even in the Indian Premier League and the Premier Hockey League, the contracts have been criticized by various players and academics alike. It must be remembered that the CBAs in the United States have also become successful only over a period of time, and in fact had come in for severe criticism from several fronts at the time of adoption. They

have, however, proved to be a useful tool in maintaining certain minimum conditions in the standard player agreements, thereby ensuring that the standard contract is not merely a contract with unconscionable terms, but is actually one with terms beneficial and agreeable to all parties. Further, certain clauses traditionally perceived to be unfair have also been phased out through such collective bargaining, the foremost example of this being the "reserve" or the "option" clause. Thus, CBA offers some hope to the sportspersons in the leagues of professional sports in India.

In addition to adopting a proper CBA, there must be a strong base underlying the CBA. In most countries, the player unions or the player associations negotiate with the leagues and the teams for the CBA. It is, thus, important to develop such an institution which shall be free from politics and nepotism often found in Indian sports. Further, certain principles such as the morality clauses and the termination clauses as well as the liability and restriction clauses may need to be considered in light of the development of the general law in India. For example, though the United States and the United Kingdom recognize reasonable restrictions in trade, in India, all restrictions other than sale of goodwill or restrictions operating during the term of the contract are invalid. Thus, it will be important to reconcile the CBA with Indian laws, rather than just copying and pasting the agreements from foreign leagues. Further, courts in India have been highly restrictive as far as the specific performance of contracts of personal service is concerned.

Much of the recent legal controversy in the professional sports industry has emanated from the efforts to limit the movement of players among clubs. The traditional restraints have included devices such as the draft system, reserve and option clauses, and arrangements requiring that compensation be paid to a club whose player has accepted employment with another member of the same league. The treatment of the restraints as a private law matter changed dramatically in the mid-1970s. The advent of durable players' unions and the commencement of a series of antitrust challenges interjected the law's institutions, especially the courts, rather deeply into the issue of player mobility. The beneficial effect of these cases was to open the way for greater player input, typically through collective bargaining. What is needed today is for clubs in India to realize the benefits of CBAs, and incorporate conscionable negotiation practices. The only way to avoid unnecessary controversy regarding players is to have a fairly drafted player contract reflecting the true interests of not only the team, but also the player himself.

14

Restraint of Trade and Employment Contracts

Sairam Bhat

Introduction

In contemporary commercial environments, restraint of trade contracts are common. These are contracts that state, for example, that a person selling a business agrees not to open a similar business within 50 miles of the business being sold and for a period of 10 years. On the face of it, such contracts, while not illegal, fly in the face of public policy as it is considered to be "good for the state" that men and women be free to ply their profession without restriction. The law is that a restraint of trade is contrary to public policy[1] and unenforceable unless the restraint is reasonable in the parties' interests and also in the public interest.[2]

The restraint of trade clause is a contractual term that expressly restricts an employee's freedom to work, once the current employment relationship ceases.[3] A contract of employment is a bilateral agreement for the exchange of service and remuneration over a period of time. Employment contract is that form of contract for personal service which the courts recognize as expressing the social relationship of employer and employee, as opposed to the other relationships. The Indian Contract Act, 1872 states there is no provision that an offer or its acceptance should be made with the intention of creating legal relation. But it is now accepted that "to create a contract

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[1] See sec. 27 of the Indian Contract Act, 1872.

[2] *Attwood* v. *Lamont*, [1920] 3 KB 371.

[3] Paul D. Alexander, "Restraint of Trade Clauses in Employment Contracts," available online at http://ezinearticles.com/?Restraint-of-Trade-Clauses-in-Employment-Contracts, accessed on October 21, 2007.

there must be common intention on forming legal obligation."[4] Employment contracts need not be written, it can be oral also. A written employment contract is preferable to avoid disputes at later stage. The employer and employee should enter into such a contract after getting acquainted with all terms and conditions of the employment provided in the agreement and must agree upon them in the same sense. The acceptance of such contract must be absolute and unqualified, should be expressed in some usual and reasonable manner as provided under sec. 7 of Indian Contract Act, 1872. The parties cannot accept a part of its terms which are favorable to them and reject the rest. The contract of employment should have free consent of both the parties and should not be caused by fraud, misrepresentation, coercion, and undue influence. The promise to employ and to be employed may be for short period but still it forms an integral part of contract and the core element of the contract.

Nature of Employment Contract

The nature of employment contract may be general or particular. General contract is usually written, with duration, terms and conditions of employment, and the scale of remuneration in which the employee is placed stipulated. Particularly, an employment contract may involve complex clauses which may include confidentiality, non-compete, and non-solicitation. It is these particular clauses in an employment contract which are the crux of issues in this chapter.

A contract of employment also contains various other terms and conditions to which both employee and employer are bound. A breach of such terms and condition will repudiate the contract. The terms and conditions are regarding wages, status designated, place of working, timings, list of benefits to be given during employment, restraint of trade, if any, etc. Another important condition is regarding the settlement of disputes between the employer and the employee. The terms and conditions must be provided to the employee before or at the time of signing the agreement, so that he can understand the terms he is going to be bound by. After reading all the terms and conditions of the agreement, it should be signed by both the parties. A

[4] See *Balfour* v. *Balfour*, [1919] 2 KB 571; *Weeks* v. *Tybald*, [1604] 74 ER 982; *Jones* v. *Padavatton*, [1969] All. E. R 616; *Baldwin* v. *Everingham* [1993] 1 Qd R 10; *Rose and Frank Co* v. *J R Crompton and Bros. Ltd.*, [1923]; *Esso Petroleum Co. Ltd.*, v. *Customs and Excise Commissioners*, [1976] 1 WLR 1.

subsequent notification will indeed amount to modifications in the original contract and will not bind the other party unless he has assented thereto. In a normal contract the negotiating parties stand at equal footing.[5] But in case of employment contract, the employee is always at the receiving end and necessarily at the mercy of the employer and cannot be expected to possess the equal bargaining power. Normally, all employment contracts contemplate the employee not to divulge any confidential information and trade secrets. An employee has a duty even after termination to protect the trade secrets and other confidential information of business until and unless they are made public. Similarly, the employer is under obligation, it will give the employee sufficient work to enable him to earn what the parties have contemplated he should earn and make his living as an employee.

Courts have historically expressed hostility to contractual provisions that limits the employee conduct after the employment relationship has terminated and have therefore regarded restrictive covenants with suspicion and often refused to enforce them. In general, judicial objections to enforce restrictive covenants have historically fallen into two categories: opposition to restraint of trade and concern over the need to protect employees.[6] More specifically, courts have traditionally been hostile to restrictive covenants because they regard them as (i) deprivations of employees' ability to earn a living, (ii) anti-competitive, (iii) the result of unequal bargaining power between employers and employees, and (iv) contrary to general principle of promoting free labor.

Indian Perspective

During the period of employment the employer has the exclusive right to the service of the employee. But a restraint operating after the termination

[5] Inequality of bargaining capacity has been explained in *Central Inland Water Transport Corp* v. *Brojo Nath Ganguly* [1986 2 SCR 278] where the court held: "The doctrine of unequal bargaining power is the result of great disparity in the economic strength of the contracting parties, where the inequality is that of circumstances, whether of the creation of the parties or not. It will apply to situations in which weaker party is in a position in which he can obtain goods or services or means of livelihood only upon the terms imposed by the stronger party or go without them. It applies to situations where man had not reasonable choice but to give assent to the contract on dotted line in a prescribed standard format or to accept a set of rules however unfair, unreasonable and unconscionable a clause in the contract or form or rules may be."

[6] See for example, *Oregon Steam Navigation Co*. v. *Winsor*, 87 U.S. (20 Wall.) p. 64, 68 (1873).

or retirement is for freedom from competition from a person who no longer works within the contract. And holding the same is declared void by a court of law. The reason for upholding restraint of trade against employee is to protect the proprietary rights of the employer, that is, the trade secrets or trade connections but it is not available if directed to prevent exercise of extra skill or knowledge acquired by the employer during the course of employment.

Historically the Indian law on restraints, whether general or partial, despite being in service contract or business contracts were generally held void by the courts. Accordingly a stipulation in a contract prohibiting the defendants from engaging in the cultivation of tea for a period of 5 years from the date of the termination of their agreement with the plaintiff was held void, although the restriction only extended to a distance of 40 miles from the plaintiff's tea gardens.[7] It is an implied term in every employment contract that the employee will give faithful service to the employer and certain activities of the employee are regarded as breaches of that duty to faithful service.[8]

Section 27 of Indian Contract Act, 1872 states, "every agreement by which anyone is restrained from exercising a lawful profession, trade or business of any kind, to that extent, is void." The above does not mean an absolute restriction and are intended to apply to a partial restriction. However, the Contract Act was drafted during the British rule more than a century and a quarter ago, when trade and commerce in the country were in infancy. The measure was taken at that time to protect and help the growth of trade and commerce in the nation.[9] In several trade practices, especially employment contracts, an absolute adherence to sec. 27 of the Contract Act would not be a practical solution and there is violation of this section as well. Section 27 of the Indian Contract Act was wholly imported from Hon. David D. Field's Draft Code from New York which was based upon the old English doctrine of restraint of trade, as it prevailed in ancient times. An employee may be restricted from competing against his employer. Trade secrets are considered the employer's property and, hence, restriction on the disclosure of such information is in the public interest.[10]

[7] *Brahmaputra Tea Co* v. *Scarth*, [1885] ILR 11 Cal 545.

[8] For example, in *Robb* v. *Green*, [1895] 2 QB 315, it was held that an employee who copies out names and addresses of his employer's customers for personal use after leaving employment has breached the duty of fidelity and can be prevented from using the lists.

[9] Avatar Singh, *Law of Contract and Specific Relief* (9th ed., Lucknow: Eastern Book Company, 2006) at 254.

[10] Ramya Seetharaman and Vandana Pai, "Restrictive Covenants in Employment Contracts," *Company Law Journal* 2 (2002) at 104.

Even the Allahabad High Court in *Bholanath Shankar Dar* v. *Lachmi Narain*[11] has observed that "it is unfortunate that Section 27 seriously trenches upon the liberty of the individual in contractual matters affecting trade. Section 27 was enacted at a time when trade was yet undeveloped and the object underlying the section was to protect the trade from restraints. But when trade in India was developed to a larger extent, there is no reason why a more liberal attitude should not be adopted by acknowledging such restraint as reasonable."[12]

Nevertheless, the relationship between an employer and employee have an element of trust and confidence, thereby imposing the principles of utmost good faith between the two parties. However, the duty of fidelity does require that an employee should disclose his material interest in any transaction which he might have benefited from the information, contacts, and homework which an employer might have carried out. Thus, disclosure of interest and maintaining loyalty to the employer is an implied term of employment contract. Take for example in *Industrial Development Consultants* [IDC] v. *Cooley*,[13] the defendant, a reputed architect was employed with IDC. The Eastern Gas Board Company was offering a lucrative contract for building four depots and IDC was keen to bid for the same. Cooley thought that he too was keen to get the contract on his own, resigned from IDC claiming nervous breakdown and bid for Eastern Gas Board contract. The contract was given to Cooley. IDC filed a suit against Cooley for breach of duty and account for the profits. The court held that there was a breach of implied duty of fidelity and Mr. Cooley must account for the profits. Cooley could not have bid for the contract without all the material information he acquired during the nature and course of his employment with IDC.

The other aspect is that the Constitution of India recognizes the freedom and liberty to practice whatever business, trade or profession, as and where they want.[14] Traditional restrictive covenants in employment agreements contain one or more of the following provisions:

1. Confidentiality agreements (non-disclosure clauses): in which the employee promises not to reveal confidential or proprietary information

[11] AIR [1931] All. 83.

[12] Pollock and Mulla, *Indian Contract and Specific Relief Acts* (13th Edition, ed. Nilima Bhadbhade, Vol. 1, Lexis Nexis, Butterworths, 2006, New Delhi) at 813.

[13] [1972] 2 All ER 162.

[14] *Supra* n. 4, at 254.

acquired in the course of employment after the employment is terminated;[15]

2. Non-competition agreements (non-compete clause): in which the employee promises not to start a competing business or work for a competitor for a given period after departing;[16] and
3. Non-solicitation agreements: in which the employee promises not to solicit the employer's clients or employees for a given period after terminating the employment.

Impact of Non-disclosure Agreement (NDA)

In India, the courts have shown reluctance in enforcing NDA[17] clauses. The Supreme Court in *Shree Gopal Paper Mills* v. *SKG Malhotra*[18] NDA clause case held against the company. The defendant employee had signed an employment contract wherein clause 2(c) read as follows: "Employee or managing agents … shall not divulge nor communicate to any person or persons whatsoever any information which he may receive or obtain in relation to the affairs of the Company." The defendant worked as an apprentice for one year and left the company. The company sought an injunction which was denied by the court. The court held that on evidence it can be concluded that no special training was imparted to the defendant so as to treat any information which the employee may have as trade secrets. Thus, the clauses in the contract were non-enforceable.[19] This case was followed by the famous *Niranjan Shanker Golikari* v. *The Century Spinning*

[15] Bob Hepple, "The Duty of Loyalty: Employee Loyalty in English Law," 20 *Comparative Labor Law & Policy Journal* 205, 214 (1999) at 215.

[16] *Ibid.*

[17] Non-disclosure agreement.

[18] AIR [1960] SC 61.

[19] Also see *V.N. Deshpande* v. *Arvind Mills*, AIR [1964] Bombay 423. In the said case, the High Court of Bombay was considering a clause relating to confidentiality of information and stated as follows: "Clause 9 of the agreement prevents the appellant from divulging any secret information of the nature mentioned in that clause after the termination of his service. As pointed out in (1916) 1 AC 688 the defendant is not prevented from acquiring knowledge which makes him a better employee for the public for future employment. It only prevents him from divulging information which he has received as respondents' employee to another party. It is therefore, clear that the clause as worded is proper and an injunction granted in terms thereof is not unreasonable or wider latitude than justified in law."

Company.[20] Century Spinning Company entered into a foreign collaboration, with a German company, for technology transfer. The company also entered into an agreement with its foreign collaborators for maintaining confidential information. Contract of employment with the employee was for 5 years. The employee received training for 9 months and left the company. Cl. 9 of contract stated: "Employer shall have the right to restrain an employee from divulging any and all information, instruments, documents, reports etc which may have come to his knowledge while in service of the company." While distinguishing between special information and general knowledge, the court held that *general knowledge is the asset of the employee* and no injunction can be granted. The court held that "Any restraint of trade for the protection of trade secrets is reasonable, if restricted to time, nature of employment and area." A restraint is valid if it protects a "legitimate" interest of the covenantee. The nature of interests recognized as legitimate by law will vary according to the subject matter of the contract. In no case will the law allow a covenant merely to avoid competition;[21] also an employer has an interest in preserving the trade secrets and business connections.[22]

Impact of Non-compete Clause

Traditionally, Indian lawyers would rubbish the very idea of signing *non-compete clause* with employees because it was judicially indefensible. This was because of case laws which reflect the above said position. An employer is not entitled to protect himself against competition per se on the part of an employee after the employment has ceased.[23] A bare covenant not to compete cannot be upheld.[24] But in an employment contract, the employer may protect two interests: trade secrets and business connections. But even though the employer has trained the employee or enabled him to become a skilled craftsman or professional worker, he cannot demand that these skills should not be used against him.[25]

Perceptions about "restraint of trade" clause have changed with the decision of the Supreme Court in *Gujarat Bottling* v. *Coca Cola Co*.[26] Coca

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[20] AIR [1967] SC 1098.

[21] *Premji Damodar* v. *Firm LV Govindji and Co*, AIR [1943] Sind 197.

[22] *Eastham* v. *Newcastle United Football Club Ltd.*, [1963] 3 All ER 139.

[23] *Halsbury's Laws of England*, 4th edn., Vol. 47, para 27.

[24] *Vancouver Malt and Sake Brewing Co Ltd.* v. *Vancouver Breweries Ltd.*, AIR [1934] PC 101.

[25] *Supra* n. 6, at 825.

[26] AIR [1995] SC 2372.

Cola licensed Gujarat Bottling to bottle and sell the beverage subject that Gujarat Bottling Co. could not manufacture, sell, deal, or otherwise associate with competing products. When Gujarat Bottling breached the covenant, the matter went up to the Supreme Court. The Supreme Court held that "a negative covenant that the employee would not engage himself in a trade or business or would not get himself employed by any other master for whom he would perform similar or substantially similar duties, is not therefore a restraint of trade unless the contract as aforesaid is unconscionable or excessively harsh or unreasonable or one sided…" But the court went on to hold that "any Non disclosure clause shall be applicable only during the period of service and any restraint beyond the service is violative of sec. 27[27] Indian Contract Act 1872." Thus, any such restraint can be held reasonable during the period of employment and post the termination of employment the clauses cannot be enforced against the employee.

An agreement of service by which an employee binds himself during the term of his agreement, not to compete with his employer, directly or indirectly, is not in restraint of trade. In *Makhanlal Natta* v. *Tridib Ghosh*,[28] a stage artist had agreed with a drama company not to join another drama company. The clause was considered reasonable, and the artist was restrained from joining another company. The clause was reasonable considering that the remuneration given to him by the plaintiff was much more that offered by the other company, and that injury to the plaintiff was irreparable. Similarly a negative covenant in a contract of service of an assistant engineer not to leave the service of his employer during the term of the contract, and not to serve or engage for any other firm in India or elsewhere during that period was held to be not in restraint of trade.[29]

To this contrast one must note that wrongful dismissal of an employee, being an entire repudiation of the contract, puts an end to an ancillary agreement like the covenant in restraint of trade. The same was reiterated by the court in *Superintendence Company* v. *Krishna Murgai*.[30] The employment contract clause read as follows: "Employee hereby agrees not to take employment in a competitor firm or set up a similar business himself after he '*left*' the service of the employer." The defendant's service was terminated and he subsequently established a competing business. Company sought an injunction. The court interpreted the term "leave" to mean

[27] Section 27 of the Contract Act states that "Every agreement by which any one is restrained from exercising a lawful profession, trade or business of any kind is to that extent void."

[28] AIR [1993] Cal 289.

[29] *Lalbhavi Dalpatbhai and Co* v. *Chittarangan Chandulal Pandiya*, AIR [1966] Guj. 189.

[30] AIR [1980] SC 1717.

voluntary and not termination. The court held that wide interpretation of the term "leave" to include termination would violate sec. 27 ICA being in restraint of trade and unreasonable.

Thus, it can be inferred that restrictive covenants are not per se violative of sec. 27, they would be invalid only if the employer fails to prove that they are reasonable. However, in Gujarat Bottling case[31] the court refused to consider the question whether reasonableness of restraint is within the purview of sec. 27 of the Contract Act and proceeded on the basis that an enquiry into reasonableness of the restraint is not envisaged by sec. 27. On that view, it held that instead of being required to consider two questions as in England, the courts in India have only to consider the question whether the contract is or is not in restraint of trade.[32] A breach of a valid covenant in restraint of the trade may be restrained by injunction even though the covenant gives an alternate remedy. But no injunction will be granted which will have the effect of specific performance of the contract of personal service, although a negative covenant not to serve elsewhere may be enforced; but the court will not enforce it if it deprives the employee of his means of livelihood.[33]

In *Sunilchand C. Mazumdar* v. *Aryodaya Spg and Wvg Mills Co. Ltd.*,[34] the defendant, a qualified technician and diploma holder, in textile technology agreed to serve the plaintiff's spinning mills for 5 years. After serving for about a year as a senior assistant he resigned and accepted an employment in another spinning company on a salary higher than he was getting. He was employed by the plaintiff because of his specialized training and there was considerable dearth of such trained technicians. This agreement was held valid and an injunction to prevent breach of negative covenant was granted. If the contract as a whole appears, on the face of it, not to be unreasonable in the interest, either of the parties or of the public, that is enough and the question is not of evidence. The only matter in which respect such a negative covenant can be justified is to protect the business or trade secrets and business connections of the employer. An employee can be restrained from making misuse of trade secrets. A restraint against competition is justified, if the object of the restraint is to prevent the exploitation of trade secrets

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[31] AIR [1995] SC 2372.

[32] Note that both the Niranjan Shanker and Gujarat bottling case decisions were delivered by Division benches of equal strength. Hence, as per rule of precedents, one decision cannot be said to have overruled the other. Further, the Gujarat case did not refer to the Niranjan case.

[33] *Supra* n. 12, at 856.

[34] AIR [1964] Guj. 115.

learned by the servant in the course of his employment.[35] It must, however, be proved definitely that the servant has acquired substantial knowledge of some secret process or mode of manufacture used in the course of his business. But, there can be no valid restraint in case the so called secret is nothing more than a special method of organization adopted in the business, or only part of the secret is known to the employee so that its successful exploitation by him is impossible.[36] Further, an employee can be restrained from exploiting his master's customer. An employer is entitled to protect his business connections, that is, prevent his customers from being enticed away by his former employee, who has had special opportunities of becoming acquainted with his clientele.[37]

English judges[38] became more tolerant of voluntary restraints in the early 18th century. "Partial" restraints (i.e., agreements not restrictive in primary effect) were deemed enforceable, as were restraints that conformed to a flexible standard of reasonableness, that is, agreements that were self-contained, or limited in duration, or harmless to the public.[39]

Restraint after Employment

The issue is if employment contract can be enforced after the period of employment. The courts have often restrained the enforcement of such negative stipulations unless the stipulation is "reasonably necessary for the protection of the legitimate interest of the employer. If it's not going to benefit the employer in any legitimate manner, the court would not injunct the employee from exercising his skill, training and knowledge merely because the employee has agreed to it."[40] Further, the courts have hesitantly held that such negative convenant are inoperative after an employee leave the employment of the master. In *Pepsi Food Ltd* v. *Bharat Coca Cola Holdings Pvt Ltd*[41] case, the court held that a negative covenant clause in the employment agreement restraining the employees from engaging in employment for a period of 12 months from leaving the employment was void as being opposed to public policy and the action for temporary injunction was denied.

[35] *Forster and Soaps Ltd* v. *Sugget*, [1918] 35 I.L.R. 87.
[36] *Herbert* v. *Saxelby* [1916] A.C. 688.
[37] *Dews* v. *Fitch*, [1902] 2 Ch. 159.
[38] http://www.answers.com/topic/restraint-of-trade?cat=biz-fin
[39] The "rule of reason" was first stated in *Mitchel* v. *Reynolds*, 1711.
[40] *Lalbhai Dappatbhai and Company* v. *Chitranjan Chandulal Pandya*, AIR [1966] Guj. 189.
[41] MANU/DE/0740/1999.

Similarly in *Star India* v. *Lamiraj Seetharam Nayak*[42] the court held that considering that an employer has right to terminate the contract of employment on the ground of misconduct, it would be unfair to the employee if employee had absolutely no right to resign from the employment on account of better prospects or other personal reasons.

In *Jet Airways Ltd* v. *R. Jan Peter Ravi Karnik*[43] the defendant was employed by the plaintiff aircraft company as a pilot. The plaintiff had organized necessary training for the defendant and other pilots. In consideration, the defendant agreed and undertook that during a period of 7 years from the date of completion of training in India and abroad and on resuming actual service with the plaintiff as First Officer, he would not accept employment, similar in nature, either in full time or part time with any other employer. The defendant resigned from the services for which the plaintiff had invoked the negative covenant clause in the agreement. The court accepted the contention that it would be unfair and unreasonable to enforce such a vague and blanket restraint after the period of employment as he has a right to explore new business opportunities and it goes to the fundamental right to earn a livelihood. The Bombay High Court held that the plaintiff had failed to show *prima facie* any legal or equitable right for the grant of injunction. The court emphasized the requirement on behalf of the employer (*a person who can dominate the will even if one considers that freedom of contract is paramount in all employment contracts*) to substantially prove that the employee intends to misuse or disclose confidential information, trade secrets, and intellectual property right (IPR) of the employer. Unless the employer convinces the court, the freedom of trade, occupation, and business under Article 19 of the Constitution shall overrule the implication of such negative stipulations. One must note that in the foregoing case, the employee had received training at his own expenses on the basis of a loan advanced by the employer. On this basis the court held that the employer did not have any proprietary right in the IPRs which flow from the training.[44]

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[42] MANU/MH/0406/2003.

[43] MANU/MH/0434/2000.

[44] Also see *Faccenda Chicken Ltd.* v. *Fowler et al.*, [1986] 1 All E.R. 617 (C.A.). In creating the trichotomy of "trade secrets," "highly confidential information," and "less confidential information," the court in *Faccenda Chicken* case was wrestling with two competing interests in employment cases where disputes arise after the termination of employment. From the employee's perspective, the question is, "What can I do when I go to work for a new employer or into business for myself?" From the employer's view point, the question is, "Can I prevent my former employee from using my trade secrets or confidential information?" This problem often

In *Zaheer Khan* v. *Percept D' Mark*[45] *[India] Pvt Ltd*[46] an agreement was entered to manage the media affairs and promotional activities of a cricketer. The agreement was for a period of three years commencing on October 30, 2000 and expiring on October 29, 2003. Few months before the expiry of the contract, the company offered Khan the terms for extension of their agreement for another five years. Zaheer informed the company that he did not intend to renew the contract. The company then informed Zaheer that according to the agreement he could not accept any offer for endorsements, promotions, advertising, or affiliation with regard to any product or services and that prior to accepting any offer, he was under an obligation to provide Percept in writing all the terms and conditions of such third party and offer the company the right to match such third-party offer. The company sent another letter where it further clarified its position in the letter saying that if Zaheer intended to enter into an agreement with a third party for managing media affairs, he must first inform the company of the offer and give a chance to match up its offer. Zaheer wrote back saying that he owed no such obligation after the termination of the contract and thus the arrangement was unfair. The court did not hesitate in holding the contention of Percept as violative of sec. 27 and thus to that extent the clause in the agreement were held void. The restraint of trade principle is based on the footing that an employer has no legitimate interest in preventing an employee, after he leaves his service, from entering the service of a competitor merely on the ground that he is a competitor.[47]

arises when the former employee is competing directly with his former employer. Underlying the answers to these basic questions are two competing policy considerations which the courts must attempt to balance. On the one hand, employees should be free to use their general skills and knowledge freely for themselves or for employers of their choice. In the absence of the misuse of confidential information or breach of a fiduciary duty, employees should be able to compete with their former employers. On the other hand, employers should be able to protect their business assets, tangible or intangible, from being used without authorization and/or to their disadvantage. Employers should not be made to suffer from unfair competition from former employees who may either be in business for themselves or employed by a competitor. Michael G. Horan and Ian D. Werker, "Trade Secrets, Confidential Information and the Employment Relationship," available online at http://www.werkerlaw.com/tradesecrets.htm, accessed on October 12, 2008.

[45] Percept D' Mark is a company which carried on business of event management, model, and celebrity endorsements.

[46] AIR [2004] Bom. 362.

[47] *Kores Manufacturing Co Ltd.* v. *Kolok Manufacturing Co Ltd.*, [1959] Ch 108 at p. 126.

Not in Restraint of Trade

Comparatively, there are several instances wherein the courts were convinced enough to protect the interest of the employers. An agreement of service by which a person binds himself during the term of the agreement not to take service with anyone else, or directly or indirectly take part in, promote, or aid by any business in direct competition with that of his employer is not hit by sec. 27.

The court in *Pragi* v. *Pranjiwan*[48] observed: "An agreement to serve a person exclusively for a definite term is a lawful agreement and it is difficult to see how that can be unlawful which is essential to its fulfillment, and the due protection of the interest of the employer while the agreement is in force." The result of the earlier discussion is that consideration against restrictive covenants are different in cases where the restriction is to apply during the period after the termination of the contract than those in cases where it is to operate during the period of the contract. Therefore, a negative covenant that the employee would not engage himself in a trade or business or would not get himself employed by any other master for whom he would perform similar or substantially similar duties is not therefore a restraint of trade unless the contract as aforesaid is unconscionable or excessively harsh or unreasonable or one-sided.[49]

Similarly in *Lloyd Electric Engg* v. *Dr. Rajeshwar Kr. Malhotra*[50] the court considered the applicability of a negative covenant imposed by the company on the employee wherein the employee was required not to compete with the company for 3 years from date of termination of employment, directly or indirectly. The court upheld the reasonability of the covenant and the contention of the employer was accepted.[51]

The courts, however, have distinguished between a restraint applicable during the term of contract of employment and those that apply after cessation.[52] But in *W. H. Milsted and Sons Ltd* v. *Hamp and Ross and Glendinning Ltd*,[53] where the contract of service was terminable only by notice by the employer, Eve, J. held it to be bad as being sided. But where the

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[48] [1903] 5 Bom. L. R 878.

[49] W. H. Milsted and Sons Ltd. (1927) W. N 233.

[50] Civil Revision No. 715/96.

[51] Also see Naina Krishna Murthy, "Restraint of Trade: Bane or Boon?" *Manupatra Newsline*, Vol. 2 Issue 9, September 2007.

[52] *Halsbury's Law of England*, 3rd edn., Vol. 38, p. 31.

[53] Report [1927] W. N 233.

contract is not assailable on any such ground, a stipulation therein that the employee shall devote time to the employer, and shall not during the term of the contract serve any other employer would generally be enforceable.

In post-term covenants, most courts apply a four pronged test[54] to determine reasonableness: The covenant must:

1. be ancillary to an otherwise lawful contract and reasonable with respect to time and territorial scope;
2. be no greater than required to protect the legitimate interest of the employer;
3. not impose undue hardship on the employee;
4. not be injurious to public policy.

Termination of Negative Covenants

Any question as to duration and termination of employment depends upon the intention of the parties. It is open to the employer and the employee at any time to terminate the contract by mutual agreement. An employee is entitled, on the wrongful dismissal, to the damages for loss of earning and other benefits he would be entitled to, had this employment been terminated according to contract, and if no period is fixed for termination he is entitled to reasonable compensation for loss of earning for such a period. In any other case, damages are to be measured by the amount of remuneration which the employee has been prevented from earning by reason of wrongful dismissal including the value of any other benefit he is entitled by virtue of his contract. An employee is also entitled to interest or reasonable compensation on the event he is not paid due salary. Moreover, if an employee fails to discharge his duties properly, he is obliged to indemnify his employer for the loss. And where the employee is guilty of grave misconduct in his capacity as an employee, he may be dismissed without notice. Thus, it can be concluded that employment contract is a contract of service between the employee and the employer to serve the latter, fulfilling all terms and conditions provided in the contract. There are certain conditions which become statutory

[54] *Kutka* v. *Temporaries Inc.*, 568 F Supp 1527, 1536, Bus Franchise Guide (CCH) 8084 (SD Tex 1983); *South Bend Customer Club, Inc.* v. *United Consumers Club, Inc.*, 572 F Supp 209, Bus Franchise Guide (CCH) 8106.

responsibility of the employer and thus protect the employee in certain circumstances even without having been covered by the terms of an employment contract.[55]

There are public policy elements involved in determining if a restraint of trade covenant is valid. The court will consider the equality of the bargaining power between the parties, the length and scope of the clause, and the type of prohibition involved in the restraint of trade clause.[56]

The court has consistently held that the *onus of proof* of a violation of employment contract is on the party who claims the violation of the agreement. The learned judges in *Niranjan Shanker* case[57] were of the opinion that where an agreement is challenged on the ground of it being in restraint on trade, the onus is upon the party supporting the contract to show that the restraint is reasonably necessary to protect his interests. The Gujarat High Court in *Sandhya Organic Chemicals* v. *United Phosphorus Ltd*.[58] held that the onus of proof shall lie on the party who claims the violation of an agreement. Sandhya Chemicals invented a new process of manufacturing aluminum and zinc phosphides and claimed that one of its employee who had known the trade secrets leaked information to United Phosphorus. The employee joined United Phosphorus. After 2½ years of leaving Sandhya, the employee was alleged to have leaked trade secrets in helping United Phosphorus start selling a similar product using the same process. Sandhya Chemicals brought a suit of injunction against United Phosphorus from making use of the trade secrets by a former employee of Sandhya.[59] The court held that unless Sandhya can prove patentability of its product, United Phosphorus can bring out similar products and hence would have no liability whatsoever toward Sandhya. Neither is it liable for making use of trade secrets from an ex-employee of Sandhya. This case shows how difficult it would be for any company to actually prove the violation of NDA post employment. Further, even if the information is clearly a trade secret, proving that a former employee has disclosed trade secrets to a new employer can be difficult. Some federal courts outside

[55] www.netlawman.co.in/info/india-employment-contracts.php

[56] *Orton* v. *Melman*, [1981] 1 NSWLR 533.

[57] AIR [1967] SC 1098.

[58] AIR [1997] Guj 177.

[59] This case is significant because of the fact that Sandhya decided to bring in the liability of a new employer over NDA clauses as Sandhya knew that it would fail in enforcing NDA agreement over the employee after nearly 2½ years.

California have adopted a theory commonly referred to as the "inevitable disclosure" doctrine. Under this doctrine, the former employer need not show that trade secret information has actually been disclosed, but rather, that the new position would necessarily require the former employee to rely on trade secret information.[60] In those jurisdictions in which the doctrine has been adopted, employers have successfully relied on it to prevent a former employee from working for a direct competitor. The inevitable disclosure doctrine has developed around the issue of employees seeking new employment in a similar business. The underlying principle is that employees who have had access to confidential information will inevitably disclose the information to a future employer if working in the same field. Even if the employee has good intentions the doctrine presumes that it is inevitable that the information, skills, and knowledge absorbed while working in one employment will automatically or instinctively come out when working in the next employment if it is in the same field. The policy considerations referred earlier come into play here. Society needs to protect the confidential information of its enterprises but it also cannot restrict the freedom of employment of its members.[61]

Thus, the onus of justifying the covenant in restraint of trade or of proving reasonableness lies upon the covenanatee.[62] But once this onus is discharged, the onus of proving that the restraint tends to injure the public lies upon the party attacking the covenant.[63] The court will take judicial notice of illegality of a covenant, which is on the face of it in restraint of trade, even though it is not pleaded; but if it is not restraint *ex facie*, the court in the absence of the evidence cannot decide against the covenantor.

In the test of application of restrictive covenant, the court has always balanced non-compete clause (NCC) and NDA clauses with reasonableness and the value of public policy present in the society. Thus, a blanket application and enforcement of such clauses would obviously lead to exploitation of "freedom of contract." The evolutions of certain principles have thus helped in reasonable NDA and NCC agreements. The test of NDA and NCC can be summed up:

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[60] *PepsiCo, Inc*. v. *Redmond*, 54 F.3d 1262 (7th Cir. 1995).

[61] Talhiya, Sheikh, "Trade Secrets and Employee Loyalty," available online http://www.wipo.int/sme/en/documents/trade_secrets_employee_loyalty.html, accessed on February 1, 2008.

[62] *Hukmi Chand* v. *Jaipur Rice and Oil Mills Co*, AIR [1980] Raj 155. Also see *Lindner* v. *Murdock's Garage*, [1950] 83 CLR 628 at 646.

[63] *Niranjan Shankar Golikari* case.

1. Clauses in the contract should not be greater than necessary to protect its legitimate business interests, such as a trade secret.
2. Clauses in the contract should not be unduly harsh or oppressive in restricting the employee's ability to earn a living.
3. Clauses should not be against public policy.[64]
4. The law which applies to restraints of trade in sale of *business transactions* permits the prohibition of behavior by the seller which derogates from the goodwill the seller sold to the buyer. This is an example of a protectable interest.[65]
5. All NDA and NCC clauses must have limitations as to the restraint on time–space–locality rule.

Non-solicitation Clause

A non-solicitation clause attempts to prevent an ex-employee from using personal influence and knowledge of clients to entice them away.

In *Loral Corp.* v. *Moyes*,[66] the California Court of Appeal upheld an agreement that restrained former employees from disrupting, damaging, impairing, or interfering with the former employer's business by "raiding" its employees, presumably referring to solicitation of a large number of employees. In upholding the anti-raiding clause, the court reasoned that an agreement penalizing a former employee for obtaining employment with a competitor to be reasonable. However, according to the court, the clause should not affect an agreement limiting *how* the former employee can compete. Such clauses do not restrain trade because the former employee is not restricted in finding employment and current employees may seek employment with the former employee's new employer. In the words of the court, "[E]quity will not enjoin a former employee from receiving and considering applications from employees of his former employer, even though the circumstances be such that he should be enjoined from soliciting their applications."[67]

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[64] *Paramount Termite Control Co., Inc* v. *Rector*, 380 S.E.2d 922, 924 (Va. 1989).

[65] Noric Dilanchian, "Contract Drafting Tips Series: Restraint of Trade Clause," available online at http://www.dilanchian.com.au/corporate-and-business-dealings/contract-drafting-tips-series-restraint-of-trade-c-33.html, accessed on October 24, 2007.

[66] 174 Cal. App. 3d 268 (1985).

[67] *Ibid.*

Given the broad reasoning in the *Loral* opinion, there is a strong argument that clauses restricting solicitation of employees—not just "raiding" of employees—are enforceable and do not run afoul. However, inclusion of such a clause in an employment agreement may be of limited value to an employer. As stated in the *Loral* decision, a clause prohibiting the solicitation of employees does not restrain current employees from contacting, seeking employment with, or being employed by the former employee's new employer.

Recently, a California Court of Appeal addressed the enforceability of a non-solicitation clause in the context of a wrongful termination case.[68] The *Thompson* case arose when Impaxx fired Daniel Thompson for refusing to sign an agreement that restricted his ability to "call on, solicit, or take away" its customers for a period of 1 year after his employment ended. Thompson sued Impaxx for wrongful termination in violation of public policy, and claimed the non-solicitation clause was an unenforceable restrictive covenant. The trial court dismissed Thompson's claims, and found the non-solicitation clause to be enforceable. However, the California Court of Appeal reversed this decision. In its decision, the California Court of Appeal held that Impaxx's non-solicitation clause was enforceable only if it was necessary to protect the company's trade secrets, and directed the trial court to determine whether Impaxx's customer list was, in fact, a trade secret.

Thus, a clause prohibiting solicitation of customers is generally enforceable when the identities of customers are trade secrets. Whether a customer list constitutes a trade secret depends entirely on the facts of the particular company and its market. Although many employers may wish to have employees sign non-solicitation clauses, even when a trade secret is not involved, employers should not require employees to sign such clauses as a condition of employment.

The limitation of non-solicitation clauses is that they only prevent employees from approaching your customers and do not prevent your employees from dealing with customers who contact them. There is sometimes a natural gravitation of customers toward an employee who has left and it is sometimes difficult to show whether the employee or customer made the first contact. In these circumstances, the employer will generally be well advised to have a "non-dealing clause" in the contract of employment which will prevent the employee from having dealings for a limited period with the customer even where the customers makes the first approach. The non-dealing clause is more difficult to enforce than the non-solicitation clause

[68] *Thompson* v. *Impaxx, Inc.*113 Cal. App. 4th 1425 (2003).

but a narrowly drafted non-dealing restriction is still likely to be enforceable in most circumstances.[69] Courts have further developed the principle called the springboard doctrine. In *Terrapin* v. *Builders Supply*[70] the court held that "a person who has obtained information in confidence is not allowed to use it as a springboard … and a springboard it remains even when all the features have been published or can be ascertained by actual inspection by any member of the public."

Conclusion

Over the past few months, employers have been creating more jobs and hiring more employees. In recent years, with more employment opportunities available, employees are more mobile than they have been. However, as employee mobility increases, so do employer concerns about the possible disclosure of trade secrets when employees leave to join other companies. Restraint of trade clauses usually contain restrictions on the employee's ability to work in a geographical area, or for a defined length of time. It is not uncommon or illegal for an employer to restrict a former employee from working within a fixed geographical area, or from working with a rival business to the former employer for a period of time after the cessation of the contract of employment. However, the restrictions must not be excessive. What is excessive depends on the nature of the work in question and the structure of the business.[71]

Employment contract is a dynamic issue which changes with time as the nature of employment and scope of employment progresses. Today due to globalization contracts are developing newer facets; thus, the remark of Lord Wilberforce in *Esso Petroleum Co. Ltd.* v. *Harper's Garage [Stourport] Ltd.* can be recollected. The Lord had stated that "classification of agreements in restraint of trade must remain fluid and the categories can never be closed."[72] The policy of restraint of trade does not allow any unnecessary restraint on trade; this policy is justified on the grounds that, first, autonomy

[69] Protecting Business Interests in Employee Contracts; http://www.lemon-co.co.uk/article_protecting-business-interests.php, accessed on November 24, 2008.

[70] [1967] RPC 375.

[71] *Supra* n. 3.

[72] [1968] AC 269.

is a crucial ingredient in individual well-being and law should not help individuals to give up future autonomy unnecessarily; and second, that unnecessary restraints hinder the free flow of labor and resources crucial to the efficient functioning of a market economy. Thus, any policy on restraint of trade should balance the conflicting principles of public policy: a person entering into a contract by his own freewill shall be bound by his own bond, and everyone should have unfettered liberty to exercise his skills for the benefit of the community.[73]

Factors taken into account in deciding whether a restraint is reasonable include: the nature of the employee's job; whether the employee is prevented from earning a living in his chosen field.[74] One may safely conclude that any negative covenant in an employment contract will be tested by the courts first based on the rule of "reasonability." In England, the courts have applied the test of reasonability in determining whether the restraint of trade is enforceable or not, replying on the authority of the *Nordenfelt* v. *Maxim Nordenfelt Ltd*.[75] Lord Macnaghten laid down the general test of restraint of trade as "….whether a restraint is reasonable with reference to the particular case." Thus, all restraints are *prima facie* void, but valid if reasonable.[76] The reasonableness of the restraint depends upon: (i) the nature and extent of the trade; (ii) the nature and extent of the servant's employment therein; and (iii) the factors of time and scope; as the time of restriction lengthens or the space of its operation grows, the weight, or the onus on the covenants to justify it, grows too.[77]

Distinction must be clearly drawn between commercial contracts and employment contracts. In commercial contracts, restraints of trade are allowable to a greater degree because the parties are generally held to be dealing with equal bargaining power. However, in employment contracts, the courts have used the test of reasonability in determining the validity of the agreement as it is presumed that in employment contracts there is unequal bargaining power between the parties. Courts have recognized the fundamental right of an individual to practice any profession, trade, or vocation and have often stated that no right is absolute. Reasonable restriction on the exercise of this right is to maintain equilibrium between

[73] *Supra* n. 12, at 254.

[74] http://www.mofo.com/news/updates/bulletins/bulletin1205.html

[75] [1894] AC 535.

[76] This approach in England was confirmed by the House of Lords in *Mason* v. *The Provident Supply and Clothing Co*, [1913] AC 724.

[77] *Attwood* v. *Lamont*, [1920] 3 K.B 57, at 589.

the employee's right and the interest of the employer's. The courts have allowed the enforceability of non-compete covenants during the course of the employment, unless they were too harsh.[78] The second test is that negative covenant must be restrained by the time–space–locality rule. This rule says that any absolute restriction on post-employment opportunities can be valid only if it stipulates the time during which the employee will be restricted or to the extent of number of years an employee cannot seek employment with another competitor and the restriction should reasonably apply to the "space" of business in which the employer has transferred trade secrets or confidential information to the employee and the restriction should not apply to the world at large or to the country as such, but to a limited "locality" which might be the competing edge of business to the employer.

Finally, all restraints of trade in the absence of especially justified circumstances are contrary to public policy and void. Further, it is question of law whether the special circumstances do or do not justify the restraint, and if a restraint is not justified, the court will not, since it relates to a matter of public policy, enforce such agreements.

To add, a restraint can only be justified if it is reasonable in the interest of the parties and the interest of the public; thus, the onus of showing that the restraint is reasonable rests on the party who alleges its violations. Currently sec. 27 of the Indian Contract Act does not stipulate clearly the boundaries and limitation in relation to an employment contract, the foregoing test of reasonability and time–space–locality must be read into the contractual terms.

[78] *Supra* n. 12, at 257.

15

Insurance Contracts

Divya Anne Jeswant,
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Introduction

A working definition of insurance contracts sourced from a dictionary of insurance reads as follows:

> "Insurance is a contract whereby one party, called the insurer, in return for a consideration, called the premium, undertakes to pay to the other party, called the insured, a sum of money or its equivalent in kind upon the happening of a specified event that is contrary to the interest of the insured."[1]

The purpose of insurance contracts is to combat individual, group, and societal risks by distributing the losses to those who are better able to bear them.[2] The aim of insurance is to restore the position of the insured to that before the loss-causing event occurred. Thus, except in the case of some forms of insurance such as life insurance, an insurance contract is an indemnity contract, that is, an insurer provides exact financial compensation for the damage or injury suffered.[3]

Insurance contracts are governed by the general law of contract contained in the Indian Contract Act, 1872 or by special legislation, if any, as well as trade usage and custom. This is usually discerned through the use of judicial precedent.[4]

All insurance contracts may broadly be classified on the basis of the nature of the interest involved into personal insurance, property insurance, and

[1] H. Cockerell, *Dictionary of Insurance* (London: Witherby and Co. Ltd., 1980) at 101.
[2] B.N. Singh, *Insurance Law* (3rd edn., Allahabad: The University Book Agency, 1993) at 2.
[3] M. Clarke, *Policies and Perceptions of Insurance: An Introduction to Insurance Law* (Oxford: Clarendon Press, 1997) at 23.
[4] *Supra* n. 2, at 13.

liability insurance. This chapter has been divided into three parts studying the key types of insurance within each category of insurance contracts. This study is selective as it intends to cover areas of insurance based on importance, on one hand, and emergent issues and the urgency of reform required in the selected areas on the other. Life insurance is studied under personal insurance contracts; fire insurance and marine insurance under property insurance; and public liability insurance, motor vehicle insurance, product liability insurance, and employer's liability insurance under liability insurance.

Personal Insurance: A Fresh Look at the Life Insurance Sector

"Life insurance," as correctly pointed out by Justice Ramaswami, is a broad term encompassing "any contract in which one party agrees to pay a given sum upon happening of a particular event contingent upon the duration of human life, in consideration of the immediate payment of a smaller sum or certain equivalent periodical payments by another party."[5] This definition is apposite for two reasons. First, it demonstrates the nature of life insurance as a form of contingency insurance (along with accident insurance) as opposed to indemnity insurance, a distinction brought out by the Court of Appeal in the United Kingdom in *Gould* v. *Curtis*,[6] wherein Buckley, L.J. pointed out that life insurance does not involve compensating a person for the loss flowing from an adverse event, but is simply an agreement to pay a specified sum of money on the happening of a particular event, whether or not that event is adverse to the assured. This distinction leads to at least two important corollaries:

1. Unlike a contract of indemnity, where the objective is to put the assured in the same position he/she would have been if the loss had not occurred, a life insurance contract, by virtue of involving an obligation to pay a definite sum of money, does not purport to measure the loss, and is therefore a *valued* policy.[7]

[5] *Chandulal Harjivandas* v. *I.T. Commissioner, Gujarat*, AIR [1967] SC 816. In *LIC* v. *Vishwanath Verma*, AIR [1995] SC 189, the definition is somewhat restricted as "life insurance" is defined merely in terms of a promise to pay a certain sum upon the death of the assured.

[6] [1913] 3 K.B. 84.

[7] S.S. Huebner and Kenneth Black, *Life Insurance* (Englewood: Prentice-Hall, 1982) at 153.

2. The *doctrine of subrogation*, conferring upon the insurer the right of action of the assured against a third party, is inapplicable in relation to life insurance (and accident insurance) given that the insured can never recover a full indemnity for loss as human life cannot be valued, as a result of which he/she should not be deprived of any right of recovery vis-à-vis a third party.[8]

The second reason why the foregoing definition found in Justice Ramaswami's judgment is appropriate is because in speaking of "a particular event contingent upon the duration of human life," it does not limit the scope of life insurance contracts to those triggered by the occurrence of death. While various types of policies exist, the chief among them are:

1. Term insurance, which furnishes protection for a limited period, where the sum assured is paid only if death occurs in that period[9]
2. Whole-life insurance, which provides for payment of face-value upon death of the insured regardless of when it occurs.[10]
3. Endowment Insurance, which provides for payment of the face value to the nominee on the death of the insured during a fixed term of years, while also ensuring payment of the face value to the insured in case death does not occur by the end of the said term;[11]
4. Annuities, where a periodic payment is made for a fixed period or for the duration of a life or lives, being made with reference to life contingencies. Such a scheme, however, involves "systematic liquidation" of that which has been created, as opposed to the creation of an estate in the generality of cases, which is why annuities are often distinguished from life insurance in general.[12]

The scheme of offer and acceptance in life insurance usually begins with negotiation of terms, following which the applicant makes a proposal which is treated as an invitation to offer if it is unaccompanied by premium, in which case the insurer makes the offer by issuing the policy which can then be accepted by the applicant by paying the premium. If the applicant's proposal

[8] *Colinvaux's Law of Insurance* (Robert Merkin ed., 8th edn., London: Sweet & Maxwell, 2006) at 381.

[9] *Supra* n. 7, at 66.

[10] *Supra* n. 7, at 77.

[11] *Supra* n. 7, at 92.

[12] *Supra* n. 7, at 100.

is accompanied by the premium, it is treated as an offer which will then be treated as a binding contract through absolute and unqualified acceptance on the part of the insurer.[13]

It is trite to state that, in common law, the insured must have an *insurable interest* in the assured life, in the absence of which the insurance contract in question will be void.[14] In India, the source of this rule would be public policy, given that a contract where the insured has no insurable interest would be contrary to public policy as the insured would have an incentive to destroy the subject matter of the contract (namely the life itself), along with sec. 30 of the Indian Contract Act, 1872 which declares contracts by way of wager to be void,[15] which would apply in the absence of an insurable interest since such a contract would be one which merely hinges on chance, namely that of a person's death at a given time, as opposed to being one which provides a financial cushion to one genuinely affected by the assured life coming to an end.

The interesting question in respect of insurable interest, however, is whether cohabiting partners have an interest in the lives of each other. The strict tenets of English law would deny such a proposition, given that only one's interest in one's own life or in the life of one's spouse is recognized as an insurable interest in the absence of proof of some pecuniary interest.[16] In the United States, the law is more flexible, given that insurable interest may be grounded in "natural affection," though there must always be a "reasonable ground, founded upon the relations of the parties to each other, either pecuniary or of blood or affinity, to expect some benefit or advantage from the continuance of the life of the assured."[17] While neither of the foregoing positions clearly brings cohabiting partners within its fold, there is a powerful argument for adopting the position of the Scottish Law Commission which favors acceptance of the proposition that a cohabitant has an insurable interest in the life of his/her partner, without any qualifying

[13] See Janice E. Greider, Muriel L. Crawford and William T. Beadles, *Law and the Life Insurance Contract* (Homewood: Richard D. Irwin, Inc., 1984) at 147–48. See also M.N. Srinivasan, *Principles of Insurance Law* (8th edn., Nagpur: Wadhwa and Co., 2005) at 417–18; *LIC* v. *Raja Vasireddy Komalavalli Kamba*, [1984] 2 SCC 719.

[14] Andrew McGee, *The Law and Practice of Life Assurance Contracts* (London: Sweet & Maxwell, 1995) at 17.

[15] M.N. Srinivasan, *Principles of Insurance Law* (8th edn., Nagpur: Wadhwa &Co., 2005) at 436.

[16] See *Colinvaux's Law of Insurance* (Robert Merkin ed., 8th edn., London: Sweet & Maxwell, 2006) at 610–14.

[17] *Warnock* v. *Davis*, 104 U.S. 775.

period of cohabitation. The commission argues that only in the case of a relationship of some permanence would the question of life insurance even arise.[18] In any case, the death of one partner would result in the reduction of the living standards of the other, regardless of whether there is total financial dependence or not, hence giving rise to a pecuniary interest sufficient for an insurable interest to exist.[19] In India, it would make sense to adopt such a stance, especially since the Protection of Women from Domestic Violence Act, 2005 signals a recognition of a special relationship arising from cohabitation, given that the definition of "domestic relationship" under sec. 2 (f) of the Act includes within it persons living in a shared household having a "relationship in the nature of marriage."

It is significant to note that the Life Insurance Corporation of India (hereinafter "the LIC") no longer has a monopoly over the life insurance business, by virtue of the enactment of the Insurance Regulatory and Development Authority Act, 1999 which introduced sec. 30A into the Life Insurance Corporation Act, 1956 (hereinafter "the LIC Act").[20] The issue is whether the introduction of private players takes the LIC outside the scope of "State" under Article 12 of the Constitution, hence removing the possibility of constitutional remedies based on fundamental rights in addition to contractual remedies. In *L.I.C. of India* v. *Consumer Education and Research Centre*,[21] the LIC was declared to fall within the domain of Article 12, as a result of which it was required to act reasonably by virtue of Part III of the Constitution in introducing terms within insurance policies, and the rationale for the same was as follows:

> If it is shown that the exercise of the power is arbitrary unjust and unfair, it should be no answer for the State its instrumentality, public authority or person whose acts have the insignia of public element to say that their actions are in the field of private law and they are free to prescribe any conditions or limitations in their actions as private citizens, simpliciter, do in the field of private law. Its actions must be based on some rational and relevant principles.

[18] Malcolm A. Clarke, *The Law of Insurance Contracts* (London: LLP, 1997) at 87–88.

[19] Janice E. Greider, Muriel L. Crawford and William T. Beadles, *Law and the Life Insurance Contract* (Homewood: Richard D. Irwin, Inc., 1984) at 21–22.

[20] Section 30A states—"Notwithstanding anything contained in this Act, the exclusive privilege of carrying on life insurance business in India by the Corporation shall cease on and from the commencement of the Insurance Regulatory and Development Authority Act, 1999 and the Corporation shall, thereafter, carry on life insurance business in India in accordance with the provisions of the Insurance Act, 1938."

[21] [1995] 5 SCC 482.

Admittedly, the LIC's monopoly over the life insurance business has been eroded. However, the "insignia of public element" would remain intact. One reason for this would be that while the introduction of sec. 30A of the LIC Act extinguishes LIC's monopoly over the life insurance business, it does not repeal the Act itself. As a result, the change does not nullify the statutory nature of the corporation, the control over the company by the central government by virtue of Sections 4 and 5 of the Life Insurance Corporation Act, dealing with the constitution and capital of the company respectively, and the fact that the LIC is still under an obligation to act in the best interests of the community by virtue of sec. 6 of the LIC Act. The LIC remains a major player, if not the most major player, in the life insurance business today, and the mere fact of private players entering the market should not affect its status as an instrumentality of the state, especially since the test to determine the applicability of Article 12 of the Constitution involves a multi-pronged test.[22] Even though monopoly status may be a "highly relevant" fact, it cannot be the sole factor in determining whether a body is an instrumentality of the state.[23]

Having dealt with the changing contours of life insurance in India, it would now be useful to shift focus to the realm of property insurance.

Property Insurance

Fire Insurance

Fire insurance is defined under Section 2(6B) of the Insurance Act, 1938 in the following manner:

> "Fire insurance business means the business of effecting, otherwise than incidentally to some other class of insurance business, contracts of insurance against loss by or incidental to fire or other occurrence customarily included among the risks insured against in fire insurance policies."

However, the detailed legal regime governing fire insurance contracts is found not under the Insurance Act per se but under the various regulations formulated by the Tariff Advisory Committee (hereinafter "TAC"), a statutory body set up under the Insurance Act.[24]

[22] See, for example, *Ajay Hasia* v. *Khalid Mujib*, [1981] 1 SCC 722.
[23] *Ramana Dayaram Shetty* v. *International Airport Authority of India*, [1979] 3 SCC 489.
[24] Part IIB, Insurance Act, 1983.

The governing law for fire insurance contracts was recently formulated and comprises the All India Fire Tariff, 2001 issued by the TAC (which applies to a Standard Fire and Special Perils Policy), the Consequential Loss (Fire) Tariff (which applies to a Consequential Loss (Fire) Insurance Policy), and the various TAC Circulars issued from time to time.[25]

A typical fire insurance contract is no longer restricted purely to events related to loss caused by fire. The standard policy now issued is a "fire and special perils policy" which covers numerous other loss-causing events. The scope of the cover of this policy extends to a multitude of events including fire, explosion, riot, strike, terrorism, storm, flood, landslide, impact damage, overflowing of water tanks, missile testing, and bushfire.[26] There are also optional main extensions to the policy which include earthquakes and spontaneous combustions.[27]

The sum that is insured is determined by one of two methods. The first of these is to utilize the depreciated market value of the property commonly known as Depreciated Cost (Market Value) Basis. The second is the Reinstatement/Replacement Cost Basis in which the cost of restoring the property to its condition prior to the loss-causing event is used. Since the latter is more likely to restore the person more closely to the position he was in, prior to the loss, it is the recommended basis for calculating the sum insured.[28]

The premium to be paid by the insured is determined by taking into account factors such as the condition of the property in question and the past claims history on that property which will indicate the likelihood of a fire or other standard peril.[29]

It must be noted that every fire insurance contract also has significant exclusions. Of course, the exclusions may themselves be excluded by negotiation and incorporation of an express clause to that effect in the contract. Some of the usual exclusions include the first 5 percent of every claim arising out of act of God perils and loss due to war for an amount greater than Rs 10,000. However, these exclusions are inapplicable to dwellings.[30]

As noted in *Vijaykumar* v. *New Zealand Insurance Co.*,[31] prior to the coming into force of the All India Fire Tariff, 2001, there was no Indian

[25] See http://www.tac.org.in (accessed on September 20, 2008).

[26] Regulation 1(e), All India Fire Tariff, 2001.

[27] Add On Covers, All India Fire Tariff, 2001.

[28] http://www.icicilombard.com/app/ilom-en/Businessproducts/Fire-Perils.aspx (accessed on September 20, 2008).

[29] *Ibid.*

[30] Section II, All India Fire Tariff, 2001.

[31] *Vijaykumar* v. *New Zealand Insurance Co.*, 56 Bom LR 341.

enactment that dealt with the contractual principles to be applied to fire insurance contracts. Consequently, reference has been made to the general law of contract and Indian and English judicial decisions.[32]

Today, the various regulations of the TAC taken together form a detailed and comprehensive legal regime for the regulation of fire insurance. This may be attributed to the fact that the TAC deals not only with the legal aspects of fire insurance but its technical aspects as well.[33] Thus, with each circular, provisions for more specific areas of fire insurance contracts can be included. For instance, one of the TAC circulars dealt specifically with fire ratings for tractors lying in the open.[34] Further, a body like the TAC can also take business or trade practice into account in updating the legal regime.

Thus, the allocation of the regulation of fire insurance to the TAC is a commendable move. The only suggestion that may be made in this respect is that the various regulations and circulars of the TAC be consolidated and simplified further.

Marine Insurance

A marine insurance contract is defined under sec. 3 of the Marine Insurance Act, 1963 as "an agreement whereby the insurer undertakes to indemnify the assured, in the manner and to the extent thereby agreed, against marine losses, that is to say, the losses incidental to marine adventure."

Marine insurance contracts are governed in India by a special legislation, namely the Marine Insurance Act, 1963, which is largely based on the Marine Insurance Act, 1906 in the United Kingdom. The schedule to the Act contains a standard form of marine insurance policy as well as rules for its construction. To the above standard form is appended the institute clauses containing provisions insuring specific marine interests along with the attendant terms and conditions.[35]

However, if the provisions of the Act are studied vis-à-vis current trade practice, it is found that the form of policy used therein is outdated. The schedule to the Act contains an SG form of policy, which has now been replaced by the new MAR form of policy which is accompanied by new

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[32] M.N. Srinivasan, *Principles of Insurance Law* (6th edn., Bangalore: Ramaniya Publishers, 1997) at 221.

[33] *Supra* n. 25.

[34] http://www.tac.org.in/fcir2001.html#c18 (accessed on September 20, 2008).

[35] R.H. Brown, *Marine Insurance Vol. I: Principles and Basic Practice* (5th edn., London: Witherby and Co. Ltd., 1986) at 146–47.

institute clauses. This new form has been imported from the United Kingdom just as the SG policy was in its day.[36] Insurance companies in India now use the MAR policy and its key features are described in the following.[37]

There are four main types of marine insurance contracts in use, namely, marine import transit insurance, marine export transit insurance, marine inland transit insurance, and marine hull insurance. The first three of these are cargo insurance purchased either by the buyer or seller of the cargo. The last of these is the hull and machinery insurance which is purchased by the vessel owner to insure his vessel.[38]

A cargo insurance contract typically covers goods, freight, and other interests against loss or damage to goods during transportation. The policies opted for may be of various kinds. For instance, the insurance policy may be specific to a particular voyage for carriage of a particular kind of cargo (specific policy) or may cover carriage of a particular kind of good for a specified period (open policy).[39]

The sum insured against in a cargo insurance contract is the contract value for the sale of the cargo along with 10–15 percent for incidental expenses. In a standard marine insurance policy, events such as strikes are not covered by the insurance. However, strikes, riots, terrorist acts, etc., are available as add-on covers and such contingencies can also be insured against.[40]

In hull and machinery insurance, the scope of cover is the hull and machinery and the sum insured upon is an agreed upon value. The premium is determined as per the type of vessel, its age, its trading limit, past claims, etc.[41]

The contractual principles applicable to marine insurance contracts are contained in the Marine Insurance Act, the most important of which is the principle of *uberrimae fide* or utmost good faith contained in Sections 19 and 20. This requirement is imposed so that the insurer may decide upon the premium to be paid based on accurate information that represents the actual risk involved. If this requirement is not fulfilled, either party may

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[36] P. Millett, *The Encyclopedia of Forms and Precedents, Vol. XXXIX: Shipping, Solicitors, Stock Exchange, Telecommunications* (5th edn., London: Butterworths, 1991) at 265–66.

[37] http://www.icicilombard.com/app/ilom-en/Businessproducts/Bp-Marine.aspx (accessed on September 20, 2008).

[38] *Ibid.*

[39] http://www.niacl.com/comm-cargo.html (accessed on September 20, 2008).

[40] *Ibid.*

[41] http://www.icicilombard.com/app/ilom-en/Businessproducts/Marine-Hull.aspx (accessed on September 20, 2008).

avoid the insurance contract. As held in *Cantiere Maccanico* v. *Janson*,[42] there is a positive duty to disclose all material facts pertaining to the contract. However, at the same time, the court held in *Pan Atlantic Insurance Co. Ltd.* v. *Pine Top Insurance Co. Ltd.*[43] that the insurer cannot avoid the contract if the fact not disclosed to him would not have caused him to refrain from entering into the contract or would not have caused him to charge a higher premium.

Assessing the law in India, it is seen that, while it is true that the SG form of policy in the schedule to the Marine Insurance Act is not mandatory,[44] it is clear that the Act is in need of an update if it is to stay in step with the business practice of using the MAR policy. The TAC, which has been instrumental in fire insurance regulation in India, has been dealing with some aspects of marine insurance[45] and also plans to deal with hull insurance.[46] It is submitted that it may be more efficacious for the TAC to undertake the task of regulation of marine insurance as a whole. Updated legislation could then be formulated after taking into account legal and technical aspects as well as current business practice.

Liability Insurance

Liability insurance is a part of the general insurance system of risk financing designed to provide specific protection against third-party claims. This means that payment is not typically made to the insured person, but to a third party who has suffered some loss who is not a party to the insurance contract. Hence, what is envisaged by the insurance policy is, protection to persons engaged in certain kinds of activities that expose them to liabilities arising from claims of third parties exposed to the risk associated with the insured person, his property, products, etc.

"Liability" means responsibility and "legal liability" means responsibilities which can be enforced by law. Legal liability may be classified into *criminal liability* and *civil liability* and only civil liability claims are payable.[47] These arise when there is *prima facie* evidence of negligence by the insured resulting

[42] *Cantiere Maccanico* v. *Janson*, [1912] 3 K.B. 452.

[43] *Pan Atlantic Insurance Co. Ltd.* v. *Pine Top Insurance Co. Ltd.*, [1994] 3 WLR 677 (HL).

[44] Section 32(1), Marine Insurance Act, 1963.

[45] J. Kumar, "Gordian Knots of Marine Insurance," 23(03) *Insurance Times* (2003) at 27.

[46] *Supra* n. 25.

[47] See http://www.niacl.com/liab-pub.as (accessed on October 2, 2008).

in injury or death to any third party or resulting in damage to property belonging to a person other than insured, or in the custody of the insured. Liability may arise under tort or statute as will be seen in this section.

Liability insurance today primarily depends upon insurance companies that offer protection against specified perils in consideration of a premium. Premium is the cost of insurance and is generally calculated using a book rating and using a base rate, which includes the costs incurred by the insurer and the type of business for which the insurance has been taken. The premium is also calculated based on the estimate of the insurer of the level of risk associated with that particular business or industry area. Factors that will affect the premium include claims history, the size of the perceived risk, and the approach to risk management followed by the insured person.[48] In case an event that may give rise to liability as mentioned above occurs, the insurance company should be informed immediately to facilitate the processing of the claim.

Liability insurance does not in general cover damage caused intentionally and contractual liability are not covered under liability insurance policies. The insurance carrier can defend the insured in case a legal claim arises and this may not be affected by any policy limits.

In this section, we shall be examining three kinds of liability insurance:

1. Public Liability Insurance;
2. Employer's Liability Insurance; and
3. Product Liability Insurance.

Public Liability Insurance

Persons with the greatest public liability risk exposure are those whose premises are occupied frequently by members of the public, for instance, shopping mall and recreational facilities. However, public liability insurance covers a wide gamut of activities and processes in India, for example, it is compulsory for industries engaged in the production of hazardous substances to take out public liability insurance under the Public Liability Insurance Act, 1991. This is a direct fallout of the Bhopal Gas Tragedy in the 1980s.

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[48] "How liability insurance works," available online at http://www.businesslink.gov.uk/bdotg/action/detail?r.11=1073858799&r.13=1074299774&type=RESOURCES&itemId=1074301627&r.12=1074298750&r.s=m (accessed on October 2, 2008).

The public liability insurance policy covers the amount which the insured becomes legally liable to pay as damages to third parties as a result of accidental death, bodily injury, and loss or damage to the property belonging to a third party. The legal cost and expenses incurred in defending the case with prior consent of the insurance company are also payable subject to certain terms and conditions. Hence, it might be payable even if it is greater than the amount insured for.[49] A single policy can provide insurance for more than one unit of the company which may be in a different location.

Coverage

Tortious liability can arise in the following circumstances, necessitating liability insurance—collapse of the building structure; accidental falling of fixtures; accidents to visitors arising from bad maintenance or poor housekeeping of the premises; or accidental leakage of toxic substance which pollutes the atmosphere and injures or kills people.[50]

Hence, the following risks are usually covered in a public liability insurance policy:

1. Public Liability Non-industrial Risk which arises for offices, hotels, cinema houses, hospitals, schools, etc.
2. Public Liability Industrial Risk which arises in the case of godowns, warehouses, and factories.
3. Policies under the Public Liability Insurance Act, 1991, which is mandatory for owners, users, or transporters of hazardous substance as defined under Environment (Protection) Act, 1986 in excess of the minimum quantity specified under the Public Liability Insurance Act, 1991.[51]

The event giving rise to the claim should have occurred during the period of insurance or retroactive period and the claim should be first made in writing against the insured during the policy period. The maximum amount payable including defence cost will be the AOA (Any One Accident) limit selected. The Any One Year limit will get reduced by the amount of claim or indemnity paid for any one accident. Any number of such claims made during the policy period will be covered subject to the total indemnity not exceeding the Any One Year limit.

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[49] *Supra* n. 47.

[50] *Ibid.*

[51] *Ibid.*

In case of Public Liability Insurance Act, 1991 Policy, any award which exceeds the AOA limit will be paid by the government through Environment Relief Fund to which the insured has to contribute an amount equivalent to the premium paid under the Public Liability Insurance Act Policy. In the case of Public Liability Insurance Act, 1991, the AOA limit should represent the paid up capital of the company subject to maximum of Rs 5 crores. The AOY (Any One Year) limit is fixed at three times the AOA limit.

Exclusions

Exclusions include claims arising out of contractual liability, intentional non-compliance of any statutory provision, loss of goodwill, slander, fines, penalties, libel, false arrest, defamation, and mental injury.

Employer's Liability Insurance

Under modern labor laws, liabilities of an employer have been considerably extended and in such a situation, insurance aids an employer in meeting liability requirements. It was initially introduced in England to counter the insolvency of a company resulting in the employee being unable to recover compensation.[52] Employers often take out policies that will assure payment of gratuity, commuted pension, etc. Employer's liability insurance is not a compulsory class of insurance in India.

In England, employer's liability insurance is a compulsory class of insurance under the Employers' Liability (Compulsory Insurance) Act, 1969. The policy will cover the specific activities that relate to the employer's business. It is required by law to have insurance with a limit of indemnity of at least £5 million. It can be part of a group policy for the employees as a whole.[53]

It is required for the employer to carry out a risk assessment, take practical measures to protect employees, and report incidents. If the insurer believes that employer has failed to meet legal responsibilities for the health and safety of employees and that this has led to the claim, the policy may enable the insurer to sue employer to reclaim the cost of the compensation.[54]

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[52] "Liability Insurance," available online at http://www.berr-ec.com/CGIBIN/priamlnk.cgi?MP=CATSER%5EGINT65&CNO=1&CAT='223' (accessed on October 2, 2008).

[53] *Ibid.*

[54] "Employers' Liability Compulsory Insurance," available online at http://www.businesslink.gov.uk/bdotg/action/detail?r.l1=1073858799&r.l3=1074299774&r.t=RESOURCES&type=RESOURCES&itemId=1074302010&r.i=1074301656&r.l2=1074298750&r.s=sc (accessed on October 2, 2008).

Whether a particular employee is covered depends upon terms of employee's contract. This could lead to some tricky situations wherein the definition of the term "employee" needs to be looked at closely to determine the extent, if any, of the coverage. For instance, in the United Kingdom, domestic help is a tricky area. A significant emphasis is placed on whether the employee works solely for the employer.

Product Liability Insurance

Product liability insurance is with respect to products and services that can cause damage to buyers on account of some defect in the product or service concerned.[55] Product liability insurance is usually as part of a combined insurance policy.

Coverage

Indemnity will be provided for any harm or defect caused by any product (or container thereof) sold or supplied by the insured, in connection with his business and happening at any time during the period of insurance.[56] This policy will indemnify the insured against all sums up to the limits specified for which the insured shall become legally liable to pay compensation for accidental bodily injury or illness to any person not being a member of the insured's family or engaged in or upon the service of the insured and accidental loss or damage to property, not being property belonging to or in the custody of or in the control of the insured or any member of the insured's family or any person who at the time of the accident is engaged in and upon service of the insured.[57]

Additionally, as is common for all liability policies, costs of legal proceedings will also be included and payable. In the policy, the "persons insured" provision can be amended to include any person or organization, "the vendor" as an insured. This extension of the definition is advisable when specific representatives of the insured are involved in the storage/marketing/sale of the products of the insured.

[55] "Products liability, A Sword of Damocles," *The Hindu Business Line*, http://www.hinduonnet.com/2001/08/30/stories/0630000h.htm (accessed on October 2, 2008).

[56] *Ibid.*

[57] *Ibid.*

Exclusions

However, there are some exclusions. These are, including but not limited to, the cost of removing, replacing, or repairing defective products or loss of use thereof; losses arising out of any product which is intended for incorporation into the structure, machinery, or control of any aircraft; liabilities arising out of deliberate, wilful, or intentional non-compliance with any statutory provision; expenses arising out of pure financial loss such as loss of goodwill and loss of market; damages arising out of contractual liability which would not have existed in the absence of the specific contract; and losses arising out of any product guarantee.[58]

Other Jurisdictions

Product liability insurance is not a compulsory class of insurance in all countries. However, in the United Kingdom, the Consumer Protection Act and in the European Union, EC Directive on Product Liability (July 25, 1985) requires those manufacturing or supplying goods to carry some form of product liability insurance.

In India, the market for products liability insurance is in its nascent stage of development. The Consumer Protection Act, 1986 and Sale of Goods Act, 1938 are relevant statutes in this regard. The liability is slowly attaining a global aspect especially in the case of exporters of products or services. Therefore, enlarging the scope of the coverage and reducing exclusions is carried out in respect of a specific large contract where the overseas buyer demands such alterations. Overseas reinsurers usually arrange these changes, which calls for intense negotiations.[59] The issue of product recall is especially in demand these days.

Motor Vehicle Insurance

A motor vehicle insurance policy must contain provisions for indemnifying a third party in respect of death or bodily injury. The amount is usually fixed by the court or the Motor Claims Tribunal.[60]

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[58] V. Patkar, "Liability Insurance," available online at www.birlaglobal.com/insurance.html (accessed on October 2, 2008).

[59] *Ibid.*

[60] M.N. Srinivasan, *Principles of Insurance Law* (8th edn., Nagpur: Wadhwa &Co., 2005) at 255.

It may be pointed out that Chapter IX of the Motor Vehicles Act, 1988 deals with third-party risks. An insurance policy covering third-party risk is compulsory by virtue of sec. 146 of the Act, the nature of such coverage being stated in sec. 147. In sum, the policy must cover, *inter alia*, death or bodily injury to "a third party caused by or arising out of the use of the vehicle in a public place," or to any passenger of a public service vehicle (where that public service vehicle is the vehicle in question). Section 149(2) of the Act provides the insurer with defences against claims in respect of third-party risks. Interestingly enough, the court may issue a direction asking the insurer to pay the third party even if one of the defences in sec. 149(2) is applicable, this sum being recoverable by the insurer from the owner of the vehicle.[61]

Insurance companies in India usually offer one kind of policy with the minimum cover compulsorily required by law, namely third-party liability, often referred to as "Liability Only" policies[62] or "Motor Insurance Policy 'A'."[63] However, the alternative product is a comprehensive policy, also known as "Motor Insurance Policy 'B'"[64] or a "Package Policy."[65] Here, the minimum cover under a "Liability Only" policy is supplemented by coverage for loss or damage to the insured vehicle and its accessories due to:[66]

1. Fire, explosion, self-ignition or lightning.
2. Burglary, housebreaking or theft.
3. Riot and Strike.
4. Malicious Act.
5. Terrorist Act.
6. Earthquake (Fire and Shock) Damage.
7. Flood, Typhoon, Hurricane, Storm, Tempest, Inundation, Cyclone and Hailstorm.
8. Accidental external means.
9. Whilst in transit by road, inland waterway, lift, elevator or air.
10. By landslide/Rockslide.

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[61] See *Samundra Devi* v. *Narendra Kaur*, Civil Appeal No. 4748 of 2008.

[62] See, for example, http://www.niacl.com/per-motor.asp (accessed on October 28, 2008) (New India Assurance differentiating between their liability only policy and package policy).

[63] See, for example, http://www.orientalinsurance.nic.in/MotorCycleProposal.pdf (visited on October 28, 2008) (a motor cycle proposal form differentiating between 'A' and 'B' policy).

[64] *Ibid.*

[65] *Supra* n. 62.

[66] *Ibid.*

In the context of this "property aspect" of motor vehicle insurance, a 2008 ruling by the Supreme Court of India in *Dharmendra Goel* v. *Oriental Insurance Co. Ltd.*[67] demonstrated that the apex court recognizes the problems which an insurance policy holder may face in obtaining the amount due to them by insurance companies. In ensuring that the respondent insurance company did not deviate from its valuation of the insured vehicle 7 months prior to the accident and in rejecting the contention that it was the policy holder's burden to show that the subsequent valuation by the surveyor was on the lower side, the court opined, "[B]eing in a dominant position the insurance companies often act in an unreasonable manner and after having accepted the value of a particular insured good, disown that very figure on one pretext or the other when they are called upon to pay compensation. This 'take it or leave it' attitude is clearly unwarranted not only as being bad in law but ethically indefensible."[68] Hence, the judiciary is taking steps to stamp out unhealthy practices in the insurance sector.

Often, beyond the compulsory third-party liability and the coverage of damage to the car itself, policies also have a "personal accident" aspect. One part of this, again, is a compulsory cover provided for under the India Motor Tariff formulated by TAC requiring personal accident cover for the "owner-driver." G.R. 36A of the India Motor Tariff states, "Compulsory Personal Accident Cover shall be applicable under both 'Liability Only' and 'Package policies' *(do u want to put these?).* The owner of insured vehicle holding an 'effective' driving license is termed as Owner-Driver for the purposes of this section." Besides this minimum, insurance companies often give the option of extension clauses which extend the scope of personal accident insurance to individuals other than the owner driver who may be occupants of the car at the time of the accident.[69]

Motor vehicle insurance, therefore, combines liability insurance with personal and property insurance, and compulsory insurance with non-compulsory coverage.

Summary

Liability insurance is a scheme of insurance that merits much greater understanding and study than what it has been granted so far. Liability

[67] MANU/SC/7887/2008.

[68] *Ibid.*

[69] See, for example,http://www.bajajallianz.com/BagicCorp/bajaj_home/pdf/brochure/Motor_Brochure.pdf (accessed on October 28, 2008).

insurance such as product liability and employer's liability is not compulsory in India. Even in the realm of public liability insurance, the only compulsory form of insurance is that which is stated under the Public Liability Insurance Act, 1991. With the advent of liberalization and the opening up of the Indian markets, the need for adequate product liability insurance cannot be emphasized enough. In the case of employer's liability insurance, the element of social security is inherent. It would be advisable for Indian policy makers to grant further study for expanding the scope of liability insurance in India.

Standard Forms and Insurance Contracts

Judicial decisions in India have specifically addressed the applicability to insurance contracts of principles relating to standard forms of contract. Supreme Court decisions which made observations on the point will be looked into here. In *LIC of India and Anr.* v. *Consumer Education and Research Center and Ors.*,[70] a case concerning life insurance policy, it was held that any authorities in the field of insurance have a public duty to evolve their insurance policies such that they contain just terms and conditions and are thereby rendered accessible to all segments of society for insuring lives of eligible persons. Thus, the rule that unreasonable terms of a standard form of contract will not be enforced finds application to insurance contracts as well.

While coming to this decision, the court referred to the position of law on standard forms of contracts in the United Kingdom and the United States. It was noted that, in the United Kingdom, so long as a standard form of contract was entered into between two parties to a commercial transaction with equal bargaining power, it would be binding on them. In the United States, such contracts are known as contracts of adhesion and if the presumption of their enforceability is retained, undesirable outcomes could result.

In another case, *Central Bank of India Ltd.* v. *Hartford Fire Insurance Co. Ltd.*,[71] the Supreme Court stated that the usual rule of *contra proferentem* would be applicable to insurance contracts as well. As the policy is in a standard form of contract and is prepared by the insurer alone, it should be interpreted in a manner favorable to the insured.

[70] AIR [1995] SC 1811.
[71] AIR [1965] SC 1288.

High courts have also enunciated upon these principles. In *Narain Sharma son of Late R.K. Sharma* v. *The New India Assurance Company Ltd.*,[72] as recently as 2007, the Allahabad High Court, while interpreting a provision of an insurance policy, observed that the interpretation being adopted by the insurance company in that case was against public policy and, therefore, contravene sec. 23 of the Indian Contract Act. Importantly, the court noted that the standard form of an insurance contract is imposed by the insurance company and the insured has to sign on the dotted lines without any opportunity to bargain the terms and conditions. If an onerous interpretation is then permitted by the courts, as argued by the insurance company, it would result in no claim being ever paid.

In another instance, the Delhi High Court in *Usha International Limited* v. *United India Insurance Co. Ltd.*[73] espoused on the principles of interpretation applicable to a standard form of insurance contract. The court first noted the fact that insurance cover has become indispensable in our everyday life. However, when insurance covers are taken, prospective policyholders are not warned to carefully read the policy, which is in the standard form. Furthermore, consumers customarily do not consult a lawyer each time, before taking insurance. This is problematic, given that standard forms of contract are usually used by entities with greater bargaining power compared to the other party to the contract. The result is that the weaker party to a standard form of contract does not end up reading the terms that he had no role in drafting. At the heart of the contract is the assurance that if a loss is incurred by the consumer as a result of any of the envisaged events, he will be indemnified because he has paid the premium demanded by the insurer. Therefore, the words employed in the policy must be imputed with their ordinary meaning, unless the terms of the insurance contract are shown to have been carefully negotiated by both parties.

Conclusion

Insurance contracts and the law in connection with such contracts clearly require scrutiny in the present context, both by the legislature and the judiciary.

[72] 2007 (1) AWC 487.

[73] AIR [2005] Delhi 424.

As has been pointed out, a clear stand must be taken on the issue on cohabiting partners and their interests in each others' lives, as also on the issue of whether the insurance contracts issued by the LIC can be scrutinized under a constitutional lens. The foregoing analysis has demonstrated what the authors consider the most coherent positions in this connection.

With respect to property insurance, fire insurance and marine insurance are a study in contrasts. The TAC's role in regulating fire insurance has been commendable. The scope of its regulation should also be extended to marine insurance so that trade practices like the MAR form of policy are given timely recognition in law.

Liability insurance, especially in the area of product liability insurance, should also be brought under the auspices of the TAC. The reason for this is that product liability insurance is an area that has vast scope for development. There is no specific regulation guiding it as of now and the highly technical nature of liability insurance makes it ideal to be regulated by the TAC. The need for a body to regulate it holds greater significance in the light of increased export of goods and services to countries that either have compulsory forms of product liability insurance or strict regulations guiding them. Indian manufacturers and providers of services should not lose out owing to a lack of domestic regulations guiding product liability.

Therefore, the authors favor specialized regimes dealing with insurance contracts, and a clarification or restatement of the law which keeps Indian law abreast with changing times.

16

Contract Farming

Abhas

Introduction

In spite of a substantial decrease in the contribution of agriculture to the gross domestic product (GDP) of India, agriculture still remains the most important sector in India's economy in terms of creation of employment.[1] Against the backdrop of this fact, it can be said that the content of arrangements involving the farmer and another party (i.e., corporate) assumes importance for India as a country.

Definition of Contract Farming

The dictionary meaning of the term *contract farming* can be aptly described as a contract for *managing or working on an area of land, used for growing crops and/or keeping animals*.[2] This definition highlights the objective of such an agreement, that is, production of agricultural goods by managing or working on an area of land. However, this definition fails to identify certain important aspects pertaining to the agreement such as:

[1] Agriculture provides livelihood to 60 percent of the rural people in India. http://www.worldbank.org.in/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/INDIAEXTN/0,,contentMDK:21462715~pagePK:141137~piPK:141127~theSitePK:295584,00.html (accessed on September 23, 2008).

[2] Borrowed from A.S. Hornby, *Oxford Advanced Learner's Dictionary of Current English* (S. Wehmeier ed., 6th edn.: New Delhi: Oxford, 2000).

1. Ownership of the area of land, that is, who owns the area of land that is to be managed or worked upon.
2. Rights and obligations of parties to such a contract—with respect to say, supply of inputs, labor, and payment of price, etc.
3. Objective of the contract, that is, whether the contract is for production aimed at supplying products to a party or for satisfying the needs of the landowner's family.

Taking into account the above-mentioned aspects, a new and perhaps better definition of *contract farming* can be described as *an agreement between a farmer and a sponsor or a buyer for the production of specified agricultural products according to the requirements of the latter.*[3] It is pertinent to note that this definition captures the aforementioned aspects—objective of the contract identified as meeting the requirements of the buyer or the sponsor; the term sponsor denotes some obligations in the form of support, to the activity of *managing or working on the area of land*, and the term farmer is intended to denote that the owner of *the area of land* is the farmer.

However, of late a new term *corporate farming* has received a lot of attention—this is a term used to describe an arrangement wherein a landowner leases or sells his land to a corporate which uses it for farming and pays the sale-price or the lease-amount to the owner as opposed to the arrangement underlying *contract farming* wherein the landowner retains the ownership and possession of his property.

Depending upon the sponsor, role of the sponsor, and role of other parties, *contract farming* can be implemented by adopting more than one model. Three models have been adopted in the past in our country.[4] These are as follows:

The bipartite model (Figure 16.1) was adopted by Pepsi in its contract farming enterprise in Punjab which commenced in early 1990s. Pepsico, Voltas, and Punjab Agro Industries Corporation (PAIC) formed a joint venture. This joint venture supplied seedlings to the contract-farmers and agreed to purchase a specified quantity of a certain quality of produce at pre-fixed price and time.[5]

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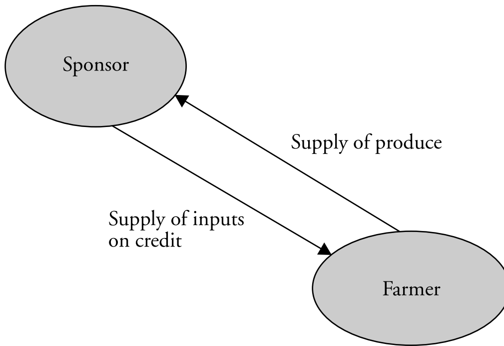
[3] This definition is based upon the one propounded by Punjab Agro Industries Corporation Limited as mentioned on the website http://www.punjabagro.co.in/pafc-c-farming.html (accessed on September 22, 2008).

[4] As mentioned by Sukhpal Singh, in his article "Crisis and Diversification in Punjab Agriculture: Role of State and Agribusiness," *Economic and Political Weekly* (December 25, 2004) at 5583–89.

[5] *Supra* n. 4, at 5585.

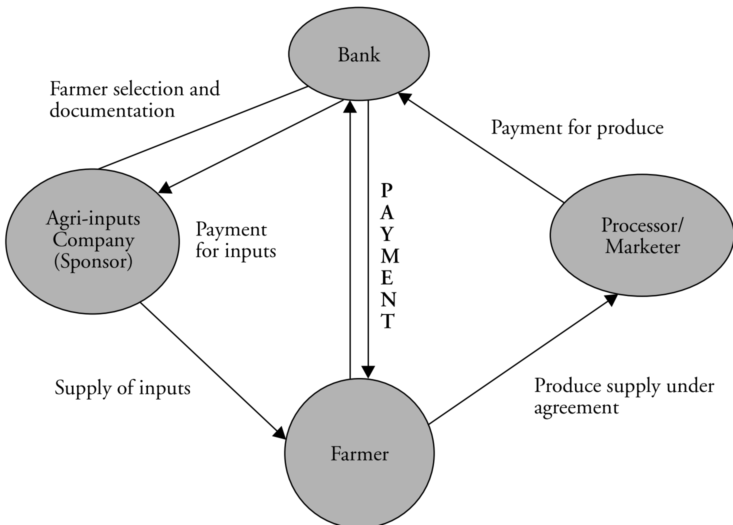
Figure 16.1 Bipartite Model



Source: Author.

The quadripartite model (Figure 16.2) has been followed by companies such as Mahindra Shubhlabh Services Ltd. (MSSL) and Rallis. Under this system, the sponsor provides inputs to the registered growers for a fee.[6] The sponsor, by virtue of its tie-up with processors/marketers and banks is capable of offering the registered grower a complete package, if it may be termed so.

Figure 16.2 Quadripartite Model

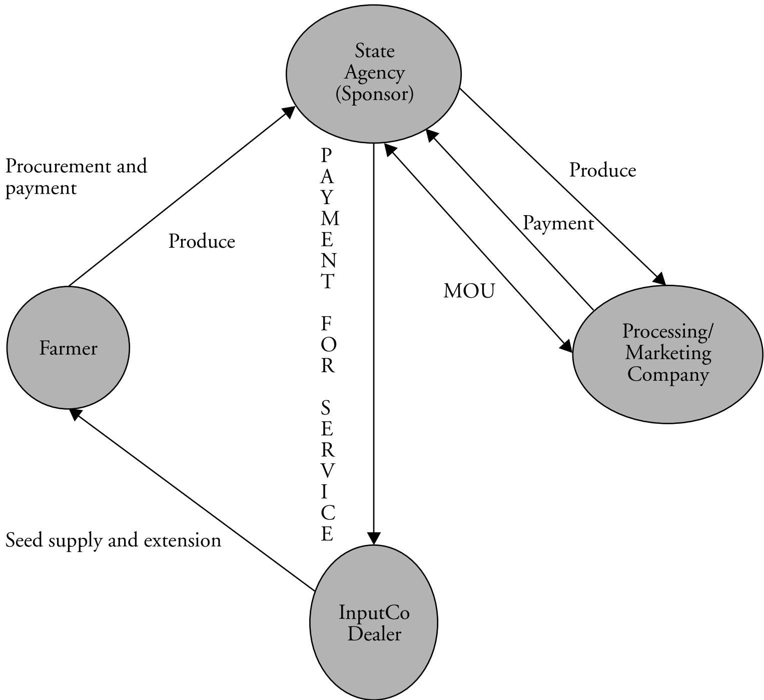


Source: Author.

[6] *Supra* n. 4, at 5588.

Under the state-led contract farming model (which was launched in Punjab in 2002), the state agency such as Punjab Agro Food-grains Corporation (PAFC) provides inputs and extension services to contract growers and buys back the produce at pre-agreed price to be sold to a processing or marketing company later (Figure 16.3).[7]

Figure 16.3 State-led Contract Farming System



Source: Author.

In spite of the apparent differences among the several models of contract farming as described earlier, there are certain common features of contract farming manifesting in probably all kinds of models.

[7] *Supra* n. 4, at 5587.

Salient Features of the Contract between the Grower and the Sponsor

Duration of the Contract

The first step toward fulfilling conditions laid down in such a contract is generally the supply of inputs to the grower either through the sponsor or via some other agency which has tied-up with the sponsor to supply certain inputs. The last stage of such a contract is the payment of the agreed price to the farmer.

Standards Stipulated by the Sponsor

This issue pertains to the grading of the agricultural produce at the time when the agricultural produce is ready. It is a common practice, and also advisable, to make an exhaustive mention of the mode of grading in the contract.

Supply of Inputs

The word sponsor as has been described earlier indicates some kind of support on part of the company to the grower. This support can take the form of supply of inputs, such as seedlings, pesticides, and insecticides, and also technical advice on aspects pertaining to cultivation.

Inspection

Since the sponsor invests a substantial sum of money in assisting the grower, it is only natural that the former would want the latter to follow certain standard practices so as to facilitate the realization of inherent goal of producing agricultural products of a certain desired quality. Experience shows that while recruiting a workforce who will interact with the growers, it is better to rely upon local talent who understand the local conditions well.[8]

[8] S. Erappa, *Contract Farming in Karnataka: A Boon or Bane?* Research Report, Centre of Rural Studies, Lal Bahadur Shastri National Academy of Administration, March 2006.

Process of Calculation of and Payment of Price

From the perspective of the farmer/grower, one among the major attractions of contract farming is its promise of a fixed price that will protect him from the vagaries of the market. However, it might so happen that the price of the agricultural product in the market shoots up due to a supply shock and the same settles at a level higher than the price agreed between the sponsor and the buyer. In such situations, the real incentive for the grower to fulfill his obligations under the contract might become very low. To account for such a situation, in addition to the legal implications[9] of the difference in the bargaining power of the grower vis-à-vis the sponsor, it is perhaps advisable to follow a system of pricing which obviates problems arising out of such a difference. One way in which it can be done is by structuring the pricing clause in such a manner so as to provide for payment of a certain (fixed) quantum of price for the agricultural product before the market arrives at a price and for certain (extra/variable) quantum based upon an increase (if any) in the market price.[10]

In order for such a clause to serve the aforementioned purpose effectively, it is important to fix the relevant dates for ascertainment of market price and for payment of the extra-quantum (if the need arises), not to forget, clearly mentioning the date and mode of payment of the fixed quantum of the price.

Force Majeure

It is common knowledge that agriculture is affected by factors beyond the control of human beings. The key to ensuring that this does not become an impregnable shield for a party allowing it to renege on its promises, is to remember that the effort of the grower or the sponsor to prevent or limit the effects of such an occurrence needs to be delineated precisely. From the perspective of the sponsor, ensuring that the scope of technical advice to be rendered (assuming that this is a part of the obligations of the sponsor) and

[9] This statement refers to the judgment in the case of Brojo Nath Ganguly as discussed later in this article.

[10] To illustrate, let's assume that the market price for an agricultural product was Rs 100/unit in the last season. Let's further assume that the sponsor expects the price to be more or less at the same level in the current season and the fixed quantum is set at Rs 105/unit, but on account of climatic factors the supply of the product shrinks and the market price reaches Rs 125/unit. In such a situation, the variable quantum of the price assumes importance and to match the price of the agricultural product in the market the sponsor would pay the grower an extra Rs 20/unit.

the obligations of the grower upon being advised on a technical matter as also the consequence of not fulfilling such obligations needs to be clearly mentioned in the contract.

Termination of the Contract

In view of the technical advice rendered by the sponsor as also supply of inputs undertaken by it there may be a situation wherein the grower refuses to use the inputs or follow the technical advice. This may lead to an adverse effect on the quality of the crop and make the venture a futile one for the sponsor. From the perspective of the farmer/grower, delayed supply of inputs may jeopardize the timely sowing of crops. These illustrations highlight the importance and need to precisely state each clause, in order to confer a right upon the other party to terminate the contract.

Dispute Resolution

As with other contracts, the forum of dispute resolution needs to be decided. With the recent amendments in the respective Agriculture Produce Marketing Committee (APMC) Acts,[11] dedicated dispute-resolution authorities have been mooted.

Major Issues in Agreements Related to Contract Farming

Unequal Bargaining Power

The Supreme Court in the case of *Brojo Nath Ganguly*[12] observed that "gross inequality of bargaining power" may indicate that there are elements of deception and compulsion involved in a contract. It is anybody's guess that an incorporated entity, compared to a farmer, is an unequal match in terms of the superior financial position and also access to technical advice. However, in case the sponsor enters into an agreement with a co-operative of farmers the above-stated presumption may not hold true.

[11] This legislation and the proposed as well as passed amendments have been discussed in detail in a separate section of this article which deals with law and policy considerations relevant to contract farming.

[12] AIR [1986] SC1571.

Quality of inputs and long-term effects on farmers/growers

The emphasis of sponsor would be on high yield and so, on varieties that yield a high produce per area of land. However, this emphasis on high yield and the stress on usage of inorganic substances might lead to a loss in the productive value of the land owned by the farmer/grower. Also, should the farmer choose not to continue his association with the sponsor for the next sowing season the usage of a new variety of seeds might lead him to no seeds for sowing in the next season.[13]

Refusal on Part of the Sponsor on Account of Grading

As mentioned in the trailing section, the process of ascertaining whether a particular stock of produce meets the grading requirements and sorting of agricultural products which is very important for the much superior knowledge commanded by the sponsor may be held against it on the ground of being a characteristic of bargaining power. In the opinion of the researcher, involvement of a neutral third party such as an agricultural university or a research institute or reliance upon standards issued by an agency of the government[14] in this aspect of the contract farming would be beneficial from the point of view of both parties and also from the perspective of salvaging the enforceability of such a contract.[15]

Law and Policy Considerations

1. **Essential Commodities Act, 1955**: It empowers the central government to control (to the point of prohibition) the supply and distribution of *essential commodities*—the list of such commodities may be altered by a notified order of the government. Such an

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[13] Generally, older varieties of crops also generated seeds that could be used in the next sowing season unlike the newer hybrid varieties.

[14] For example, grade standards notified under the Agricultural Produce (Grading and Marking) Act, 1937 may be used for the purpose of grading the agricultural produce. http://agricoop.nic.in/AnnualReport06-07/AGRICULTURAL%20MARKETING.pdf (accessed on September 27, 2008).

[15] This has been identified as a very important criticism of the present legal system in respect of contract farming. http://www.manage.gov.in/pgpabm/spice/March2k3.pdf (accessed on September 25, 2008).

alteration may render a contract ineffectual for production of an essential commodity. In such a case the sponsor might be barred from procuring the quantity agreed to be produced by the grower and hence a mechanism needs to be evolved in lieu of the expenditure incurred by the sponsor in supplying inputs.

2. **APMC Acts of various states**: These Acts provided for setting up of *state-regulated* markets and this resulted in creation of a near monopoly of the state (through markets operated by Agricultural Produce Marketing Committees). This system has been criticized on account of lack of fair price discovery mechanism, fragmentation of supply chain, and other such factors.[16]
3. **Reforms in APMC Acts**: Many states pursuant to finalization of the Model APMR [Agricultural Produce Marketing (Regulation) Act] Act by central government[17] in consultation with state governments, with the view to facilitate implementation of contract farming, have amended their respective APMC Acts. These amendments provide for state support for contract farming in the form of registration of contract farming sponsors and mechanism for settlement of disputes.

Conclusion

From strict control by the state, there has been a shift toward a free-market system wherein private players are allowed to participate. The model of contract farming has evolved from in-house consumption by sponsors (bipartite model) to a more complex one—quadripartite model. In view of the increased complexity on account of linkages to other players, such as banks and processors/marketers, it has become very important to precisely apportion the rights and obligations of the grower/farmer and the sponsor.

[16] http://agricoop.nic.in/Mosconference/UKS%20Chauhan.ppt (accessed on September 24, 2008).

[17] Amendments in APMC Acts were suggested by Expert Committee on Market Reforms constituted by the Ministry of Agriculture (report in June, 2001) and a Model APMR Act was finalized on September 9, 2003. http://agricoop.nic.in/Mosconference/UKS%20Chauhan.ppt (accessed on September 24, 2008).

About the Editor

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