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Indira Gandhi National Open University
School of Management Studies

BCOC-133
BUSINESS LAW

Volume 2

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PARTNERSHIP

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BLOCK 4 PARTNERSHIP

Partnership in India is governed by Indian Partnership Act and Limited Liability Partnership Act 2008. Partnership is also one of the specific contracts which was a part of Indian Contract Act. 1872. In 1930 however the provisions relating to partnership contracts were repeated and a separate Act called Indian Partnership Act. 1932 was passed which is in force till today. The Act mainly contains the provisions relating to the formation of partnership the rights and duties of partners and the procedure for its dissolution. Limited liability partnership Act was passed in 2008. It is a partnership in which some or all partners (depending on the jurisdiction) have limited liabilities. It is an alternative form of organization which has benefits of limited liability of a company and flexibility of a partnership.

Unit 12 describes the meaning of partnership and the procedure of its registration.

Unit 13 deals with rights and duties and partners and discusses their liability towards the third party.

Unit 14 describes the modes of the dissolution of a partnership firm and the procedure for the settlement of its accounts.

Unit 15 describes the limited liability partnership, its nature, incorporation; and partners and their relationships.

UNIT 12 DEFINITION AND REGISTRATION OF PARTNERSHIP

Structure

12.0 Objectives

12.1 Introduction

12.2 Definition and Characteristics

12.3 Test of Partnership

12.4 Partnership and Co-ownership

12.5 Partnership and Joint Hindu Family

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- 12.7.1 Procedure for Registration
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12.0 OBJECTIVES

After studying this unit, you should be able to:

- define partnership and explain its characteristics;
- determine whether a group of persons is or is not a partnership;
- distinguish between partnership and co-ownership;
- distinguish between partnership and Joint Hindu Family;
- explain how registration\of a partnership firm can be effected and what are the consequences of non-registration;
- describe different types of partners; and
- explain the position of a minor when he is admitted to the benefits of the firm.

12.1 INTRODUCTION

Partnerships in India are governed by the Indian Partnership Act, 1932. Partnership is formed as a result of an agreement between two or more persons who have agreed to share the profits of a business carried on by all or any of them acting for all. Hence, the general principles of law of contracts and agency (as contained in the Indian Contract Act 1872) also apply to partnerships except where the Act specifically provides to the contrary. The Act mainly contains the provisions relating to the formation of partnership, the rights, duties and liabilities of partners and the procedure for its dissolution etc. In this unit you will learn about the definition and test of partnership, its difference with co-ownership and Joint Hindu Family, the procedure for its registration, and various types of partners including the position of a minor partner.

12.2 DEFINITION AND CHARACTERISTICS

In simple words, a partnership is an association of persons who have agreed to share the profits of business. The persons who have entered into partnership with one another are individually called as 'partners' and collectively a 'firm' and the name under which their business, is carried on is called the 'firm's name'.

Section 4 of the Indian Partnership Act has defined partnership as *Partnership is the relation between two or more persons who have agreed to share the profits of a business carried on by all or any of them acting for all.*

This definition clearly indicates the following characteristics of partnership.

1. It is an association of two or more persons.
2. It must arise out of an agreement.
3. The agreement must be to carry on a business.
4. The agreement must be to share the profits of the business.
5. The business must be carried on by all or any of them acting for all.

All the above elements must be present before an association of persons can be called a partnership. Let us now discuss these elements one by one.

Two or more persons: There should be at least two persons to form a partnership. If the number of partners gets reduced to one by any reason, say death or insolvency of partner it would cease to be a partnership. As for the maximum number of partners in a firm, the partnership Act is silent. However, the Companies Act, 2013, puts a ceiling on the number of partners in a partnership firm as under.

As per Rule 10 of Companies (Miscellaneous) Rules, 2014, if a partnership firm consists more than 50 persons, it will be illegal. Thus, the current limit is 50.

However, Section, 464 (1) of 2013 Act states, 'Provided that the number of persons which may be prescribed under this sub-section shall not exceed one hundred'. This means, by rules limit ceiling can be prescribed, but whatever limit is prescribed it must not be greater than 100.

Notwithstanding, the above maximum ceiling of 100 partners does not apply to a partnership firm, formed by professionals who are governed by special Acts

[Section 464(2)]. Accordingly, a firm of chartered accountants, for instance, can have maximum 50 partners (i.e. at par with a business firm), all being chartered accountants of-course, but by amendment of Companies Rule, the said limit may go even beyond 100.

Agreement between persons: A partnership originates from an agreement between persons. This agreement may be express (written or oral) or implied. It should also be noted that a partnership does not arise out of status as in the case of Joint Hindu Family or by operation of law as in the case of co-ownership. It is essentially the creation of a contract between two or more persons and all elements of a valid contract must be present. For example, the persons must be competent to contract, the object of partnership must be lawful, and so on.

Business: Partnership can be formed only for the purpose of carrying on some business. An association created primarily for charitable, religious and social purposes are not regarded as partnership. Similarly, when two or more persons agree to share the income of a joint property, it does not amount to partnership. Such relationship is termed as co-ownership. According to Section 2(b) of the Act, the term 'business' includes every trade, occupation and profession. Thus, business does not refer merely to trade or industry, but also includes profession like architecture, legal practice, chartered accountancy, etc.

Sharing of profits: Sharing the profits of business is the essence of partnership. Unless otherwise agreed, sharing of profits of a business implies sharing of its losses as well. However, a person can become a partner on the understanding that he will not share the losses. The ratio in which the profits and losses will be shared is a matter of agreement amongst the partners. It should be noted that though sharing of profits of a business is essential, it does not follow that everyone who participates in the profits of a business is necessarily a partner. For example, a manager who as a part of his remuneration shares in profits of the business can only claim to be an employee of the firm and not a partner.

Business carried on by all or any of them acting for all: The underlying principle which governs partnership is the agency relationship amongst the partners. The business of the firm may be carried on by all the partners or by any of them acting for all. This means that a partner is both an agent and a principal. He, can, by his acts, bind the other partners and is bound by the acts of the other partners. Thus, the partners have relationship of mutual agency between them and the law of partnership is regarded as an extension of the general law of agency.

It should also be noted that it is not essential that all partners should actively participate in business, the business may be managed by one or two partners and the remaining partners will be bound by their acts provided such acts relate to carrying on the business of the firm and have been done in the name of the firm.

12.3 TEST OF PARTNERSHIP

According to the Partnership Act, the liability of partners is joint and several. It means that the creditors of a firm can realise their dues from any partner of the firm. It is quite possible that a person, in order to escape his liability, may deny the fact of his being a partner in the firm. In such a situation, it becomes necessary for the creditors to prove that the person concerned is a partner in the firm

To determine whether or not a group of persons constitutes partnership and whether a particular person is or is not a partner in the firm, we have to ascertain the real relationship amongst the parties. If the parties have drawn an express contract, their real relation may be known from the terms of partnership contract. But, if they have not drawn an express contract, their real relationship is to be gathered from other relevant factors such as conduct of parties, circumstances under which the contract took place, books of account, statement of employees, etc. Section 6 of the Act clearly states that *in determining whether a group of persons is or is not a firm, regard shall be had to the real relation between the parties as shown by all relevant facts taken together*.

When all the facts taken together show that all essential elements of partnership as outlined earlier are present, the group shall be regarded as partnership. It needs to be emphasised that sharing of profits is an important evidence of partnership. In other words, if a person has been sharing profits of a business he is normally regarded as a partner. But it is not true in all cases. There may be persons who are in receipt of a share in profits of a business, or of a payment contingent upon the earning of profits or varying with the profits earned by a business, but are not partners. Such persons are:

i) Creditors of the firm who, on having lent money to the firm, may agree to take a share in profits;

ii) the widow or child of a deceased partner who receives share of profits of business as annuity;

iii) a person receiving a share of profit in consideration of sale of business or goodwill of the business that he has sold to the firm, and

iv) a servant or an agent receiving share in the profits of the business in consideration of his association with the firm.

Examples

1. A and B who are partners in a firm, borrow money from C who lends it on the condition that he will take 10% share in profits and have the right to inspect the books of accounts. Despite these factors C cannot be regarded as a partner because there was no intention to associate C as a partner.

2. B, a contractor, appointed one of his servants to manage his business of loading and unloading railway wagons. The servant was to receive 50% of the profits of this business and also bear the losses, if any. The servant was simply an agent of B , and not a partner,

Similarly, two persons who jointly own a house let it out on a rent of Rs. 16,000 per annum and share the rental income equally, are not regarded as partners. They are simply co-owners of the property. As per explanation 1 to Section 6, the joint owners of some property sharing profits or gross returns arising from the property do not become partners.

While there can be no partnership without sharing of profits of the business, sharing of profits alone does not constitute partnership. **The true test of partnership lies in the existence of mutual agency relationship i.e., the capacity of a partner to bind other partners by his acts done in firm's name and be bound by the acts of other partners**. This relationship of principal

and agent distinguishes a partnership from co-ownership and the simple agreements for sharing profit. It should also be noted that the following persons are not deemed to be partners:

i) The members of a Joint Hindu Family carrying on family business.

ii) A Burmese Buddhist husband and wife carrying on a business.

12.4 PARTNERSHIP AND CO-OWNERSHIP

As stated earlier, sharing of profits or gross returns arising from property by persons holding a joint or common interest in that property does not of itself make such persons partners. Thus, the mere fact that two or more persons own some property jointly and share its income does not mean that they are partners. They are called co-owners. For example, sons who inherit some property from the father, are not partners though the property were to be managed jointly and its income shared by them. Such relationship is regarded as co-ownership. If, however, the sons enter into an agreement to run a coffee house in that building and share the income thereof, they will be regarded as partners.

According to Lord Lindley the main points of difference between co-ownership and partnership are as follows:

1. Co-ownership is not necessarily the result of an agreement, but partnership is.

2. Co-ownership does not necessarily involve profit or loss, but partnership does.

3. One co-owner can, without the consent of the others, transfer his interest to a stranger. A partner cannot do this without the consent of all the other partners.

4. A co-owner is not an agent of the other co-owners, but a partner is.

5. A co-owner has no lien on the property owned in common for outlays or expenses nor for what may be due from the others as their share of a common debt, but a partner has.

6. Co-ownership does not necessarily exist for the sake of gain, but partnership exists for no other purpose.

Besides the above differences, a few more points of distinction between the two are also worth noting. These are:

7. In co-ownership there is no maximum limit of co-owners. In partnership the maximum limit of partners is 50.

8. Co-ownership does not necessarily involve carrying on of a business but a partnership does.

9. A co-owner has the right to claim partition of property owned with other co-owners. A partner has no such right. He can simply sue the other partners for the dissolution of the firm and accounts.

12.5 PARTNERSHIP AND JOINT HINDU FAMILY

Joint Hindu Family is a unique form of business organisation prevailing only in India. It is the business which belongs to Hindu undivided family and is governed by the provisions of Hindu Law.

In Hindu Law there are two schools:

a) **Mitakshara**: It is applicable to the whole of India except Bengal and Assam. According to this school, a Hindu inherits property from his father, grandfather and great-grandfather. Thus, three successive generations in the male line (son, grandson, and great-grandson) inherit the ancestral property. They are called 'coparceners' and the senior most member of the family is called 'Karta'. The Hindu Succession Act, 1956 is extended the line of coparcenary interest to female relatives of the deceased coparcener or male relatives claiming through such female relatives.

b) **Dayabhaga**: It is applicable in Bengal and Assam. According to this, the male heirs become members only on the death of the father.

According to Hindu Law, a business is an inheritable asset. After the death of a Hindu, the business will be jointly owned by all the coparceners. The elder person among the coparceners becomes the new Karta and manages the business. If any property is inherited from any other relative, or acquired from personal resources, such property is regarded as personal property and treated as distinct from ancestral property.

Important features of the Joint Hindu Family firm are:

1. Business is managed by the senior member of the family called Karta. Other members do not have the right to participate in the management of the firm.
2. Other members cannot question the authority of the Karta. Their only remedy is to get the family dissolved by mutual agreement.
3. Karta has the power to borrow funds for the business. The liability of the Karta is unlimited whereas the other coparceners are liable only to the extent of their share in the business.
4. If the Karta has misappropriated the funds of the business, he has to compensate the other coparceners to the extent of their shares in the joint property.
5. The death of any member of the family does not dissolve the business of the family.
6. Through mutual agreement, the Joint Hindu Family firm can be dissolved.

Comparing the above features of a Joint Hindu Family with the essential characteristics of a partnership firm, we can easily ascertain the points of difference between the two. These can be summarised as follows.

1. **Creation**: Partnership comes into existence by an agreement. A Joint Hindu Family is created by status or operations of law, no agreement is needed for it.
2. **Regulating law**: A partnership is governed by the provisions of the Indian Partnership Act, 1932. A Joint Hindu Family business in governed by Hindu Law.

3. **Admission of new members**: No person can be admitted to the existing partnership without the consent of all the other partners. A person becomes a member (coparcener) in Joint Hindu Family merely by his birth.

4. **Minor member**: A minor cannot become a partner in a firm, he can be admitted only to the benefits of the firm. In Joint Hindu family, a person becomes a coparcener right on his birth.

5. **Number of members:** There is a limit on the number of partners in a firm. But, there is no limit on the number of coparceners in Joint Hindu Family.

6. **Authority for active participation**: Each partner can participate in the business of the firm and bind the other partners by his acts. In Joint Hindu Family this authority rests with Karta only. Of course, the other members can be allowed by Karta to take part in family business.

7. **Liability of members**: In partnership, the liability of all the partners is unlimited; they are personally liable to third parties for the debts of the firm. In Joint Hindu Family only Karta's liability is unlimited, the other coparceners liability is limited only to their shares in the family property.

8. **Right to demand account**: Each partner has a right to inspect and copy the account books and, on severing connections with the firm, he can demand even the account of the past dealings. The coparceners have no right to ask for the account of part dealings, they can ask for the position of the existing assets only.

9. **Death of a member**: In the absence of any agreement to the contrary, partnership is dissolved on the death of any partner. The Joint Hindu Family continues to operate even after the death of a coparcener.

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Check Your Progress A

1. Assess the following situations. Can the relationships given below be called partnership. Answer in Yes or No.

   i) Two computer firms, each having 12 partners, combine by agreement into one firm.

   ii) A and B jointly own a car which they use for themselves on sundays and holidays, and occasionally they let it on hire and divide the earnings equally.

   iii) Several men form an association to which each member contributes Rs. 10,000 annually. The purpose is to produce sarees for free distribution to refugees.

   iv) Two brothers A and B convert their family house into a hotel and agree to divide equally the earnings from this business. Each of them also acts as the agent for each other than that of the business.

   v) B has a business styled as B & Co. He employed X as manager of the business who is entitled to 50% share in profits.

2. Fill in the blanks.

   i) The maximum number of partners in a partnership firm is ....

ii) Partnership is created neither by ....nor by operation of law.

3. Tick mark the correct answers.

   a) Sharing of profits is

      i) a conclusive test of partnership.

      ii) merely a strong evidence of partnership

   b) In a co-ownership

      i) the maximum number of co-owners can be 10.

      ii) there is no limit on maximum number of co-owners.

   c) Carrying on a business is the necessary characteristic of

      i) partnership

      ii) co-ownership.

12.6 PARTNERSHIP DEED

You have learnt that a partnership is formed by an agreement. This agreement may be oral or in writing. But, in order to avoid any dispute, with regard to the terms of partnership, it is considered desirable to have it in writing. The document in which the terms of partnership as agreed by the partners are set forth, is called a 'partnership deed'. It should be drafted with care and signed by all the partners. The partnership deed usually covers the following.

1. Name of the firm
2. Names and addresses of all partners
3. Nature and place of business
4. Date of commencement of partnership
5. Duration of partnership
6. Amount of capital contributed or to be contributed by each partner
7. Management of firm's business
8. Ratio of sharing profits and losses
9. Interest, if any, on partners' capital and drawings
10. Interest on loan advanced by a partner to the firm
11. Salaries, commission, etc., if payable to any partner
12. The safe custody of books and other documents
13. Mode of auditor's appointment, if any
14. Rules to be followed in case of admission
15. Retirement, death, etc. of a partner
16. Method of settling disputes amongst partners
17. Settlement of accounts on dissolution of the firm

It should be noted that the terms laid down in the partnership deed may be varied by the consent of all the partners. But, it should not contain any terms which are in contravention with the rules given in the Partnership Act.

12.7 REGISTRATION

Registration means getting the partnership registered with the Registrar of firms of the area in which the place of business of the firm is situated or proposed to be situated. Under the Partnership Act, it is not compulsory for a partnership firm to get itself registered. Hence, it is for the partners to decide whether to get their firm registered or not. But, indirectly, by creating certain disabilities from which an, unregistered firm suffers, the law has made the registration of firms desirable, These disabilities are such that sooner or later, every firm has to get itself registered. It should be noted that registration does not create a partnership. It is only an evidence of the existence of a partnership, and the facts entered in the records of the Registrar of firms are treated as conclusive proof by the courts.

12.7.1 Procedure for Registration

Since, registration of a firm is not compulsory, it can be effected at any stage. When the partners decide to get the firm registered, they have to file a statement in the prescribed form and send the same along with the prescribed fees by post or deliver it to the Registrar of Firms of the area in which any place of business of the firm is situated or is proposed to be situated. The statement must be signed by all the partners or by their authorised agents. It shall state

a) the name of the firm;

b) the principal place of business of the firm;

c) the names of other places where the firm carries on business;

d) the date when each partner joined the firm;

e) the names in full and permanent addresses of the partners; and

f) the duration of the firm.

As required under Section 58(1), the contents of the statement should be duly verified by the persons signing it. Further, the firms are restrained from using the words in the name such as 'Crown', 'Emperor'. 'Imperial', 'Royal', etc, or any other such name by which it would appear as if the firm has some sanction or patronage of the government. When the Registrar is satisfied that the provisions of Section 58 have been duly complied with, he shall record an entry of the statement in a register called 'Register of Firms' and shall file the statement. He shall then issue a certificate of registration. If, later on, any change is made, (i) in the name of the firm, (ii) in the location of its principal place of business, (iii) in the names and/or addresses of partners, or (iv) in the constitution of the firm, the same should be duly notified to the Registrar so that he can incorporate the same in the register of firms.

12.7.2 Effects of Non-Registration

As stated earlier, though registration of firms in India is not compulsory. But, it is considered desirable because if the firm is not registered, it suffers from many disabilities. These disabilities have been clearly stated in Section 69 of the Act and are termed as 'effects of non-registration'. These are summarised below.

1. **No suit can be filed in a civil court by a partner against the firm or the other partners**: If any dispute arises among the partners or between a partner and the firm or between a partner and the ex-partners, and the dispute is related to the rights arising from the partnership agreement or to the rights conferred by the Partnership Act, a partner of an unregistered firm cannot file suit against the firm or the partner/partners. This is possible only when the firm is registered and the person has been shown in the register of firms as a partner in the firm. Thus, if a partner of an unregistered firm is not paid his share of profits, he cannot claim it through the court. However, criminal proceedings can be brought by one partner against the other(s). For example, if a partner steals the property of the firm or puts fire to the buildings of the firm, any partner can prosecute him for the same.

2. **No suit in a civil court by the firm against third parties**: An unregistered firm cannot file a suit against a third party to enforce any right arising from contract. For example, such firm cannot go to the court for the recovery of the price of goods supplied. Of course, criminal proceedings can be brought against the wrong doers. It may be noted that if the third party has any claim against the firm or its partners it can certainly file a suit. Thus, it is only a suit by the firm or its partners against a third party which is prohibited and not a suit by the third party against the firm or its partners.

3. **The firm or its partners cannot make a claim of set-off or other proceedings based upon a contract**: The above two disabilities also apply to a claim of set-off or other proceedings to enforce any right arising from a contract. Thus, if a third party sues the firm to recover a sum of money, the firm cannot claim a set-off, i.e., the firm cannot say that since the third party also owes some money to the firm the same should be adjusted against the claim in question.

Exceptions

Non-registration of a firm does not however, affect the following rights :

1. The right of third parties to sue the firm or any partner.

2. The right of the firm to institute a suit or claim of set-off if the value of suit does not exceed Rs. 100.

3. The right of partners to sue for the dissolution of the firm or for the accounts of a dissolved firm, or the right or power to realise the property of a dissolved firm i.e., for claiming share of the assets of a dissolved firm or for recovering money from the firm's debtors.

4. The power of an official Assignee, Receiver or Court to realise the property of an insolvent partner and to bring an action on behalf of the insolvent partner.

5. The rights of the firm or the partners of the firm having no place of business in India.

6. The right of an unregistered firm to bring a suit to enforce a right arising otherwise than out of a contract.

It must now be clear to you that though there is no compulsion under the law that a firm must be registered, the disabilities that beset a firm make it advisable to register it.

Check Your Progress B

1) Answer the following:

   i) A, a publisher, agrees to publish, at his own expense, a book written by B and to pay to B half of the net profits. Can B claim half share? Is B liable to C, a paper merchant who had supplied paper to A for B's book …………..

   ii) The sole proprietor of a business dies and his heirs inherit his business. Are heirs partners? …………..

   iii) A, a sole owner of firm, admits B as a partner. B does not bring any capital. He is not liable for any loss and is to receive salary every month in lieu of profits and have all powers of a partner. B deals with third parties. Will he bind the firm? …………..

2) State whether each of the following statements is True or False.

   i) Registration of firm is compulsory under the Indian partnership Act. …………..

   ii) Registration of firm provides protection to, the outsiders dealing with the firm. …………..

   iii) An unregistered firm can sue a third party to enforce any right …………..

   iv) A firm whether registered or not, can always claim a set-off in proceedings instituted against it by a third party. …………..

   v) In case of an unregistered firm the official assignee or receiver can realise the property of an insolvent partner. …………..

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12.8 DURATION OF PARTNERSHIP

While forming a partnership firm the partners may fix some specific term for its duration or decide that it may be terminated any time at will of the partners. Thus, a partnership firm in terms of duration can be (i) partnership at will, or (ii) particular partnership.

Partnership at will: When there is no provision in partnership agreement for duration of the partnership, the partnership is called 'partnership at will' (Sec. 7). In such a situation, the partners are free to terminate their relationship at will i.e, simply by giving a notice to that effect to all other partners. Thus, such partnership is for an indefinite period.

Particular partnership: When a partnership is formed for a specific venture or for a particular period, it is called particular partnership (Sec. 8). Such partnership automatically comes to an end on the completion of the venture or on the expiry of the period. If, however, the partners want to dissolve the partnership before the fixed period, it can be done only by the mutual consent of all the partners. Similarly, if the partnership is continued after the expiry of term or completion of the venture it is deemed to be a partnership at will.

12.9 PARTNER, FIRM AND FIRM'S NAME

As stated earlier (12.2), persons who have entered into partnership are individually called 'partners' and collectively "a firm", and the name under which their business is carried on is called the "firm name" (Set. 4). In law "a firm" is only a convenient phrase for describing the group of partners. But, the firm has no legal existence apart from the partners. It is not a separate entity like a company. It is simply a collective name of members of a partnership firm.

As regards the "firm name", partners are free to choose any name and style provided they do not violate the rules relating to trade name or goodwill. They must not adopt a name calculated to mislead the public into confusing them with a firm of repute already in existence with a similar name. They must not use a name implying the sanction or patronage of the Government.

12.10 TYPES OF PARTNERS

An outsider dealing with a firm must know who the partners in the firm are and to what extent each partner is liable. This becomes all the more necessary when there is default by the firm. The extent of partner's liability, to some extent, can be ascertained with reference to the type of partners they are. Hence it becomes necessary to know what are the various types of partners. They are as follows:

i) **Active or ostensible partner**: A person entering into partnership by contract and taking active part in the conduct of business is called 'active' or 'ostensible' partner. For all acts done in the ordinary course of business he acts as an agent of other partners, He thus, has the capacity of binding himself and other partners vis-à-vis the third parties for all acts done in the firm's name and in the ordinary course of business. In the event of his retirement he must give a public notice of his retirement in order to absolve himself of liabilities for acts of other partners done after his retirement.

ii) **Sleeping or dormant partner**: A sleeping partner is one who contributes to the capital of the firm and has a share in the profits of the firm. But, he does not take an active part in the conduct of the business of the firm. Though the third parties may be unaware of his existence as partner, he is equally liable for all debts of the firm like an undisclosed principal. In the event of his retirement from partnership, however, he need not give a public notice.

iii) **Nominal partner**: A partner who neither contributes to the capital of the firm nor takes a share in the profit or takes part in the management of the firm is called 'nominal partner'. Such a partner merely lends his name to the firm and does not have any real interest in the affairs of the firm. But he, along with other partners is liable to third parties dealing with the firm only for all the debts of the firm.

iv) **Partner in profits only**: If it has been agreed among partners that a particular partner shall have a share in the profit only and not he liable for losses, such a partner is known as 'partner in profits'. Towards the third parties, however, he is liable for all the acts of the firm. Since the liability of partners is joint and several, he may have to contribute the major share if the firm bears heavy losses and other partners are not in a position to pay the debts of the firms.

v) **Sub-partner**: When a partner agrees to share his profits derived from the firms with a third person, that third person is known as 'sub-partner'. A sub-partner is in no way connected with the firm. He has no rights against the firm nor does he carry any liability for the debts of the firm.

vi) **Partner by estoppel or holding out**: (Sec, 28): Normally a person becomes a partner only by agreement. But, for outside world, a person can also be treated as a partner by virtue of his conduct. This happens by way of estoppel or holding out. According to Section 28(1), "when a person, by words spoken or written, or by his conduct, represents himself or knowingly permits himself to be represented to be a partner in a firm, he is liable as a partner in that firm to any one who has on the faith of any such representation gives credit to the firm." The person so representing himself is called a partner by estoppel or holding out. For example, a renowned sportsman assumed the honorary presidentship of a publishing business bringing out a sports magazine because the other partners requested him to do so. He would be considered liable for all the debts of the firm to all those third parties who gave credit to the firm in the bonafide belief that this sportsman was a partner in the firm. Similarly, Shyam had business in the name of Ram Shyam & Co. He employed a person, whose name was Ram, as a manager of the firm's business. The third parties dealing with the firm treated him a partner of the firm. Ram neither objected nor disclosed his true status. It was held that Ram was a partner by estoppel.

To hold a person liable as a partner by estoppel or holding out the following two conditions must be satisfied:

i) He must have represented himself to be a partner by word, spoken or written, or by his conduct (active representation), or knowingly allowed himself, to be represented as a partner (tacit representation); and

ii) The third person acting on the belief of such representation must have given credit to the firm. It is immaterial whether the person so holding himself out to be a partner is aware or not that the representation has reached the third party.

A retiring partner who has not given a public notice of his retirement; can also be held liable on grounds of holding out if his name is still being used by the other partners in the firm. It is because the third parties may continue to believe that he is still a partner. However, where in the event of death of a partner, the firm continues the business and uses the deceased partner's name as part of the firm's name, the estate of the deceased partner or his legal representatives cannot be held liable for acts of the firm done after his death.

Check Your Progress C

1. State whether the following statements are True or False.

   i) A firm has no legal existence apart from its partners. …………

   ii) If firm has already been doing business under certain name, the new firm cannot adopt such name. …………

iii) Partnership for a fixed term automatically comes to an end on the expiry of the said fixed term unless the partners agree otherwise. ………………..

iv) A particular partnership cannot be continued after the completion of the adventure for which it was formed. ………………..

2. Fill in the blanks.

i) A partner actively engaged in the conduct of the business of partnership is called .... partner.

ii) A nominal partner contributes only his ....to the firm.

iii) A retiring partner not giving public notice of his retirement can be held liable for the acts of the firm after his retirement on grounds of ....

iv) A sub-partner .... represents himself to outsiders as a partner.

v) A person who is not a partner in a firm, represents himself or knowingly allows himself to be represented to be a partner in that firm is called a partner by .... or holding out.

12.11 POSITION OF A MINOR AS A PARTNER

You know that an agreement by, or with, a minor is void ab initio. Since partnership is created by an agreement, a minor cannot enter into partnership. He can however, be admitted to the benefits of the firm with the consent of all other partners by an agreement executed between his guardian and the partners of the firm. The rights and liabilities of a minor admitted to the benefits of a partnership are as follows :

12.11.1 Rights

i) In accordance with the agreement, the minor has a right to share the profits and the property of the firm. But he cannot take part in the conduct of the business of the firm.

ii) He has a right to have access to, and inspect and copy, any of the accounts of the firm. But, he does not enjoy such right in respect of books other than account books as they may contain secrets which may be restricted to partner only.

iii) He has a right to file a suit for his share of profits or the property of the firm when he is not given his due share of the profits. However, he can exercise this right only when he decides to sever his connections with the firm.

iv) He can become partner in the firm on attaining majority and shall be entitled to the same share which he was getting as a minor.

v) On attaining majority he also has the option to sever his connections from the firm and, if necessary, sue the firm for accounts and his share in profits and property of the firm.

12.11.2 Liabilities

The minor partner is liable only to the extent of his share in the profits and the property of the firm. He is not personally liable to the third parties and so his private property cannot be used for payment of the firm's debts incurred during his minority. He cannot be declared insolvent if the firm's debts cannot be repaid out of the property of the firm.

On attaining majority, however, if he becomes a partner in the firm, he shall become personally liable to third parties for all the acts of the firm done since he was admitted to the benefits of the firm.

12.11.3 Position on Attaining Majority

Within six months of his attaining majority or his obtaining knowledge that he had been admitted to the benefits of firm, whichever date is later, the minor partner has to decide whether he shall remain a partner or leave the firm. If he decides to sever his connections with the firm, he must give a public notice of his intention failing which it must be presumed that he has opted to become a partner in the firm.

When he becomes a partner: If the minor becomes a partner of his own volition or by his failure to give notice within the specified time, his rights and liabilities as given in Section 30 (7) are as follows :

i) He becomes personally liable to third parties for all acts of the firm done since he was admitted to the benefits of the firm.

ii) His share in the property and profits of the firm remains the same as he was entitled as a minor.

When he elects not to become a partner: If he decides to severe his connection with the firm, his rights and liabilities as given in Section 30 (8) will be as follows:

i) His rights and liabilities continue to be those of a minor up to the date of giving public notice.

ii) His share is not liable for any acts of the firm done after the date of the public notice.

iii) He is entitled to sue the partners for his share of the property and profits in the firm

Check Your Progress D

1. State whether the following statements are True or False.

   i) A new partnership cannot be formed with a minor. ………..

   ii) In the event of firm's failure to pay off its debts, the minor partner can also be declared insolvent. …………

   iii) The liability of a minor partner to a third party is limited to the extent of his share in the partnership property. …………

   iv) If a minor on attaining majority, elects to become a partner, he is not liable for acts of the firm done before the date of his becoming partner. ………..

v) A minor admitted to the benefits of the firm can file a suit against the partners for his share of the profits or the property of the firm without severing his connections with the firm. ………..

vi) A minor partner can inspect books of account of the firm. …………..

12.12 LET US SUM UP

Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. The main characteristics of partnership are: (i) It is an association of two or more persons, (ii) It arises out of an agreement, (iii) It is to carry on a business, (iv) It is for sharing the profits of the business, and (v) It has an element of mutual agency amongst the partners.

Persons entering into partnership are individually called partners and collectively a firm. The name under which the firm carried on its business is called the firm's name. While selecting a name, however, partners should ensure that it does not violate the rules relating to trade name or implies the patronage of the government.

To determine whether a group of persons is or is not a firm, we have to ascertain the real relationship amongst the partners with the help of their agreement or from other relevant facts taken together. Sharing of profits is a strong evidence of partnership. But, the mutual agency relationship between them is the real test of partnership. The partnership is different from co-ownership and Joint Hindu Family.

Registration of firms is not compulsory under the partnership Act. But it is considered desirable because an unregistered firm suffers from a number of disabilities. These are : (i) The partners cannot file a suit against the firm or any other partner for enforcing his contractual rights or rights accruing under the partnership Act. (ii) The firm cannot file a suit against a third party for enforcing rights arising out of contracts with him, and (iii) It cannot claim any set-off. The firm can be registered any time by supplying the necessary particulars to the Registrar of firms along with the prescribed fees.

Based on their conduct or sharing of profit, the partners can be of various types such as actual partner, sleeping partner, nominal partner, partner in profits only, sub-partner, partner by estopple or holding out. The liability of a partner to third parties to a great extent, is determined by the type of partner a person is.

Being incompetent to contract a minor cannot become a partner in a firm. He can, however, be admitted to the benefits of partnership with the consent of all the partners. In that case, his liability is limited to his share in the partnership business. He has a right to share the profits and enjoys full access to the accounts. On attaining majority he can also opt to become a partner. But, if he wants to sever his connection with the firm he can do so by giving a public notice to that effect.

12.13 KEY WORDS

Association of Persons: A body of persons associated for a common purpose.

Co-owner: A person owning a property jointly with the other or others.

Co-ownership: Joint ownership of property.

Firm: A collective name for partnership.

Illegal Association: A firm in which the number of partners exceed the prescribed limit.

Joint Hindu Family: A Hindu Undivided Family carrying on business inherited from its ancestors.

Minor Partner: A minor admitted to the benefits of a firm,

Mutual Agency Relationship: A relationship between persons whereby each member is authorised to act on behalf of the other members.

Nominal Partner: A partner who just lends his name to the partnership firm, neither invests any capital nor participates in the management.

Ostensible Partner: A partner who actively participates in the business of the firm (an active partner).

Partner: A person who has entered into partnership with the other person(s).

Partner by Estoppel: A person whose conduct creates an impression that he is a partner in a particular firm.

Partner by Holding Out: A person who allows himself to be represented as a partner and makes no effort to disclaim even after coming to know about it.

Partner in Profits only: A partner who only shares the profits of the business and not the losses.

Sleeping Partner: A partner who does not actively participate in the business of the firm (dormant partner).

12.14 ANSWERS TO CHECK YOUR PROGRESS

A) 1. i) No ii) No iii) No iv) Yes v) No

2. i) 50 ii) status

3. a) ii b) ii c) i

B) 1. i) Though it is not a partnership, B can claim his share in profits. But he cannot be held liable for paper supplied by C.

ii) No, there is no agreement amongst the heirs. It is case of Joint Hindu Family.

iii) Yes, all essentials of a partnership are fulfilled and B is a partner. Bringing of capital and sharing of losses is not relevant.

2. i) False ii) False iii) False , iv) False v) True

C) 1. i) True ii) True iii) True iv) False.

2. i) Actual ii) Name iii) holding out iv) cannot v) estoppel

D) i) True ii) False) True iv) False v) False vi) True

12.15 TERMINAL QUESTIONS

1. Define Partnership and describe the essential characteristics of a partnership.
2. Explain how you will determine whether a group of persons is a partnership or not.
3. Explain briefly the procedure for registration of firms. What are the consequences of non-registration?
4. Enumerate the different types of partners and briefly explain the extent of their liabilities.
5. Can a minor be admitted to a partnership? If so, what are his rights and liabilities during minority and after he has attained majority?
6. Explain the circumstances under which a person can be made liable as a partner even if he is not a partner.
7. Comment on the following statements:
   a) The relationship of partnership arises from agreement and not from status.
   b) Mere participation in profits of a business is not a conclusive test of the existence of partnership.
   c) The Indian Partnership Act has effectively ensured the registration of firms without making it compulsory.
8. Distinguish between :
   a) Partnership and Co-ownership
   b) Partnership and Joint Hindu Family

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Note : These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University for assessment. These are for your own practice only.

UNIT 13 RIGHTS, DUTIES AND LIABILITIES OF PARTNERS

Structure

13.0 Objectives

13.1 Introduction

13.2 Mutual Relations of Partners
- 13.2.1 Rights of Partners
- 13.2.2 Duties of Partners

13.3 Property of the Firm

13.4 Relation of Partners with Third Parties
- 13.4.1 Implied Authority of a Partner
- 13.4.2 Implied Authority and Third Parties

13.5 Position of Incoming and Outgoing Partners
- 13.5.1 Admission of a Partner
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- 13.5.5 Death of a Partner
- 13.5.6 Transfer of Partner's Interest

13.6 Let Us Sum Up

13.7 Key Words

13.8 Answers to Check Your Progress

13.9 Terminal Questions

13.0 OBJECTIVES

After studying this unit, you should be able to:

- describe the mutual rights and duties of partners;
- explain the concept of the property of the firm;
- explain the extent of implied authority; and
- describe the rights and duties of incoming and outgoing partners.

13.1 INTRODUCTION

In Unit 12 you learnt that a partnership is formed by an agreement between two or more persons called partners. The rights, duties and liabilities of partners are usually determined by the terms specified in the agreement. But, the agreement may not provide for all the rights and duties of partners. In such a situation, the provisions of the Partnership Act become automatically applicable. You have also learnt that the law of partnership is an extension of the law of agency. A partner

is both a principal and an agent. He is, therefore, bound by the acts of other partners and binds other partners by his acts done on behalf of the firm. In this unit you will learn about the provisions of the Partnership Act which govern the mutual rights and duties of partners and those which determine the extent of the authority of a partner to bind the firm by his acts. In this connection, we shall also discuss the position of the incoming and the outgoing partners.

13.2 MUTUAL RELATIONS OF PARTNERS

It is generally believed that since partnership comes into existence by an agreement, the mutual rights and duties of partners will be determined only by the provisions made in the agreement. But, this is not the true position. The partnership agreement may not specifically provide for all rights and duties of partners. In that case, the provisions of the Act will become applicable. Then there arc certain rights and duties given in the Act (Sections 9 and 10) which cannot be changed by agreement. They are mandatory and are binding on all the partners. Thus, the mutual right and duties of partners are governed by the partnership agreement as well as the Partnership Act.

Sections 9 to 13 and Sections 16 to 25 of the Partnership Act lay down the majority of rules that govern the mutual rights and duties of partners. As indicated earlier, except sections 9 and 10 which lay down absolute duties of partners, all other provisions given in the Act can be changed by an agreement amongst the partners, Let us now discuss the main provisions of the Act governing the mutual rights and duties of partners.

13.2.1 Rights of Partners

Unless otherwise agreed by the partners, every partner has following rights:

i) **Right to take part in the conduct of business**: Each partner can participate in the conduct and management of the business of the firm.

ii) **Right to be consulted**: Each partner has the right to express his opinion and be heard in all matters affecting the business of the firm. All decisions will, however, be made by majority with the exception of certain matters like change in the nature of business and reconstitution of the firm.

iii) **Right to have access to books**: Each partner has the right to inspect and copy any of the books of the firm. But, a minor admitted to the benefits of the firm can inspect and copy only the books of account. He cannot claim access to other books of the firm.

iv) **Right to share profits equally**: Each partner will share the profits of the business of the firm equally.

v) **Right to claim interest on capital**: Normally, no interest is allowed on the capital contributed by the partners. But, if the partnership agreement provides for the payment of interest on capital, it shall be payable only out of the profits. In other words, if there are losses, the interest on capital will not be allowed.

vi) **Right to interest on advances**: If partner has advanced some amount as loan to the firm, he will be entitled to interest at a rate agreed upon, and where no rate is decided, at six per cent per annum. Interest on loan will be payable even if there are losses.

vii) **Right to be indemnified**: A partner has to be indemnified by the firm in respect of all expenses and liabilities incurred by him in the ordinary and proper conduct of business. He will also be entitled to claim reimbursement for all payments made by him in an emergency for protecting the firm from loss provided he acted in a manner as a person of ordinary prudence would have acted in similar circumstances in his own case.

viii) **Right to use partnership property**: Every partner is, as a rule, a joint owner of the partnership property and is entitled to have held and applied exclusively for the purpose of the business.

ix) **Right in emergency**: A partner has the right in an emergency to do all such acts as are reasonably necessary for protecting the firm from loss.

x) **Right to stop the admission of a new partner**: Every partner is entitled to prevent the introduction of a new partner into the firm. As per rules, unless otherwise agreed, no new partner can be admitted without the consent of all the partners,

xi) **Right to retire**: Each partner has the right to retire from the partnership either as per the terms of the partnership agreement or with the consent of all the partners, or if the partnership is at will by giving notice of his intention to retire.

xii) **Right not to be expelled**: Every partner has a right to continue in the partnership. He cannot be expelled from partnership by majority of partners unless such power is conferred by partnership agreement and is exercised in good faith and for the benefit of the firm.

xiii) **Right to do competing business**: Every outgoing partner has a right to carry on a competing business. But, he cannot (i) use the firm's name (ii) solicit the firm's customers, or (iii) represent the firm.

xiv) **Right to share profits after retirement**: Unless otherwise agreed, an outgoing partner has the right to claim a share in the profits of the firm or claim interest @6% per annum on his share in the property of the firm till his account is finally settled. This rule is also applicable in case of the death of a partner.

13.2.2 Duties of Partners

As stated earlier, certain duties are mandatory while others are subject to agreement amongst the partners. These are summarised below.

Mandatory Duties

The partnership is based on mutual trust and confidence. Hence, each partner must act in good faith and carry on the business of the firm for mutual benefit and not for his personal benefit. Section 9 has clearly stated that all partners are bound (i) to carry on the business of the firm to the greatest common advantage, (ii) to be just and faithful to each other, and (iii) to render true accounts and full information of all things affecting the firm to any partner or his legal representative. Similarly, Section 10 lays down that every partner shall indemnify the firm for loss caused to it by his fraud in the conduct of the business of the firm. These duties given in Section 9 and 10 are absolute provisions of the Act and are mandatory. They cannot be changed by an agreement amongst the partners.

Duties Subject to Agreement by Partners

Besides the provisions of Sections 9 and 10, the other duties of partners as provided in the Act are subject to the agreement by partners. They can be changed by partners by making necessary provisions in their agreement. Such duties are:

i) To attend diligently to his duties in the conduct of the business.

ii) To perform partner's duty without receiving any remuneration for taking part in the conduct of the business.

iii) To contribute equally to the losses sustained by the firm.

iv) To indemnify the firm for any loss suffered by the firm due to willful neglect in the conduct of the business of the firm.

v) To ensure that the property of the firm is held and used by the partners exclusively for the business of the firm.

vi) To account for and to pay to the firm any private profits derived by the partner from any transactions of the firm or from the use of property or business connections of the firm.

vii) To account for and to pay to the firm all profits made by a partner by carrying on any private business. Normally, there is no restriction on the partner to carry on any business other than and of the firm. But, if the partners have agreed that no partner shall do any business other than that of the firm, he should not carry on any other business, whether competing or not competing with that of the firm, without the consent of other partners.

viii) To act as an agent of the firm for the purposes of the business of the firm.

ix) To act within the scope of actual or apparent authority. In case a partner exceeds his authority and the other partners do not approve of it, he will be liable to other partners for the loss suffered on account of his such acts.

x) Not to assign his rights and interests in the firm to the outsiders without the consent of all other partners.

xi) To be liable jointly with all other partners and also severally for all acts of the firm done while he is a partner. This means that the creditors of the firm can realise their dues from any partner.

13.3 PROPERTY OF THE FIRM

You know that all partners are joint owners of the property of the firm (unless there is all agreement to the contrary) and it should be held and used exclusively for the firm by the partners, Hence, it becomes necessary to ascertain what constitutes the property of the firm. Normally the partners, by an agreement, are free to determine as to what shall be the property of the firm and what shall be treated as a separate property of one or more of the partners. But, when there is no such agreement, and you want to know whether a certain property is the property of the firm or not, you will have to ascertain the source from which the property had been acquired, the purpose for which it was acquired and the manner in which it has been dealt with. According to Section 14, when there is no contract to the contrary, the property of the firm includes:

i) all properties, rights and interests originally brought to the stock of the firm,

ii) the property acquired by purchase or otherwise by or for the firm,

iii) the property acquired with money belonging to the firm, and

iv) the goodwill of the business of the firm.

Thus, whatever is brought to the common stock of the firm and whatever is added to or obtained by means of this common stock during the continuance of partnership either directly or by conduct of business, is included in the property of the firm unless a contrary intention can be shown. However, if a partner's property is used for the purpose of the business of the firm it does not automatically become the property of the firm. It can only become the property of the firm if the partners show an intention to make it so. For example, a piece of land which is bought in the name of one partner but is paid for by the firm (or out of the profits of the firm) shall be deemed to be the property of the firm unless there is an intention to the contrary. Similarly, if two persons take a lease of a coal mine for the purpose of working it in partnership, the lease will be treated as the property of the firm.

Check Your Progress A

1. Answer the following with 'Yes' or 'No'.

   i) Can a partner be prevented from taking part in the partnership business? ....

   ii) Is a partner liable for the acts of the firm before his joining the firm? ....

   iii) Can a majority of partners by an agreement expel a partner? ....

   iv) Can a person to whom a share of profits has been assigned be asked to share losses also? ....

   v) Does a minor admitted to share the profits of a firm have a right to inspect and copy any books of the firm? ....

2. If there is no express provision in the partnership agreement how would the partners

   a) charge interest on capital ....

   b) divide profits between then ....

3. A and B are partners of a firm. B was appointed to buy sugar for the firm. Without the knowledge of A, he supplied his own sugar to the firm at market price and made huge gain. Is he accountable to firm?

   ....

   ....

   ....

   ....

4. State by 'Yes' or 'No' whether the following constitute firm's property or not.

   i) Property belonging to a partner who enters into an existing partnership. ....

   ii) Share bought by a partner in his own name without the consent of other partners but with the money of the firm. The other partners later adopt the transaction. ....

   iii) Land bought with partnership money on account of, and for the sole benefit of, one partner who becomes a debtor to the firm for the amount of the purchase money. ....

   iv) Goodwill of the firm having a saleable value. ....

   v) Property belonging to a partner who enters into an existing partnership. ....

13.4 RELATION OF PARTNERS WITH THIRD PARTIES

In unit 12 you learnt that mutual agency is an essential element of partnership. Each partner acts both as the agent and the principal. It is this position of the partners which governs their relationship with the third parties. Section 18 clearly states that from the point of view of the third parties, a partner is an agent of the firm, for the purposes of the business of the firm. In that capacity, he binds all other partners by his acts done on behalf of the firm provided these are done in the ordinary course of business and in the name of the firm. So, all partners are liable to third parties for such acts.

13.4.1 Implied Authority of a Partner

In the context of a partnership firm, the authority of a partner means his authority to bind the firm by his acts. This authority may be express or implied. The authority conferred on a partner by mutual agreement is called an express authority. But, where there is no agreement or where the partnership agreement is silent, the act of a partner which is done to carry on, in the usual way, business of the kind carried on by the firm, binds the firm (Section 19). This capacity of a partner to bind the firm by his acts is called the 'implied authority of a partner.' In order that his act may fall within the scope of his implied authority, the following conditions must be fulfilled.

1. **The act done by the partners must relate to the normal business of the firm**. If it is of a nature which is not common in the type of business carried on by the firm, it will not bind the firm even if it has been done in the name of the firm. For example, an exporter of readymade garments places an order for a huge quantity of liquor in the name of the firm. As this act does not relate to the normal business of the firm, it will not fall within the scope of implied authority. The firm, therefore, will not be bound by it.

2. **The act must have been done in the usual way of carrying on the firm's business**. In other words, the act should be such as is usual in the type of business carried on by the firm. For example, X and Y are partners in a retail business. Goods were sold on credit to Z. Later on, X received

the amount from him (Z) on behalf of the firm. Y does not know of this receipt and X utilises this amount for his personal use. Receiving money from debtors is an act done in the usual course of business. Hence, the firm cannot claim the amount from Z on the plea that X had no authority to receive the amount. It is difficult to clearly lay down as to what is usual and what is unusual in a business. It will depend on the nature of business and the usage of trade. For example, buying and selling of goods, drawing and accepting bills of exchanges, taking loan, etc, are considered normal activities in case of a trading concern. But, in case of an auctioneering firm or a firm of solicitors, taking loan is not considered to be a usual activity.

3. **The act must be done in the firm's name or should, in some manner, imply an intention to bind the firm**. For example, A and B are partners in a stationery business. A goes to a wholesaler and buys on credit certain quantity of pencils in the firm's name. He uses these pencils for the family. Since this act is of the kind usually done in the stationery business and is done in the firm's name, it will bind the firm.

Act within the implied authority of a partner: The implied authority of a partner shall normally include:

i) purchasing, on behalf of the firm, goods in which the firm deals or which are used in the firm's business;

ii) selling the goods of the firm;

iii) receiving payment of the debts due to the firm and giving receipt therefore;

iv) settling accounts with third parties dealing with the firm;

v) employing servants necessary for carrying on the firm's business;

vi) borrowing money in the credit of the firm;

vii) pledging goods of the firm as security for the purpose of getting loans;

viii) drawing, accepting and endorsing negotiable instruments on behalf of the firm; and

ix) employing solicitor to defend action against the firm

Acts outside the implied authority of a partner: Sections 19(2) has restricted the scope of implied authority of a partner. According to this section, in the absence of any usage or custom of trade to the contrary, the implied authority of a partner does not enable him to:

i) submit to arbitration a dispute relating to the business of the firm;

ii) open a bank account on behalf of the firm in partner's own name;

iii) compromise or relinquish any claim or portion of the claim by the firm;

iv) withdraw a suit or proceedings filed on behalf of the firm;

v) admit any liability in a suit or proceedings against the firm;

vi) acquire immovable property on behalf of the firm;

vii) transfer immovable property belonging to the firm, and

viii) enter into partnership on behalf of the firm.

However, the partners, by mutual agreement, can restrict or extend the implied authority of a partner.

Partner's authority in an emergency: According to Section 21, in an emergency a partner will have an authority to do all such acts to protect the firm from loss as a prudent man would undertake under similar circumstances in his own case. These acts do not form part of the implied authority of the partner but, nevertheless, they would bind the firm. For example, the partners of a trading firm by an express contract decided that no partner would have the authority to sell goods of the firm above the value of Rs. 10,000 without consulting all other partners. Owing to a sudden slump in market, the prices, crashed. One partner, in order to save the firm from loss, sold all the stock worth Rs. 1,00,000 without consulting any other partner. The firm is bound by such act of the partner.

13.4.2 Implied Authority and Third Parties

All partners are liable to third parties for all acts of a partner which fall within the scope of his express or implied authority. Their liability to the third parties for such acts can be discussed under the following heads.

1. **Extension or restriction of partner's implied authority**: As stated earlier, the partners of a firm by mutual agreement, may extend or restrict the scope of implied authority of any partner. But, the third party is not bound by any restriction imposed on the implied authority of a partner unless it has the knowledge of such restriction. In other words, the third party remains unaffected by any secret restriction on the implied authority of any partner. For example, a trading firm limited the authority of partners to purchase goods on credit upto Rs. 50,000. A third party who had no knowledge of such restriction sold goods worth Rs.1,00,000 on credit to a partner of the firm. The firm is liable to pay the full amount to the third party.

2. **Effect of admission by a partner**: Since, for the purpose of the business of the firm, a partner is an agent of the firm, any admission or representation by a partner about the affairs of the firm is sufficient evidence against the firm, provided the admission is made in the ordinary course of business.

3. **Effect of notice to an acting partner**: You already know that a notice to an agent on matters relating to agency is notice to the principal. The same rule applies to partnership. Thus a notice of any matter relating to the affairs of the firm, when given to a partner who habitually receives it in the ordinary course of business of the firm, is taken to be a notice to the firm. This rule would not apply in case of a fraud committed by the partners and the third party against the firm.

4. **Liability of partners for acts of the firm**: For all acts of the firm, done while he is a partner, every partner is jointly and severally liable to third parties. This means that for every act of the firm, the third party can sue each partner individually and also jointly with other partners.

5. **Liability for wrongful acts of a partner**: When a partner, in the ordinary course of business, commits a wrongful act, the firm is liable for such an act. Section 26 specifically provides that if on account of the wrongful act or omission of .a partner acting in the ordinary course of business or with the authority of other partners, some loss or injury is caused to any third party or any penalty is incurred, the firm is held liable to the same extent as the

partner. For example, A, B and C are partners in a newspaper business. A is also the editor of the newspaper. A allows the publication of a defamatory article about a prominent person P, without checking its validity. P sues the firm for libel. The firm will be liable for this act of the editor partner as the omission which caused loss of goodwill to P was done in the usual course of business.

6. **Liability of firm for misapplication by partners**: Section 27 provides that the firm is liable to the third parties where (i) a partner, acting within his apparent authority, receives money or property from a third person and misapplies it, or (ii) the firm in the course of its business receives money or property from a third party and the money is misapplied by any of its partners while it is in the custody of the firm. For example, X, Y and Z are partners in a business. K, a debtor of the firm repays his debts of Rs. 10,000 to X who does not inform Y and Z about the repayment and misuses the money. K would be discharged of the debts on account of payment made to X.

Check Your Progress B

1. What is meant by the implied authority of a partner to bind the firm?

   ....

   ....

   ....

2. Fill in the blanks:

   i) The authority of a partner to bind the firm may be .... or implied.

   ii) In order to bind the firm the acts done by a partner under his implied authority must relate to the .... business of the firm.

   iii) In the case of ....in order to prevent losses to the firm, a partner may exceed his express or .... authority.

   iv) In the absence of any usage or custom of trade to the contrary, a partner acting in his implied authority .... submits a dispute relating to the firm's business to arbitration.

3. In which of the following cases the firm is liable to the third parties for the acts of the partners. Answer with Yes or No.

   i) The managing partner of a firm laying sewerage lines does not get the manholes covered as required by law. A worker falls in the manhole and is injured.

   ii) A, B and C partners in a business as construction contractors. A manages to get a contract for the firm worth Rs.5,00,000. But, he secured this contract only after paying a bribe of Rs. 5,000 to an officer in the client's business. He charges this amount to the account of the firm. But, the other partner's objected.

   iii) X, Y and Z are partners in a business of, supplying construction material. K, a regular buyer dealing with firm places a verbal order with X to

supply the required material, X forgets to inform the other partners. The goods are not delivered. K sues the firm for the non-delivery of goods.

iv) A, B and C are partners in a trading firm. By an agreement between them, they decide that no partner shall have the right to buy or sell goods beyond the value of Rs. 10,000 without the consent of other partners. Unaware of this restriction, a third party T sells goods worth Rs. 17,000 to C who does not consult his partners about this transaction. T sues the firm for the price of goods.

13.5 POSITION OF INCOMING AND OUTGOING PARTNERS

When there is any change in the composition of the partnership, it is called reconstitution of the partnership firm. The reconstitution takes place when

1. a new partner is admitted
2. a partner retires
3. a partner is expelled
4. a partner is declared insolvent
5. a partner dies
6. a partner transfers his interest to another person.

On the happening of the above events there is some change in the rights and liabilities of partners. Let us now study the relevant provisions of the Act which govern the above situations and know their effect on the rights and liabilities of partners.

13.5.1 Admission of a Partner

A person cannot be admitted as a partner in an existing firm without the consent of all the partners. This rule is however, subject to any provision to the contrary in the partnership agreement. For example, the partnership agreement between A, B and C provides that A could introduce into partnership any of his sons on attaining the age of majority. In such a situation, there is no need for the consent of B and C if A decides to admit his son (who has attained majority) as a partner.

An incoming partner is not liable for any debts of the firm, incurred before his admission as partner. His liability is limited only to those acts of the firm which are done after he becomes a partner. This general rule has two exceptions which are as follows.

a) By mutual agreement, he may undertake to share the liabilities for the past acts of the firm. But, this does not entitle the creditors to proceed against the new partner for the recovery of old debts unless (i) the new firm has assumed the liabilities of the old firm, and (ii) the creditors have accepted the new firm as their debtor and discharged the old firm from its liability.

b) A minor admitted to the benefits of the firm who, on attaining majority decides to become a partner, shall be personally liable to third parties for all acts of the firm done since he was admitted to the benefits of partnership.

13.5.2 Retirement of a Partner

Any partner may retire from the firm in any of the following ways:

i) with the consent of all the other partners; or

ii) in accordance with an express agreement among the partners; or

iii) where the partnership is at will, by giving a notice in writing to all other partners of his intention to retire,

Liabilities: A retiring partner continues to remain liable for all the acts of the firm done before retirement or acts pending at the time of his retirement. He may, however be discharged from his liability towards the third parties by mutual agreement. Such agreement should be entered into between the three parties viz., all members of the reconstituted firm, the retiring partner and the concerned third party. Such an agreement may be express or implied.

Until public notice of the retirement of a partner is given, the retiring partner continues to be liable to third parties for any act done by any of the partners even after his retirement, which would have been an act of the firm if done before his retirement. However, the retired partner will not be liable to any third party who deals with the firm without knowing that he was not a partner. This would generally hold good in case of the retirement of a sleeping partner. (Public notice of retirement may be given either by retiring partner himself or by any other partner).

Rights: A retiring partner has the following two rights

1. He can carry on business competing with that of the firm and may advertise such business. But, in the absence of any agreement to the contrary, he cannot (i) use the name of the firm; (ii) represent himself as carrying on the business of the firm, or (iii) solicit the old customers. By mutual agreement, however, some restrictions can be imposed on the retiring partner. For example, he may be restrained from carrying on the competing business in a specified area for a specified period. This shall not be treated as restraint of trade.

2. If there is no final settlement of accounts between the retiring partner and the remaining partners and they continue to carry on business with the property of the firm, the retiring partner is entitled to claim (i) such share of the profits earned after his retirement which is attributable to the use of his share of the property of the firm, or (ii) interest at the rate of 6% p.a. on the amount of his share in the property. He can choose any of these two alternatives.

13.5.3 Expulsion of a Partner

Normally a partner cannot be expelled from partnership. However, the expulsion of a partner is possible if following three conditions are satisfied.

i) the power to expel a partner is available by an express agreement between the partners;

ii) the power has been exercised by a majority of the partners, and

iii) the power has been exercised in good faith and for the benefit of the firm.

A partner who is expelled from the firm is subject to the same right and liabilities as those of a retired partner.

13.5.4 Insolvency of a Partner

Where a partner of a firm is declared insolvent by a court of competent jurisdiction, he ceases to be a partner in the firm on the date on which the order of adjudication is made. It is not necessary that the firm is dissolved when a partner is declared insolvent. If, in accordance with the provisions of the partnership contract, the firm is not dissolved on the insolvency of a partner, the estate of the insolvent partner is not liable for any act of the firm, and the firm is not liable for any act of the insolvent, done after the date on which the order of adjudication is made.

13.5.5 Death of a Partner

Normally the firm is dissolved on the death of any of its partners. But, if the partnership contract provides that on the death of any partner the firm will not be dissolved, the remaining partners can continue with the firm's business.

In that case, the estate of a deceased partner can be held liable only for those acts of the firm, which were done during the life time of the deceased partner. It shall not be liable for any act of the firm done after the date of his death. No public notice is required on the death of a partner.

13.5.6 Transfer of Partner's Interest

A partner has the right to transfer his interest in the firm, fully or partially, to a third person. But, such a person (the transfree) is not treated as a partner. Neither he can take part in the conduct of the business of the firm not inspect its account books. He can simply claim his share in the profits of the firm.

If, however, the partner transfers his share in the firm on its dissolution or on ceasing to be a partner, the transferee will be entitled to claim the share of the transferring partner in the assets of the firm and for the purpose of ascertaining that share he can ask for on account as from the date of dissolution.

As a matter of fact, no partner can transfer his interest in the firm with the intention of making him a partner in the firm without the consent of all the other partners.

You should note that whenever change takes place in the constitution of the firm, the mutual rights and liabilities of the old partner in the reconstituted firm continue to remain the same as they were before the reconstitution took place. For example, A, B, C and D are partners who share profits in the ratio of 4:3:2:1. They admit a new partner E who is entitled to one-third share in the profits of the firm. In this situation, unless the partners decide otherwise. A, B, C and D shall continue to share the remaining two-third of the firm's profits in the ratio of 4:3:2:1, the new profit sharing ratio being 5:4:3:2:1.

Check Your Progress C

1. List various ways in which a change in the constitution of the firm takes place.

   ....

   ....

   ....

   ....

2. State whether each of the following statements is True or False.

   i) A partner in a particular partnership cannot retire from the firm by giving a notice in writing to other partners. …………

   ii) A partner may be expelled from the firm only with the consent of all the other partners. …………

   iii) A firm is dissolved when any partner of the firm is declared insolvent. …………

   iv) When some change occurs in the constitution of the firm, in the absence of any agreement to the contrary, the partners of the reconstituted firm have the same rights and liabilities as they were having before. …………

13.6 LET US SUM UP

The mutual rights and duties of partners in a firm are generally governed by their agreement. But, where the agreement does not specify certain rights or duties the same shall be governed by the provisions of the Act. The Act also specifies certain rights and duties of partners that are binding and cannot by changed by an agreement.

Unless otherwise agreed, the main rights of a partner as per the provisions of the Act are: (i) to take part in business, (ii) to be consulted, (iii) to have access to books, (iv) to share profits equally, (v) to claim interest @ 6% p.a. on advances to the firm, (vi) to be indemnified for all expenses incurred by him in conduct of firm's business, and (vii) not to do competing business.

The duties of each partner can be divided into two categories (a) mandatory duties and (b) duties subject to agreement among partners. The mandatory duties are: (i) to act in good faith and carry on the business of the firm for mutual benefit, and (ii) to indemnify the firm for loss caused to it by his fraud. The main duties subject to agreement are: (i) to perform partner's duty without any remuneration, (ii) to contribute to losses equally, (iii) to account for and pay to the firm any private profits derived from any transactions of the firm, (iv) to act as an agent of the firm (v) to act within the scope of his authority, and (vi) to be liable jointly and severally for all acts of the firm done while he is a partner.

Unless there is an agreement to the contrary, all partners are joint owners of the property of the firm and such property should be held and used exclusively for the purpose of the firm's business. The property of the firm includes all property originally brought to the common state of the firm or later acquired by or for the firm.

The relation of partners with third party is governed by partner's capacity to act as an agent of the other partners. The third parties may bind the firm by all acts of the partners done within his express or implied authority.

Implied authority covers the acts of a partner which is done to carry on in the usual way business of the kind carried on by the firm. However, there are certain restrictions on the scope of the implied authority of a partner.

There are various ways in which a partnership firm is reconstituted. It could be admission of a partner, retirement of a partner expulsion of a partner, insolvency

of a partner, death of the partner or transfer of his interest by a partner to a third person. In the absence of a contract to the contrary, a partner is liable for all acts of the firm, done by the firm till he ceases to be a partner. Similarly, unless otherwise agreed, the mutual rights and duties of the remaining partners of the old firm continue to be the same.

13.7 KEY WORDS

Arbitration: Determination of a matter in dispute by the judgment of one or more persons called arbitrators.

Common Stock: Property held in common ownership.

Implied Authority: The authority of a partner as conferred by law to bind the firm by his acts done on behalf of the firm in the firm's name.

Incoming Partner: New partner admitted to a partnership firm.

Insolvent Partner: A partner whose assets (including his interest in the firm) at their present fair valuation are insufficient to pay his debts.

Mandatory: Absolute provisions of law that are compulsory and cannot be changed by agreement.

Order of Adjudication: A judicial order declaring a person insolvent.

Outgoing Partner: A partner who leaves the partnership firm by way of retirement, death, expulsion, insolvency, etc.

Partnership Property: Property originally brought to the common stock of the firm or acquired later by or for the firm.

13.8 ANSWERS TO CHECK YOUR PROGRESS

A 1 i) No ii) No iii) No, unless their is a provision in the agreement iv) No v) No, this right is restricted to books of account.

2 a) No, interest on capital is allowed b) equally

3 Yes, B will have to surrender the whole of the profit from the transaction

4 i) No ii) Yes iii) No iv) Yes

B 2 i) express ii) normal iii) emergency, implied iv) cannot

3 i) Yesii) No iii) Yes iv) Yes

C 2 i) True ii) False iii) False iv) True

13.9 TERMINAL QUESTIONS

1. Discuss the mutual rights and duties of partners in the absence of any express agreement between them.
2. Are the partners absolutely free to lay down their rights and duties? If not, state the provisions that cannot be changed by agreement amongst partner?

3. What is partnership property? State how far is the partnership property liable for the separate debts of the partners.

4. What do you understand by an implied authority of a partner? Describe the restrictions on the implied authority of a partner.

5. What is the extent of the implied authority of a partner. How far is a firm liable to third parties for act of an individual partners?

6. Explain the rights and duties of (i) incoming partners. and (ii) an outgoing partner.

7. State the liabilities

   a) of the partners for the acts of the firm;

   b) of the firm for wrongful acts of a partner, and

   c) of the firm for misapplication of money or property of partner.

Note : These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University for assessment. These are for your own practice only.

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UNIT 14 DISSOLUTION OF PARTNERSHIP FIRM

Structure

14.0 Objectives

14.1 Introduction

14.2 Dissolution of Partnership and Dissolution of Firm

14.2.1 Dissolution of Partnership

14.2.2 Dissolution of Firm

14.3 Modes of Dissolution of Firm

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14.5 Settlement of Accounts

14.6 Let Us Sum Up

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14.8 Answers to Check Your Progress

14.9 Terminal Questions

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14.0 OBJECTIVES

After studying this unit, you should be able to:

- distinguish between dissolution of partnership and dissolution of firm;
- describe the modes of dissolution of firm;
- explain the rights and liabilities of partners consequent to dissolution of firm; and
- explain how accounts are settled among partners on dissolution.

14.1 INTRODUCTION

You have learnt about the formation of a partnership firm and the provisions of the Indian Partnership Act relating to mutual relationship of partners and their liability towards third parties. In this unit, you will learn about the rules relating to dissolution of a firm which includes modes of dissolution, right and liabilities of partners on dissolution and the mode of settlement of accounts among the partners.

14.2 DISSOLUTION OF PARTNERSHIP AND DISSOLUTION OF FIRM

The Indian Partnership Act makes a distinction between dissolution of partnership and dissolution of firm

14.2.1 Dissolution of Partnership

Dissolution of partnership simply means a change in the relation of the partners. Such a change is usually caused when a firm is reconstituted i.e., when a new partner is admitted or when an existing partner retires, dies, becomes insolvent or is expelled. The dissolution of partnership may or may not involve the dissolution of a firm. A firm, after a change in relation of the partners, may decide to continue as a reconstituted firm. But, when a firm is dissolved, it necessarily involves the dissolution of partnership.

For example, A, B, C and D are carrying on trading business as a partnership firm. A, is declared insolvent by the court. The partnership between A, B, C and D comes to an end and a new partnership between B, C and D comes into existence. This new partnership between B, C and D shall be known as 'reconstituted firm'. Thus, on declaration of A as insolvent, the partnership stands dissolved, but the firm continues with the remaining partners B, C and D.

14.2.2 Dissolution of Firm

Dissolution of a firm means the dissolution of partnership between all the partners of a firm (Section 39). It occurs when there is complete breakdown of relationship between all the partners. In such a situation, the business of the firm is completely stopped, its assets are realised, the liabilities paid off and the surplus distributed among the partners according to their share in the property of the firm. Thus, the partnership is completely discontinued.

14.3 MODES OF DISSOLUTION OF FIRM

The dissolution of firm may take place either without the order of the court or by an order of the court. The circumstances under which such dissolutions take place are shown in Figure 14.1.

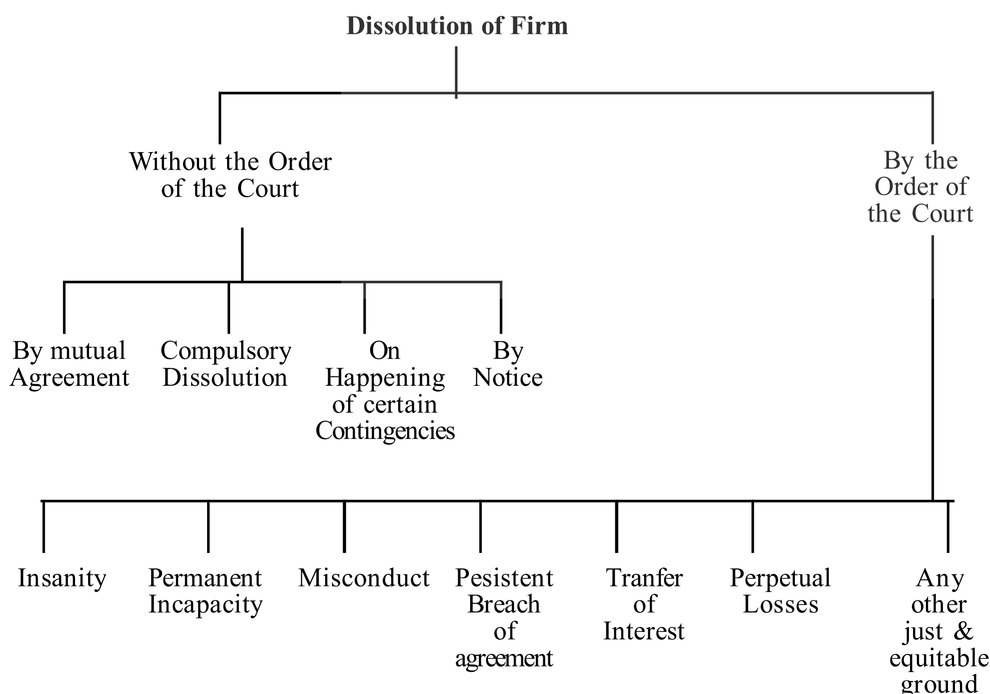

Fig. 14.1: Modes of Dissolution of Firm

14.3.1 Dissolution without the Order of Court

Dissolution of firm without the order of the court may take place in the following ways:

1. **Dissolution by mutual agreement**: You know that a firm comes into existence by mutual agreement. It can also be dissolved by mutual agreement among the existing partners.

2. **Compulsory dissolution**: A firm is automatically dissolved.

   i) if all the partners, or all but one partner, of the firm are declared insolvent. Or

   ii) if some event takes place which makes it unlawful for the business of the firm to be carried on. For example, a war breaks out and some partners of the firm are declared alien enemies. In such a situation, it becomes unlawful for the business of the firm to be carried on. Take another case where a firm is carrying on the business of trading in sugar and a law is passed by which trading in sugar is prohibited. In this case also the business of the firm becomes unlawful and so the firm will have to be compulsorily dissolved. In this connection, you should also note that where a firm is carrying on more than one business, the illegality of one or more shall not necessitate the dissolution of the firm. The firm can carry on those ventures which remain lawful.

3. **Dissolution on the happening of certain contingencies**: According to Section 42, in the absence of a contract to the contrary, a firm will be dissolved on the happening of the following contingencies :

   i) where the firm is constituted for a fixed term, it is dissolved on the expiry of the fixed term,

   ii) where the firm is constituted for completion of one or more adventures or undertakings, the firm is dissolved when those adventures or undertakings have been completed.

   iii) on the death of a partner, and

   iv) on the adjudication of a partner as insolvent.

4. **Dissolution by notice**: When a partnership is at will, the firm may be dissolved by any partner by giving notice in writing to all the other partners of his intention to dissolve the firm.

If the partners has, in his notice, mentioned some specific date for the dissolution of the firm, the firm is dissolved from that date. But if no date has been mentioned, the firm is dissolved from the date when the notice is communicated. It should be noted that a notice once given, cannot be withdrawn without the consent of all other partners.

14.3.2 Dissolution by an Order of Court

Section 44 of the Partnership Act deals with those situations where the court may, on receipt of a petition by a partner, order for the dissolution of the firm, provided it is satisfied that in the interest of justice, it is necessary to order for the dissolution of the firm. Under this section, the court can order even for premature dissolution

when the firm is created for a fixed period. When a petition is brought before the court, the court will give other partners an opportunity to put forward their defence against passing an order for dissolution of firm. It is only after evaluating all the evidences before the court that the court shall pass an order for dissolution of the firm. Let us now study the grounds on which a petition can be presented before the court for obtaining a dissolution order. These grounds are:

1. **Insanity**: When a partner becomes insane, he is incapable of forming a rational judgement. Hence, it is treated as a valid ground for the dissolution of the firm. On this ground a suit may be filed either by any other partner of the firm or by the next friend of the partner who has become of unsound mind. In either case the court may order dissolution of the firm. In the case of a dormant partner, however, the court may not order dissolution because such a partner does take an active part in the conduct of firm's business.

2. **Permanent incapacity**: When a partner has become permanently incapable of performing his duties as a partner, any other partner can file a petition for the dissolution of firm. However, the court will not pass an order for dissolution if the incapacity of a partner is only temporary. For example, a partner in a firm had an 'attack of paralysis. Another partner of the firm filed a petition for dissolution of the, firm. The court refused to pass on order, according to doctors, paralysis was of a temporary nature and the patient's condition was improving. **(Whitwell v. Arthur)**

3. **Misconduct**: When a partner, other than the partner suing, is guilty of misconduct which is likely to adversely affect the carrying on of the business, the court may dissolve the firm. In determining the gravity of misconduct to order dissolution, regard is to be had to the nature of business. For example, an immoral conduct of a partner in a firm of medical men may be considered an adequate ground for dissolution but it may not be so in case of a firm trading in Coal.

4. **Persistent breach of agreement**: When a partner, other than the partner suing, wilfully or persistently commits breach of agreement relating to the management of the affairs of the firm or he conducts himself in such a manner or that it is not practicable for other partners to reasonably carry on the business in partnership with him. Thus, embezzlement, fraudulent breach of trust, or keeping erroneous accounts may be sufficient ground for the court to order dissolution of the firm.

5. **Transfer of interest**: The court, at the instance of any other partner, may dissolve the firm when a partner has in any way

   i) transferred the whole of his interest in a firm to a third party, or

   ii) allowed his share to be charged on account of a decree passed by a court towards payment of liabilities of that partner, or

   iii) allowed his share to be sold in the recovery of arrears of land revenue.

6. **Perpetual losses**: When the firm is continuously suffering losses and it is apparent that in future also the business cannot be carried on except at a loss, the court may order for the dissolution of the firm at the instance of any partner.

7. **Any other just and equitable ground**: If on any other ground, it can be proved to the satisfaction of the court that it is just and equitable to dissolve the firm, the court may order dissolution of the firm. Examples of such ground are continued quarrelling between the partners, refusal to meet on matters of business.

Check Your Progress A

1. Given below are two statements, only one statement in each pair is true. Indicate the correct statement by ticking in the bracket.

   a) i) A firm may be dissolved by the consent of all the partners. ( )

   ii) The agreement of parties to dissolve the firm must be put in writing. ( )

   b) i) Insolvency of all partners except one, can be a ground for dissolution. ( )

   ii) If the firm is carrying on several businesses and if even one of the businesses becomes illegal, it would become a ground for dissolution of firm. ( )

   c) i) A partnership at will can be dissolved by a notice to all partners. ( )

   ii) A partnership for a fixed term cannot be continued after the expiry of that term. ( )

   d) i) If the partnership is for a particular venture, it is compulsorily dissolved on the completion of such venture. ( )

   ii) If two partners belong to different countries and there is an outbreak of war between the two countries, the partnership is automatically dissolved. ( )

2. Fill in the blanks.

   i) When a partner has transferred the whole of his ....to a third party, the other partners can sue for dissolution.

   ii) When the share of a partner is sold to pay arrears of the .... court may dissolve the firm.

   iii) The court may order dissolution of a firm on any just and .... ground.

   iv) The court may order dissolution of the firm, if a partner becomes .... incapable of carrying on his duties.

   v) In the event of continued losses, the court may dissolve even a partnership for ……………..

   vi) When a firm is dissolved it necessarily involves the dissolution of............................

14.4 CONSEQUENCES OF DISSOLUTION OF FIRM

Consequent to the dissolution of a partnership firm, the partners have certain rights and liabilities. These rights and liabilities are discussed below.

14.4.1 Rights of a Partner on Dissolution

1. **Right of equitable distribution of firm's property**: According to Section 46 of the Act, every partner is entitled to have the property of the firm applied in payment of debts to the third parties and the other liabilities of the firm and have the surplus distributed amongst the partners or their representatives according to their rights. This right is also described as partner's general lien.

2. **Right to return of premium on premature winding-up**: If a partner joined a firm for a fixed term, and had paid a premium (goodwill), and the firm is dissolved before that fixed time, he has a right to the return of the whole or part of the premium. The amount of premium will depend upon (i) the terms upon which he became a partner, and (ii) the length of the time during which he was a partner. For example, Ram entered into partnership of a firm for a period of 10 years and paid Rs. 1,000 as premium. The firm was dissolved after expiration of two years because of the insolvency of a partner. Ram shall entitled to Rs. 800 as return of the premium. However, such a partner will not be entitled to claim any return of the premium when the premature dissolution is (i) due to death of a partner, (ii) due to the misconduct of the partner who paid the premium, and (iii) where the firm has been dissolved according to an agreement which had no provision for the return of premium or any part thereof.

3. **Right in the event of dissolution on account of fraud or misrepresentation**: Like any other contract, the partnership contract can also be rescinded on grounds of fraud or misrepresentation and the aggrieved partners, besides other rights, will have the right to claim damages. Section 52 of the Act gives the following rights to partners where the partnership is rescinded on grounds of fraud or misrepresentation.

   i) **Lien of surplus assets**: For any sums paid by him for purchase of a share in the firm or for the capital contributed by him, the partner rescinding the partnership contract has right of lien on the surplus assets left after the debts of the firm have been paid.

   ii) **Right of subrogation**: For all payments made by him towards the debts of the firm, the partner rescinding the partnership ranks as a creditor of the firm. In other words, if he has used his personal assets to pay off the debts of the firm, he becomes a creditor of the firm for that amount.

   iii) **Right to be indemnified**: The partner rescinding the partnership contract has the right to be indemnified by the partner or partners guilty of fraud or misrepresentation against all the debts of the firm.

4. **Right to restrain any partner or his representative from use of firm name or firm property**: Subject to contract between the partners, a partner

during the continuance of winding up has the right to restrain every other partner or his representative from carrying on a similar business in the firm name or making use of any of the property of the firm for his own benefit till the accounts of the firm are completely settled and the affairs of the firm have been completely wound up. Of course, where a partner has bought the goodwill of the firm, he can carry on the business in the firm's name and cannot be restrained by other partner or his representative from using the firm's name even during the pendency of winding up.

14.4.2 Liabilities of a Partner on Dissolution

1. **Liability for acts of partners done after dissolution**: For third parties, partnership continues till a public notice is given of its dissolution. Therefore, each partner of the dissolved firm continues to be liable to third parties for any act done by any of them even after the dissolution and such acts are deemed to be acts done before dissolution. For example, A, B and C are partners in a firm trading in rice, They decide to dissolve the firm from August 1, 2019 but fail to give a public notice of its dissolution and continue the business of the firm even after that date. On August 10, A enters into a contract with D in firm's name to deliver five quintals of rice to D. The firm is liable for the consequences of the contract.

   It should be noted that the following shall not be liable for acts done after the dissolution of the firm even though no public notice has been given.

   i) the estate of a partner who died

   ii) the estate of a partner who is adjudicated as insolvent, and

   iii) a sleeping or dormant partner who has retired from the firm.

2. **Liability for winding up the affairs of the firm and completing unfinished transactions**: According to Section 47, after dissolution of a firm, the authority of partners to bind the firm as well as their mutual rights and obligations continue to operate, as far as may be necessary for the following purposes.

   i) to complete the winding up of the affairs of the firm. For example to realise the dues from the debtors, to pay off the creditors, and dispose off the partnership property, etc.

   ii) to complete all unfinished transactions that had begun before dissolution. For example, supplying goods for orders received by the firm before dissolution. Thus, the partner's liability in respect of the above matters continue even after the dissolution of the firm.

Check Your Progress B

1. State whether the following statements are True or False.

   i) If a public notice of dissolution is not given the partner continues to be liable even after dissolution of the firm. …………

   ii) If the partnership is for a fixed term and the firm is dissolved on account of the death of a partner, the partner who had paid a premium to join the firm, is entitled to return of premium proportionately. …………

iii) If the firm has been dissolved on account of fraud, only the third parties have the right to be indemnified. …………

iv) In order to complete transactions begun before dissolution, partners may continue to have the authority to bind the firm, even after dissolution. …………

v) An insolvent partner is also liable for acts of the other partners done after the dissolution of the firm. …………

vi) The sleeping partner is not liable for the acts of the other partners done after the dissolution of the firm. …………

14.5 SETTLEMENT OF ACCOUNTS

The manner for settling partnership accounts after dissolution of the firm, is usually provided in the partnership contract itself. If, however, the partnership contract is silent on the matter, the accounts of the dissolved firm shall be settled according to the rules given is sections 48, 49 and 55 of the Act. These rules are as follows:

1. **Sharing of deficiency**: According to Section 48(a) the losses including deficiencies of capital, shall be paid first out of profits next out of capital, and lastly, if necessary, by the partners individually in the proportion in which they were entitled to share profits.

This implies that if the assets of the firm are insufficient to discharge the liabilities of the firm, the partners shall bear the deficiency in their profit sharing ratio and pay them out of their private assets, if necessary.

Example: A, B, C and D are partners in a business sharing profits and losses equally. A dies and the firm is dissolved. On the date of dissolution it was found that the capitals of A and B were Rs. 20,000 each and that of C and D Rs. 10,000 and Rs. 5,000 respectively. The outside liabilities stood at Rs. 61,000 and the total value of assets at Rs. 41,000. Thus, the deficiency works out at Rs. 20,000 (61,000 - 41,000). This would be equally shared by B, C and D and the legal heir of A i.e., Rs. 5,000 each.

2. **Application of assets**: The assets of the firm including any sums paid by the partners to make up deficiencies of capital shall be applied in the following order:

   i) in paying off the debts of third parties,

   ii) in paying to each partner ratably what is due to him from the firm for advances as distinguished from capital,

   iii) in paying to each partner ratably what is due to him on account of capital, and

   iv) the surplus, if any shall be divided among the partners in the proportion in which they were entitled to share profits. [Section 48(b)]

Let us understand this with the help of an example. A, B and C were partners in a firm sharing profits and losses equally. The accounts show that, on the date of dissolution, partners' capital was A–Rs. 20,000, B–Rs. 10,000 and C–Rs. 2,000. A had advanced Rs. 2,000 as loan to the firm, the outside liabilities were Rs. 13,000. The asset could realise Rs. 50,000. This amount shall be utilised first

to pay Rs. 13,000 of outside liability, next Rs, 2,000 to A for repayment of his loan then Rs. 32,000 to A, B and C for their capital (Rs. 20,000 to A. Rs. 10,000 to B and Rs. 2,000 to C), and the remaining amount of Rs. 3,000 shall be shared equally (profit sharing ratio) by A, B and C.

Suppose the assets realised Rs. 42,500 only resulting in a loss of Rs. 4,500 (Rs. 47,000 - Rs. 42,500). This loss shall be shared by A, B and C equally reducing their capital balances to Rs. 18,500, Rs. 8,500 and Rs. 500 respectively. So, the amount of Rs. 42,500 shall be used as follows :

i) Rs. 13,000 to pay outside liabilities

ii) Rs. 2,000 to pay A's loan, and

iii) Rs. 27,500 to pay the capital balances of A, B and C.

3. **Payment of firm's debts and separate debts of partners**: You know that the partners are jointly and severally liable to pay the debts of the firm. This means that even the private assets of the partners can be utilised for payment of firm's debts, if necessary. Not only that, the third party has the right to realise the whole amount from any partner. This however is subject to the provision of Section 49 which states that the private assets of any partner shall be applied first, to pay his private debts, and then, if there is any surplus, it can be applied to pay the debts of the firm, if necessary. Thus, partner's private assets can be used for payment of firm's debts only after his private liabilities have been paid off and that too if firm's assets are insufficient to pay firm's debts.

   It should be noted that firm's assets are also used first for payment of firm's liabilities and then the surplus, if any, can be used for payment of the private debts of a partner only to the extent of his share in the property of the firm.

4. **Loss arising from insolvency of a partner**: If, on distribution of the final amount of loss on dissolution, a partner's capital account shows some deficiency, he shall bring in the amount of deficiency in cash so that the other partners can be paid their amounts of capital. But, if the partner whose capital account shows deficiency is insolvent, he may not be able to bring in the necessary amount (fully or in part) resulting in additional loss to other partners. In such a situation, the question arises about the ratio in which the other partners are to share such loss. This is done in the light of a prominent English case of ***Garner v. Murray*** which states that the loss arising from the deficiency of an insolvent partner's capital should be borne by the solvent partners in proportion to their respective capitals as they stood on the date of dissolution. To continue with the same example of A, B and C who share profits equally, if the assets realise Rs. 35,000 only this would result in a loss of Rs. 12,000 (Rs. 47,000 – Rs. 35,000). When this amount of loss is shared by A, B and C their capital balances will reduce to: A – Rs. 16,000, B – Rs. 6,000 and C – Rs. (–) 2,000. After paying Rs. 13,000 for outside debts and Rs. 2,000 for A's loan, we are left with Rs. 20,000 as against Rs. 22,000 to be paid to A – Rs. 16,000 and B – Rs. 6,000. There is no problem if C can bring in Rs. 2,000 due from him. But if he becomes insolvent and only Rs. 500 can be realised from him, then there will be a deficiency of Rs. 1,500 which will be shared by A and B in the ratio of their capitals i.e.. 2:1 (not equally as per their profit sharing ratio). Thus their

capitals will stand reduced to A – Rs.15,000 (Rs. 16,000 – Rs. 1,000) and B - Rs. 5,500 (Rs. 6,000 – Rs. 500) which can now be paid to them with the help of the amount (Rs. 20,000) left after paying outside debts and A's loan plus Rs. 500 realised from C's estate.

5. **Sale of goodwill**: According to Section 55, in settling the accounts of a firm after dissolution, goodwill shall, subject to contract between the partners, be included in the assets, and it may be sold either separately or along with other property of the firm.

When, after dissolution of the firm, the goodwill of the firm has been sold, a partner may (i) carry on a business competing with that of the buyer i.e., the partner of the dissolved firm can carry on the same business as that of the dissolved firm, and (ii) advertise such business.

But, subject to agreement between him and the buyer, he may not

a) use the firm's name.

b) represent himself as carrying on the business of the old firm, or

c) solicit the business from the customers of dissolved firm.

However, any partner may enter into an agreement with the buyer of goodwill that such partner will not carry on any business similar to that of the dissolved firm within a specified period or within the specified local limits. Such agreement shall be valid if restrictions imposed are reasonable as it would not be barred by Section 27 of the Indian Contract Act, which deals with the agreements in restraint of trade.

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Check Your Progress C

1. A, B and C were partners in a firm. Their profit sharing ratio was 4:3:3. After working together for five years, they agreed to dissolve the firm. After paying off the debts of third parties and repaying the capital of the partners, there was a residual balance of Rs. 50,000. What shall each partner get?

2. A, B, C and D are four partners in a firm sharing profits equally. On March 31, 2018, D becomes insolvent and the partners decide to dissolve the firm. On that date their capital balances were Rs. 30,000, Rs. 20,000, Rs. 20,000 and Rs. 5,000 respectively. The outside liabilities were Rs. 40,000. The assets realised Rs. 81,000. Calculate how much will be paid to A, B and C assuming nothing is realised from D's estate.

3. State whether the following statements are True or False.

   i) The private property of a partner has to be used first for the payment of his private debts. ....

   ii) Any surplus left after payment of firm's debts is divided equally among all partners. ....

   iii) Losses, of the firm have to be paid first out of partner's private property and then out of the firm's property. ....

iv) Any deficiency of partner's capital arising on the insolvency of a partner is shared by other solvent partners in the light of Garner v. Murray rule. …………

v) When, after dissolution of the firm, goodwill of the firm has been sold, a partner may carry on business competing with that of the buyer. …………

14.6 LET US SUM UP

When there is a change in the relation of partners such as on admission of a new partner or on retirement of a partner, it is called dissolution of partnership and not the dissolution of firm. The dissolution of firm involves the dissolution of partnership between all the partners. This may happen with or without the intervention of the court. The court can order dissolution on a petition by a partner in case of (i) insanity of a partner, (ii) permanent incapacity of a partner, (iii) misconduct by a partner, (iv) persistent breach of agreement by a partner, (v) transfer of the whole of his interest to a third party, or (vi) perpetual losses in the firm's business. The dissolution without the order of the court takes place (i) by mutual agreement among partners, (ii) on the happening of certain contingencies, (iii) by notice from a partner when partnership is at will, or (iv) by compulsory dissolution of all (or all but one) partners become insolvent or if the business of the firm becomes unlawful.

Consequent to dissolution of the firm, the partners are entitled to (i) equitable distribution of firm's property, (ii) return of premium on premature dissolution, (iii) restrain the use of firm's name and property, and (iv) certain rights where partnership is rescinded for fraud, etc. The partners continue to remain liable to third parties for any acts done after dissolution if public notice is not given. In any case, the partner's authority to bind the firm, and mutual rights and obligations of the partners continue so far may be necessary to wind up the affair of the firm, and to complete transactions began but unfinished at the time of the dissolution.

Section 48, 49 and 55 of the Act lay down detailed rules regarding settlement of accounts between the partners. In the absence of any contract to the contrary, all losses including deficiencies of capital must be paid first out of profits, next out of capital, and lastly, if necessary, by contribution by all partners in their profit sharing ratio. The assets of the firm, including sums contributed by partners to make up the deficiency of capital, shall be applied (i) in paying debts of the firm, (ii) in paying each partner, rateably, for advances by him to the firm, (iii) in paying each partner, rateably amount due for his capital contribution, and (iv) the surplus in paying each partner according to his share in profits. If, however, a partner becomes insolvent and is unable to pay the amount due from him, the solvent partners will share such deficiency in the ratio of their capitals as on the date of dissolution as per *Garner v. Murrray* rule.

The partner's liability is unlimited. Hence, his private assets can also be used for payment of firm's debts. But, the private assets of a partner will be first used for the payment of his private liabilities and the surplus, if any, shall be used for payment of firm's liabilities if necessary. In settling the accounts of a firm after dissolution, goodwill shall, in the absence of a contract to the contrary, be included in the assets of the firm and it can be sold either separately or alongwith other assets of the firm.

14.7 KEY WORDS

Dissolution: Breaking up of any constituted body of persons.

Dissolution of Partnership: A change in relation of partners caused by events like admission of a new partner, etc.

Dissolution of a Firm: Dissolution of partnership between all the partners of a firm.

14.8 ANSWERS TO CHECK YOUR PROGRESS

A) 1. a) i b) i c) i d) ii

2. i) interest ii) land revenue iii) equitable

iv) permanently v) fixed term vi) partnership

B) 1. i) True ii) True iii) False iv) True v) False vi) True

C) 1. In proportion to their share in profit. Thus, A will get Rs. 20,000; B – Rs.15,000; and C – Rs. 15,000

2. After Rs. 34,000 as loss on realisation of assets (Rs. 1,15,000 – Rs. 81,000) is adjusted equally in partner's capitals, D's capital will show a deficiency of Rs. 3,500. This amount will be borne by A, B and C in the ratio of 3:2:2 (ratio of capitals). Thus, A will finally get Rs. 20,000; B – Rs. 10,500; and C – Rs. 10,500.

3 i) True ii) False iii) False iv) True v) True

14.9 TERMINAL QUESTIONS

1. What do you understand by dissolution of firm? How can a firm be dissolved?
2. Under what circumstances the court can order dissolution of the firm on a suit by a partner?
3. Describe the rights and liabilities of partners on dissolution of a firm.
4. What are the rules regarding settlement of accounts of a firm after dissolution? Explain fully.
5. Where goodwill has been sold after dissolution of the firm, what are the rights of a partner in relation to the business of the firm?
6. If a firm has been dissolved on account of insolvency of a partner and the assets of the firm are not sufficient to repay the capital of the partners, how would this deficiency be settled? Discuss.
7. Describe the rights of a partner when the firm has been dissolved on the grounds of fraud or misrepresentation of a partner.

Note : These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University for assessment. These are for your own practice only.

UNIT 15 LIMITED LIABILITY PARTNERSHIP

Structure

15.0 Objectives

15.1 Introduction

15.2 Nature of Limited Liability Partnership

- 15.2.1 Definition
- 15.2.2 Features

15.3 Who can be a Partner?

- 15.3.1 Designated Partners
- 15.3.2 Liability of a Designated Partner
- 15.3.3 Change in Designated Partners

15.4 Incorporation of Limited Liability Partnership

- 15.4.1 Incorporation Document
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- 15.4.3 Registered Office and Change Therein
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- 15.4.6 Reservation of Name
- 15.4.7 Change of Name

15.5 Partners and their Relations

- 15.5.1 Eligibility
- 15.5.2 Relationship
- 15.5.3 Cessation of Partnership Interest
- 15.5.4 Registration of Changes in Partners

15.6 Limited Liability Partnership and Partnership

15.7 Limited Liability Partnership and Company

15.8 Let Us Sum Up

15.9 Key Words

15.10 Answers to Check Your Progress

15.11 Terminal Questions

15.0 OBJECTIVES

After studying this unit, you should be able to:

- define limited liability partnership and explain its characteristics;
- explain who can be a partner;
- describe the procedure for registration and its effect;
- describe partners and their relationship;
- distinguish limited liability partnership and partnership and company; and
- distringuish between limited liability partnership and company.

15.1 INTRODUCTION

During the last 14-15 years, the limited liability concept of a company has been extended by many countries to limited partnerships. In USA Limited Liability Partnership (LLP) emerged in early 1990s. while only two states allowed LLPs in 1992, over forty states had adopted LLP statutes by 1996; the time when LLPs were added in Uniform Partnership Act in 1996 in USA. In UK, LLPs are governed by limited partnership Act 2000. In Singapore, LLPs can be formed under LLPs Act 2005. In Japan they were introduced in 2006. In India the concept was introduced in 2008 by limited liability partnerships Act 2008, published in official Gazette of India on 09-01-2009 and has been notified with effect from 31-03-2009. It contains 81 sections and four schedules. Limited liability partnership can be called a hybrid between a company and traditional partnership firm.

Partnership form of business entity helps entrepreneurs, professionals and enterprises providing services of any kind or engaged in scientific and technical disciplines, to form commercially efficient vehicles suited to their requirements. Limited Liability Partnership Act, 2008, is a new piece of legislation. This Act enables formation of partnerships with liability of partners being kept limited like that of share holders in case of companies. Thus, the public has been given a choice to form a partnership either under the partnership law, i.e., Partnership Act, 1932 or under Limited Liability Partnership Act, 2008. In this unit you will learn about the nature of Limited Liability Partnership, its incorporation, who can be a partner of Limited Liability Partnership nd partners and their relationship.

15.2 NATURE OF LIMITED LIABILITY PARTNERSHIP

15.2.1 Definition

A Limited Liability Partnership (LLP) means partnership formed and registered under the Act 2008, Sec-2(20). Let us know its features.

15.2.2 Features

The features of a limited liability partnership are as follows:

i) **Body Corporate:** The Limited Liability Partnership is a body Corporate and a legal entity separate from its partners, Section Sec 3 (1). Any two or more persons, associated for carrying on a lawful business with a view to profit, may subscribe their names to an incorporation document and filing the same with the Registrar, form a Limited Liability Partnership.

ii) **Perpetual Succession:** The Limited Liability Partnership has a perpetual succession, Sec 3(2).Any changes in the partners is not to affect the existence, rights and liabilities of limited liability partnership.

iii) **Mutual Rights and Duties :** The mutual rights and duties of partners inter se and those of the Limited Liability Partnership and its partners are governed by an agreement between partners or between the Limited Liability Partnership and partners subject to the provision of the Act.

iv) **Separate Legal Entity :** The Limited Liability Partnership has a separate legal entity, liable to the full extent of its assets, with the liability of the partners being limited to their agreed contribution to the Limited Liability Partnership which may be of tangible or intangible nature or both. No partner would be liable on account of independent or unauthorized actions of other partners or their misconduct. The liabilities of the Limited Liability Partnership and partners who are found to have acted with intent to defraud the creditors or for any fraudulent purposes shall be unlimited for all or any of the debts or liabilities of the Limited Liability Partnership.

v) **Number of Partners :** Every Limited Liability Partnership shall have at least two partners and shall also have at least two individuals as designated partners, of whom at least one shall be resident in India. The maximum number may be any. If number falls below two partners, the only partner left, if carries on business for more than six months shall be personally liable for the obligation of Limited Liability Partnership incurred during that period [Sec-6 (g)].

vi) **Annual Account and Audit :** The Limited Liability Partnership is under obligation to maintain annual accounts reflecting time and fair view of its state of affairs. A statement of accounts and solvency shall be filed by every Limited Liability Partnership with Registrar every year. The accounts of Limited Liability Partnership shall be audited provided that the central government may exempt any limited liability partnership from this requirement.

vii) **Application of other laws :** The Indian Partnership Act 1932, shall not be applicable to Limited Liability Partnership (Sec-4). However, central government can apply some provisions of Companies Act.

viii) **Conversion :** A partnership firm, a private company and unlisted public company can be converted into Limited Liability Partnership.

15.3 WHO CAN BE A PARTNER?

Any individual or a body corporate may be a partner in Limited Liability Partnership. A body corporate means a company registered under Companies Act 1956, as well as a Limited Liability Partnership registered under Limited Liability Partnership P Act 2008 or Limited Liability Partnership registered outside India and a company incorporated outside India. It does not include a corporation sole and a cooperative society.

Any individual shall not be capable of becoming a partner of Limited Liability Partnership if – (a) he has been of unsound mind, (b) he is an un-discharged insolvent or has applied to be adjudicated as an insolvent and his application is pending (Section-5).

15.3.1 Designated Partners

1) Every Limited Liability Partnership has at least two designated partners who are individuals and at least one of them shall be a resident in India:

   Provided that in case of a Limited Liability Partnership in which all partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such Limited

Liability Partnership or nominees of such bodies corporate act as designated partners [Section – 7(1)].

A resident in India means a person who has stayed in India for a period of not less than 182 days during the immediate preceding one year. Limited Liability Partnership and every partner shall be punishable with a fine of not less than Rs. 10 thousand and upto Rs. 5 lakh for contravention of this provision.

2) The designated partners may be named at the time of incorporation of Limited Liability Partnership or if they are changed from time to time, then changed partners shall be designated partners. Any designated partner may so become or may cease to be such partner in accordance with Limited Liability Partnership agreement.

3) A designated partner has to give his prior consent before becoming such partner Section 7 (3). His consent shall be filed by Limited Liability Partnership within 30 days of such appointment with the Registrar as per the prescribed form [Section 7(4)].

4) Every designated partner of Limited Liability Partnership has to obtain a Designated Partner Identification Number (DPIN) from the Central Government (like Directors according to Sec 266 A to 266 G of Companies Act 1956). (Sec 7)

15.3.2 Liabilities of a Designated Partner

A designated partner is –

(a) responsible for doing of all acts, matters and things as are required to be done by Limited Liability Partnership to comply the Act including filing of any return, statement and the like report pursuant to the provisions of this Act and as may be specified in Limited Liability Partnership Agreement and (b) for any contravention of this provision liable to all penalties imposed on Limited Liability Partnership by law. (Sec 8)

15.3.3 Change in Designated Partners

Any vacancy arising for any reason must be filled within 30 days of that vacancy. Punishment for not giving consent by designated partner or no compliance of any provision of the Act or not filling the vacancy, a fine of not less than Rs. 10 thousand, which may be extend up to Rs. One lakh rupees shall be imposed on Limited Liability Partnership and on its every partner (Sec 9).

Check Your Progress A

1. What is Limited Liability Partnership?

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2) Who are designated partners?

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3) What is the minimum and maximum number of partners in a limited liability partnership.

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15.4 INCORPORATION OF LIMITED LIABILITY PARTNERSHIP

15.4.1 Incorporation Document

Every Limited Liability Partnership has to prepare an incorporation document. The steps to prepare incorporation documents are as under:

a) The incorporation document shall be in a form as may be prescribed. It should state: (i) the name of Limited Liability Partnership (ii) the proposed business of Limited Liability Partnership (iii) the address of registered office of the Limited Liability Partnership (iv) the name and address of each persons who are to be partners of Limited Liability Partnership on incorporation (v) the name and addresses of designated partners of Limited Liability Partnership on incorporation (Sec 11). A person making statement which he knows is false or does not believe to be true shall be punishable with fine of Rs. 10,000 upto Rs. 5 lakh and imprisonment for a term which may extend upto two years.

b) Two or more persons associated for carrying on a lawful business with a view to profit subscribe their names to an incorporation document.

c) The incorporation document shall be filed in such manner and with such fees as may prescribed, with Registrar of the State in which the registered office of Limited Liability Partnership is to be situated.

d) There shall be filed along with the incorporation document, a statement in prescribed form, made by either an advocate or a company secretary or a chartered or cost accountant, who is engaged in the formation of Limited Liability Partnership and by any one who subscribed his name to the incorporation document, that all the requirement of the Act and rules made there under have been complied with, in respect of incorporation and matters precedent and incidental thereto.

15.4.2 Incorporation by Registration

When above requirements have been complied with, the Registrar shall retain the incorporation document, register this document and will give a certificate that Limited Liability Partnership is incorporated by that name, the certificate shall be

signed by the Registrar and authenticated by his official seal. The certificate shall be conclusive evidence that Limited Liability Partnership is incorporated by registration (Sec 12).

15.4.3 Registered Office of Limited Liability Partnership and Change Therein

Every Limited Liability Partnership shall have a registered office to which all communications and notices may be addressed and where they shall be received. A document may be sent by post under certificate of posting or by registered post or by any other manner. A Limited Liability Partnership may change the place of its registered office, file the notice of such change with the Registrar and change shall take place upon such filing. For contravention of this provision every partner shall be punishable with fine not less than two thousand rupees which may extend up to twenty five thousand rupees (Sec 13).

15.4.4 Effect of Registration

A Limited Liability Partnership, on registration shall by its name, capable of (a) suing or being sued (b) acquiring, owning, holding and developing or disposing of property, whether movable or immovable, tangible or intangible (c) having common seal, if it decides (d) doing or suffering such acts and things as bodies corporate may lawfully do and suffer (Sec 14).

15.4.5 Name

Every Limited Liability Partnership shall have either the words 'Limited Liability Partnership' or the acronym 'LLP' as the last word of its name. No Limited Liability Partnership shall be registered by a name which, in the opinion of Central Government is undesirable or identified or too nearly resembles to that of any other partnership firm or Limited Liability Partnership or body Corporate or a registered trade mark or a trade mark which is subject to an application for registration, of any other person under Trade Marks Act 1999 (Sec. 15). Penalty for improper use of above words is a fine of rupees not less than fifty thousand and may extend upto Rs. five lakhs (Sec. 20).

15.4.6 Reservation of Name

A person may apply to the Registrar for reservation of a name of Limited Liability Partnership or name which is proposed to be changed (Sec. 16).

15.4.7 Change of Name

The Central Government may direct to change the name if it is identical or resembles and has been already registered. Limited Liability Partnership may be fined rupees ten thousand which may extend to the Rupees five lakhs if name is not changed. Partners also may be fined of not less than Rs. 10 thousand which may extend up to Rupees one lakh (Sec. 17). The Limited Liability Partnership also may apply within 24 months of registration if it finds its name similar or identical of the other Limited Liability Partnership (Sec. 18).

Every Limited Liability Partnership shall publish it name on its invoices, official correspondence and publications, as well as name and address of its registered office, registration number and a statement that it registered as Limited Liability Partnership. Failure to comply may invite a fine between rupees two thousand and rupees twenty five thousand (Sec. 21).

15.5 PARTNERS AND THEIR RELATIONS

15.5.1 Eligibility

On incorporation of a Limited Liability Partnership, the persons who subscribed their names to the incorporation document shall be partners and any other person may become partner by and according to Limited Liability Partnership agreement.

15.5.2 Relationship

The mutual right and duties of partners are governed by Limited Liability Partnership agreement between them and Limited Liability Partnership. The agreement, and any changes, if any, made therein shall be filed with the Registrar. Any agreement between partners before incorporation may impose obligations on Limited Liability Partnership provided such agreement is ratified after incorporation of Limited Liability Partnership. If no agreement is made, the mutual rights and duties shall be determined by provisions set out in first schedule of the Act. The schedule provides e.g. equal share of all partners, indemnify for all losses caused by fraud by any partner, take part in management, entitled for remuneration and admission of a new partner with consent by all.

15.5.3 Cessation of Partnership Interest

A person may cease to be a partner of Limited Liability Partnership in accordance with an agreement with other partners or by giving a notice in writing of not less than 30 days to other partners. A person shall cease to be a partner of Limited Liability Partnership –

a) on his death or dissolution of Limited Liability Partnership; or

b) if he is declared of unsound mind by Court; or

c) if he is declared insolvent or applied to be declared as insolvent.

Where any person has ceased to be a partner (former partner) is to be regarded as still being a partner in relation to any person dealing with Limited Liability Partnershipunless the person has notice that the former partner has ceased to be a partner or notice that former partner has ceased to be partner of Limited Liability Partnership has been delivered to the Registrar.

The former partner will not be discharged from any obligation to the Limited Liability Partnershipor to other partners or to any other person which he incurred while being a partner. The former partner or a person entitled to his share because of death or insolvency of former partner shall be entitled to receive from Limited Liability Partnership the amount equal to his capital contribution made toLimited Liability Partnership and his right to share in accumulated profits of Limited Liability Partnership, after deduction of accumulated loses of Limited Liability Partnership as at the date the former partner ceased to be a partner. The former partner or a person entitled to his share due to death or insolvency of former partner shall not have any right to interfere in the management of Limited Liability Partnership.

15.5.4 Registration of Changes in Partners

Any change in name or address of any partner, the Limited Liability Partnership shall file a notice within 30 days to the Registrar. The partner shall inform changes

within 15 days of such change to Limited Liability Partnership. Notice should be in prescribed form, signed by designated partner. The incoming partner shall sign his written consent. A fine of not less than two thousand rupees and upto 25 thousand rupees or contravention of above provisions shall be imposed on Limited Liability Partnership and every designated partner (Sec. 25).

15.6 DIFFERENCE BETWEEN LIMITED LIABILITY PARTNERSHIP AND PARTNERSHIP

The main differences between partnership and limited liability partnership are as under:

1. **Regulatory Act**: Partnership is governed by the partnership act, 1932 whereas a Limited Liability Partnership (LLP) is governed by Limited Liability Partnership Act, 2008.

2. **Registration**: In partnership registration is not compulsory whereas in Limited Liability Partnership it is required.

3. **Perceptual succession**: Partnership does not have prepetual succession whereas Limited Liability Partnership has perpetual succession.

4. **Liability of partners**: A liability of a partner is unlimited in partnership whereas in Limited Liability Partnershipliability of a partner is limited to his agreed contribution.

5. **Mutual Rights and Duties**: In partnership mutual rights and duties of partners are subject to agreement between the firm and the partners whereas in Limited Liability Partnership no partner is liable for the independent acts of other partners.

6. **Number of Partners**: In partnership there the maximum number of partners cannot exceed 50 whereas in Limited Liability Partnershipthere is no upper limit on number of partners.

15.7 DIFFERENCE BETWEEN LIMITED LIABILITY PARTNERSHIP AND COMPANY

Although, in case of a Limited Liability Partnership, the liability of partners is limited but it differs from a company in many respects. The main points of distinction between a 'limited liability partnership' and 'limited liability company' are as follows:

1) **Regulating Act**: A Limited Liability Partnership is regulated by the Limited Liability Partnership Act, 2008, whereas a company is governed by the Companies Act, 2013.

   The name of a company must end with words 'Limited or Private Limited' whereas of limited liability partnership with words LLP or Limited Liability Partnership'.

2) **Minimum and Maximum Number of Members**: In case of limited liability partnership, minimum number of partners required are 2 whereas in case of

public company minimum number of members required are 7. There is no limit to maximum number of partners in case of limited liability partnership but in case of a private company number of members cannot exceed 200.

3) **Governance Structure**: A basic difference between a limited liability partnership and a joint stock company lies in that the governance structure of a company is regulated by statute (i.e., Companies Act, 2013) through memorandum and articles of association whereas for a limited liability partnership it would be by contractual agreement between partners.

4) **Management**: In case of a limited liability partnership, management rests with those partners (including designated partners) who are authorised by limited liability partnership agreement. But in the case of a company the right to control and manage the business is vested in the Board of Directors elected by the shareholders. Thus, the management ownership divide inherent in a company is not there in a limited liability partnership.

5) **Transfer of Interest**: In the case of a limited liability partnership, a partner's economic rights (i.e. right to a share of the profits and losses and to receive contribution at the time of winding up) shall be transferable (Section 42). However, such transfer shall not by itself cause the disassociation of the partner and a dissolution and winding-up of the Limited Liability Partnership. Further, such transfer would not make the transferee a 'partner' of the Limited Liability Partnership entitled to participate in its management (Section 42). For becoming a partner of Limited Liability Partnership, unless otherwise provided in theLimited Liability Partnership agreement, consent of all the existing partners is required (Schedule I appended to Limited Liability Partnership Act). But in the case of a public company a shareholder can transfer his shares freely without restriction and the transferee succeeds to all the rights of membership.

6) **Audit**: The audit of the accounts of a company is a legal necessity but it is not so in the case of a Limited Liability Partnership If the capital contribution does not exceed Rs.25 lakhs or if the annual turnover does not exceed Rs.40 lakhs [Rule 24(8) of the LLP Rules, 2009] audit is not compulsory.

7) **Meeting**: Annual General meeting of shareholders of a company is compulsory by law but in Limited Liability Partnership, the annual meeting of partners is not mandatory.

Check Your Progress B

1. State whether the following statements are True or False.

a) A Limited Liability Partnershipcan have not more than 10 partners.

b) The liability of only one partner is limited in Limited Liability Partnership.

c) A Limited Liability Partnershipcan have a name identical or too nearly resembling
of any other partnership registered under Indian Partnership
Act 1932.

d) If limited company is a partner in a Limited Liability Partnership, any Director can act as a designated partner.

e) Limited Liability Partnershipagreement can be oral.

f) Death of a partner will not dissolve a Limited Liability Partnership.

15.8 LET US SUM UP

The Limited Liability Partnership (LLP) is a body corporate, a separate legal entity, having perpetual succession and has a common seal if it decides to have one. It must be registered with Registrar as "LLP" as last part of its name. It is like a company. The rights and duties of partners inter-se and partnership are governed by agreement between them. It should have at least two members and shall also have at least two individuals as designated partners, one of whom should be a resident in India. It should maintain annual accounts and a statement of accounts and solvency. A firm, private company and an unlisted public company can be converted into LLP. LLP can sue and be sued in its own name. A company can be a partner of LLP. A LLP differs from a parternship and a company in many respects like regulatory act, perpetual succession, liability of members and number of members.

15.9 KEY WORDS

Limited Liability Partnership (LLP): It is a partnership in which liability of the partners is limited to their agreed contribution.

Designated Partners: It is concept introduced by Limited Liability Partnership. They are accountable for legal compliances, besides their liability as partner per-se. They are similar to directors of a company.

15.10 ANSWERS TO CHECK YOUR PROGRESS

B) 1. (a) False; (b) False; (c) False; (d) False; (e) False

(f) True

15.11 TERMINAL QUESTIONS

1. What is Limited Liability Partnership? What are its characteristics?
2. Which characteristics of a Limited Liability Partnership and a company are similar? In what respects it differs from a company?
3. Who can't be a partner of a Limited Liability Partnership?
4. Explain the following :

   (a) Designated Partner (b) Registration of Limited Liability Partnership

Note : These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University for assessment. These are for your own practice only.

SOME USEFUL BOOKS

M. C. Kuchhal, and Vivek Kuchhal, Business Law, Vikas Publishing House, New Delhi.

Avtar Singh, Business Law, Eastern Book Company, Lucknow.

S. N. Maheshwari and SK Maheshwari, Business Law, National Publishing House, New Delhi.

G. K. Kapoor Business Laws, Scholar Tech Press, New Delhi.

P. C. Tulsian and Bharat Tulsian, Business Law, McGraw Hill Education.

Sharma, J. P. and Sunaina Kanojia, Business Laws, Ane Books Pvt. Ltd., New Delhi.

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5

SALE OF GOODS

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BLOCK 5 SALE OF GOODS

Sale of Goods involves sale and purchase of goods through the medium of a contract. Essentially, therefore, transactions of sale of goods are a specie of contracts. In fact till 1930, transactions relating to sale and purchase of goods were regulated by the Indian Contract Act, 1872. In 1930, Section 76 to 123 of Indian Contract Act were Repealed and were replaced by a new Act – The Indian Sale of Goods Act, 1930. With effect from 22nd September 1963, the word 'Indian' was also removed. The present Act is entitled as the Sale of Goods Act, 1930. This Act contains all rules and regulations relating to various types of contracts of sale of goods. It provides the definitions of various terms and covers detailed rule relating to the effect of destruction of goods, the conditions and warranties implied in a contract of sale, the transfer of ownership and delivery, and the position of an unpaid seller. This block consists of four units from Unit 16 to 19.

Unit 16 describes the meaning of a contract of sale and its essentials and distinguishes sale from an agreement to sell and hire purchase agreement. It also explains the meaning ot goods, the types of goods and the effect of destruction of goods.

Unit 17 covers the rules regarding conditions and warranties and describes their meaning, distinction and kinds. It also explains the circumstances under which the breach of a condition is treated as a breach of warranty.

Unit 18 deals with the rules relating to transfer of ownership and delivery of goods.

Unit 19 describes the rights of an unpaid seller as against the goods and as against the buyer personally. It also discusses the rules relating to auction sales.

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UNIT 16 NATURE OF CONTRACT OF SALE

Structure

16.0 Objectives

16.1 Introduction

16.2 Meaning of a Contract of Sale

16.3 Essentials of a Valid Contract of Sale

16.4 Sale and Agreement to Sell

16.5 Sale and Hire-Purchase Agreement

16.6 Meaning and Types of Goods

- 16.6.1 Meaning of Goods
- 16.6.2 Types of Goods

16.7 Effect of Destruction of Goods

16.8 Let Us Sum Up

16.9 Key Words

16.10 Answers to Check Your Progress

16.11 Terminal Questions/Exercises

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16.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning of a contract of sale and describe its essential features;
- distinguish sale from an agreement to sell and hire-purchase agreement;
- explain the meaning of the term goods and identify different types of goods; and
- describe the effect of destruction of goods.

16.1 INTRODUCTION

Sale of goods is the most common transaction in business as well as in day-to-day life of individuals. In law, it is regarded as a specific contract for which the Contract Act had made special provisions. But, looking at the importance and the complexities of such contracts a separate Act entitled 'Sale of Goods Act' has been enacted which contains all rules and regulations relating to various types of contracts for the sale of goods. To be more specific, it provides definitions of various terms and covers detailed rules relating to the effect of destruction of goods, the conditions and warranties implied in such contracts, the transfer of ownership and delivery, and the position of an unpaid seller. In this preliminary unit, you will learn about the nature of a contract of sale, the essentials of a valid contract of sale, the distinction between sale and an agreement to sell, and the difference between sale and hire-purchase agreement. In this unit, you will also

learn about the exact connotation of the term 'goods', the various types of goods as well as the effect of the destruction of goods.

16.2 MEANING OF A CONTRACT OF SALE

According to Section 4 of the Sale of Goods Act, "*a contract of sale of goods is a contract whereby the seller transfers or agrees to transfer the property in goods to the buyer for a price*" (Section 4). A contract of sale may be absolute or conditional according to the desire of the contracting parties. The term 'contract of sale' is a generic term and, therefore, broader than 'sale'. It includes 'sale proper' and 'an agreement to sell'. Where under a contract of sale, the property in goods has passed from the seller to the buyer, it is called a 'sale', but where the transfer of property in goods is to take place at a future time or subject to some conditions thereafter to be fulfilled, it is an 'agreement to sell'. You should remember that an agreement to sell becomes a sale when the time elapses or the conditions are fulfilled subject to which the ownership in the goods, is to be transferred (Sec.4(4)).

Examples

i) A enters into a contract with B to buy 100 quintals of potatoes, from B's cold storage for Rs. 2,000. It shall amount to a sale if the seller authorises A to come to his cold storage and take away the potatoes whenever A desires.

ii) A agrees to sell his scooter to B after ten days for Rs. 5,000. B agrees to buy it after ten days, for Rs. 5,000. It is an 'agreement to sell' and it will become sale after ten-days. The specific points of distinction between 'sale' and 'agreement to sell' shall be discussed a little later in this unit.

Formalities of a Contract of Sale (Section 5)

A contract of sale is regulated by the general law of contract. Accordingly, there must be an offer to buy or sell goods and an acceptance of that offer, parties must be competent to contract and there should be free consent. The subject matter of such contract is goods the property in which is transferred or is to be transferred for a money consideration called the price-paid or promised to be paid. As per Section 5 of the Sale of Goods Act, a contract of sale may be made in any of the following modes:

i) There may be immediate delivery of the goods;

ii) There may be immediate payment of the price but the delivery to be made at some future date;

iii) There may be immediate delivery of goods and also immediate payment of price;

iv) It may be agreed that the delivery or payment or both are to be made in instalments; or

v) The delivery or payment or both may be made at some future date.

Except where specially provided by some law for the time being in force, no specific formalities are required to constitute a valid contract of sale of goods. However, the buyer and the seller should mutually agree for the transfer of property in goods. A contract of sale may be express or implied from the conduct of the

parties and in the case of express contract, it may be oral or in writing or partly in writing and partly by wards of mouth.

A written offer to sell goods may be accepted verbally or by writing, similarly, a verbal offer may be accepted in writing. In case of a contract made with a company, the contract may have to be in writing.

16.3 ESSENTIALS OF A VALID CONTRACT OF SALE

A contract of sale is a special type of contract, therefore all the essentials of a valid contract must be fulfilled. If any of the essential element of a valid contract is missing, then the contract of sale will not be valid. For example, A agreed to sell his scooter to B without any consideration. This contract of sale is not valid since there is no consideration.

From the definition of Contract of Sale as per Section 4 of the Sale of Goods Act, the following essential features may be noted.

1. **There must be two parties:** There must be two parties, one seller and the other buyer. A person cannot be a seller as well as a buyer. A person cannot buy his own goods. For example, X is the owner of certain goods, but he is not aware of this fact. A pretends to be the owner of the goods and sells them to X. There is no sale, for X cannot buy goods which are already his own (**Bell v. Lever Bros. Ltd**.). However, a part-owner may sell to another part-owner (Section 4). Partners are not regarded as separate persons for the purpose of sale of the partnership property. They are the joint owners of the goods and as such they cannot be both seller and buyer. But a partner may buy goods from the firm or sell goods to the firm.

2. **Subject matter of sale must be 'goods':** The subject matter of a contract of sale must be goods and the goods must be movable. Sale and purchase of immovable property is not covered by this Act, but is regulated by the Transfer of Property Act. Similarly, contracts relating to services are not treated as contract of sale. The meaning of the term 'goods' is explained in detail in 16.6.

3. **Transfer of Property in the goods:** In every contract of sale, it is the ownership that is transferred and in an agreement to sell the ownership is agreed to be transferred as in case of pledge. According to Section 2(II) of the Act, property means the general property in the goods and not merely a special property. In a contract of sale the general property is transferred from seller to the buyer. On the other hand, when the goods are pledged, it is only the special property which is transferred i.e., possession of the goods is transferred to the pledgee while the ownership rights remain with the pledger. You should note that for transferring the ownership of goods, the physical delivery of the goods is not essential.

4. **Consideration in Price:** Consideration in a contract of sale has necessarily to be money. Thus, if for instance, goods are offered as consideration for goods, it will not amount to sale, but it will be called a 'barter'. Similarly, in case there is no consideration, it amounts to gift and not sale. However the consideration may be partly in money and partly in goods.

Sale and Contract for Work and Labour

A contract of sale of goods has to be distinguished from a contract for work and labour, involving the exercise of skill or labour on some material. The dividing line between the two is very minute. The distinction essentially rests on whether the rendering of the service and exercise of skill is the essence of the contract or the delivery of the goods is the essence of the contract, although some labour on the part of the seller might also have been out. In case of the former, it is a contract of work while in the later case it will be a contract of sale of goods. The distinction between the two may be understood by referring to the case of **Robinson v. Graves**. In this case A engaged an artist to paint a portrait. Canvas, paint and other necessary articles were to be supplied by A to the painter. Applying the above-mentioned test that whether application of the skill and labour in the production of the portrait is the substance of the contract, it was held that it is a contract for work and labour and not a contract of sale. On the other hand, a contract for providing and fixing four different types of windows of certain size according to specifications, designs, drawings and instructions set out in the contract and a contract for making and supplying of wagons or coaches on the underframe supplied by Railways have been held by the Supreme Court to be contracts for work and labour and not a contract of sale.

From the above it should become clear to you that in a contract of sale ownership and possession of goods is transferred, while in a contract for work and labour though there may be delivery of goods, yet the emphasis is on the exercise of skill and labour upon the goods.

Does providing food in a restaurant amount to sale of goods? The Punjab High Court while delivering judgement in **Northern India Caterers (India) Ltd., v, Lt. Governor of Delhi** observed that the supply of meals, whether to residents or stray customers is essentially in the nature of service and not a transaction of sale. The customers come there not to buy food and drinks but to find bodily satisfaction that service of food in the setting of a restaurant can afford to give.

Check Your Progress A

1. What is a Contract of Sale?

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 ....

 ....

2. What is meant by the term 'property' as used in Sale of Goods Act?

 ....

 ....

 ....

 ....

 ....

3. What is the salient feature of a contract for work and labour?

....

....

....

....

4. State whether the following statements are True or False:

   i) In a sale the property in goods is transferred when the buyer pays the price.

   ii) The consideration for the contract of sale can be partly in money and partly in goods.

   iii) A contract of sale must be made in a particular form.

   iv) In an agreement to sell the ownership of goods passes to the buyer when the stipulated condition is fulfilled.

   v) The subject matter of a contract of sale must be movable goods.

   vi) A sale by a partner of a firm to his firm is valid.

16.4 SALE AND AGREEMENT TO SELL

As noted earlier in this unit itself, contract of sale is a generic term and includes both sale and an agreement to sell. The two, however, have different legal ramifications. The rights and obligations of the parties vary with the fact whether the transaction is a sale or an agreement to sell. Distinction between the two is, therefore, of prime importance. The vital point of distinction between the two is that in a sale the buyer becomes the owner of the goods as soon as the contract of sale is made, whereas in an agreement to sell, the seller continues to be the owner of the goods agreed to be sold, till it becomes a sale and as you have already read an agreement to sell becomes a sale on the expiry of the stipulated time or when the conditions arc fulfilled subject to which the property in goods is to be transferred. Other points of distinction between the two may be noted as under:

1. A 'sale' is an executed contract whereas an agreement to sell is always an executory contract. Executed means that the ownership of the goods has been transferred to the buyer, while executory means that something remains to be done i.e., ownership shall pass on some future date.

2. An agreement to sell is a contract, pure and simple, and creates merely *jus in personam*, i.e., gives a right to either, buyer or seller against the other for any default in fulfilling his part of the agreement. A 'sale' is a contract plus conveyance, and creates *jus in rem*, i.e., gives right to the buyer to enjoy the goods as against the whole world including the seller.

3. In a sale, if the buyer wrongfully refuses to accept the goods, and pay the price, the seller can sue for the price, even if the goods are in his possession and he can exercise the right of lien, stoppage of goods in transit and of resale. But in an agreement to sell only remedy available to the seller is to

sue for damages if buyer fails to accept and, pay for the goods. For example, A sells ten bags of rice to B for Rs. 3,000. If B refuses to accept the goods, A can file a suit against B for price even though the goods are in A's possession. But instead if it was an agreement to sell, then A's only remedy is to claim damages from B because the ownership has not yet passed to B.

4. In an agreement to sell, the seller being still the owner, he can dispose of the goods as he likes and the buyer's remedy against the seller's breach is a suit for damages. For example, A agreed to sell a particular horse to B for Rs. 5,000. Subsequently A sells the same horse to C for Rs. 6,000. B's remedy is to claim damages from A. B cannot recover the horse from C. In a 'sale' breach by the seller gives the buyer a double remedy; a suit for damages against the seller, and the right to follow property in the hands of the subsequent buyer. Thus in sale if the goods are resold, the buyer can recover them as the owner from the subsequent purchaser. If, in the above example where A sells a particular horse to B for Rs.5,000 and subsequently it is sold to C for Rs, 6,000, B shall have the right to recover the horse from C, because at the time of sale A was no longer the owner of the said horse. B can also claim damages from A for wrongful conversion.

5. 'Risk follows ownership' is the golden rule i.e., whosoever is the owner of the goods at the time of loss, will bear the loss.

   In case of 'sale', if there is any loss to the goods, the loss will fall on the buyer, even though the goods are in the possession of the seller. On the other hand in case of 'an agreement to sell', the loss shall be borne by the seller, even though the goods are in the possession of the buyer. It is because, ownership in case of agreement to sell continues to vest in the seller.

6. Insolvency of the seller: If in a sale the seller becomes insolvent while the goods are still in his possession, the buyer shall have a right to claim the goods from the official Receiver or Assignee because the ownership of goods has passed to the buyer. However, in case of an agreement to sell, the buyer cannot claim the goods even when he has paid the price. Buyer's only remedy in this case is to claim rateable dividend for the money paid from the estate of the insolvent seller.

7. Insolvency of the Buyer: In case of sale, if the buyer becomes insolvent before paying the price, the ownership having passed to the buyer, the seller shall have to deliver the goods to the Official Assignee or Receiver. For the unpaid price, the seller will rank as an unsecured creditor and thereby entitled to rateable dividend out of the estate of the insolvent buyer.

   In case of an agreement to sell, where the seller continues to be the owner of the goods, the seller can refuse to deliver the goods to the Official Assignee or Receiver unless he is paid full price of the goods.

16.5 SALE AND HIRE-PURCHASE AGREEMENT

A transaction of sale has to be distinguished from another apparently similar but different transaction, called hire-purchase 'agreement'. A hire-purchase agreement is an agreement under which the owner delivers his goods on hire basis to a person called 'hirer' and the hirer has the option to buy the goods by paying the agreed, amount in specified instalments.

The hirer, under this agreement, is required to pay every month a particular sum of money, and if he pays in that way for an agreed number of months, the hirer will become the owner of the goods on the payment of the last instalment. But if the hirer fails to pay any particular instalment, the owner can terminate the contract and take away the goods because the ownership continues to remain with him. The hirer has two option: i) he may buy the goods after paying all the agreed instalments or ii) he may return the goods at any time. In case he decides to return the goods he shall not be liable for further payment of instalments, the amount already paid is treated as hire charges for the use of goods.

A hire-purchase agreement, therefore, entitles the hirer only to possession of the goods. He cannot accordingly pass a good title to any buyer from him. A hire purchase agreement is distinct from 'sale' in which price may be payable by instalments. In case of sale, the property in goods passes as soon as the contract is made, though price may not yet have been paid. A hire-purchase agreement, on the other hand, does not result in passing of the property unless the option to purchase is exercised, usually by payment of all the instalments. Till such time, it continues to be a bailment. Thus, it is primarily the option on the part of the hirer to buy or to terminate the hiring that marks the distinction. In **K. L. Johar & Co. v. Dy. Commercial Tax Officer,** the Supreme Court observed as follows:

The essence of a sale is that the property is transferred from the seller to the buyer for a price, whether paid at once or paid later in instalments. On the other hand, a hire-purchase agreement has two aspects. There is first an aspect of bailment of goods subject to the hire-purchase agreement, and there is next, an element of sale which fructifies when the option to purchase is exercised by the intending purchaser.

You should note that in a contract in which the person taking the goods does not have the option to return the good, it will be an 'agreement to buy' and not an agreement of hire-purchase, even though the price is payable in instalments and the seller has the power to take the goods back in case of default. In **Les v. Butler**, a lady hired certain furniture from the plaintiff. The contract provided that the hirer has no option to return the goods and owner can take the furniture back if any instalment was not paid. Before the last instalment was paid, the lady sold the furniture to the defendant. It was held, that the defendant had acquired a good title, the lady being in possession of the furniture under an 'agreement to buy' and not under an agreement of 'hire-purchase', because the lady did not have the option to return, but was under compulsion to buy.

Thus, in case of sale by instalment, the buyer cannot terminate the contract and as such is bound to pay the price of the goods. The hire-purchaser, on the other hand has an option to terminate the contract at any stage and cannot be forced to pay the further instalments. Further, if the agreement is an agreement to sell and under it if the buyer obtains possession of the goods, with the consent of the seller, he can validly sell or pledge the goods and thereby give the transferee or pledgee a good title on the goods provided they have acted in good faith. However, in a contract of hire purchase, the hirer cannot transfer ownership to such buyer even if the latter acts in good faith, because the position of the hirer is that of a bailee only. He becomes the owner when all the installments are paid.

In this connection the following points should also be noted:

i) A hirer cannot claim the benefit of implied conditions and warranties (you will read about these in the next unit) unless it becomes a sale. However, conditions implied under Hire-Purchase Act, 1972 do apply.

ii) Sales-Tax is not leviable on a hire-purchase until it becomes a sale.

iii) A contract of sale may be made orally or in writing, but the hire-purchase agreement must be in writing.

16.6 MEANING AND TYPES OF GOODS

You have already learnt that the Sale of Goods Act does not extend to the sale and purchase of immovable property. The subject-matter of a contract of sale is goods. Let us, therefore, understand the meaning of the term 'goods' and explain its various types relevant to the contract of sale.

16.6.1 Meaning of Goods

Goods are defined to mean every kind of movable property other than actionable claims and money. The term includes stock and shares, growing crops, grass, and things attached to, or forming part of the land which are agreed to be severed before sale or under the contract of sale [Section 2(7)]. .

Stock and shares have been expressly included in the definition of goods primarily to avoid any misunderstanding because they are excluded from the term 'goods' under English Law.

You will have noticed that 'money' and 'actionable claims' have been expressly excluded from the term 'goods'. 'Money' means the legal tender, it excludes old coins and foreign currency, as they can be sold or bought as goods. Sale and purchase of foreign currency is, however, regulated by the Foreign Exchange management Act. 'Actionable claims' like debts are things which a person cannot make use of, but which can be claimed by him by means of a legal action. Actionable claims cannot be sold or purchased like goods, they can only be assigned.

Thus, you should note the goods include every kind of movable property, i.e., things which can be carried from one place to another. However, all such things which form part of the land itself but are agreed to be served from the land under the contract of sale, are considered as goods. Thus, grass, growing crops, trees to be cut and their logwood to be delivered are goods as per the above definition, similarly things like goodwill, copyright, trade mark, patents, water, gas, electricity are all goods and may be the subject-matter of a contract of sale.

16.6.2 Types of Goods

The goods forming subject-matter of the contract of sale may be classified into following types as shown in Figure 16.1.

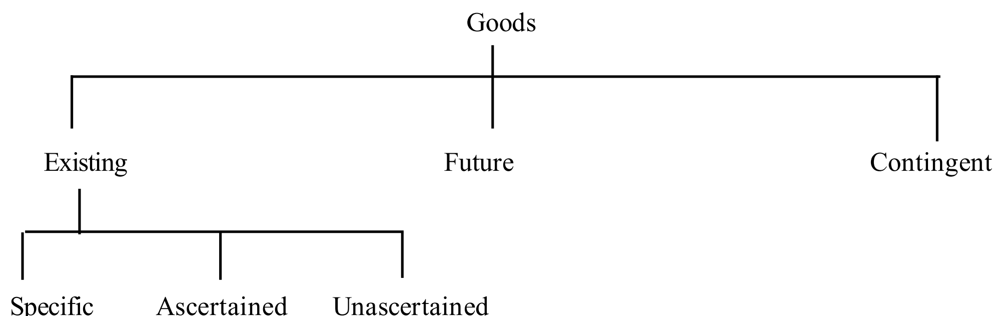

Fig. 16.1: Types of Goods

Existing Goods

As per Section 6 of the Act, existing goods are those goods which are owned or possessed by the seller at the time of contract of sale. The seller is either the owner of goods or he is in possession of goods. For example A, a manufacturer of fans, sells a fan to B. It is a contract of sale of existing goods because A owns the fan. Similarly when a person sells goods possessed by not owned by him such as sale by an agent, it is a sale of existing goods. For instance in the above example, if the manufacturer sends the fans to his agent in Delhi and sells them through the agent it is a sale of existing goods because the dealer possesses the goods, although he is not the owner of them, at the time of the contract of sale. The existing goods may be:

i) **Specific goods**: These are the goods which are identified and agreed upon by the parties at the time a contract of sale is made [Section 2(14)], for example, a specified watch, ring or a car.

ii) **Ascertained goods**: Though normally used as synonym for specific goods, ascertained goods are intended to include goods which have become ascertained subsequently to the formation of the contract. In **re Wait, Lord Atkin** observed that ascertained probably means "identified in accordance with the agreement after the time a contract of sale is made." When the 'unascertained goods' are identified and agreed upon by the parties, the goods are called 'ascertained'. You should note that ascertainment involves unconditional appropriation of the goods as the subject-matter of a particular contract. Thus when out of a mass of unascertained goods, the quantity contracted for is identified and set aside for a given contract, the goods are said to be ascertained.

iii) **Unascertained goods:** These are the goods which are not identified and agreed upon at the time when the contract is made. They are identified only by description. For example, A, who owns an Ambassador car show room, has 50 cars and agrees to sell any one of them to B. The contract is for unascertained goods, because which particular car shall be sold to B has not been identified at the time of the contract of sale.

Future Goods

As per [Section 2(6)] of the Act '*future goods' means goods to be manufactured or produced or acquired by the seller after making the contract of sale*. Thus, future goods are goods which either are not in existence at the time of contract of sale or they may be in existence when the agreement of their sale is entered upon but have not yet been acquired by the seller by that time. For example, S agrees to buy the entire crop of wheat that would yield in B's farm, at the rate of rupees 200 per quintal. This is an agreement of sale of future goods. As future goods are not in the possession of the seller at the time of contract, they can become the subject-matter of an agreement to sell only, and not the contract of sale.

Contingent Goods

Contingent Goods are the goods the acquisition of which by the seller depends upon a contingency which may or may not happen [Section 6 (2)]. For example, A agrees to sell to B a certain painting only if C, its present owner, sells it to him. Here the contract is for the sale of contingent goods as the availability of the painting depends on its sale by C.

16.7 EFFECT OF DESTRUCTION OF GOODS

You have learnt in Block 1 that a contract becomes void on the destruction of the subject-matter. Similarly a contract of sale becomes void on the destruction of goods. We can study the effect of destruction of goods under following two heads.

1. **Goods perishing before making of the contract:** Sometimes, the goods might have perished before making of the contract of sale. In such a situation the contract of sale is void. Section 7 of the Act provides that a contract for the sale of specific goods is void, if at the time when the contract was made, the goods have without the knowledge of the seller, perished or become so damaged as no longer answer to their description in the contract. This is based on the principle of impossibility of performance of the contract. Thus, the contract of sale shall be void on the destruction of goods, if the following conditions are satisfied:

   a) It must be a contract of sale for specific goods;

   b) The goods must have perished before making of the contract; and

   c) The seller must not be aware about the destruction of goods.

Examples

i) A agrees to sell a horse to B. Unknown to both the parties, the horse was dead at the time of making the contract. This contract of 'sale is void.

ii) A agrees to sell 1,000 bags of sugar coming on a particular ship. On arrival of the ship, it is discovered that because of sea water entering the cabin the sugar had become syrup (sharbat). The contract is void as the goods no longer answer to their description.

Sometimes, only part of the goods may be destroyed. In such a situation, the deciding factor would be whether the contract is divisible or indivisible. If the contract is divisible and only a part of the goods are lost, then the contract remains valid for the part which is in good condition. In **Barrow Lane & Ballard v. Philips**, A agreed to sell to B a parcel of 700 bags of groundnuts lying in his godown. Unknown to A, 109 bags had been stolen at the time of the contract. A, therefore, tendered delivery of the parcel containing 591 bags. It was held that the contract had become void and B cannot be compelled to accept 591 bags because the contract was indivisible.

Goods perishing before sale but after agreement to sell: It is also possible that the goods might perish after an agreement to sell is made but before it becomes a sale. In this connection Section 8 of the Act provides that in an agreement to sell specific goods, the agreement becomes void if the goods are destroyed without any fault of the seller or the buyer. This rule is based on the fact that it was only an agreement to sell and the goods were lost before the passing of the risk.

In ***Elphic v. Barnes*,** a horse was delivered on trial for eight days. However, the horse died on the third day, without any fault of either the seller or buyer. It was held that this agreement is void and the seller could not recover the price from the buyer.

You should note that Section 7 and 8 are applicable only in case of specific goods. Therefore, if unascertained goods are destroyed either before or after making the agreement, the contract shall not become void. Thus, in an agreement to sell unascertained goods, even if the entire stock of goods is destroyed, the contract shall not become void and the seller will have to perform his promise. For example, A agreed to sell to B 100 bags of wheat from his stock of 1,000 bags in his godown. The entire stock was destroyed by fire. A is bound to deliver 100 bags of wheat or else he will be liable for damages.

Check Your Progress B

1. Define the term' 'Goods'.

   ....

   ....

   ....

2. What do you mean by specific goods?

   ....

   ....

   ....

3. What is the main feature of hire-purchase agreement?

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   ....

   ....

4. What is the effect of destruction of specific goods on a contract of sale?

   ....

   ....

   ....

5. State whether the following statements are True or False:

   i) A contract of sale of goods is a contract by which the seller transfers or agrees to transfer the property in goods to the buyer for a price.

   ii) In case of sale 'on instalments', the seller has a right to take possession of the goods if the buyer fails to pay any instalments.

   iii) When A buys certain goods from B and the payment is to be made partly for the goods and partly for a service, it is a contract of sale.

   iv) In a sale, insolvency of the buyer entitles the seller to withhold the possession of the goods if price remains unpaid.

   v) Goods in return for goods is an acceptable mode of sale of goods.

   vi) In case of hire-purchase agreement, the hirer has an option to buy or refuse to buy.

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vii) In a sale, if the goods are destroyed, the loss falls on the seller.

viii) A rare coin can be the subject-matter of a contract of sale.

ix) Future goods cannot be the subject-matter of a sale.

16.8 LET US SUM UP

A contract of sale of goods is a specie of contracts but since a distinct legislation, viz., Sale of Goods Act regulates it, the transactions relating to sale and purchase of goods fall within the purview of the Sale of Goods Act. However, where specific provisions are not available in this Act, the provisions of Indian Contract Act shall apply.

Contract of sale of goods may take the shape of sale or an agreement to sell. The two have different legal implications. Sale should also be distinguished from contracts for work and labour and the hire-purchase agreements.

The subject-matter of a contract of sale, is 'goods'. Goods, generally, mean movables other than actionable claims and money. Certain items have, however, been specifically included in goods. These are stock and shares, growing crops, grass and things attached to or the land which are agreed to be severed before sale or under the agreement of sale. Goods may be existing goods, future goods or contingent goods. A contract of sale of goods becomes void on the destruction of goods provided certain conditions are satisfied

16.9 KEY WORDS

Sale : A contract of sale where the property in goods passes from the seller to the buyer when the contract is made.

Price : It means the money consideration for sale of goods.

Agreement to Sell : When the property in goods is to transfer at a future time or subject to some condition being fulfilled.

Jus in personam : Rights against a particular person.

Jus in rem : Rights against the whole world.

Property : It means the general property in the goods and not merely a special property.

16.10 ANSWERS TO CHECK YOUR PROGRESS

A 4 i) False; ii) True; iii) False; iv) True; v) True; vi) True.

A 5 i) True; ii) False; iii) True; iv) True; v) False; vi) True; vii) False; viii) True; ix) True.

16.11 TERMINAL QUESTIONS/ EXERCISES

1. Define a contract of sale. How is a contract of sale different from an agreement to sell?

2. Explain the essentials of valid contract of sale.

3. How is a contract of sale made? State briefly with illustrations the necessary formalities of such a contract.

4. What is meant by goods? What are the various types of goods?

5. Distinguish between sale and hire-purchase agreement.

6. What is the effect of destruction of specific goods on a contract of sale?

7. What is a 'Contract for work and labour'? Distinguish it from sale.

8. Answer the following, giving reasons for your answer:

   i) A agreed to sell his radio set to B for 20 kg of rice. Is it a contract of sale?

   ii) A delivered a manuscript to B for printing. B agreed to use his own ink and paper for printing the book. Is it a contract of sale?

   iii) A gave a piece of cloth to a tailor to make a suit for him. The tailor agreed to supply the lining material and buttons. Is it a contract of sale?

   iv) A purchased certain books from a book-seller and agreed to take them with him on his way home. As a result of accidental fire in the shop, the books were lost. Who will bear the loss and why?

   v) A sold a piano on hire-purchase basis to B. After paying five instalments, B refused to pay the remaining instalments and sold the piano to C. Can A recover the piano from C?

   vi) X sold to Y 100 bags of cement lying in his godown. As a result of heavy rainfall the cement has become stone on the date of making the contract, but this fact was not known to either party. Advice Y.

   vii) A agreed to sell to B all the wheat that will be grown in his farm. Before the crop was ready for harvesting as a result of flood, it was totally destroyed. Is A bound to deliver the goods?

Hints

i) No. It is barter and not sale.

ii) No. It is a contract for work and material.

iii) It is a contract for work and material and not a contract for sale of goods.

iv) A will bear the loss because it is a contract of sale and at the time of loss A was the owner of books.

v) Yes. A can recover piano from C because it was a hire-purchase agreement and the hirer has no title to it.

vi) The contract is void (Sec. 7)

vii) The contract is void (Sec. 8).

Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your own practice only.

UNIT 17 CONTITIONS AND WARRANTIES

Structure

17.0 Objectives

17.1 Introduction

17.2 Condition and Warranty

17.2.1 Definition of Condition

17.2.2 Definition of Warranty

17.3 Distinction between Condition and Warranty

17.4 Kinds of Conditions and Warranties

17.4.1 Express Conditions and Warranties

17.4.2 Implied Conditions

17.4.3 Implied Warranties

17.5 When Breach of a Condition is to be Treated as a Breach of a Warranty

17.6 Doctrine of Caveat Emptor

17.7 Let Us Sum Up

17.8 Key Words

17.9 Answers to Check Your Progress

17.10 Terminal Questions/Exercises

17.0 OBJECTIVES

After, studying this unit you should be able to:

- describe the meaning of the terms 'Condition' and 'Warranty' in relation to sale and purchase of goods;
- distinguish between a 'Condition' and a 'Warranty';
- list the conditions and warranties implied under the Sale of Goods Act;
- discuss as to when a condition may be treated as a warranty; and
- explain the fundamental principle of sale of goods, viz., Doctrine of Caveat Emptor.

17.1 INTRODUCTION

We are all consumers in one way or another. We may purchase goods for our own consumptions or for producing other goods. Many a times, we are attracted by certain claims made by the sellers in respect of their goods. Sometimes, it may be only because of such claims about the quality, usefulness or suitability of these goods that we decline to buy a brand of goods as against other competing brands.

At other times, we may decide to buy a particular brand because it carries certain assurances as to its fitness, etc. Such claims are called conditions and warranties.

Such assurances or representations may either be a condition or a warranty. In this unit we shall study the meaning of condition and warranty, the distinction between them and their effect on the contract of sale.

Besides, as a measure of consumer protection, Sale of Goods Act, 1930, assumes every contract of sale of goods (unless agreed to between the parties) to be subject to certain stipulation. These stipulations are called as implied conditions and warranties. In this unit, we shall also study these 'implied conditions and warranties.'

17.2 CONDITION AND WARRANTY

Many a times a seller of goods makes certain claims about the goods he offers for sale. These claims may relate to the quality, use, suitability, utility, etc., of those goods. The seller and buyer may also agree upon various terms relating to the subject-matter of the contract. These assurances may be a mere expression of opinion of the seller and may not form part of the contract. But, sometimes they may form part of the contract and the buyer buys the goods on the faith of such assurances. In such a case they have legal effect on the contract. An assurance or representation which forms part of the contract of sale is termed as 'stipulation'. All such stipulations cannot be treated at the same footing. Some may be intended to be of a fundamental nature whereas others may be subsidiary or merely an expression of an opinion. Depending upon whether a representation is fundamental or subsidiary, it ranks as a 'condition' and 'warranty'. If a stipulation forms the very basis of the contract, it is a 'condition'. On the other hand, if the stipulation is collateral to the main purpose of the contract, i.e., is of a lesser importance, then it is known as a 'warranty'.

17.2.1 Definition of Condition

The term 'Condition' is defined under Section 12(2) of the Sale of Goods Act, 1930. According to this Section, *a condition is a stipulation essential to the main purpose of the contract, the breach of which give rise to a right to treat the contract as repudiated.*

Thus, a condition is that stipulation which goes to the root of the contract and thus forms the basis of the contract. It is essential to the main purpose of the contract. It is that obligation the non-fulfilment of which may fairly be considered as a substantial failure to perform the contract at all. Therefore, if a condition is not fulfilled, the buyer has a right to put an end to the contract and also recover damages for the breach of contract.

The aforesaid description of condition is well illustrated by the case of **Baldry v. Marshall**. In this case 'B' consulted 'M', a motor car dealer, for a car suitable for touring purposes. M suggested a 'Buggatti' car and B accordingly bought it. The car turned out to be unfit for the touring purpose. It was held that the term that 'car should be suitable for touring purposes was a condition of the contract. It was so vital that its non-fulfilment defeated the very purpose for which B bought the car. He was, therefore, entitled to reject the car and have refund of the price.

17.2.2 Definition of Warranty

According to Section 12(3) of the Sale of Goods Act, 1930, *a warranty, is a stipulation collateral to the main purpose of the contract, the breach of*

which gives rise to a claim for damages but not to a right to reject the goods and treat the contract as repudiated. In other words, warranty is a stipulation which is not essential to the main purpose of the contract i.e., it is of a subsidiary or collateral nature. If there is a breach of warranty, the buyer cannot repudiate the contract, but he can only claim damages from the seller. In the case discussed above if the buyer had asked for a good car and while selling the car the dealer said that it could run for 15 kms per litre of petrol. But it was discovered that it could run only 12 kms per litre of petrol. Here, the statement made by the seller would amount to a warranty and the buyer could not terminate the contract and he was entitled to claim damages only.

17.3 DISTINCTION BETWEEN CONDITION AND WARRANTY

From the aforesaid discussion, you must have noted that the difference between the two terms viz., Condition and Warranty is not that of a degree and not that of kind. The crux of the decision shall lie on the fact as to whether a stipulation forms the basis of the contract or is only a collateral promise. Thus, where the buyer wouldn't have purchased those goods but for that stipulation, it shall be construed as a condition. On the other hand, if the buyer would have so purchased and the stipulation is only designed to provide an assurance as to the quality or suitability of the goods, it shall be a warranty. The distinction between the two stipulations is to be measured from the point of view that if the stipulation is such that its breach would make the rights of the aggrieved party nugatory, then such a stipulation is condition and where the stipulation is only auxillary, it is a warranty. One may, therefore, say that whether a stipulation in a contract of sale is a condition or a warranty depends in each case on the construction of the contract as a whole. The court is not to be guided by the terminology used by the parties to the contract, but is to be guided by the intention of the parties which can be gathered from the terms of the contract and circumstances. Section 12 (4) endorses this view and provides that *a stipulation may be a condition, though called a warranty in the contract.*

The above mentioned point may be clarified with the help of the following example:

'A', who desires to purchase a horse, goes to a horse dealer and asks the horse dealer to give him a quiet and non-vicious horse. The horse which the dealer supplies him turns out to be a hostile horse and on the very first ride throws him down resulting in broken limbs. In this case, the statement made by the buyer that he wants a quiet horse was a condition essential to the main purpose of the contract.

Therefore, A can reject the horse and get back the price. The buyer can also claim damage for the injuries suffered by him.

But, if 'A', himself selects a particular horse and then seeks the seller's assurance as to its being quiet and non-vicious, the stipulation shall be a 'warranty' and the only remedy of the buyer shall be a claim for damages, he cannot return the horse and claim the price.

On the basis of the above discussion, the points of distinction between the two can be summarised as follows:

Condition	Warranty
1. A condition is a stipulation (in a contract) which is essential to the main purpose of the contract.	1. A warranty is a stipulation which is only collateral to the main purpose of the contract.
2. A breach of condition gives the aggrieved party a right to sue for damages as well as the right to terminate the contract.	2. A breach of warranty gives only the right to claim damages. The contract cannot be terminated.
3. In the event of the breach of a condition, the aggrieved party may choose to treat the breach of condition as a breach of warranty. A buyer may for instance, like to retain the goods and claim only damages.	3. A breach of warranty cannot be treated as a breach of condition.

17.4 KINDS OF CONDITIONS AND WARRANTIES

Condition and warranty may either be express or implied.

17.4.1 Express Conditions and Warranties

They are said to be express when the terms of the contract expressly provide for them. Thus, where a buyer desires to buy 'White Maruti Car', the colour of the car becomes an express condition. If the two contracting parties desire they may put the contents of any specific statement or promise which has taken place between them at par as the description of the thing contracted for. This then shall be treated as express condition. The parties are at liberty to impose any condition or warranty by an express agreement in a contract of sale.

Similarly, you must have noticed companies advertising their products carrying guarantee for a certain period, for instance, 'Orient Fans - Guaranteed for Two Years'. 'Binatone TVs - Three Years Guarantee'. All these are example of express warranties.

17.4.2 Implied Conditions

Conditions and Warranties are said to be implied when the law infers their existence as implict in the contract even without their actually having been put in the contract. Hence, unless otherwise is agreed upon between the parties, every contract of sale of goods shall be subject to these implied conditions and warranties. But the parties do have the right to exclude any of the implied conditions or warranties by specifically and expressly providing otherwise. The implied conditions and warranties are enforced because the law deems that in the circumstance of the contract the parties desired to add these stipulations to their contract but did not put them expressly. These implied conditions and warranties are contained in Sections 14 to 17 of the Act and are as follows:

1. **Conditions as to title (ownership)**: Sale involves transfer of ownership and possession. Therefore, Section 14 (a) provides that in a contract of sale,

unless the circumstances of the contract are such as to show a different intention, there is an implied condition on the part of the seller that he has a right to sell the goods, and that in the case of an agreement to sell, he will have a right to sell the goods at the time when the property (ownership) is to pass.

The aforesaid provision, you should note, is based upon a simple logic that only an owner has the right to effect a valid sale of goods, since only he (subject, however, to certain exceptions which you will study later under 'Sale by Non-owners') can confer ownership. The rule of law is *Nemo dat quod non-habat*, i.e., 'one cannot give what one does not have'. In every contract of sale there is an implied condition that the seller has a valid title to the goods. This condition is very essential to protect the interest of innocent buyers.

The following example will clarify the point further:

A purchased a car from B who had no title to it. A used the car for several months. After that, C, the true owner, spotted the car and demanded it from A. Held, that A was bound to hand over the car to its true owner. A's remedy is to sue B, the seller without title, for the recovery of the price and damages even though several months had passed **(Rowland v. Divall)**.

However, this condition like other implied conditions, may be negatived by an express terms. Thus, where a thief goes to a *'Chor Bazar*' to sell the stolen goods to the knowledge of the buyer thereof, the buyer may not get the refund of sale price if those goods are to be restored to its real owner. Similarly, when the custom authorities sell any confiscated items they are absolved from any responsibility with respect to the owners title. It should further be noted that the seller should have the right to sell the goods. The term 'right to sell' is wider than 'right to pass ownership'. Thus, a seller has no right to sell, if he infringes the trade mark of another person.

Therefore if the seller sells the goods in contravention of trade mark laws, it is regarded as a breach of implied condition as to title. In such a case the buyer will have a right to terminate the contract of sale. In **Niblett Ltd. v. Confectioner's Materials Co**. certain tins of condensed milk bearing the label "Nissly Brand" were sold by A to B. In order to save themselves from any liability under the trade mark laws, B had to remove the labels and sold the naked tins at loss. A was held liable for breach of implied conditions that they had a right to sell.

2. **Sale by description**: Sometimes, the goods are sold by description. In such a case, Section 15 lays down that *there where there is a contract of sale of goods by description, there is an implied condition that the goods shall correspond with description*. The term 'correspond with 'description' means that the goods supplied must be same as were described by the seller. If it is found that the goods supplied do not correspond with the description, the buyer has a right to reject the goods and claim damages. The term 'sale of goods by description' is wide and shall include many situations.

   i) It will include a case where the buyer has never seen the goods and buys them only on the basis of the description given by the seller. For example, in a sale of a reaping machine, the seller described it to be only one year old and used only to cut 50 to 60 acres. On delivery, the

buyer found that the machine was extremely old. The buyer was entitled to reject the machine as it did not correspond with the description given by the seller (**Varley v. whipp**).

Similarly, where a person orders for 2 'Philips Juicer-made in Japan' it will not be a sufficient compliance if a 'Philips Juicer-made in Hongkong' is supplied to him.

ii) Even where the buyer has seen the goods, it may be treated a sale by description, if he purchases those goods not on what he has seen but what was stated to him. Thus, where a person orders 100 bags of a particular variety of 'Punjab Wheat' and the wheat supplied to him is found to be 'Gujarat Wheat', condition as to description shall be deemed to have been violated in spite of the fact that buyer was shown the wheat to be delivered. Similarly, in an auction sale, a set of linen napkins and table cloths were described as "dating from seventeenth century". The buyer, who was a dealer in antiques, purchased the same after seeing it, but later found it to be an "eighteenth century set". It was held that they having relied on the description, the buyer had a right to return the same for not conforming to the description (**Nicholson and Venn. v. Smith Marriott**).

iii) The methods of packing may also form part of the description, For example, where a seller agrees to deliver 5,000 tins of canned fruit to be packed in cases each containing 50 tins, the buyer shall have a right to reject the goods if the cases contain 'more' or 'less' than 50 tins.

3. **Sale by sample**: Sale by sample means that the seller has shown a sample of the goods to the buyer and has agreed to supply the goods according to the sample. It cannot be assumed that in all cases, where sample is shown, the sale shall be a sale by sample. In cases where there is no term to that effect, it is assumed that the sample is not shown as a warranty, but only to enable the buyer to form a reasonable judgement about the goods to be bought. The goods supplied may marginally differ. They may be inferior or superior to the sample shown.

In case of a contract of sale by sample, law assumes the sale to be subject to the following three implied conditions:

i) The goods must correspond in quality with the sample, i.e., the buyer shall have a right to reject goods inferior or superior to the sample.

ii) The buyer shall have a reasonable opportunity of comparing the goods with the sample. Thus, the seller will have to take the goods back, if they are not found to be according to the sample. In fact, depending upon the nature and volume of the goods involved, opportunity to compare the goods with the sample shall be available to the buyer. For example, in a sale of 100 bags of wheat, the buyer is given an opportunity to examine the contents of three bags only. The buyer can terminate the contract.

iii) The goods shall be free from any defects rendering them unmerchantable, which would not be apparent on reasonable examination of the sample, i.e., latent defects. Such defects are discovered when the goods are put to use. However, seller will not be liable for apparent or visible defects

which could be easily discovered by an ordinary prudent person. For example, A sold to B certain quantity of worsted coating equal to sample. The coating was equal to sample but had a latent defect as a result of which the cloth was found to be unfit for making coats. It was held that the buyer could reject the goods. The reason for this was that though the sample also contained the defect was not apparent on an examination of sample (**Drummond & Sons v. Van Ingen**).

4. **Sale by sample as well as by description**: If the sale is by sample as well as by description, Section 15 requires that the goods must not only correspond with the sample but should also correspond with the description. The following examples explain the point :

   i) In **Wallis v. Pratt** case the agreement was for the sale of ‘English Sainfoin Seeds’, exhibited by sample and described as common English Sainfoin. However seller did not give any warranty regarding the growth description or any other matter. The seeds supplied did correspond to the sample but both the sample and the seeds supplied were found to be ‘Gaint Sainfoin’, in altogether different variety. *Held*, there was a breach of condition as to description and therefore the buyer may recover damages from the seller.

   ii) ‘Foreign refined rape-seed oil’ was sold which was warranted to be equal to sample. The oil which was supplied by the seller was according to the sample. The sample was actually not ‘foreign rape-seed oil’ but contained a mixture of rape oil and hemp oil . Held, the buyer could reject the oil (**Nichol v. Godts**).

5. **Condition as to quality or fitness**: The general rule in respect of the sale of goods is that a buyer is supposed to satisfy himself about the quality as well as the suitability of the goods. Thus, later on, if the goods turn out to be unsuitable or unfit for the purpose he purchased them for, he shall not be entitled to return or exchange them or seek compensation. There are, however, certain exceptions to this rule. It is in these exceptional circumstances that implied condition as to fitness applies.

   Where the buyer, expressly or by implication, makes known to the seller the particular purpose for which the goods are required so as to show that the buyer relies on the seller’s skill or judgement, and the goods are of a description which it is in the course of the seller’s business to supply (whether he is the manufacturer or producer or not) there is an implied condition that the goods shall be reasonably fit for such purpose [Section 16(1)]. Thus, to avail of the condition as to fitness, all the three conditions must be satisfied, viz.,

   i) the exact purpose for which the goods are being bought must have been disclosed (expressly or impliedly) by the buyer to the seller,

   ii) the buyer must have relied upon the seller’s skill or judgement with respect to the fitness of the goods for any particular purpose, and

   iii) the seller’s business must be to sell such goods (the condition cannot be invoked against a casual seller).

   Thus, in **Priest v. Last,** a draper went to a chemist shop and asked him to give a hot water bottle. He told him the purpose also for which it was

required. The chemist gave the hot water bottle but told him only to use hot water because the bottle would not stand the boiling water. While the bottle was being used, it burst and injured her. Held, breach of condition as to fitness was committed and the chemist was liable for refund of price as well as damages because the bottle was unfit for being used as a hot water bottle.

When the goods can be used only for one particular purpose, the buyer need not tell the seller the purpose which the goods are being bought. Thus, a refrigerator that failed to make ice would be rejected on grounds of breach of this condition (**Evens v. Stelle Benjamin**). A set of false teeth bought from a dentist may be rejected if they do not fit the buyer's mouth (**Dr. Baretto v. T.R. Price**).

The problem may arise where the goods are capable of being put to multiple uses. In such a case, to avail the relief under the aforesaid condition, the buyer must show that he had explained to the seller the exact purpose for which the goods were purchased. For example, in **Re: Andrew Yule & Co.**, hessian cloth, which is generally used for packing purposes, was supplied to buyer in accordance with his order. The buyer found it unfit for his purpose of packing foodstuffs because this cloth has a peculiar smell, although it was good as a packing cloth. Held, the buyer cannot reject it because he had not disclosed to the seller, the particular purpose for which he required the cloth. The buyer need not disclose the exact purpose for which he is buying the goods when the goods are fit only for a specific purpose or where the nature of the goods itself by implication tells the purpose for which they are being bought. In those conditions the purpose is deemed to have been impliedly told. For example, if the buyer demands a cold drink from the seller, it is implied that the buyer needs it for consumption and subsequently, if it is found to contain some unhealthy contents, it is a breach of implied condition as to fitness and makes the seller liable to pay damages.

However, condition as to fitness shall not be applicable in the following cases :

i) Where the buyer fails to disclose to the seller any abnormal circumstances. In **Griffith v. Peter Conway Ltd.,** a woman with abnormally sensitive skin asked for a warm tweed coat and was supplied a 'Harris Tweed Coat'. She got rashes on wearing the coat. Her claim for return of price and damages was struck down because there was nothing in the Harris tweed which would have affected the skin of a normal person and she had failed to inform the seller about her abnormally sensitive skin.

ii) When the buyer buys the goods by a patent or other trade name. Thus, where a person goes to a chemist and purchases 'Bournvita' as a health drink, he cannot claim any compensation if he finds no improvement in his health in spite of its prolonged use.

6. **Condition as to merchantable quality**: Section 16(2) of the Act provides that where the goods are bought by description from a seller who deals in goods of that description (whether he is the manufacturer or producer or not), there is an implied condition that the goods shall be of merchantable quality. The expression 'merchantable quality' in simple words means that the quality of the goods shall be such that they are capable of being used as the goods of that description and should be free from any latent or hidden defects. If the goods are purchased for resale, then they should be resaleable

in the market under the description by which they are ordinarily known in the market. There should be no defect in the goods which renders them unfit for sale. For example, if sugar becomes syrup (*Sharbat*) it is no longer merchantable. The term 'merchantability' also means that the goods must be properly packed. For example, A purchased wine from B. While opening its cork in the normal manner, the bottle broke off and injured A's hand. It was held that the bottle was not of merchantable quality and A could recover damages from B.

Examples

a) A person purchases a 3 metre suit length to make it into a three-piece suit and gives it to the tailor for stitching. The tailor after stitching coat and waist-coat finds that the balance of the cloth is sufficient to make only half-pants instead of full pants – the cloth having a texture defect, i.e., it is not uniform throughout its width. The buyer shall have a right to claim compensation.

b) A purchases Black Yarn from B and finds it to be damaged by white ants, the condition as to merchantability shall be said to have been breached.

c) A sold a plastic catapult to B. While B's son was using it in the usual manner, the catapult broke due to the fact that the material used in its manufacture was unsuitable. As a result, the boy was blinded in one eye. It was held that A, the seller was liable as the catapult was not of merchantable quality (***Godley v. Perry***).

   It should be noted here that when the buyer buys the goods after examining them, the implied condition as to merchantability shall not be applicable as regards those defects which the buyer by an ordinary examination could have discovered. For example, A purchased glue from B, which was packed in barrels. A was given every facility to examine the goods, but the buyer A did not bother to examine the contents. Here A cannot reject the goods by saying that they are not merchantable. Had he taken the trouble of examining the goods, he would have easily discovered the defect (***Thornett v. Beers***).

7. **Condition as to wholesomeness**: In case of items which are supposed to be physically consumed, e.g. provisions or foodstuffs, condition as to merchantability assumes another form, viz., condition as to wholesomeness. Condition as to wholesomeness means that the goods shall be fit for human consumption, that is, they shall not be stale or contaminated. In ***Frost v. Aylesbruy Dairy Co. Ltd***. F bought milk from A's dairy. The milk contained typoid germs. F's wife consumed the milk, became infected and died. A was held liable for damages because the milk was not fit for human consumption. Thus, an action shall lie if a 'house fly' is found in a bottle of cold drink or a 'lizard' in a bottle or pack of milk and the consumer, therefore, suffers thereby.

17.4.3 Implied Warranties

There are only two implied warranties under the Act and both of them are in fact necessary corrollories to the 'implied condition as to title'. These are:

1. **Warranty as to quiet possession**: In every contract of sale, unless contrary intention appears from the circumstances of the contract, there is an implied warranty that the buyer shall have and enjoy quiet possession of the goods.

Thus, if the right of enjoyment or possession of the buyer is disturbed by the seller or any other person, the buyer shall be entitled to sue the seller for damages. Breach of this warranty shall arise where the title of the seller is not exclusive and he has not been conferred a clear right to effect the sale or where his title is defective.

This implied warranty can be understood by referring to the case of ***Niblett Ltd. v. Confectioner's Materials Co. Ltd***. which you have already read in this unit. In that case the seller was held responsible for two things. Firstly, that they had committed a breach of implied condition as to their title and secondly, for committing breach of implied warranty that the buyers would have quiet possession of the goods sold.

2. **Warranty of freedom from encumbrances**: Under this warranty, the buyer is entitled to assume that the goods are free from any charge or encumbrance in favour of any third person, not declared to or known to him before or at the time when the contract is made. Thus, this clause will not be applicable where the buyer has been informed of the encumbrances or has notice of the same. Further, it was held in ***Collinge. v. Heywood*** case that the claim under this warranty shall be available only when the buyer discharges the amount of encumbrance. If the possession of the buyer is disturbed due to such charge in favour of a third person, he can claim damages from the seller. For example, A sells certain goods to B. A had already taken a loan of Rs. 500 from X on the security of those goods. B was not aware about this charge on the goods. B had to pay Rs. 500 to X in order to enjoy the goods. Now B can claim this amount from A.

17.5 WHEN BREACH OF A CONDITION IS TO BE TREATED AS A BREACH OF A WARRANTY

Section 13 provides for certain circumstances where a condition may be reduced to the status of a warranty. Consequently, the buyer loses his right to reject the goods. His only remedy in such case shall be to claim damages. This shall happen in the following cases:

1. **Waiver by buyer**: Where a contract of sale is subject to any condition to be fulfilled by the seller, the buyer may: (i) waive the condition; or (ii) elect to treat the breach of condition as a breach of warranty. You know that the conditions, express or implied, are for the benefit of the buyer. He has, therefore, the option to waive the breach of a condition and accept the performance short of it. In that case, he remains liable for the price but may only recover damages if there is any breach. Once the buyer exercises his option, he cannot later on compel the seller for its fulfilment.

2. **Compulsory treatment of breach of condition as breach of warranty**: When the contract of sale is not severable and the buyer has accepted the goods or part thereof, the breach of any condition to be fulfilled by the seller can only be treated as a breach of warranty. As per Section 42 of the Act, a buyer is deemed to have accepted the goods:

   i) When he intimates to the seller that he has accepted them, or

   ii) When the goods have been delivered to him and (a) he does any act in relation to them which is inconsistent with ownership of the seller

(say, pledges the same), or (b) when, after the lapse of a reasonable time, he retains the goods without intimating to the seller that he has rejected them.

But if the contract is severable, and the buyer has accepted part of the goods, he can still exercise his right to reject the remaining goods.

17.6 DOCTRINE OF CAVEAT EMPTOR

'Coveat Emptor' is a fundamental principle of the law relating to sale of goods. It means 'Caution Buyer', i.e., **Let the buyer beware**'. In other words, it is no part of the seller's duty to point out defects of the goods he offers for sale. The buyer must examine the goods and find out their suitability for the purpose he buys them for.

Examples

a) A person buys a readymade shirt for his son, he will not have a right to return or exchange the same if the shirt doesn't exactly fit his son, i.e., too tight or loose.

b) Pigs were sold 'subject to all faults', and these pigs, being infected, caused typhoid to other healthy pigs of the buyer. It was held that the seller was not bound to disclose that the pigs were unhealthy. (**Goddard *v.* Hobbs**)

Exceptions

The doctrine of 'Caveat Emptor' is however, subject to the following exceptions:

1. Where the seller makes a misrepesentation and the buyer relies on that representation, the rule of 'Caveat Emptor' will not only apply and the contract entered between the parties would be a contract voidable at the option of the buyer.

2. Where the seller actively conceals a defect in the goods, so that on a reasonable examination the same could not be discovered, or where the seller makes a false representation amounting to fraud, and the buyer, relying upon the false representation, enters into a contract with the buyer, in both these circumstances the resulting contract would be a voidable contract. The buyer's remedy in that is that he can put the contract to an end and can also claim damages from the seller for fraud.

3. Where the buyer makes known to the seller the purpose for which he is buying the goods, so as to show that the buyer relies on the seller's skill or judgement and the seller happens to be a person whose business is to sell goods of that description, then there is an implied condition that the goods shall be reasonably fit for such purpose. The rule of 'Caveat Emptor' will not apply in such cases.

4. In case of sale by description where the goods are bought from a seller who deals in such goods there is an implied condition as to their being of a merchantable quality, i.e., they should be capable of being used as such goods. For example, a cricket bat should be fit enough to play cricket with a 'cricket ball'. If the goods are not found to be of merchantable quality, the seller cannot take the defence of the doctrine of Caveat Emptor. But, if the

buyer has examined the goods, there is no implied condition as regards defects which such examination ought to have revealed, i.e., in such cases the rule of Caveat Emptor will be applicable.

5. An implied warranty or condition as to quality or fitness for a particular purpose may be annexed (attached) by the usage of trade, Section 16(3). This exception may be explained by the facts of **Jones v. Bowden's** case as follows:

   It was usual in the sale of drugs by auction that if the goods were sea damaged, it should be declared.

   This usage in effect created an implied condition that when the drug were sold without such declaration, they were free from sea damage. In this case the seller exhibited the sample without disclosing that the drugs were sea damaged. The rule of Caveat Emptor would, therefore, not apply here.

6. Where the goods are sold by description and the goods supplied by the seller do not correspond to the description, this doctrine would not apply.

7. If the goods are sold by sample and the bulk of the goods supplied do not correspond with the sample, this doctrine would not apply. In addition to it, when the goods are delivered and the buyer is not provided an opportunity to compare the goods with the sample or where there is any latent defect in the goods, the doctrine will not apply.

8. In a sale by sample as well as by description, if the bulk of the goods supplied does not correspond to the sample as well as with description, this doctrine will not apply.

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Check Your Progress A

1. Define 'Condition' in a contract of sale.

   ....

   ....

   ....

2. What is a 'Warranty' in a contract of sale?

   ....

   ....

   ....

3. What is a sale by sample?

   ....

   ....

   ....

4. When can a breach of condition be treated as a breach of warranty?

   ....

   ....

   ....

5. Fill in the blanks

   i) A condition is a stipulation .... to the main purpose of the contract of sale of goods.

   ii) A warranty is a stipulation .... to the main purpose of the contract of sale of goods.

   iii) A contract of sale involves transfer of ....

   iv) An implied condition as to quality or fitness for a particular purpose may be annexed by the .... of trade

   v) In a contract of sale of eatables, there is an implied condition that the goods shall be .... and .... for human consumption.

6. State whether the following statements are True or False :

   i) Breach of condition gives rise to a claim for return of price as well as damages.

   ii) Breach of warranty entitles the buyer to only claim return of price.

   iii) A breach of condition can be treated as a breach of warranty.

   iv) ‘Sale’ and a ‘Contract of Sale’ are interchangeable expressions.

   v) In case of sale by sample the bulk must correspond to sample as well as be merchantable.

   vi) When the goods are sold by trade mark, there is no implied condition as to their fitness.

7. Fill in the blanks.

   To avail relief under condition as to fitness, the condition to be satisfied are:

   a) ....

   b) ....

   c) ....

8. Deepak purchased a Colour TV from M/s Paul Brothers for a sum of Rs. 30,000. The TV set was defective from the beginning and it did not work in spite of repairs by the expert mechanics. Deepak wants to return the TV set to M/s Paul Bros, and claim refund. Advise.

17.7 LET US SUM UP

The seller sometimes makes certain claims, statements or representation about the goods which he intends to sell. These representations are called 'stipulations'. A stipulation in a contract of sale with reference to the goods which are the subject thereof may be a condition or a warranty.

A condition, is a stipulation essential to the main purpose of the contract. The breach of a condition gives the buyer the right to repudiate the contract and claim damages.

A warranty, is a stipulation collateral to the main purpose of the contract. The breach of warranty gives the buyer the right to claim damages only. He does not have a right to put an end to the contract. A breach of condition may be treated as a breach of warranty by the aggrieved party whereas a breach of warranty cannot be treated as a breach of condition.

In a contract of sale, condition and warranties may be express or implied. The express conditions and warranties are those which are agreed upon between the contracting parties at the time of contract. Implied condition and warranties are those which are implied by law, unless otherwise agreed upon by the parties. Implied conditions are (1) condition as to title, (2) sale by description (3) sale by sample, it includes that the bulk should correspond with the sample, goods should be free from any defect rendering them unmerchantable, the buyer should have the opportunity to compare the bulk with the sample (4) sale by sample as well as description (5) condition as to quality or fitness (6) condition as to merchantable quality (7) condition as to wholesomeness. Implied warranties are (1) warranty as to quiet possession, and (2) warranty of freedom from encumbrances.

Caveat Emptor means let the buyer beware. However this doctrine does not apply: (1) where the seller makes a misrepresentation, or fraud (2) where the seller conceals a defect in the goods, which cannot be found out on reasonable examination, (3) in case of sale by description (4) when there is usage of trade (5) In case of implied conditions and warranties.

17.8 KEY WORDS

Caveat Emptor : Let the buyer beware

Encumbrance : A charge over goods

Wholesomeness : Worthy of human consumption

Title : Ownership

Stipulation : Representation or claims about goods

17.9 ANSWERS TO CHECK YOUR PROGRESS

5. i) essential, ii) collateral, iii) ownership, iv) usage, v) wholesome, fit

6. i) True, ii) False, iii) True, iv) False, v) ‘True, vi) True

7. i) that the goods are capable of being used as the goods of that description.

   ii) a) the exact purpose must have been disclosed.

   b) the seller must be a dealer in such goods.

   c) the buyer must have relied upon the seller’s skill or judgement.

8. There is a breach of implied condition as to merchantability (i.e., the goods should be capable of being used as the goods of that description). A TV set, therefore, must function as a TV set. The dealer shall have to either replace the set or refund the price.

17.10 TERMINAL QUESTIONS/ EXERCISES

1. Define and distinguish between ‘condition’ and ‘warranty’.

2. What is the doctrine of ‘Caveat Emptor’? What are the exceptions to this doctrine?

3. Discuss the provisions of Sale of Goods Act relating to the implied conditions in a contract of ‘Sale by sample’.

4. In case of ‘Sale by sample as well as by description’, the goods must not only correspond to the sample but also to the description. Comment.

5. Under what circumstances does a ‘Condition’ descend to the level of a ‘Warranty’?

6. State the two implied warranties in a contract of sale of goads.

7. Where a buyer has examined the goods, the condition as to merchantability extends only to the latent defects. Comment.

8. Answer the following problems giving suitable reasons:

   i) A Railway company purchased timber for railway sleepers, the timber was unfit for the purpose. Advise the railway company.

   ii) A contracts to sell B a saree which B believes to be a pure silk saree. A does not tell anything to B. Can B terminate the contract’?

   iii) X sold a Cola bottle to Y. While opening the bottle it bursts and injures Y. Can Y claim damages from X?

   iv) Certain goods were sold by sample by A to B, who in turn sold them by sample to C. The goods were not according to sample. Therefore, C rejected the goods and gave notice to B. B sued A. Advise B.

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v) A contracts to sell to B timber of a ½” thickness. The timber actually supplied varied in thickness from ½” to 5/8” and was fit for the purpose. Can B reject the timber?

vi) A desi ghee dealer while selling ghee described it as pure ghee. The ghee was adulterated. What is the remedy to the buyer?

Hints

i) Railway company can reject the timber, there is a breach of implied condition as to quality and fitness.

ii) No. The rule of Caveat Emptor will apply.

iii) Yes. The bottle was not merchantable.

iv) B is liable to C, and B cannot take action against A because B has accepted the goods. B can claim damages only from A.

v) Yes. The goods must correspond to the description.

vi) There is a breach of implied condition. The buyer can reject the goods.

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Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your own practice only.

UNIT 18 TRANSFER OF OWNERSHIP AND DELIVERY

Structure

18.0 Objectives

18.1 Introduction

18.2 Meaning of Transfer of Ownership

18.3 Significance of Transfer of Ownership

18.4 Rules Regarding Transfer of Ownership

- 18.4.1 In Case of Specific or Ascertained Goods
- 18.4.2 In Case of Unascertained and Future Goods
- 18.4.3 In Case when Goods are sent 'on Approval' or 'on Sale' or 'Return Basis'

18.5 Delivery to a Carrier

18.6 Reservation of Right of Disposal

18.7 Sale by Non-Owners

18.8 Delivery of Goods

- 18.8.1 Types of Delivery
- 18.8.2 Rules Regarding Delivery of Goods
- 18.8.3 Acceptance of Delivery
- 18.8.4 Liability of the Buyer

18.9 Let Us Sum Up

18.10 Key Words

18.11 Answers to Check Your Progress

18.12 Terminal Questions/Exercises

18.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning of transfer of ownership;
- describe the significance of transfer of ownership;
- state the rules regarding transfer of ownership;
- explain the cases where a non-own can pass on a better title;
- outline the meaning and types of delivery of goods; and
- describe the rules regarding delivery of goods and liability of the buyer.

18.1 INTRODUCTION

You have learnt in Unit 16 the meaning of the contract of sale of goods. From the meaning it should be clear to you that the main purpose of the contract of sale

is transfer of ownership, the seller ceases to be the owner of the goods. There are various rights and liabilities of the parties which are linked with the transfer of ownership. It is, therefore, very important for us to know the exact time of transfer of ownership of goods from seller to the buyer.

In this unit, you will study in detail the various rules regarding the transfer of ownership of goods from seller to the buyer. You will further study the circumstances where even a non-owner can pass on a better title to the buyer. You will also learn the rules relating to the delivery of goods.

18.2 MEANING OF TRANSFER OF OWNERSHIP

In the Sale of Goods Act, the word property is used for the 'ownership'. When the goods are sold, it is the property in the goods which is transferred to the buyer. The term 'property in the goods' should not be confused with the physical 'possession of goods'. A person may be in possession of goods but he may not be the owner of those goods. For example, an agent, or servant or a bailee may be in possession of goods, but is not the owner because the properly in the goods does not vest in him, he is holding the goods for his principal, master or the bailor. Similarly, a person may be the owner of the goods but he may not be in possession of goods, for example, the principal, master or bailor, may not be in possession of the goods but the property in goods vests in him. Thus, the transfer of possession of goods is not the same thing as the transfer of ownership. You will notice that the, ownership of the goads may pass with or without the transfer of possession.

In a contract of sale of goods when the goods are sold to the buyer, the buyer becomes the owner of the goods irrespective of the fact whether the buyer has taken the delivery of goods or not. Thus, it should be clear to you that transfer of property or ownership means the legal ownership and not the physical possession of goods.

18.3 SIGNIFICANCE OF TRANSFER OF OWNERSHIP

In a contract of sale of goods, one of the most important question is as to when the property in goods passes from seller to the buyer. The time of transfer of ownership of goods decides various rights and liabilities of the seller and the buyer. In business, the goods are generally bought for resale and it is only the owner of goods who can sell them. Therefore, a buyer who has become the owner of the goods can sell those goods. Thus, it becomes very important for us to know the exact moment as to when the ownership passes from the seller to the buyer for the following reasons:

1. **Risk passes with the ownership**: It is the rule of law that 'risk prima facie passes with the property' (Section 26). It implies that if the goods are lost or suffer any damage then whosoever is the owner of the goods at the time of loss or damage, he shall bear the loss. Therefore, if the property in goods is transferred to the buyer, the buyer becomes the owner of goods and in case the goods are lost or damaged, the buyer will have to bear the loss. Hence it is important to know whether the property in the goods has passed to the buyer or is still with the seller. It is the owner of the goods who runs the risk of loss and not the person who may be in possession of goods.

Examples

i) A sold certain books to B. B left the books in A's shop. The books were damaged as a result of fire in the shop. The loss is to be borne by B because at the time of loss of books he had become the owner of the books.

ii) A lends his book to B. As a result of an accidental fire the book is totally damaged. The loss will be borne by A because at the time of loss he was the owner of the book.

2. **Action against third party**: In the case of loss or damage to the goods caused by a third party, it is the owner who alone can take action and not the person who was in possession of the goods. The buyer gets proprietory rights over the goods i.e., he gets all the rights over the goods as their owner.

3. **Suit for price**: The seller becomes entitled to recover the price of the goods from the buyer only when the property in the goods has passed to the latter.

4. **Insolvency of seller or buyer**: If the seller or buyer becomes insolvent, the question arises as to whether or not the Official Receiver or the Assignee can take over the goods. The answer depends upon whether the property in the goods has passed to the buyer or not. If the property in goods has passed to the buyer and the buyer is adjudged insolvent, the buyer's Official Receiver or Assignee shall take the possession of the goods even though the goods have not been delivered by the seller.

18.4 RULES REGARDING TRANSFER OF OWNERSHIP

You learnt the importance of knowing the time of transfer of ownership from seller to buyer. Now the next important thing is to determine the time of transfer of ownership. The rules regarding the transfer of ownership are contained in Sections 18 to 24 of the Sale of Goods Act, 1930. The general rule is that the 'property in goods is transferred to the buyer at such time as the parties intend it to be transferred' [Section 19(i)]. Thus the whole question of transfer of ownership is left to the intention of the parties. The parties are free to fix any time for the transfer of ownership from seller to the buyer. But sometimes the intention of the parties may not be clear from the contract itself. In such cases, the intention could be ascertained according to the rules laid down in Section 20 to 24 of the Sale of Good Acts.

For the purposes of knowing the time of passing of ownership from seller to the buyer, the goods have been classified into three classes, viz.,

i) Specific or ascertained goods,

ii) Generic or unascertained goods; and

iii) Goods send 'on approval' or 'on sale or return' basis,

Let us now discuss the rules for each of the class separately.

18.4.1 In Case of Specific or Ascertained Goods

Specific goods means goods identified and agreed upon at the time a contract of sale is made. According to Section 19(2) of the Act *where there is a contract*

for the sale of specific or ascertained good the property in them is transferred to the buyer at such time as the parties to the contract intend it to be transferred. It further provides that for the purpose of ascertaining the intention of the parties regard shall be had to the terms of contract, the conduct of the parties and the circumstances of the case.

For knowing the intention of the parties with respect to the time when the properly in the goods is to pass to the buyer, the following rules are applicable:

1. **Specific goods in a deliverable state**: Where there is an unconditional contract for the sale of specific goods and the goods are in a deliverable state, the property in the goods passes to the buyer when the contract is made. You should note that it is immaterial whether the time of payment of the price or the time of delivery of goods or both, is postponed (Section 20). On analysing this section you find that the ownership shall pass at the time of making the contract if the goods are specific, the contract is an unconditional one and the goods are in a deliverable state. By an unconditional contract we mean that there is no condition regarding the transfer of ownership of goods. For example, A sells some specific goods in a deliverable state to B on the condition that the property in the goods shall pass only when B accepts the bills of exchange. This is a conditional contract and the property in goods shall be transferred only when the condition is fulfilled.

   Another important point in this section is that the goods must be in a deliverable state. Now the question arises as to when goods can be said to be in a deliverable state, According to Section 2(3) of the Act, *goods are said to be in a deliverable state when they are in such state that the buyer would, under the contract, be bound to take delivery of them*. In simple words it means that the goods are in such a condition that the buyer can take away the goods then and there. It is possible when the goods are ready and the seller is not required to do anything with the goods.

   Examples

   i) A offers to sell his car to B for Rs 60,000 the price to be paid after 20 days. B accepts the offer and a contract is made. The property in the car passes to B immediately when the contract is made, the payment of the price is immaterial.

   ii) A selects some books from B's book shop and agrees to pay the price on the first day of the next month and the books are to be delivered at A's house on the following day. As a result of an accidental fire in the shop, the books selected by A were destroyed. A shall be liable to pay the price, as the property in the books has passed from B to A on making the contract. You should note that in this case neither the price has been paid nor the goods have been delivered, even then the ownership has passed from seller to the buyer.

   You should further note that if any of the conditions stated in Section 20 is not fulfilled, the property in the goods shall not pass to the buyer at the time of making the contract.

2. **Specific goods not in a deliverable state**: Another situation may be where goods are not in a deliverable state at the time of making the contract. In simple words, the seller has to do something to the goods to put them in a

deliverable state. For example, cutting the goods, or packing or sealing, or loading or filling them in containers etc. In such a case as per Section 21 of the Sale of Goods Act, *where there is a contract for the sale of specific goods and the seller is bound to do something to the goods for the purpose of putting them into a deliverable state, the property does not pass until such thing is done and the buyer has notice thereof*. According to this rule the property in goods will not pass to the buyer unless "something" is done in order to put them in a deliverable state.

In **Rugg v. Minett,** the whole of contents of a cistern of oil were sold, and the seller had to put the oil in casks to deliver it to the buyer. The seller filled some casks in the presence of the buyer, but, before the remainder could be filled a fire broke out and the entire quantity of oil was destroyed. It was held that the buyer must bear the loss of the oil which was put into casks and the seller will bear the loss of the remainder, the reason being that the oil that was put in a deliverable state became the property of the buyer. You should note that here the ownership did not pass to the buyer at the time of the contract but it passed only when the goods were put into a deliverable state and the buyer has notice thereof.

3. **Specific goods in a deliverable state, when the seller has to do something to ascertain the price**: Sometimes the goods may be in a deliverable state, but the seller is bound to do something for the purpose of ascertaining the price. In such a case the property in goods shall not pass to the buyer unless the seller has done that thing for ascertaining the price. In this regard Section 22 of the Act provides, "*where there is a contract for the sale of specific goods in a deliverable state, but the seller is bound to weigh, measure, test or do some other act or thing with reference to goods for the purpose of ascertaining the price, the property does not pass until such act or thing is done and the buyer has notice thereof*". For example, A sells to B a heap of wheat at the rate of Rs 250 per quintal. A had to weigh the wheat in order to ascertain the price of the entire wheat sold to B. The property in the goods will pass when A has weighed the wheat and a notice of it is given to the buyer.

   In **Zagury v. Furmell,** 289 specified bales of goat skins, containing 60 pieces in each sale were sold. It was the duty of the seller to count them before sale. Before counting was completed, the bales were destroyed by fire. It was held that since the seller has not done that thing (counting of bales) for ascertaining the price, the ownership had not passed to the buyer, so this loss had to be borne by the seller.

   You should notice that this rule is only an extension of the rule given in Section 21. However, it should be noted that if the buyer does something (weighing, measuring or counting etc.) for his own satisfaction, this Section will not apply.

18.4.2 In Case of Unascertained Goods and Future Goods

The general rule is that no property is goods is transferred to the buyer unless and until the goods are ascertained (Section 18). For example, A agreed to sell to B 100 bags of wheat out of 1,000 bags of wheat lying in his godown. The property in goods shall not pass to B until and unless 100 bags of wheat are separated from the rest. Thus, for transferring the property of unascertained goods the first step is to identify or ascertain the goods. Ascertainment is the process of identifying

the goods to be sold to the buyer. After the goods have been ascertained, the next step is their unconditional appropriation to the buyer.

Section 23(i) provides that in a contract for the sale of unascertained or future goods by description, the property in goods passes to the buyer when the goods are unconditionally appropriated to the contract. The term 'appropriation' has not been defined in the Act. It means an overt act showing an intention to identify and determine the specific goods as those to which the bargain of the parties shall apply. Appropriation is done with the mutual consent of the seller and the buyer. Appropriation may be done either by the seller or by the buyer with the consent of the other, The consent of the seller or the buyer, may be express or implied and may be given before or after the appropriation is made. Once the goods are appropriated with the mutual consent of the parties, they become the property of the buyer.

Here you should note the difference between ascertainment and appropriation. Ascertainment is an unilateral act and is usually done by the seller alone, while in case of appropriation the mutual consent of the parties is required. The goods are appropriated by putting them in suitable receptacles i.e. by putting the goods in bags or boxes or putting the oil in bottles or casks. Sometimes, when the seller delivers the goods to the carrier or other bailee for transmission to the buyer without reserving the right of disposal, the property in goods passes.

Appropriation of goods may be done either by the seller or by the buyer with the consent of the other party.

Appropriation by the seller with the buyer's assent: Goods are generally in the possession of the seller, so he appropriates the goods with the consent of the buyer in such a case the property in goods shall pass to the buyer only when he agrees to such appropriation. For example, A agreed to sell 10 bags of rice to B out of his stock of 500 bags. A separates 10 bags with B's assent; the ownership of 10 bags would pass to B as soon as this is done.

Section 23(2) of the Act provides that "*where, in persuance of the contract, the seller delivers the goods to the buyer or to a carrier or other bailee (whether named by the buyer or not); for the purpose of transmission to the buyer, and does not reserve the right of disposal, he is deemed to have unconditionally appropriated the goods to the contract*". Whether or not the seller has reserved the right of disposal over the goods even after delivering them to the carrier, is a question of fact depending on the circumstances of the case.

Where the seller takes out the railway receipt or bill of lading in his own name, the presumption is that the seller has reserved the right of disposal and in such a case the ownership of goods shall not pass. Similarly, if the railway receipt or bill of lading is in the name of the buyer but is sent through the bank with the instructions that the same are to be delivered to the buyer on payment of the price or acceptance of the bill, the property in the goods will not pass to the buyer until and unless he makes the payment or accepts the bill of exchange.

Appropriation by the buyer with the seller's assent: Where the goods are already in the possession of the buyer, as in the case where he is the warehouseman for the seller, the goods can be appropriated by the buyer with the consent of the seller. For example, 500 bags of wheat belonging to A are stored in B's warehouse. A sells 100 bags of wheat to B. Since B is in possession of the goods, he may

with A's consent appropriate 100 bags. Here the property in goods will pass from A to B as soon as the appropriation is done.

Now it should be clear to you that property in goods cannot pass in unascertained goods. It is, in fact, an agreement to sell. It becomes sale only when the goods are ascertained and unconditionally appropriated to the contract.

18.4.3 In Case when Goods are Sent 'On Approval' or 'On Sale or Return' Basis

When goods are sent 'on approval' or 'on sale or return' basis, it means that the buyer has the option to return the goods to the seller, if he is not satisfied with the goods. According to Section 24 of the Act, when goods are delivered to the buyer on approval or 'on sale or return' or other similar terms, the property therein passes to the buyer (a) when he signifies his approval or acceptance to the seller or (b) does any other act adopting the transactions or (c) If he does not signify his approval or acceptance to the seller but retains the goods without giving notice of rejection. Let us now discuss these points in detail.

i) **When he signifies his approval or acceptance**: When the buyer accepts the goods and the seller is informed about it, the property in goods passes to the buyer. For example, A delivered a scooter to B on approval for seven days. B informs A that he has accepted to buy the Scooter. The ownership shall pass to B on his approval. This is a case at express approval.

ii) **When he adopts the transaction**: Sometimes the buyer does not send his express approval but does some act in regard to the goods which shows that he has accepted the goods, there the ownership shall pass to the buyer on the act of adoption. This is implied acceptance or approval. For example, A delivered some jewellery to B 'on sale or return' basis. B pledged the jewellery with P. It was held that B has adopted the transaction by pledging the jewellery with P, the property has passed to B. A can recover the price from B but has no right against P.

iii) **When he fails to return the goods**: When the buyer does not signifies his approval or rejection, but retains the goods without giving notice of rejection, the ownership passes to the buyer. We can take up this point under the following two sub-heads.

   a) **If time is fixed for the return of the goods**: In case the goods are sent on approval or 'sale or return' basis and a time has been fixed for the return of the goods, the ownership passes to the buyer on the expiry of such fixed time. For example, A delivered a horse to B on 'sale or return' basis for seven days. B retains the horse even after the expiry of seven days, B shall be deemed to have become the owner. But if the horse dies on the third day itself without any fault of B, B shall not be liable for the price because the ownership has not yet passed to the buyer.

   b) **If no time is fixed for the return of the goods**: When the goods are delivered on approval or 'sale or return' basis and no time is fixed for the return of the goods, if the buyer his to return the goods within reasonable time, the ownership passes to the buyer on the expiry of reasonable time. The question as to what is a reasonable time is a question of fact depending on circumstances of each case. For example

A delivered his scooter to B on approval. B kept the scooter with him for three months. B shall be liable to pay the price to A because B has become the owner of the scooter on the expiry of a reasonable time.

However, you must remember that in case the goods are sold on sale or return basis upon the condition that the property in goods will pass only on payment, then the property will not pass until payment has been made. For example, A delivered a scooter to B on approval on the condition that the ownership will not pass until the price of the scooter is paid to the seller. B pledges the scooter with P without making the payment of the price. Here, since B has not yet become the owner of the scooter, A can recover his scooter from P.

Check Your Progress A

1. Define the term 'property' as used in the Sale of Goods Act.

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2. State the reasons of knowing the exact moment when property in goods passes to the buyer.

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3. What are the rules relating to transfer of property of specific goods from seller to the buyer?

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4. When goods are delivered on approval or on sale or return basis, when does property therein pass to the buyer?

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5. State whether the following statements are True of False:

   i) The term 'property in goods' and 'possession of goods' mean the same thing.

   ii) Risk follows ownership only when goods have been delivered.

   iii) Property in goods can pass only in case of ascertained goods.

   iv) Seller can file a suit for the price against the buyer only when the property in goods has passed to him.

(v) In an unconditional contract for the sale of specific goods in deliverable state, the property in the goods passes to the buyer when the buyer accepts the goods.

(vi) In a contract for the sale of unascertained goods, the property in goods passes when the contract is entered into.

(vii) When goods are sent on sale or return basis, the property in goods passes when the buyer retains the goods beyond a reasonable time.

(viii) In case of unascertained goods, the goods can be appropriated either by the seller or the buyer.

18.5 DELIVERY TO A CARRIER

The term 'carrier' means an agency to whom the goods are delivered for the purpose of transmission to the buyer. The carrier may be railways, shipping company, road transport agency or airways. Delivery of goods to a carrier, whether named by the buyer or not, operates prime facie as a delivery of goods to the buyer. You have learnt in Section 23(2) that in case of sale of unascertained goods, when the goods are delivered to the carrier, it amounts to appropriation of goods. When goods are unconditionally delivered to the carrier, it amounts to the delivery to the buyer.

Section 39(1) of the Sale of Goods Act provides that where, in persuance of a contract of sale, the seller is authorised or required to send the goods to the buyer, delivery of goods to a carrier for the purpose of transmission to the buyer or to a wharfinger for safe custody, is prima facie, deemed to be a delivery of the goods to the buyer. If we read this Section along with Section 25(i), we can state that where the seller without reserving the right of disposal, delivers the goods to the carrier, the property in goods passes to the buyer. Here the carrier is treated as the agent of the buyer. For example, A of Delhi sells certain goods to B of Kolkata. A sends the goods by railway and the railway receipt is taken in the name of B. Here the property in goods passes when the goods were delivered to the railway.

But it must be noted that where it is agreed, that the goods are to be delivered at a particular place, for example, at the buyer's godown, then the delivery of goods to a carrier does not amount to a delivery of the goods to the buyer.

It should further be noted that merely by delivering the goods to the carrier, the seller's duty is not over. Section 30(2) provides that unless otherwise authorised by the buyer, the seller must make a reasonable contract with the carrier or wharfinger, for the safe carriage of goods. It should be noted that this contract, shall be made on behalf of the buyer. If the seller fails to take such precautions (as are necessary and reasonable) and the goods are lost or damaged in course of transit in whilst in the custody of the wharfinger, the buyer may decline to treat the delivery to the carrier or wharfinger as a delivery to himself, or may hold the seller responsible for damages.

Sometimes, the goods are sent by sea transit wherein it is quite usual to insure the goods. In such cases the seller should give to the buyer such notice as shall enable him to insure the goods. If the seller fails to give such notice and the goods are not insured, the goods will be deemed to be at the risk of the seller. The duty of giving notice to the buyer arises only where the goods are to be insured by the

buyer. In CIF (cost, insurance and freight) contracts, the sale price includes insurance, here the seller is required to insure the goods. But in FOB (free on board) contracts when goods are delivered on board the ship, the liability of the seller comes to an end. In such cases, the buyer must be given a notice so that he can get the goods insured.

18.6 RESERVATION OF RIGHT OF DISPOSAL

Reservation of right of disposal – this is a right vested in the seller by which he reserves to himself the right to dispose of goods until certain conditions are fulfilled. Therefore, when the goods are delivered to a carrier certain conditions are fulfilled. Therefore, when the goods are delivered to a carrier or other bailee, the seller can reserve the right of disposal of the goods and in such cases the property in goods will not pass to the buyer until the conditions imposed by the seller are fulfilled. For example, A sells certain goods to B upon the condition that B must pay the price before delivery of the goods. Here the seller has reserved his right of disposal by making the delivery of the goods conditional upon the payment of the price. The property in goods will not pass to B until the price is paid by him.

From the above it should be clear to you that the delivery of goods to the carrier does not mean transfer of property if the seller has reserved the right of disposal to himself. The seller may reserve the right of disposal of goods either expressly or by implication. When the seller exercises this right expressly he may do so at the time of entering into the contract or at the time of making appropriation of unascertained goods.

In the following two cases, the seller is deemed to have reserved the right of disposal to himself.

Where the goods are shipped or delivered to a railway administration for carriage and by the bill of lading or railway receipt, as the case may be, they are deliverable to the order of the seller or his agent Section 23(2). In such a case the seller keeps to himself the right of dealing with the goods and also the right of demanding possession of the goods from the carrier. For example, A sold some goods to B with the terms that the goods shall be sent by railway. The railway receipt is taken in the name of B, but it was sent by A to his agent. The goods were damaged in the course of journey. A will have to bear the loss because the property in goods has not got passed to the buyer. However, if the bill of lading or railway receipt are endorsed in the name of the buyer and sent to him, the properly in goods passes to the buyer because then the buyer becomes entitled to take possession of the goods from the carrier.

Where the seller of goods draws a bill of exchange on the buyer for the price of the goods and sends the bill of exchange along with the bill of lading or the railway receipt, to the buyer to secure acceptance or payment of the bill of exchange, the property in goods will not pass to the buyer until the buyer accepts the bill of exchange. If the buyer does not accept the bill of exchange, he must return the bill of lading or railway receipt to the seller. If he wrongfully retains the bill of lading or railway receipt, the property in the goods does not pass to the buyer [Section 25(3)]. In such a case, as soon as the bill of exchange is accepted, the ownership is transferred to the buyer.

Passing of risk: The general rule is that 'the risk prima facie passes with the ownership' i.e., the goods are at the risk of the party who has the ownership of the goods. According to Section 26 unless otherwise agreed, the goods remain at the seller's risk until the property therein is transferred to the buyer, but when the property therein is transferred to the buyer, the goods are at the buyer's risk whether delivery has been made or not. For example, A bids Rs 5,000 for a costly flower case at a sale by auction. After the bid, when the auctioneer struck his hammer to signify acceptance of the bid, he hit the case which was destroyed. The loss will have to be borne by the seller, because the ownership of goods has not yet passed from the seller to the buyer.

The general rule that the risk passes with the ownership is only a prima facie rule and is subject to the following exceptions:

i) The rule is not applicable where the parties have made some agreement to the contrary. For example, if the parties have agreed that during the transit the goods shall be the property of the seller but they shall be at the risk of the buyer.

ii) The rule is not applicable, where delivery has been delayed through the fault of either buyer or seller. In such a case the goods are at the risk of the party in fault as regards any loss which might not have occurred but for such fault. For example, A contracted to sell 100 casks of apple juice to B to be delivered in February. B took the delivery of part of the juice but made a default to accept the remaining casks. Consequently the juice became unfit for consumption. The loss will have to be borne by the buyer. It should however be remembered that the general rule shall not affect the duties or liabilities of either seller or buyer as a bailee of goods for the other even when the risk has passed.

18.7 SALE BY NON-OWNERS

You learnt the rules regarding the transfer of ownership from the seller to the buyer, wherein you have noted that once the goods are sold, the buyer becomes the owner of such goods. Here we have presumed that the seller is the owner of the goods. Now what will happen if it turns out that the seller was not the owner of the goods? Our answer will be that since the seller was not the owner, therefore, the buyer does not become the owner thereof.

The general rule as to transfer of property is that it is only the owner of the goods who can transfer the ownership in the goods to the buyer. In simple words, a person who is not the owner of the goods can not sell them and transfer the ownership to the buyer even though the buyer has purchased them in good faith and for value. No one can sell the goods and give a good title thereof unless he is the owner of such goods. This general rule is expressed by the maxim: "*Nemo dat quid non habet*", which means that "no one can give what he himself has not got". Therefore, if a person deals with the goods of another person and without the owner's authority, such transaction is of no value in the eyes of law. If the seller's title is defective, the buyer's title will also be defective. This is so because the buyer acquires his title to the goods from the seller. For example, A finds a ring of B and sells it to C who buys it in good faith and for value. The true owner (B) can recover the ring from C, since A had no title to the ring.

This general rule is contained in Section 27 of the Act which lays down that *subject to the provisions of this Act and of any other law for the time being in force, where goods are sold by a person who is not the owner thereof and who does not sell them under the authority as, with the consent of the owner, the buyer acquires no better title to the goods than what the seller had*. Thus, it can be stated that a person who is not the owner of the goods cannot make a third person owner of the goods.

But the above rule is subject to some exceptions where seller may confer a better title than what he himself possess. These exceptions are as follows:

1. **Title by estoppel**: You are already familiar with the principle of estoppel. Applying this principle to a contract of sale of goods, when the owner of the goods, by his statement or conduct, leads the buyer to believe that the seller has the authority to sell later on he may be estopped from denying the seller's authority to sell. For example: A says to B, in the presence of C that he (A) is the owner of the goods and C, who is the real owner of the goods does not contradict the statement. B buys the goods from A. Here, B will get a better title. In this example if the real owner C wishes to deny A's authority to sell the goods he (C) may be estopped from doing so.

2. **Sale by a mercantile agent**: Where a mercantile agent is, with the consent of the owner, in possession of the goods or of a document of title to the goods, and he sells those goods in the ordinary course of business as a mercantile agent the buyer will get a good title to the goods provided he (the buyer) buys them in good faith and for value. Section 2(9) defines a mercantile agent as an agent having in the customary course of business as such agent authority either to sell goods, or to consign goods for the purpose of sale, or to buy goods, or to raise money on the security of goods. In a sale by mercantile agent the buyer will acquire a good title to the goods only if the following conditions are satisfied:

   a) the goods are sold by a mercantile agent who is in possession of goods or of a documents of title to the goods with the consent of the owner;

   b) the agent sells the goods in the ordinary course of his business as a mercantile agent;

   c) the buyer must have acted in good faith i.e., the buyer must have no knowledge that the agent had no authority to sell.

   In **Folkes *v.* King**, F, the owner of the car, instructed an agent A to sell the car at a stipulated price and not below that. But A sold the car to B at a price lower than the stipulated price and misappropriated the money. B bought the car in good faith. It was held that B got a good title to the car and the real owner F cannot recover the car from B.

   From the above, it should be clear that where the buyer does not act in good faith or has the knowledge that the agent has no authority to sell, this rule shall not apply. This rule has been framed to protect the interest of innocent buyers.

3. **Sale by one of joint-owners**: According to Section 28 of the Act, if one of several joint owners of goods has the sole possession of them by permission of the other co-owners, and he sells them to a person who buys them in

good faith, and has, at the time of the contract of sale, notice of the fact the seller has no authority to sell, the buyer will get a good title to goods. As a rule a joint owner can transfer his share only. However, if he is in sole possession of the goods with the consent of other joint-owners and the buyer buys them in good faith, the buyer get a good title to the goods. For example, A, B and C are the joint-owners of some furniture and with the consent of B and C, the furniture was kept in possession of A. A sells the furniture to P who buys it in good faith and without notice that A had no authority to sell. P gets a good title to the goods.

You should note that this exception is applicable only in such cases where the joint-owner is in possession of goods with the consent of other co-owners.

4. **Sale by person in possession under voidable contract**: According to Section 29 of the Act, where a seller is in possession of goods under a voidable contract, and he sells the goods to a bonafide buyer before the contract is rescinded the buyer gets a good title to the goods. This exception is limited to contract of sale of goods obtained under a contract voidable under Section 19 or 19A of the Contract Act, i.e., voidable on the ground of coercion, undue influence misrepresentation or fraud. For the application of this exception it is necessary that:

   a) the seller must be in possession of goods under a voidable contract;

   b) the goods must be sold before the contract is rescinded; and

   c) the buyer must buy in good faith and without notice of the seller's defect of title.

   Thus, if the seller is in possession of goods under a contract which is void, even an innocent buyer will not get a good title to the goods.

   Example: A obtains a necklace from B, a jeweller, by playing fraud upon him. This contract is voidable at the option of B. But before B could terminate the contract, A sells the necklace to C who buys it in good faith and without notice of A's defective title. C gets a good title.

5. **Sale by seller in possession after sale**: Sometimes, the buyer after buying the goods, leave them with the seller. Section 30(1) of the Act provides that where a person having sold the goods continues or is in possession of the goods or of the documents of the title of the goods, after sale and he resells the same goods to another buyer, the buyer shall get a good title to the goods provided the buyer buys them in good faith and without notice of the previous sale. For example, A buys some goods from B, but leaves them with B for the time-being. In the meanwhile, B sells the same goods to C who buys them in good faith and without knowledge about the previous sale. C gets a good title to the goods.

   For the application of this action it is necessary that the seller must be in possession of goods as seller and not in any other capacity. Thus, if the first sale was completed and the seller again gets possession of the goods for same specific purpose and he resells those goods, then the buyer shall not get a good title to the goods even though he buys them in good faith.

Example: A sold a wrist watch to B and it was delivered to B. Later on, B delivered the watch to A for some repair. A resells that watch to C, who buys in good faith, Here C will not get any title to the goods because A was in possession of the watch not in the capacity as a seller but in the capacity of a bailee.

Thus, it is necessary that the seller must be in possession of goods as a seller and not as a bailee or a hirer.

6. **Sale by a buyer in possession after sale**: Section 30(2) deals with cases where goods are sold or agreed to be sold and the goods are in the possession of the buyer but the ownership has not yet passed to the buyer. If such a buyer resells the same goods to a new buyer who buys them in good faith and without any knowledge about the first seller's rights over the goods, the second buyer gets good title to the goods. For the application of this rule it is necessary that the first buyer must have obtained the possession of the goods or documents of title to the goods with the consent of the original seller. For example, A buys a scooter on instalment basis from B. It is agreed that B will remain the owner of the scooter till the last instalment is paid. A sold the scooter to C even before the payment of the last instalment. C buys in good faith and has no knowledge about the arrangement between A and B. C gets a good title to the scooter.

   You should note that this exception will apply only in such cases where the buyer is in possession of goods or the documents of title to the goods.

7. **Sale by an unpaid seller**: Section 54(3) provides that where an unpaid seller exercises his right of lien or stoppage in transit and is in possession of the goods, if he resells such goods, the subsequent buyer gets a good title to the goods as against the original buyer (discussed in detail in Unit 19).

8. **Sale by a finder of goods**: According to Section 169 of the Contract Act, a finder of goods has the power to sell the goods under certain circumstances and the buyer will get a better title. A finder of goods can sell such goods:

   a) if the owner cannot be found with reasonable deligence, or

   b) if found, he refuses to pay lawful charges of the finder, or

   c) if the goods are in danger of perishing or of losing the greater part of its value, or

   d) if the lawful charges of the finder, in respect of the thing found, amount to two thirds of its value.

9. **Sale by a pawnee or pledgee**: If the pawner or pledger makes a default in payment of the debt or the performance of the promise at the stipulated time, the pawnee has the right to sell the goods pledged after giving a reasonable notice to the powner. In such a case, even though the pawnee is not the owner of the goods but still he can convey a good title to the buyer.

10. **Sale by Official Receiver or Official Assignee**: The official receiver or the official assignee are appointed by the court to sell the property of the insolvent person. Though they are not the owners of the property, they can pass on a better title to the buyer.

Check Your Progress B

1. Does delivery of goods to a carrier amount to transfer of ownership?

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2. What is meant by reservation of right of disposal?

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3. State the circumstances when a Non-Owner can sell the goods?

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4. State whether the following statements are True or False.

 i) Delivery of the goods to the carrier amounts to transfer of ownership to the buyer.

 ii) Property in goods passes to the buyer where the seller has reserved the right of disposal.

 iii) When the seller takes a railway receipt in his own name, he is said to have reserved the right of disposal.

 iv) Property in goods passes to the buyer when documents of title are endorsed in the name of the buyer.

 v) Risk follows ownership whether the goods have been delivered or not and whether price has been paid or not.

 vi) Sale by a non-owner does not make the buyer an absolute owner of the goods.

 vii) A seller in possession of goods under a void contract can pass on a good title to a bonafide buyer.

 viii) A joint owner in possession of goods with the consent of other joint-owners, can make a valid contract of sale,

18.8 DELIVERY OF GOODS

You learnt the process of making the contract of sale and the transfer of ownership from seller to the buyer. Apart from transferring the ownership to the buyer, it is the duty of the seller to deliver the goods. Let us now study the meaning and types of delivery of goods.

Delivery is defined in the Act as a voluntary transfer of possession from one person to another [Section 2(2)]. If the transfer of possession of goods is not

voluntary i.e. if the possession of goods is taken by force or by fraud or by theft, there is no delivery in the strict legal sense. If B steals goods from A, there is no delivery from A to B though possession is transferred.

Delivery of goods sold may be made by doing anything which the parties agree shall be treated as delivery or which has the effect of putting the goods in the possession of the buyer or of any person authorised to hold them on his behalf (Section 33).

18.8.1 Types of Delivery

Delivery of goods may be of three kinds, viz., (1) actual, (2) symbolic, (3) constructive.

1. **Actual Delivery**: In this case the goods are physically handed over to the buyer or his authorised agent. For example, A sells a scooter to B and delivers it to B, it amounts to actual delivery of the goods.

2. **Symbolic Delivery**: In cases where the goods are bulky and heavy and it is not possible to physically hand them over to the buyer, some symbol which carries with it the real possession or control over the goods is handed over to the buyer. For example, delivery of the keys of godown where goods are lying or transferring the bill of lading or railway receipt to the buyer, amount to symbolic delivery of the goods. In this case even though there is no change in possession of goods, but it amounts to delivery.

3. **Constructive Delivery**: In this case neither actual nor symbolic delivery is made. When a person who is in possession of the goods, acknowledges to hold the goods on behalf of the buyer, it amounts to constructive delivery. For example, A sells to B 100 bags of wheat lying in C's warehouse. A orders C to deliver the wheat to B. C agrees to hold the 100 bags on behalf of B and makes the necessary entry in his books. In this case, there is constructive delivery of goods from A to B.

18.8.2 Rules Regarding Delivery of Goods

After learning the meaning and types of delivery, let us now study the rules regarding the delivery of the goods. These rules are as follows:

1. **Delivery of the goods may be made in any of the types discussed above.** The important point to remember is that it should have the effect of putting the goods in the possession of the buyer or his authorised agent.

2. **Delivery and payment are concurrent conditions**: Unless otherwise agreed, the delivery of goods and payment of price are concurrent conditions. The seller should be ready and willing to give possession of the goods to the buyer, and the buyer should be ready and willing to pay the price (Section 32).

3. **Effect of part delivery**: Sometimes when goods in large quantity are to be delivered, then during the process of delivery when part of the goods are delivered, it is treated as the delivery of the whole, for the purpose of passing the property in the goods. But where part delivery is made with the intention of separating it from the whole lot, then it does not amount to the delivery of the whole of the goods (Section 34).

You should, however, note that part delivery should not be confused with instalment delivery.

4. **Buyer to apply for delivery :** Unless some contract exists the seller of goods is not bound to deliver them until the buyer applies for delivery (Section 35). In case the goods are to be subsequently obtained or procured by the seller, then the duty of the seller is to intimate the buyer that the goods have been obtained by him, even then, the buyer should apply for delivery. The buyer can have no cause of action against the seller, if he fails to apply for delivery.

5. **Place of delivery**: The place where goods are to be delivered is generally agreed between the parties. Where the place of delivery is agreed upon, the goods must be delivered at that place during business hours on a working day. But if nothing specific is agreed upon them.

   a) the goods sold are to be delivered at the place at which they are at the time of the sale, and

   b) goods agreed to be sold are to be delivered at the place at which they are at the time of the agreement to sell, or

   c) if the goods are not in existence at the time of the agreement to sell, they are to be delivered at the place at which they are manufactured or produced Section 36(1).

6. **Time of delivery**: Where under the contract of sale the seller is bound to send the goods to the buye but no time for sending them is fixed, the seller is bound to send them within a reasonable time [Section 36(2)]. What is a reasonable time is a question of fact depending upon the facts and circumstances of each case.

7. **Manner of delivery**: Where the goods at the time of sale are in the possession of a third person, there is no delivery by seller to buyer unless and until such third person acknowledges to the buyer that he holds the goods on his behalf [Section 36(3)].

8. **Expenses of delivery**: Unless otherwise agreed, the expenses of and incidental to putting the goods into a deliverable state shall be borne by the seller [Section36(3)].

9. **Delivery of wrong quantity**: Wrong quantity may be either ‘short delivery’, ‘excess delivery’ or ‘mixed delivery’. Following are the rules, but they are subject to any usage of trade, special agreement or course of dealing between the parties.

   a) **Short delivery**: Where the seller delivers to the buyer a quantity of goods less than he contracted to sell, the buyer may reject them. But if the buyer accepts the goods so delivered, he shall pay for them at the contract rate [Section 37(1)]. By accepting a lesser quantity, the buyer is not debarred from suing for damages on the ground of short delivery.

   b) **Excess delivery**: Where the seller delivers to the buyer a quantity of goods larger than contracted for, the buyer has the option: -

      i) to accept the contracted quantity and reject the excess; or

      ii) to accept the whole, in this case, he shall become liable to pay for all the goods at the contract rate; or

      iii) to reject the whole quantity [Section 37(2)].

Example: A agrees to sell 1000 quintals of rice to B at Rs. 2,000 per quintal. A delivers 1,050 quintals. B may reject the whole lot, or accept only 1,000 quintals and reject the rest or accept the whole lot and pay for them at the contract rate.

c) **Mixed Delivery**: Where the seller delivers to the buyer the goods he contracted to sell mixed with the goods of a different description not included in the contract, the buyer may accept the goods which are in accordance with the contract and reject the rest, or reject the whole [Section 37(3)]. For example: A agrees to sell 10 quintals of wheat to B. A sends 20 quintals of wheat and 10 quintals of rice. B may reject the whole or may accept 20 quintals of wheat and reject the rice.

You have noted that when goods in wrong quantity are delivered, the buyer has the option to reject the whole lot. If the buyer does so, it does not amount to cancellation of the contract. The seller still has the right to deliver the goods contracted for, and the buyer shall be bound to accept the same.

10. **Instalment deliveries**: In the absence of an agreement to the contrary, the buyer is not bound to accept delivery by instalments Section 38(1). For example, A agrees to deliver to B 100 quintals of wheat in April. But A delivers only 80 quintals in April and the remaining 20 quintals in the first week of May. B is entitled to reject the whole100 quintals.

    Sometimes, there may be a contract for the supply of goods in instalments which are to be separately paid for. In such a case a problem arises when there is a breach either by the seller or the buyer. In such a situation it is a question of fact whether the whole contract is to be treated as repudiated or only one instalment is repudiated for which the party may claim damages and the remaining instalments are to be duly delivered and accepted.

11. **Delivery to a carrier or wharfinger**: According to Section 39(1), where the seller is authorised or required to send the goods to the buyer, delivery of the goods to a carrier for the purpose of transmission to the buyer or the delivery of the goods to a wharfinger for safe custody, is prima facie deemed to be a delivery of goods to the buyer.

    The seller must make a reasonable contact with the carrier or wharfinger for the safe transmission or custody of the goods, and if he fails to do so, and the goods are lost or damaged, the buyer may either decline to treat the delivery to the carrier or wharfinger as a delivery to himself, or hold the seller liable for damages [Section 39(2)].

18.8.3 Acceptance of Delivery

You have learnt that it is the duty of the buyer to accept the delivery of the goods. Now the question arises as to when the buyer can be said to have accepted the delivery of the goods. It should be noted that when buyer receives the goods, it does not mean that he has accepted them. Acceptance is something more than this. Following are the rules in this regard:

i) When goods are delivered to the buyer which he has not previously examined, he is not deemed to have accepted them unless and until he has had a reasonable opportunity of examining them for the purpose of ascertaining whether they are in conformity with the contract [Section 41(1)].

ii) The buyer is deemed to have accepted the goods:

a) When he intimates to the seller that he has accepted the goods, or

b) When the goods are delivered to the buyer and he does any act in relation to them which shows that he has accepted them, for example, he resells them or pledges them, or

c) When the buyer retains the goods beyond a reasonable time without intimating the seller that he has rejected them.

iii) Unless otherwise agreed, when goods are delivered to the buyer and he refuses to accept them, he is not bound to return them to the seller. But the buyer must inform the seller that he refuses to accept the goods.

18.8.4 Liability of the Buyer

When the seller is ready and willing to deliver the goods and requests the buyer to take delivery, and the buyer does not within a reasonable time after such request, take delivery of the goods, he is liable to the seller for

a) any loss caused by his neglect or refusal to take delivery; and also

b) a reasonable charge for the care and custody of the goods.

It is further provided in Section 44 that where the neglect or refusal of the buyer to take delivery amounts to a repudiation of the contract, the seller may sue for the price or for damages.

Check Your Progress C

1. What is meant by delivery of goods?

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2. What is constructive delivery?

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3. Delivery of goods to the carrier amounts to delivery to the buyer. Do you agree?

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4. What happens if wrong quantity of goods are delivered?

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5. When the buyer is said to have accepted the goods?

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6. State whether the following statements are True or False

   i) When the keys of the warehouse where goods are lying are delivered to the buyer, it amounts to symbolic delivery.

   ii) Unless otherwise agreed, delivery of goods and payment of the price are concurrent conditions.

   iii) Buyer must apply for delivery in all cases.

   iv) If no place is agreed upon, the goods are to be delivered at the place of the buyer.

   v) Where the seller delivers to the buyer goods larger in quantity than contracted for, the buyer may reject the whole lot.

   vi) When goods are rejected by the buyer, he is bound to return them to the seller.

   vii) Unless otherwise agreed, the buyer is not bound to accept the goods in instalments.

   viii) When the buyer refuses or neglects to take delivery of the goods and it amounts to termination of the contract, the seller has a right to sue for price and damages.

18.9 LET US SUM UP

The main object of a contract of sale of goods is to transfer the property in goods to the buyer. Property in goods means the ownership of the goods and not the possession of goods. The ownership of goods can pass to the buyer even though the goods have not been delivered or the buyer has not paid the price.

It is very significant to know the exact time as to when the ownership passes to the buyer owing to these reasons: (i) risk passes with the ownership; (ii) right to taking action against third parties, (iii) suit for the price; and (iv) in the event of insolvency of seller or buyer.

In case of specific goods, the ownership passes to the buyer when the parties intend it to pass. When the intention is not clear, following rules shall apply:

i) In case of specific goods in a deliverable state, the property passes immediately when the contract is made.

ii) In case the goods are specific but not in a deliverable state, the ownership passes when they are put in a deliverable condition and the buyer has notice for the same.

iii) When the seller has to do something to the goods to be sold for ascertaining the price, the ownership passes when the seller has done that and the buyer is informed

In case of unascertained goods, the ownership passes only when the goods are unconditionally appropriated by the seller or the buyer with the consent of the other.

When goods are sent on approval or on sale or return basis, the ownership passes when the buyer signifies his approval or acceptance to the seller or when the buyer does any act which shows that he has accepted the goods or when the buyer retains the goods without rejecting them beyond a reasonable time.

Where the seller, without reserving the right of disposal, delivers the goods to a carrier for the purpose of transmission to the buyer, the ownership passes to the buyer.

As a general rule, only the owner of the goods can transfer the ownership, i.e., a seller cannot pass on a better title than what he himself possesses. There are some exceptions to this rule. A seller can give a better title to the buyer in the following cases:

i) title by estoppel, ii) sale by a mercantile agent, iii) sale by a joint-owner, iv) sale by a person in possession of goods under a viodable contract, v) sale by a seller in possession after sale, vi) sale by a buyer in possession of goods before buying them, vii) sale by an unpaid seller, viii) sale by a finder of goods, ix) sale by a pawnee or pledgee, x) sale by official receiver or assignee.

Delivery means voluntary transfer of possession of goods from one person to another. Delivery may be made by doing anything which has the effect of putting the goods in possession of the buyer. Delivery may be actual, symbolic or constructive.

Unless otherwise agreed, delivery and payment are concurrent conditions. Delivery has to be made at the request of the buyer. The goods are to be delivered at the agreed place, and if no place is agreed upon, then at the place at which they were at the time of making the contract. The goods should be delivered within the time stipulated, and if no time is fixed, then within a reasonable time. The expenses of delivery are normally borne by the seller.

18.10 KEY WORDS

Carrier : The person or system who is engaged to carry the goods to the buyer.

Delivery : Voluntar transfer of possession from one person to another.

Deliverable state : When the goods are in a state in which they can be delivered to the buyer and as such are in accordance with the terms of the contract.

Documents of title : Documents which establish the ownership of the goods such as a railway receipt, bill of lading, etc.

Mercantile agent : A person who is in possession of the goods with the consent of the owner and has the authority to deal with them in the normal course of business.

Property in goods : Ownership rights over the goods.

Specific goods : Goods which are identified and agreed upon at the time of a contract of sale.

18.11 ANSWERS TO CHECK YOUR PROGRESS

A) 5. (i) False, (ii) False, (iii) True, (iv) True, (v) False, (vi) False, (vii) True, (viii) True.

B) 4. (i) False, (ii) False, (iii) True, (iv)True, (v) True, (vi) True, (vii) False, (viii) True.

C) 6. (i) True, (ii) True, (iii) False, (iv) False, (v) True, (vi) False, (vii) True, (viii) True.

18.12 TERMINAL QUESTIONS/EXERCISES

1. Why is it important to know the exact time when the ownership passes to the buyer?

2. State briefly the rules regarding the transfer of ownership from seller to the buyer.

3. What is meant by reservation of the right of disposal in a contract of sale of goods?

4. "No seller of goods can give to the buyer a better title than he himself has". Explain this rule. Are there any exceptions to this rule?

5. Explain in brief the rules relating to the delivery of goods.

6. What are the remedies available to the buyer when goods in wrong quantity are delivered to him?

7. "Delivery does not amount to acceptance of goods." Comment.

8. Answer the following problems, giving reasons:

   i) Ramesh buys a radio set from a dealer. He neither makes the payment nor takes the delivery of the radio set. He asks the dealer to deliver the set next day and receive the payment. As a result of accidental fire, the radio set is destroyed. Can the dealer recover the price?

      (*Hint*: Yes, since the property in goods has passed, the seller can sue for the price.)

   ii) Mohan sells to Suresh a particular horse to be delivered to Suresh the next week. Mohan asks his servant to keep the horse separate from other horses. The horse dies before it is delivered, who shall bear the loss?

      (Hint: Suresh will bear the loss because the horse way in a deliverable state, the ownership has passed to him at the time of making the contract.)

   iii) Surendra agreed to sell 100 quintals of wheat to Harish out of his stock of 1,000 quintals. The price was to be paid on a later date. When will the property in goods pass to Harish?

      (Hint: The in goods will pass to Harish when 100 quintals of wheat is appropriated i.e., set aside.)

   iv) Karim delivers a horse to John on trial for a week. Without any negligence on the part of John, the horse dies on the third day. Is John liable to pay the price?

(Hint: No, he is not liable for the price because the ownership has not yet transferred to him.)

v) Goods are delivered by A to B on 'Sale or return' basis. They are further delivered by B to C and then by C to D on similar terms. The goods are stolen while in the custody of D. Who is to bear the loss and why?

(Hint: C will bear the loss because property in goods has passed from A to B and from B to C but not from C to D.)

vi) Motilal entrusted his car to a mercantile agent for sale at a stated price and not below that. The agent sold it to Ramesh, a bona fide buyer, below the stated price and misappropriated the proceeds. Discuss the position of Ramesh.

(Hint: Ramesh got a good title to the car from the mercantile agent.)

vii) A hirer, who obtains possession of a car from its owner under a hire purchase agreement, sells the car to a buyer who buys in goods faith and without notice of the right of the owner. Does the buyer get a good title to the car?

(Hint: The buyer will not get good title to the car because in a hire-purchase agreement the ownership does not pass. The hirer is the bailee, he has no right to sell.)

viii) A, by fraud obtains the possession of a diamond ring from B. B sells the ring to C before A rescinds the contract. C purchases the ring in good faith and for value. Examine the position of C.

(Hint: C is the owner of the ring because he bought the ring from A, who is in possession of goods under a voidable contract and before the contract is rescinded.)

ix) Rajesh purchased certain specified goods from Trehan & Co. Trehan & Co. delivered the goods along with some other goods. What is the position of Rajesh?

(Hint: Rajesh may accept the whole or reject the whole or accept the goods ordered by him and reject the rest.)

Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your own practice only.

UNIT 19 RIGHTS OF AN UNPAID SELLER

Structure

19.0 Objectives

19.1 Introduction

19.2 Meaning of an Unpaid Seller

19.3 Rights of an Unpaid Seller

19.4 Rights Against the Goods

- 19.4.1 Where the Property in the Goods has Passed to the Buyer
  - 19.4.1.1 Right of Lien
  - 19.4.1.2 Right of Stoppage of Goods in Transit
  - 19.4.1.3 Right of Resale
- 19.4.2 Where the Property in the Goods has not Passed to the Buyer

19.5 Right Against the Buyer Personally

19.6 Rights of the Buyer

19.7 Auction Sales

19.8 Let Us Sum Up

19.9 Key Words

19.10 Answers to Check Your Progress

19.11 Terminal Questions/Exercises

19.0 OBJECTIVES

After studying this unit you should be able to

- define an unpaid seller;
- state the rights of an unpaid seller;
- explain the right of lien and when it comes to an end;
- discuss the right of stoppage-in-transit;
- describe the procedure of stopping the goods in transit;
- distinguish between right of lien and stoppage in transit; and
- explain the rules of an auction sale.

19.1 INTRODUCTION

In the previous units you have learnt the meaning of a contract of sale and rules regarding ascertaining the time of transfer of ownership of goods from seller to the buyer. You have also learnt that the consideration in a contract of sale is the price. You know that the payment of the price is immaterial for transferring the

ownership i.e. ownership may change even without the payment of the price. But sooner or later, the price has to be paid. In this unit, you will learn who an unpaid seller is, what are his rights against the goods and against the buyer personally. You will also learn when and how goods are stopped-in-transit and when this right comes to an end. You will also learn the rules regarding auction sales.

19.2 MEANING OF AN UNPAID SELLER

In simple words, a seller who has not received the full price of goods sold is termed as an unpaid seller. Section 45 of the Sale of Goods Act, 1930 has defined an unpaid seller as follows:

The seller of goods is deemed to be an unpaid seller

i) when the whole of the price has not been paid or tendered; or

ii) when a bill of exchange or other negotiable instrument has been received as conditional payment and it has been dishonoured.

Thus, to be called an unpaid seller, the following conditions must be satisfied:

a) the goods have been sold and the price must be due;

b) the full price has not yet been paid;

c) a bill of exchange or other negotiable instrument, such as cheque was received as payment of the price, but the same has been dishonoured.

From the above, you should note that where a major part of the price has been paid and only a small portion remains to be paid, even then the seller shall be called an unpaid seller. But you should remember that it is only for the non-payment of the price that a seller is termed as an unpaid seller. Thus, if the price has been paid but some other expenses remain to be paid, the seller is not an unpaid seller. Similarly, where the seller has sold the goods on credit, he cannot be termed as an unpaid seller. If the seller does not receive the price in full after the expiry of the credit period, then he will become an "unpaid seller". Where whole of the price has been tendered by the buyer, and the seller has refused to accept it, the seller cannot be called an unpaid seller.

Examples

i) A sold certain goods to B for Rs. 5,000; B paid Rs. 4,500 but fails to pay the balance. A is an unpaid seller.

ii) A sold some goods to B for Rs. 5,000 and received a cheque for the full price. On presentment, the cheque was dishonoured by the bank. A is an unpaid seller.

iii) A sold some goods to B for Rs. 5,000 and allowed him a period of one month for payment of the price. A is not an unpaid seller during this period of one month. On the expiry of one month, if the price remains unpaid, then only A shall become an unpaid seller.

If before the expiry of one month's time the buyer becomes insolvent, then the seller becomes an unpaid seller.

The term 'seller' in this case means not only the actual seller but includes any person who is in the position of a seller, for example, an agent of the seller to

whom the bill of lading has been endorsed, or a consignor or agent who has himself paid, or is directly responsible for, the price [Section 45 (2)].

19.3 RIGHTS OF AN UNPAID SELLER

The rights of an unpaid seller can broadly be discussed under the two heads:(l) rights against the goods; and (2) rights against the buyer personally.

1. **The rights against the goods are as follows:**

   a) Where the property in goods has passed to the buyer:

      i) Right of lien;

      ii) Right of stoppage of goods-in-transit; and

      iii) Right of resale.

   b) Where the property in goods has not yet passed to the buyer, he has an additional right of withholding delivery.

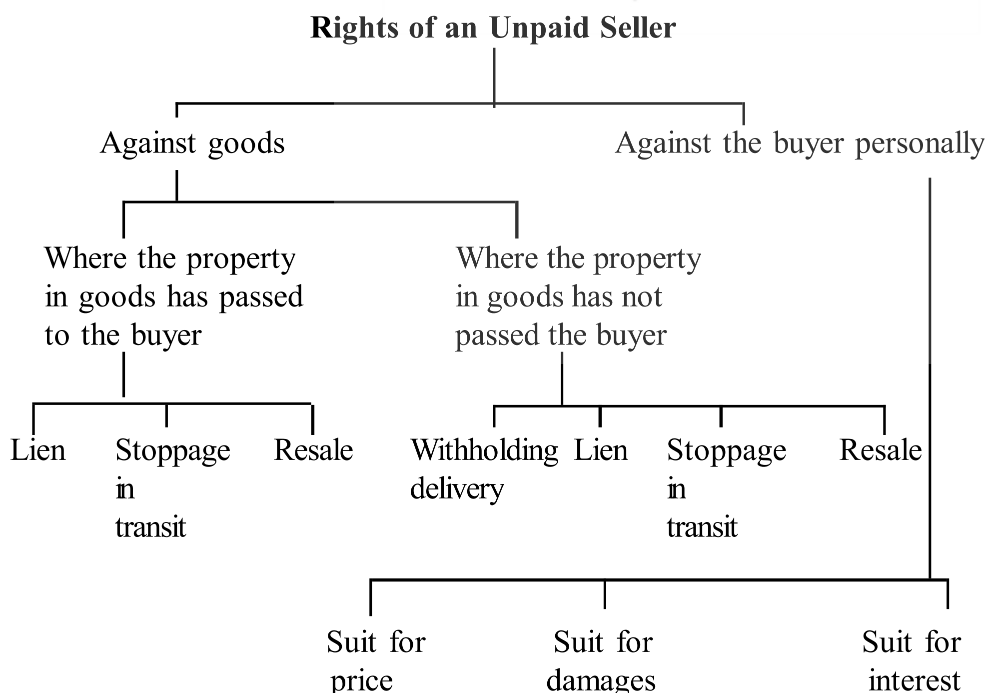
2. **The rights against the buyers personally as follows:**

   i) Right to file a suit for price;

   ii) Right to file a suit for damages; and

   iii) Right to file a suit for interest.

Look at Figure 19.1. It gives a complete picture of the various rights of an unpaid seller.



Let us now discuss these in detail.

Fig. 19.1

19.4 RIGHTS AGAINST THE GOODS

19.4.1 Where the Property in the Goods has Passed to the Buyer

As stated earlier the rights of an unpaid seller when the property in the goods has passed to buyer are as follows:

19.4.1.1 Right of Lien

You have learnt in Unit 10 that the term 'lien' means to 'retain possession' of the goods until charges due in respect of the goods are paid or tendered. The right of lien is a possessory right and can be exercised by the unpaid seller only when the goods are in his possession. An unpaid seller has the right of lien over the good until the full price is paid or tendered.

According to Section 47(1) of the Sale of Goods Act, "the unpaid seller of goods who is in possession of them, is entitled to retain possession of them until payment or tender of the price in the following cases, namely:

a) where the goods have been sold without any stipulation as to credit;

b) where the goods have been sold on credit, but the term of credit has expired;

c) where the buyer becomes insolvent."

Thus, it is clear that the unpaid seller can exercise his right of lien on goods only when the goods are in his actual possession. For exercising this right of lien, transfer of property, title or ownership is immaterial. The unpaid seller may exercise his right of lien notwithstanding that he is in possession of the goods as agent or bailee for the buyer [Section 47(2)]. Right of lien is not affected even where the seller has delivered to the buyer, the documents of title to the goods such as bill of lading or any other type of delivery order provided the goods are in his possession. For example; A sold certain goods to B for Rs. 5,000 and allowed him to pay the price within one month, B becomes insolvent during this period of credit. A, the unpaid seller can exercise his right of lien.

You should note that the term 'insolvent' in the Sale of Goods Act means "a *person who has ceased to pay his debts in the ordinary course of business, or cannot pay his debts as they became due, whether he has committed an act of insolvency or not [Section 2 (8)]*".

Rules regarding right of lien: The important legal provisions in connection with the exercise of right of lien are as following:

i) The goods must be in actual possession of the seller. Once the possession is lost, the lien is also lost.

ii) When the goods have not been sold on credit and the buyer fails to pay the full price, right of lien can be exercised.

iii) When the goods have been sold on credit and the credit period has expired, lien can be exercised.

iv) When the buyer becomes insolvent, the seller can retain possession over the goods.

v) The right of lien can be exercised even if the goods are in the possession of the seller in any other capacity, such as a bailee or agent.

vi) In case the documents of title have been delivered but the goods are in the actual possession the seller, the right of lien can be exercised.

vii) The right of lien can be exercised only for the price and not for any other expenses, e.g., godown charges, interest, etc.

viii) The right of lien is indivisible in nature. The seller may refuse to deliver a part of the goods on payment of a proportionate part of the price by the buyer.

ix) Where an unpaid seller has made part delivery of the goods, he may exercise his right of lien on the remainder, unless such part delivery has been made under such circumstances as to show an agreement to waive the lien (Section 48). In simple words, where part delivery is intended as delivery of the whole, right of lien is lost.

x) The right of lien can be exercised even though the seller has obtained a decree for the price of the goods [Section 49 (2)].

Termination of lien: You know that the right of lien depends upon the actual possession of the goods. The unpaid seller's right of lien is lost in the following cases:

i) When the goods are delivered to a carrier or other bailee for the purpose of transmission to the buyer without reserving the right of disposal of the goods [Section 49(l)(a)]. It is so because, the delivery to the carrier amounts to the delivery to the buyer himself. For example; A sold machine to B for Rs. 20,000 and delivered the same to the railways for the purpose of transmission to the buyer. The railway receipt was taken in the name of B and sent to B. Now, A cannot exercise the right of lien.

ii) When the buyer or his agent lawfully obtains possession of the goods [Section 49(1)(b)]. The possession by the buyer or his agent must be lawful.

iii) When the seller waives his right of lien. This waiver may be express or implied. Thus, when the seller extends the period of credit or when the seller agrees to a sub-sale by the buyer, there is an implied waiver.

iv) When the buyer tenders price, but the seller refuses to accept it, the right of lien is lost.

v) Where the buyer disposes of the goods by sale or in any other manner and the seller assents there to Section 53(1).

vi) Where a document of title to goods has been lawfully issued to the buyer and he transfers the documents to an innocent purchaser, who takes them for consideration and in good faith and the seller has assented to it Section 53(1), right of lien is not lost by obtaining a decree,

Where, however, the property in goods has not passed to the buyer, the question of exercising the right of lien does not arise. In such a situation the unpaid seller has the right to withhold the delivery of the goods.

Check Your Progress A

1. Define an unpaid seller.

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2. State the rights of an unpaid seller against goods.

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3. When is the right of lien lost?

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4. State whether the following statements are True or False.

   i) The right of lien of an unpaid seller depends solely on the possession of goods.

   ii) The right of lien can be exercised for the non-payment of the price of goods and other charges.

   iii) The right of lien can be exercised when goods have been sold on credit and the period of credit has expired.

   iv) An unpaid seller can refuse to deliver the goods even where the documents of title have been delivered but the goods are still in his possession.

   v) The right of lien is lost when the unpaid seller obtains a decree for the price of the goods.

   vi) The lien is not lost even when the buyer or his agent lawfully obtains possession of the goods.

   vii) The right of lien cannot be exercised on the goods repossessed after sale.

   viii) In case of part delivery, the unpaid seller can exercise his right of lien over the remainder.

   ix) The rights of an unpaid seller arise by implication of law.

19.4.1.2 Right of Stoppage of Goods in Transit

You learnt that when the unpaid seller parts with the possession of the goods, the right of lien is lost. If after delivering the goods to the carrier, the buyer becomes insolvent, the seller has got another right i.e. to stop the goods-in-transit. He can prevent the goods from being delivered lo the buyer or to his agent. The right of

stoppage in transit simply means the right of stopping the goods while they are in transit. This right arises only when the lien is lost. In this sense it is said that the right of stoppage in transit is an extension of the right of lien. By exercising this right, the unpaid seller regains possession over the goods.

According to Section 50 of the Act, "*Subject to the provisions of this Act, when the buyer of goods becomes insolvent the unpaid seller who has parted with the possession of the goods, has the right of stopping them in transit, that is to say, he may resume possession of the goods as long as they are in the course of transit, and may retain them until payment or tender of the price.*"

On analysing the above provision, you will notice that the right of stoppage-in-transit can only be exercised in the following cases:

i) The seller must be unpaid;

ii) The property in goods must have passed to the buyer;

iii) The goods must be in the course of transit i.e., the goods are neither in the possession of the seller nor in the possession of the buyer or his agent;

iv) The buyer of the goods has become insolvent; and

v) The goods-in-transit can be stopped only for the payment of the price of the goods.

Duration of transit: As you have learnt that the goods can be stopped only when they are in the course of transit. Now the question arises as to how long and up to what time the goods can be said to be in transit? In simple words, it can be said that the goods are deemed to be in transit when they are neither in the possession of the seller nor in the possession of the buyer, but they are in the possession of a carrier who is holding them in his own name for the purpose of transmission to the buyer.

If the carrier is holding the goods as an agent for the seller, there is no question of exercising the right of stoppage-in-transit because the seller can exercise lien over them. In case the carrier is holding the goods as an agent of the buyer, the seller cannot exercise the right of stoppage in transit, because the delivery to the carrier amounts to delivery to the buyer.

Section 51(1) of the Sale of Goods Act, explains the duration of transit, It provides that "*goods are deemed to be in the course of transit from the time when they are delivered to a carrier or other bailee for the purpose of transmission to the buyer, until the buyer or his agent takes delivery of them from such carrier or other bailee*" From this provision it becomes very clear that the goods are said to be in transit when they are in possession of the carrier who is acting as an independent person. However, the transit does not mean that the goods should be actually moving.

Sometimes, the buyer asks the seller to deliver the goods at a different place other than the agreed one, the goods are in transit until they are received by the buyer or his agent at that place. Similarly if the goods are rejected by the buyer and they are in the possession of the carrier, the transit is not deemed to be at an end, even if the seller had refused to receive them back [Section 5 1(4)].

Termination of transit: You know that the unpaid seller can stop the goods while they are in transit. In other words, this right will be lost when transit ends. Let us now study the cases when the transit comes to an end. Transit comes to an end in the following circumstances:

i) **Buyer taking the delivery**: Once the goods reach the hands of the buyer or his agent the transit comes to an end. Sometimes, the buyer or his agent obtains delivery of goods before their arrival at the appointed destination, the transit comes to an end [Section 51 (2)]. For example, A of Delhi sold certain goods to B of Mumbai. The goods reached Mumbai and the buyer, after taking the delivery of the goods, was loading them in his truck. Though the truck was still in the premises of station, the transit has ended because B has taken the delivery.

ii) **Carrier's acknowledgement to the buyer**: If, after the arrival of the goods at the appointed destination, the carrier or bailee acknowledges to the buyer or his agent, that he holds the goods on his behalf, the transit ends. It should be noted that this acknowledgement must be in clear terms. It is immaterial that a further destination of the goods was indicated by the buyer. Thus, in the above example, B, went to the railway authorities and after presenting the railway receipt, told them that he would collect the goods within a week. In the meanwhile, B becomes insolvent and A wants to stop the goods. A will not succeed since the transit came to an end when the railway authorities agreed to keep the goods on behalf of B.

iii) **Carrier's wrongful refusal to deliver the goods to the buyer**: Where the carrier or bailee wrongfully refuses to deliver the goods to the buyer or his agent, the transit is deemed to be at an end [Sec. 51(6)]. Here, it should be noted that the transit will come to an end only when the carriers refusal is wrongful.

iv) **Delivery to the ship:** When the goods are delivered to a ship, the question arises whether the transit ends or not. The answer to this question depends on the circumstances of each case. If the ship is chartered by the buyer, i.e., the buyer is the owner of the ship, the transit ends as soon as the goods are loaded on the ship. On the other hand, if the carrier is acting independently, the transit continues.

v) **Part delivery of goods**: Where part delivery of the goods has been made to the buyer or his agent, the remainder of the goods may be stopped in transit, unless such part delivery has been given in such circumstances as to show an agreement to give up possession of the whole of the goods [Section 51(7)].

vi) **How stoppage in transit is effected**: The unpaid seller may exercise his right of stoppage in transit either: (a) by taking actual possession of the goods; or (b) by giving notice of his claim to the carrier in whose possession the goods are [Section 52(1)]. Such notice may be given either to the person in actual possession of the goods or to his principal. In case the notice is given to the principal, to be effective, it must be given at such time and in such circumstances that the principal, by the exercise of reasonable diligence, may communicate it to his servant or agent in time to prevent a delivery to the buyer [Section 52(1)]. In other words, the notice to the principal shall be effective only, if there is sufficient reasonable time with him to further pass

on the information to his agent. The notice need not necessarily be in writing and no particular form for it is laid down. All that is required is to give a clear notice to the principal or carrier not to deliver the goods to the buyer and it must reach the carrier before he delivers the goods to the buyer.

When the carrier or the bailee who is in possession of goods receives such a notice from the seller, it becomes his duty to re-deliver the goods to, or according to the directions of the seller. The expenses of such re-delivery shall be borne by the seller [Sec.52(2)]. If the carrier, after receiving notice, delivers the goods to the buyer or his agent, he shall be liable to the seller for conversion.

Distinction Between Lien and Stoppage-in-Transit

You have learnt that both these rights can be exercised when the property in goods has passed to the buyer and the buyer has not yet paid the price in full. Though the two rights are similar in these respects, there are some important differences between the two, they are as follows:

Lien	Stoppage-in-Transit
1. The goods must be in actual possession of the seller.	1. The goods must be in possession of an independent carrier or bailee. The goods are neither in the possession of the seller nor in the possession of the buyer.
2. This right can be exercised even when the buyer is solvent but refuses to pay the price.	2. This right can be exercised only when the buyer becomes insolvent.
3. This right comes to an end when the seller parts with the goods	3. This right commences only when the seller delivers the goods to a carrier.
4. This is a right to retain possession over the goods.	4. This is a right to regain possession of the goods.
5. This right can be exercised by the seller himself.	5. This right can be exercised by the seller through the carrier or the bailee in whose possession the goods are.

From the above you must have noted that the right of stoppage in transit commences from the time when the seller delivers the goods to an independent carrier or bailee, in this sense the right of stoppage in transit begins when the right of lien ends. It is because of this it is said that the right of stoppage in transit is an extension of the right of lien.

Effect of Sub-Sale or Pledge by Buyer

You have earlier read the general rule of law is that the right of lien or stoppage in transit of the unpaid seller is not affected by a sub-sale, pledge or other disposition of the goods by the buyer unless the seller had agreed to such a sale, etc. [Section 53(1)]. For example, A sold certain goods to B of Mumbai and the goods are handed over to railways for transmission to B. In the meantime B sold these goods to C for consideration. B becomes insolvent A can still exercise his right of stoppage in transit.

But there are two exceptions to this general rule when the right of lien and stoppage in transit are affected by a sub-sale, pledge or other disposition of the goods. These exceptions are:

i) **Seller's consent**: In case, the sub-sale or other disposition by the buyer has been done with the consent of the seller, the unpaid seller cannot exercise lien or stoppage in transit. In a case of **Knights v. Wiffen,** A sold to B, 80 mounds of grain out of his granary. B then sold (out of these 80 mounds) 60 mounds to C. A told C that the grain would be delivered to him in due course. B then became insolvent. A's right against 60 mounds is lost since A recognised the title of C, the sub-buyer.

ii) **Transfer of documents of title**: Where a document of title to goods (bill of lading or railway receipt) has been issued or lawfully transferred to any person as a buyer, and the buyer transfers the document to a purchaser who buys them in good faith and for valuable consideration, then the unpaid seller's right of lien or stoppage in transit would came to an end, if the transfer by buyer to the purchaser is by way of sale. For example, A sold certain goods to B and set the railway receipt to B. B, before making the payment of the goods transferred the railway receipt to C for valuable consideration. C buys the goods in good faith. B becomes insolvent. A's right to stop the goods in transit is defeated and C shall get a good title.

   Section 53(2) further provides that *if such transfer of documents of title is by way of pledge, then the unpaid seller's rights are not completely defeated but he can exercise these rights subject to the rights of the pledge*. For example, A sold certain goods to B and sent the railway receipt to B. Without paying for the goods, B pledged the railway receipt with C as a security for a loan of Rs 10,000. Thereafter, B became insolvent. Here, A can get back the railway receipt after paying Rs 10,000 to C.

Check Your Progress B

1. When can the goods be stopped-in-transit?

   ....

   ....

   ....

2. When are the goods deemed to be in transit?

   ....

   ....

   ....

3. How is stoppage in transit effected?

   ....

   ....

   ....

   ....

4. Fill in the blanks

   i) An unpaid seller can exercise the right of lien only when he is in actual possession of ....

   ii) The right of lien is lost when .... over the goods is lost.

   iii) An unpaid seller can stop the goods in transit when ....

   iv) Transit comes to an end when .....,..........

   v) Notice of stoppage in transit can be given either to ....

   vi) If after receiving the notice to stop the goods in transit, the carrier delivers them to the buyer, the carrier shall be liable to ....

5. State whether the following statements are True or False.

   i) The right of stoppage in transit commences only when the right of lien is lost.

   ii) An unpaid seller can exercise the right of stoppage in transit when the carrier holds the goods as seller's agent.

   iii) Transit comes to an end where the wrongfully refuses to deliver the goods to the buyer or his agent.

   iv) Transit does not come to an end when goods are delivered to a ship chattered by the buyer.

   v) When the unpaid seller gives his consent to the sale by the buyer, the right of stoppage in transit is lost.

   vi) Where part delivery has been made, the seller may stop the remainder unless the part delivery shows an intention to give up the possession of the whole.

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19.4.1.3 Right of Resale

You have learnt the two important rights of an unpaid seller against the goods, namely, the right of lien and the right of stoppage in transit. After exercising any of these rights, the seller again gets the possession of the goods which have already been sold by him. Now a question arises as to how long the unpaid seller should wait for the buyer to pay the price and take the delivery of the goods. This question becomes more important in case where the goods are of a perishable nature. Therefore, the unpaid seller has been given another right, and that is, the right to resell the goods. You should note that without this right, the first two rights would become meaningless or burdensome for the seller, for without this right the seller shall have to keep the goods with him.

An unpaid seller who is in possession of the goods can resell them under the following circumstances:

a) **Where the goods are perishable**: The unpaid seller can in such a cases sell the goods without any notice to the buyer. The word 'perishable' does not only mean physical deterioration, it also includes commercially perishable goods. The unpaid seller can resell such goods after the expiry of reasonable time. What is reasonable time is a question of fact depending on the facts of such ease.

b) **Where the seller expressly reserves a right of resale**: In case where the seller expressly reserves right of resale if the buyer commits a default in making the payment, the unpaid seller may resell the goods. The consequence of this resale will be that the original contract of sale will be rescinded but without defeating unpaid seller's right to claim damages Section 544).

c) Where the unpaid seller has given a notice to the buyer about his intention to resell and the buyer does not pay or tender the price within a reasonable time.

If on such resale, the unpaid seller fails to realise the amount which he would have otherwise recovered as price from the original buyer i.e. If there is some loss to the seller, he is entitled to recover this loss from the original buyer. But if there is some profit or surplus on resale, the seller is entitled to keep it with himself, because the buyer cannot be allowed to take advantage of his own wrong i,e., breach of contract.

Notice of Resale: Except in cases of perishable goods and where the seller expressly reserves the right of resale, a reasonable notice to the buyer must be given that he (unpaid-seller) intends to resell the goods. This notice is necessary because of the following two reasons:

i) The buyer is given another opportunity to perform the contract, i.e., pay the price and take the delivery of the goods.

ii) If the buyer is still unable to pay, he can at least supervise the sale and see to it that the goods are sold at a proper price. In this way the buyer can minimise his liability to the seller.

If the unpaid seller fails to give such a notice and resells the goods he cannot claim the loss on such resale from the buyer and in case there is any surplus or profit on such-resale, he cannot keep it, he will have to give it to the original buyer. However, the buyer (who buys in case of resale) shall get good title to the goods against the original buyer, notwithstanding that no notice of resale has been given to the original buyer [Section 54(3)],

It should, however be noted that if the buyer had paid some money, by way of advance or deposit, then this amount can be claimed by him but subject to the seller's claim for damages.

19.4.2 Where the Property in the Goods has not Passed to the Buyer

Where the property in goods has not passed to the buyer then the unpaid seller has, addition to other rights, right to withhold delivery of goods. This right is similar to and is co-extensive with his rights of lien and stoppage in transit where the property has passed to the buyer [Section 46(2)].

19.5 RIGHT AGAINST THE BUYER PERSONALLY

You have studied the rights of an unpaid seller against the goods. In addition to those rights, the seller has certain remedies against the buyer persona1ly. These rights are as follows:

1. **Suit for price**: It is the legal duty of the buyer to pay the price of the goods, where, under a contract of sale, the property in the goods has passed to the buyer and the buyer wrongfully neglects or refuses to pay for the goods according to the terms of the contract, the seller may sue him for the price of the goods [Section 55(1)].

   Where the property in goods has not passed to the buyer, as a rule, the seller cannot file a suit for the price; his only remedy is to claim damages. But Section 55(2) provides that *if the contract of sale stipulates the payment of the price on a certain day irrespective of delivery and the buyer wrongfully neglects or refuses to pay such price, the seller may sue him for the price although the property in goods has not passed*. Thus, you see that transfer of ownership is immaterial. For example, A sold certain goods to B for Rs 10,000 and the price was agreed to be paid after ten days of the contract. B fails to pay the price on the agreed day. A can file a suit for price against B even though the goods have not been delivered or the property in goods has not been transferred to B.

2. **Suit for damages for non-acceptance**: Sometimes, the seller is ready, and willing to deliver the goods to the buyer but the buyer refuses to accept them. In such cases, if the buyer wrongfully neglects or refuses to accept and pay for the goods, the seller may sue him for damages for non-acceptance. What shall be the amount of damages is to be determined in accordance with the provisions laid down in Section 73 of the Indian Contract Act (Please refer to Unit 8 of Block 2).

3. **Suit for interest**: When under a contract of sale, the seller tenders the goods to the buyer and the buyer wrongfully refuses or neglects to accept and pay the price, the seller has a further right to claim interest on the amount of the price. The interest may be calculated from the date of the tender of the goods or from the date on which the price was payable. The unpaid seller can claim interest only when he can recover the price, i.e., if the seller's remedy is to claim damage, then he cannot claim interest. The rate of interest to be awarded is at the discretion of the court.

19.6 RIGHTS OF THE BUYER

So far we have discussed the rights of the seller. But there are certain rights of the buyer as well in case there is a breach of contract by the seller. The buyer has the following rights:

1. **Suit for damages for non-de1ivery**: When the buyer is ready and willing to take the delivery of the goods but the seller wrongfully neglects or refuse to deliver the goods to the buyer, in such cases the buyer may sue the seller for damages for non-delivery (Section 57).

2. **Suit for specific performance**: In a contract of sale of ascertained or specific goods, if the seller fails to deliver the goods, the buyer may file a suit for specific performance. The court may then order for the specific performance. The court shall pass such order in those cases only where the damages are not a suitable remedy or the goods are of a unique nature. For example, A agreed to sell a rare painting to B for Rs. 20,000. Later on A refused to perform his promise. B may ask the court for granting an order directing A to specifically perform his promise.

3. **Suit for breach of warranty**: Where there is a breach of warranty by the seller, or in case where the breach of condition on the part of the seller is to be treated as a breach of warranty, the buyer can claim damages from the seller for such breach. If the buyer has already paid the price, his only remedy is to sue for damages.

4. **Repudiation of contract before due date**: Just as the seller has a right against the buyer, the buyer also has a similar right against the seller. Thus, if the seller repudiates the contract, the buyer has the option to treat the contract as repudiated and claim damages or he may keep the contract open till the date of delivery of goods.

5. **Suit for interest**: If the price has already been paid by the buyer and the seller fails to deliver the goods on due date, the buyer has a right to sue for interest on the amount of the price. The interest will be calculated from the date on which the price was paid. But, you must remember that the buyer can claim interest only when he has a right to recover the price, i.e., he cannot claim interest when his only remedy is to claim damages.

19.7 AUCTION SALES

One of the method of selling the goods is to sell them by auction. Auction sale means a public sale where intending buyers assemble at one place and offer the price at which they are ready to buy the goods. The offer of the price is known as 'bid' and the person making the bid is known as the 'bidder'. The owner of the goods may himself sell them by auction or appoints an 'auctioneer' to sell the goods on his behalf. The relationship between the owner of the goods and the auctioneer is that of the principal and agent. In an auction, as a rule, the goods are sold to the highest bidder.

When goods are to be sold by auction, the auctioneer gives wide publicity regarding the time, date and place of sale. The bidders are also given an opportunity to inspect the goods. As you have already learnt in Unit 2 (offer and acceptance) an advertisement to sell goods by auction is not an offer to sell but it is simply an invitation to the public to make offers. The auctioneer is not bound to sell the goods on the date, time and place announced earlier, he can cancel or postpone the sale and the intending buyers have no right to sue the auctioneer since it was only an invitation and not an offer to the public.

The various rules regarding auction sales are given in Section 64 of the Sale of Goods Act, they are as follows:

i) Where the goods are put up for sale in lots, each lot is prima facie deemed to be the subject of a separate contract of sale [Section 64(1)].

ii) The sale is complete when the auctioneer announces its completion by the fall of the hammer or in other customary manner, for example, by saying "one, two and three" or by shouting "going, going, gone': etc

iii) When the auctioneer announces the completion of the sale, the sale is complete and the property in goods passes immediately to the buyer

iv) Since offers are invited from the public, before the sale is completed, the bidders have a right to withdraw their bid (offer). Until the announcement of the completion of sale is made, any bidder may retract his bid [Section 64(2)].

v) A right to bid may be reserved expressly by or on behalf of the seller, and where such right is expressly reserved, the seller or any one person on his behalf, may bid at the auction [Section 64(3)]. This right is given to the seller so that he can protect his interests in case the buyers agree not to outbid each other. Here it should be noted that the seller can appoint only one person to bid on his behalf. If more than one person is appointed, then it amounts to fraud and sale is voidable at the option of the buyer.

vi) Where the sale is not notified to be subject to a right to bid on behalf of the seller, it shall not be lawful for the seller himself to bid himself at such sale or to employ any such person on his behalf or for the auctioneer knowingly to accept the bid from such person. Any sale contravening this rule may be treated as fraudulent by the buyer [Section 64(4)].

vii) It is quite usual for the auctioneer to announce a 'reserve' price. It is the price below which the auctioneer will not sell. Such a reserve price is fixed by the seller to protect himself from selling the goods at a very low price. Thus, if the highest bid is below the reserve price, the auctioneer by mistake, accepts the bid which is below the reserve price, he can refuse to deliver the goods.

You may note that even where a reserve price is not notified, if the auctioneer feels that the price offered is not upto his expectation, he can refuse to accept the highest bid. This is possible because 'bid' is only an offer which may or may not be accepted by the auctioneer.

viii) If the seller makes use of pretended bidding to raise the price, the sale is voidable at the option of the buyer [Section 64(6)1.

ix) An agreement between the bidders not to bid against each other is called the 'knock-out' agreement. Such an agreement is made to avoid competition among themselves. These bidders agree that only one of them will bid, and anything obtained by him shall be shared privately. Knock-out agreements are valid and not illegal. However, if the intention of the parties to the agreement is to defraud a third parry, such an agreement shall be termed as 'illegal'.

x) Damping is an unlawful act intended to discourage the bidders from bidding. This is done by pointing out 'defects' in the goods or scaring them away so that they may not participate in the auction. Damping is highly undesirable and is illegal.

xi) Puffers are persons employed by the seller for the purpose of raising the price. A puffer has no intention to buy the goods. The seller can appoint only one puffer and not more.

Check Your Progress C

1. When can an unpaid seller resell the goods?

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....

....

....

2. Why is it necessary to give a notice for resale to the buyer?

 ....

 ....

 ....

3. Is the unpaid seller bound to return the surplus realised on resale of goods?

 ....

 ....

 ....

4. What is an auction sale?

 ....

 ....

 ....

5. What is a knock-out agreement?

 ....

 ....

 ....

6. State whether the following statements are True or False.

 i) An unpaid seller is bound to resell the goods.

 ii) In case of perishable goods, the unpaid seller can resell them without giving any notice to the buyer.

 iii) Where a notice of resale has been given to the buyer if there is loss on resale, the unpaid seller can recover it from the buyer.

 iv) Where the seller has expressly reserved the right of resale, the unpaid seller need not give any notice of resale to the buyer.

 v) If notice of resale is not given, the title of the buyer shall be affected.

 vi) Sale by auction is complete when the auctioneer announces its completion by the fall of hammer, or some other customary manner.

 vii) A bidder cannot revoke his bid.

 viii) In an auction sale, the seller has the right to fix a reserve price.

 ix) Where the right to bid at an auction is expressly reserved by the seller, the seller or any one person on his behalf may bid at the auction.

19.8 LET US SUM UP

An unpaid seller is one who has not received the full price or if the price is received in the form of a negotiable instrument, it has been dishonoured. A seller who has been partly paid is also an unpaid seller.

An unpaid seller has two rights - against the goods and against the buyer personally.

Against Good: i) Lien: He has a right to retain the possession of the goods until the price is received. Even if part of the goods have been delivered, lien can be exercised on the remaining goods. Lien is lost when possession of goods is lost. ii) Stoppage-in-transit: When the goods are delivered to a common carrier for transmission to the buyer, and in the meantime the buyer becomes insolvent then goods can be stopped in transit. Goods are said to be in transit from the moment

they are delivered to the carrier and they continue to be in transit till they are delivered to the buyer or his agent. Transit is at an end when the goods are delivered to the buyer or his agent or the carrier acknowledges to the buyer that he is holding the goods on his behalf. For stopping the goods in transit, reasonable notice should be given either to the carrier or to his principal. iii) Right of resale: An unpaid seller can resell the perishable goods without giving any notice to the buyer, but in case of other goods a reasonable notice must be given to the buyer before resale. After giving such a notice, if on resale there is some loss or deficiency, the seller can claim it from the buyer. But if there is some surplus or profit on resale, the unpaid seller can retain it. If notice of resale is not given, these rights are lost.

Against the buyer personally: i) Suit for the price: The unpaid seller can sue the buyer for the price where the property in goods has passed to the buyer. Where the property in goods has not yet passed, the seller can only claim damages. ii) Suit for damages: Where the buyer wrongfully refuses to accept and pay for the goods, the seller may sue him for damages. iii) Suit for interest: The seller can also claim interest on the price from the date of default.

In an auction sale the goods are put up for sale and bids are invited from the public. Auctioneer invites offers and intending buyers make the proposal for stating a price. The goods are sold to the highest bidder. A bidder can revoke his bid before the completion of sale. Auction sale is complete when the auctioneer announces its completion. Once the sale is complete, the property in goods passes to the buyer immediately. Sometimes the seller reserves the right to bid, then the seller or any one person on his behalf can bid at the auction. The auctioneer can notify the reserve price, below which the goods shall not be sold. In an auction sale the auctioneer is not bound to accept the highest bid.

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19.9 KEY WORDS

Auction : It is a public sale, where goods are sold usually to the highest bidder.

Bid : It is the price offered by the intended buyer.

Carrier : One to whom the goods are delivered for transportation to the buyer.

Damping : Any act by which the buyer is prevented from bidding or raising the price at an auction sale.

Insolvent : A person who has ceased to pay his debts or one who cannot pay his debts as they become due.

Knock-out agreement : An agreement among the bidders not to bid against each other.

Lien : A right to retain possession of the goods until the amount due from another is received.

Puffer : A person who is employed by the seller to raise the price and who has no intention to buy the goods.

Reserve Price : The price below which the goods are not to be sold.

Transit : Transit means when the goods are neither in the possession of the seller nor in the possession of the buyer but are with an independent carrier.

Unpaid seller : A seller who has not received the price in full, or the bill of exchange or other negotiable instrument which was received has been dishonoured.

19.10 ANSWERS TO CHECK YOUR PROGRESS

A) 4. i) True ii) False iii) True iv) True v) False vi) False vii) True viii) True ix) True

B) 4. i) goods, ii) possession, iii) the buyer becomes insolvent, iv) goods are delivered to buyer or his agent, v) the carrier or his principal, vi) unpaid seller for conversion

5. i) True, ii). False, iii) True, iv) False, v) True, vi) True

C) 6. i) False ii) True iii) True iv) True v) False vi) True vii) False viii) True ix) True

19.11 TERMINAL QUESTIONS/EXERCISES

1. Define an unpaid seller. What are his rights?
2. Explain the rights of an unpaid seller (i) against the goods and (ii) against the buyer personally.
3. "Right of stoppage in transit is an extension of the right of lien". Comment.
4. Distinguish between the right of lien and stoppage-in-transit.
5. What is the effect of sub-sale or pledge on unpaid seller's right of lien and stoppage in transit?
6. State the circumstances when the transit ends.
7. When can a seller resell the goods? Explain.
8. Explain in brief the rules applicable to an auction sale.
9. Answer the following problems, giving reasons:

   i) A sold some goods to B without any stipulation to deliver the goods until the price is paid. Advise B.

      (*Hint*: A is an unpaid seller, he can exercise right of lien. B can take the delivery of goods only after making payment.)

   ii) Suresh sold fifty bags of rice to Mohan of Kolkata and sent the goods by railways. The railway receipt duly endorsed in favour of Mohan was sent to Mohan. When the goods reached Kolkata, Mohan asked the railways to carry them to Durgapur. In the meantime Mohan became insolvent. Suresh asks the railways to stop the goods. Will he succeed? (*Hint*: No, Goods cannot be stopped because the transit came to an end when the railways agreed to carry the goods to some other place at the request of Mohan (Sec. 51(3).)

   iii) Avinash sells and consigns to Gopal goods worth Rs 20,000 on credit. Gopal assigns the railway receipt to Kumar to borrow Rs 10,000 on the security of railway receipt. Before the goods reach the destination Gopal becomes insolvent. Avinash gives notice to stop the goods in transit but Kumar claims them. Will Avinash succeed in stopping the goods?

(*Hint*: Yes, Avinash can stop the goods but. subject to the pledge of Kumar (Sec. 53).)

iv) Virender sells and consigns goods to Ashok. The price has not yet been paid. Ashok becomes insolvent and while the goods are still in transit, Ashok assigns the railway receipt for cash to Mohan who knows about the insolvency of Ashok. Can Virender stop the goods in transit?

(*Hint*: Yes, Virender can stop the goods because Mohan has not acted in good faith.)

v) Roshan sells to Rajesh a quantity of wheat lying in Roshan's warehouse. It is agreed that Rajesh shall get one month's credit. Rajesh allows the wheat to remain in Roshan's warehouse. Before the expiry of one month's credit Rajesh becomes insolvent. Can Roshan refuse to deliver the wheat to the official assignee?

(*Hint*: Yes, Roshan has the right of lien over the goods (Sec. 47.)

vi) Amar of Delhi orders Basant of Mumbai to deliver certain goods to him at Delhi. Basant sent the goods by railways. When the goods reach Delhi, the railway officials inform Amar that the goods are lying at the station at Amar's risk. Amar became insolvent in the meantime. Can Basant stop the goods in transit?

(*Hint*: No, Basant cannot stop the goods because the transit has come to an end when the railways acknowledge to the buyer that the goods are lying at Amar's risk (Sec. 5 1(3).)

vii) Kranti sold certain furniture by an auction to Manohar. Manohar gave a cheque for the price and took the delivery of furniture. One of the clauses of the agreement was that the property in goods will not pass to the buyer until the cheque was honoured. Manohar sold the furniture to Keshav, Kranti wants the furniture back from Keshav. Will he succeed? (*Hint*: No, sale is complete as the ownership has passed to the buyer. Keshav gets a good title.)

viii) Ashok made a bid for a steel almirah in an auction but withdrew the bid before the fall of the hammer, one of the condition of the sale was "bid once made cannot be withdrawn" and Ashok was aware of this condition. Auctioneer sued Ashok for the price. Will he succeed?

(*Hint*: No, Ashok is not liable for the price, because he can withdraw his bid before the completion of sale. (Sec. 64(2).)

Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your own practice only.

SOME USEFUL BOOKS

M. C. Kuchhal, and Vivek Kuchhal, Business Law, Vikas Publishing House, New Delhi.

Avtar Singh, Business Law, Eastern Book Company, Lucknow.

S. N. Maheshwari and SK Maheshwari, Business Law, National Publishing House, New Delhi.

G. K. Kapoor Business Laws, Scholar Tech Press, New Delhi.

P. C. Tulsian and Bharat Tulsian, Business Law, McGraw Hill Education.

Sharma, J. P. and Sunaina Kanojia, Business Laws, Ane Books Pvt. Ltd., New Delhi.

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6

NEGOTIABLE INSTRUMENTS ACT

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BLOCK 6 NEGOTIABLE INSTRUMENTS ACT

The law relating to negotiable instruments is contained in the Negotiable Instruments Act, 1881. This came into force on March 1, 1881. The Act extends to whole of India except the State of Jammu and Kashmir. The Negotiable Instruments Act 1881 has 140 Sections. The Act defines the key terms used in it (sections 4 to 25), the parties involved and their liabilities as well as rights (sections 26 to 45), the intricacies involved in the act of negotiation (sections 46 to 60), presentment for acceptance/payment (sections 61 to 87), the mode of getting discharged from liabilities (sections 82 to 90), and the actions arising out of dishonour, etc. (sections 91 to 117). The rest of the Act deals with rules of evidence, some general presumptions about negotiable instruments, special provisions on crossed cheques, etc.

This block, briefly examines the most relevant parts of the Act to give an understanding of the legal implications of these instruments and their negotiation. It gives a practical knowledge, as may be relevant to a student of commerce, so that you can write/draw a valid instrument and discriminate between a good and a bad document. This block comprises of four units.

Unit 20 discusses the meaning and characteristics of negotiable instruments, law relating to ambiguous and inchoate instruments, and capacity and liabilities of various parties. It also deals with the meaning and privileges of holder and holder in due course.

Unit 21 deals with the meaning and distinctive characteristics and implications of different negotiable instruments.

Unit 22 explains the difference between negotiation and assignment, requisites of a valid negotiation, meaning of negotiation back and liabilities of various parties. It also discusses the legal implications when the instruments are forged, lost or stolen, and obtained by fraud or unlawful consideration.

Unit 23 is concerned with the law relating to presentment for acceptance as well as for payment, and also the law relating to the discharge from the liability arising out of the instrument.

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UNIT 20 NEGOTIABLE INSTRUMENTS AND ITS PARTIES

Structure

20.0 Objectives

20.1 Introduction

20.2 Meaning of a Negotiable Instrument

20.3 Essentials of a Negotiable Instrument

20.4 Presumptions about Negotiable Instruments

20.5 Ambiguous Instruments

20.6 Inchoate Instrument

20.7 Capacity and Liabilities of Various Parties

- 20.7.1 Parties to Various Instruments
- 20.7.2 Competence of a Person to be a Party to a Negotiable Instrument
- 20.7.3 Liability of Various Parties

20.8 Holder

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20.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning of a negotiable instrument and its negotiability;
- narrate the implications of ambiguous and inchoate instruments;
- explain the different parties to various negotiable instruments, their capacity, and liabilities under certain circumstances;
- state the factors that affect the negotiability of an instrument;
- describe the 'holder in due course' of a negotiable instrument; and
- describe the privileges of a holder in due course.

20.1 INTRODUCTION

This is the first unit on negotiable instruments. In this unit you will study the meaning, characteristics and presumptions of negotiable instruments, law relating

to ambiguous and inchoate instruments and capacity and liability of various parties to instruments.

You will also study the meaning and privileges of holder and holder in due course.

20.2 MEANING OF A NEGOTIABLE INSTRUMENT

An "instrument" as referred to in the Negotiable Instruments Act, 1881, is a legal document or a legally recognised written paper. **Negotiable Instrument** means a written document which creates a right in favour of some person and which is freely transferable. It has the unique advantage of negotiability i.e., transferable with a simple procedure requiring just a signature and delivery. The ownership right (called title' or 'property') in a negotiable instrument can be transferred by a signature on the back of the instrument and delivery to the person to whom the transfer is to be made. The law recognises such a way of transfer of a negotiable instrument and will protect it. Easy negotiability has unique feature which is not there for other documents. For instance, if you have a document evidencing the ownership of a piece of agricultural land, you have to follow certain legal formalities to transfer the ownership rights. If you simply sign on the back and deliver the land document to the buyer, the law will neither consider it valid nor protect the action. Negotiable instruments become necessary for the faster and easy transfer of money, particularly in business. These instruments have also become a convenient addition to currency because they are transferable almost as easily as currency notes.

The Negotiable Instruments Act 1881 deals with only three specific classes of negotiable instruments, which are in common use. They are: (1) promissory note, (2) bill of exchange, and (3) cheque payable either to order or to bearer. The Act does not consider all kinds of instruments which have an element of negotiability in them, such as bills of lading, railway receipts, delivery orders on warehouses, etc. Hence an instrument may be a negotiable instrument and yet may not come under the purview of this Act. It has been held that hundi or document in vernacular is not governed by this Act even though it may be a negotiable instrument by custom and practice in a business community.

As defined by the section 13 of the Act, "negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer".

"Explanation I— A promissory note, bill of exchange or cheque is payable to order which is expressed to be so payable or which is expressed to be payable to particular person, and does not contain words prohibiting transfer or indicating an intention that it shall not be transferrable".

"Explanation II —A promissory note, bill of exchange or cheque is payable to bearer which is expressed to be so payable or on which the, only or last endorsement is an endorsement in blank".

"Explanation III — Where a promissory note, bill of exchange or cheque, either originally or by endorsement, is expressed to be payable to the order of a specified person and not to him or his order, it is nevertheless payable to him or his order at his option.

"A negotiable instrument may be made payable to two or more payees jointly or it may be made payable in the alternative to one or two, or one or some of several payees".

Since this is one of the most important sections of the Act, it has been reproduced in full. It should be read with due emphasis on each and every word in it.

The provisions noted are subject to Section 31 of the Reserve Bank of India Act 134. It provides that:

a) No person in India other than the RBI or the Central Government can make or issue a promissory note 'payable to the bearer'.

b) No person in India other than the RBI or the Central Government can draw or accept a bill of exchange 'payable to bearer on demand'.

c) A cheque 'payable to a bearer' on demand can be drawn on a person's account with a banker.

The implications of the provisions of section 31 of RBI Act are:

a) No matter whether a promissory note is payable on demand or after a certain duration, it can never be originally made payable to the bearer.

b) A bill of exchange can be made originally payable to bearer, but if it is payable to bearer, it cannot be made payable on demand, it can be made payable only to order. Subsequently, on endorsement in blank, it can be made payable to bearer on demand.

As discussed earlier, negotiable instruments mean promissory note, bill of exchange and cheque. Let us now have a brief description of these three instruments (a detailed description is presented in Unit 21).

A promissory note contains an undertaking i.e., it contains a promise to pay money. It is "*an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument*" (section 4). It is stamped and designed by its drawer or the maker. It is payable to a payee Study the specimen of a promissory note presented below.

Specimen of a Promissory Note

Place : New Delhi
Date: 17 Feb 2019

Rs. 50,000

On Demand I promise to pay to Shri Ram Kumar or order a sum of Rupees Fifty Thousand only, for value received.

Signature of S. Gupta
on Revenue Stamp

To
Shri Ram Kumar
220 Asiad Village
New Delhi-110049

A bill of exchange contains an order to a person called the drawee. It is "*an instrument in written containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of a certain person or to the bearer of the instrument*" (section 5). It is stamped and signed by the drawer or maker. The order or direction is given to the drawee to pay a certain sum of money (at sight or after a certain time) to another person called payee. The drawee by accepting it to honour (when the time for payment comes) becomes the acceptor. Study the specimen of a bill of exchange presented below.

Specimen of a Bill of Exchange

Place : New Delhi
Date: 17 Feb, 2019

Rs. 50,000

On Demand I promise to pay to Shri Ram Kumar or order a sum of Rupees Fifty Thousand only, for value received.

Signature of S. Kumat
on Revenue Stamp

Accepted
Krishnan

To
Shri Krishnan
K-76 Hauz Khas
New Delhi-110016

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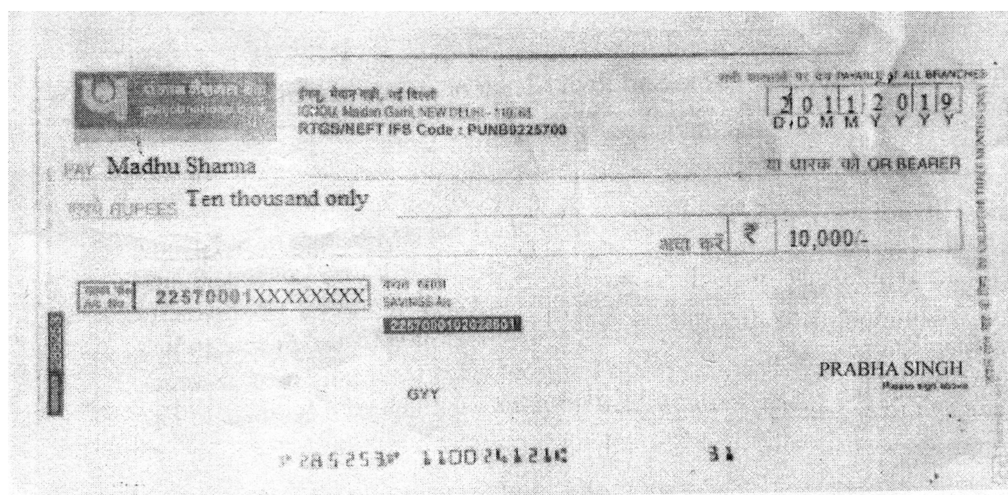
In this bill of exchange Mr. S. Kamat is the drawer and Krishnan is the drawee. Krishnan when gives his acceptance, is the acceptor. The above bill is delivered to Mr. Ram Kumar and thereby he becomes the 'holder'. When Ram Kumar wants to negotiate he signs on the back side and delivers to Mr X. On receiving the value he becomes the indorser and Mr X becomes the indorsee.

A cheque is "*a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand*" (section 6). A cheque is drawn and signed by a drawer directing a banker (the drawee) to pay on demand a certain sum of money to a payee. No stamp is required.


RTGS/NEFT IFS Code : PUNB0225700
2 0 1 1 2 0 1 9
D D M M Y Y Y Y
PAY Madhu Sharma
OR BEARER
RUPEES Ten thousand only
₹ 10,000/-
22570001XXXXXXXX
SAVINGS A/c
PRABHA SINGH

.

In this cheque Prabha Singh is the drawer, the Punjab National Bank is the drawee and Madhu Sharma is the payee. When Madhu Sharma wants to negotiate, she signs on the back to become the indorser. The specimens presented here are simple versions of these instruments to make a beginning. More will be discussed in Unit 21.

When an instrument is to be transferred to a person other than the one mentioned as the drawee in the **instrument**, it is done by indorsement i.e., signing by the drawee on the back side of the instrument. The person in whose favour the indorsement is made or who becomes a holder after the indorsement, is known as **indorsee**. There can be many consecutive indorsements and, therefore, many successive indorsees.

20.3 ESSENTIALS OF A NEGOTIABLE INSTRUMENT

The following are the essential characteristics of a negotiable instrument :

1) It is essential for the negotiability of an instrument that it should be expressed to be payable to order or bearer or some other equivalent words should be used authorising the payee to assign or transfer the same to a third person. Hence, an instrument, to be negotiable, must be made or drawn payable in one of the following forms, viz., "To A or order",."To the order of A", "To A or bearer", or "To bearer". It is not necessary that the form "To.... should be used. Any other word/form (e.g., pay to the order of A) conveying the same meaning will be equally effective. Necessary details regarding the three different instruments will be discussed in Unit 21.

   The paper currency (currency note) issued by the Government/Reserve Bank of India is one in which the value is payable to bearer. The Reserve Bank of India Act, 1934, states that no person other than the Reserve Bank or the Central Government can draw, accept, make or issue any bill of exchange, hundi, or promissory note payable to bearer on demand. Similarly, promissory notes are not to be made or issued as payable to bearer (Sections 31 and 32 of the Reserve Bank of India Act). Thus, the free negotiability is conditioned to some extent. Even though the bill or note cannot be drawn /made payable to bearer on demand, the endorsement in blank can still make it a bearer document. The cheque has not been brought under the above restriction.

2) It is already stated that a negotiable instrument means a promissory note, bill of exchange, or cheque payable either to order or to bearer. It is payable to order when it is expressed to be so payable and also when it is payable to a particular person and does not contain words prohibiting transfer or indicating an intention that it shall not be transferable. Though the Act deals only with three kinds of negotiable instruments mentioned above, it does not mean that there can be no other kinds of negotiable instruments at all. Negotiability of an instrument is also accepted by widely practised custom and long usage amongst merchants. To decide whether a certain instrument is negotiable or not, the test is not to see whether it is mentioned in section 13 of the Act. As stated in a case if "*an instrument is by the custom of trade transferable, like cash, by delivery, and is also capable of being sued upon by the person holding it pro tempore then it is entitled to the*

*name of a negotiable instrument, and the property in it passes to a bonafide transferee for value though the transfer may not have taken place in the market ove*r".

Thus, there are several instruments which are not referred to in section 13 but are negotiable by custom and usage. Accordingly, dividend warrants are negotiable by custom. But share certificates, with blank transfer deeds indorsed in blank by their registered owner, and deposit receipts are not negotiable instruments. A railway receipt can also be transferred by indorsement according to the mercantile custom, and the indorsee is competent to maintain a suit for the loss of goods against the railway administration concerned.

3) You must be aware of crossed cheque with words "A/C payee only", payable to order or to bearer. In a negotiable instrument, if the words "not negotiable" are used with special crossing, then it is still transferable but not negotiable. The Act does not provide specifically for a crossing 'A/c payee' or 'A/c payee only'. It seems that an indorsement or crossing containing the words "A/c payee" or "A/c payee only" does not restrict the negotiability of the instrument. It is only a direction to the collecting banker to put the money into the account of the person shown as the payee, on the face of the instrument. The only result of such crossing is that when it is put into the hands of the collecting banker, he is cautioned that the money must be put into the account of the payee only and not in any other account, and if the money is put into some other account, the banker is liable for negligence

4) *"When a promissory note, bill of exchange or cheque is transferred to any person, so as to constitute that person the holder thereof, the instrument is said to be negotiated*" (section 14).

A negotiable instrument may be transferred in one of the two ways (1) by negotiation, or (2) by assignment. The Act deals only with the former mode of transfer. Transfer of actionable claims is dealt with by the Transfer of Property Act. The present section is confined in its application to promissory notes, hundis, bills and cheques. Hence, when such a document is transferred to a person by indorsement or delivery, or by both, as laid down in this Act, the instrument is said to be negotiated, as distinct from transfer by means of a document under the Transfer of Property Act. Thus, if the instrument is payable to bearer, it may be negotiated by mere delivery and no indorsement is needed. But where the instrument is payable to order, the transfer will be effected by indorsement and delivery. The payee or indorse is a 'holder' by negotiation.

5) "*When the maker or holder of a negotiable instrument signs the same, otherwise than as such maker, for the purpose of negotiation, on the back or face thereof or on a slip of paper annexed thereto, or so signs for the same purpose a stamped paper intended to be completed as a negotiable instrument he is said to indorse the same and is called the 'indorser"* (section 15).

The word 'indorsement' means the signing of one's name on the instrument or any paper attached to it with the clear intention of transferring the same thereby. However, an indorsement is usually made only on the back of the instrument. It is not essential for its validity that it should be written only on

the back. An indorsement made on the face of the instrument as good as the one made on the back of it.

An instrument is said to be negotiated when it is transferred under such circumstances as to make the transferee, the holder of it. Sections 47 and 48 deal with the mode of transfer. (The meaning of 'holder' is discussed later in this unit). If the instrument is payable to order, it can be negotiated only by indorsement and delivery. If it is payable to bearer, it can be negotiated by mere delivery.

The important difference between transfer by indorsement and transfer by modes other than indorsement of a negotiable instrument is that with the latter case the assignee will acquire the instrument as any other movable property, no more than the right, the title and interest of his transferor (assignor). whereas in the former case, the assignee, by indorsement, will have all the rights and advantages of a "holder in due course" of a negotiable instrument (the holder-in-due-course has been explained in detail later in this unit).

The characteristics of a negotiable instrument considered so far may be summarised as follows:

1) Three types of instruments are specifically recognised by the Act. They are promissory notes, bills of exchange and cheques.

2) Negotiability or freely transferable character is their nature.

3) It should be expressed in the instrument that it is payable to order or bearer.

4) Hundi is a bill of exchange in vernacular.

5) 'A/c Payee' crossing on a cheque directs the collecting banker to put the money into the account of the payee.

6) Indorsement is done by signing, by convention, on the backside of the instrument.

Check Your Progress A

1. Differentiate between negotiability and assignment.

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2. A promissory note is a negotiable instrument. Can it be drawn as payable to bearer?

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3. How does the Reserve Bank Of India Act restrict the negotiable instruments?

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4. Tick mark the appropriate answer.

   a) A negotiable instrument payable to order can be negotiated by:

      i) indorsement

      ii) indorsement and delivery

      iii) delivery by the drawer

      iv) delivery by the holder

   b) An instrument which resembles a bill of exchange is known as:

      i) promissory note

      ii) bill of invoice

      iii) hundi

      iv) currency note

   c) Which one of the following is a negotiable instrument by custom and usage among businessmen?

      i) share certificate

      ii) deposit receipt

      iii) dividend warrant

      iv) demand draft

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20.4 PRESUMPTIONS ABOUT NEGOTIABLE INSTRUMENTS

Sections 118 and 119 of Negotiable Instruments Act lay down certain general presumptions in respect of negotiable instruments. These presumptions are said to prevail unless the contrary is proved. The presumptions are as follows:

1) **Consideration:** Every instrument was made, drawn, accepted, indorsed or transferred for consideration.

2) **Date:** Every instrument bearing a date was made **or** drawn on such a date only.

3) **Time of acceptance:** Every accepted bill of exchange was accepted within a reasonable time after its date and before its maturity.

4) **Time of transfer:** Every transfer of a negotiable instrument was made before its maturity.

5) **Order of indorsement:** The indorsements appearing upon a negotiable instrument were made in the order in which they appear thereon.

6) **Duly Stamped:** A lost instrument was duly stamped.

7) **Holder:** The holder of a negotiable instrument is also a holder-in-due-course,so long as it is not proved that the holder has obtained the instrument from its lawful owner by committing an offence (fraud) or for unlawful consideration.

8) **Protest:** In a suit upon an instrument which has been dishonoured, the court shall presume the fact of dishonour on proof of the protest.

There can be no other presumptions beyond what have been specifically listed in the Act. For example, when the date is found on the note, the presumption is that it was drawn only on that date and not that it was inserted later. One has to prove if he wants to dispute the date of entering the date. All the above presumptions can be rebutted by the defendant.

20.5 AMBIGUOUS INSTRUMENTS

An instrument which in form or terms is such that it may either be treated as a bill of exchange or as a promissory note, is an **ambiguous instrument.** According to section 17. *"Where an instrument may be constructed either as a promissory note or bill of exchange, the holder may, at his election, treat it as either, and the instrument shall henceforth treated accordingly*".

In the following cases, the instrument is taken as ambiguous:

a) Where drawer and drawee are the same person.

b) Where drawee is a fictitious person.

c) Where drawee is a person incapable of entering into a contract.

Where an instrument is so ambiguous in form as to be capable of being treated either as a bill of exchange or promissory note, it is in the option of the holder to treat it as either. But once this position is exercised, it cannot altered later. Bills drawn by an agent on the principal, or by one branch of a bank on another, are ambiguous instruments. For example : A draws a bill on B and negotiates it. B is a fictitious person. The holder may treat the bill as a promissory note by A. He need not prove presentment or give notice of dishonour.

Two more points may be remembered here : 1) When there is a discrepancy between the amount written in figures and words, the law states that the amount stated in words shall be the amount undertaken or ordered to be paid (section 18). The instrument is not invalidated by obvious and intelligible mistakes. 2) A promissory note or bill of exchange, in which no time for payment is specified, is to be taken as payable on demand (section 19).

20.6 INCHOATE INSTRUMENT

The term inchoate instrument means an incomplete instrument. A negotiable instrument properly stamped and signed but blank or incomplete in some respect is called an **inchoate instrument**. In business, sometimes persons may sign on blank stamped papers to be afterwards duly filled up (the name of the drawee or the date or the rate of interest or the date of repayment, etc. may be left blank) and used as bills of exchange or promissory notes. Such signatures on a blank paper carry an authority to the holder to fill up and complete the instrument, and

when done so, the signer becomes liable in the document in which he signs. By such signature on a blank paper, a person is bound himself as a drawer, maker or acceptor or indorser.

According to section 20, which deals with inchoate stamped instruments, when an incomplete instrument is signed by A and delivered to B. it provides the latter with **prima facie** authority to complete it and if, in execution of that authority, the instrument is completed, A will be liable on it to a holder in due course. However, this section is not applicable to cheques since they do not require a stamp. The right of filling up the blanks and completing an inchoate instrument is not confined to the first holder and it may be exercised by any of the holders.

Where a promissory note is properly stamped, signed and delivered to another person, and a space is left blank in the note for entering the name of the payee, the person to whom the note is delivered may even, and has authority to fill in his own name as payee.

An inchoate instrument is to be distinguished from an ambiguous instrument. Though a person may incur liability by signing and delivering an inchoate instrument, the liability does not arise until the instrument is filled up. A suit on the basis of a blank promissory note is not maintainable. On the other hand, where an instrument is ambiguous, the holder of it is not thereby precluded from suing upon it. He may elect to treat the instrument as a note or bill and having made the choice, can bring a suit upon it. An instrument in the form of a bill, but without the name of the payee or of the drawer, is an inchoate instrument, though it is addressed to a person and is accepted by him.

Check Your Progress B

1. A draws a bill on B and negotiates it with C. B is a fictitious person. As the name of a non-existent person is entered. state legal status of this instrument.

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2. A was given a note in which the amount to be paid was left blank. Is this instrument valid? If yes, how?

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3. How an inchoate stamped instrument becomes a valid instrument?

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   ....

4. How does an ambiguous instrument becomes a valid negotiable instrument?

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5. What is the presumption of the law regarding a stamp on a lost instrument?

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6. A's signature is found on a promissory note. Can we presume that it is his signature and could not be that of anybody else?

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7. In a cheque the amount in figures is written as Rs. 5,000 but in words it is written as Rs. 500. What amount is considered as the amount undertaken or ordered to be paid?

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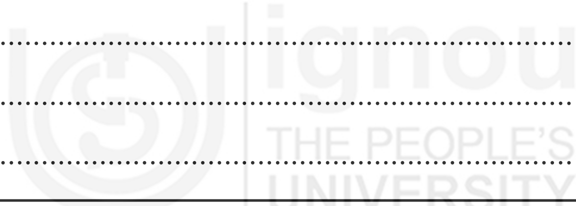

20.7 CAPACITY AND LIABILITIES OF VARIOUS PARTIES

20.7.1 Parties to Various Instruments

We have already mentioned about some parties to instruments when we have discussed the meaning of negotiable instruments. Let us now identify the parties to various instruments.

Parties to a Bill of Exchange

Drawer and Drawee : A person who has made a bill of exchange is a 'drawer' whereas **a** person who is directed by the drawer to pay the money is called the 'drawee**'.**

Payee: The person named in the instrument to whom or to whose order the money is directed to be paid by the instrument.

Indorser and Indorsee: When the holder transfers or indorses the instrument to someone else, the holder is called 'indorser' and the person to whom it is indorsed is called 'indorsee'.

Holder : The person who is legally entitled to the possession of the negotiable instrument in his own name and to receive the amount thereof

Parties to a Promissory Note

Maker: The person who promises to pay the amount stated in the note.

Payee: The person to whom the amount of the promissory note is payable.

Holder: Either the payee or the person to whom the promissory note might have been indorsed.

Parties to a Cheque

Drawer: The person who had deposited money in the bank and drawn the cheque.

Drawee : The banker on whom the cheque is drawn.

Payee : The person who is entitled to receive the payment of a cheque.

20.7.2 Competence of a Person to be a Party to a Negotiable Instrument

Section 26 states that "*every person capable of contracting, according to. the law to which he is subject, may bind himself and be bound by the making, drawing, acceptance, indorsement, delivery and negotiation of a promissory note, bill of exchange or cheque*".

The contractual capacity of a person enables him to become a party to an instrument. **Capacity** means competence to contract so as to bind oneself. **Authority**, on the other hand, means ability to contract on behalf of another so as to bind the other. Capacity to contract is governed by law whereas authority is found in the act of the parties.

As you know, there is no bar in the Contract Act disqualifying a person from becoming a promisee or payee. So, a person incapable of contracting cannot bind himself but may bind others under certain circumstances. The same principle holds good in the case of negotiable instruments also. When some of the parties to a negotiable instrument are capable of contracting and others are not, the capable parties are bound while incapable parties are not. Let us now discuss the provisions of law regarding the different cases of incapacity with regard to negotiable instruments.

Minor: As you know, a person domiciled in India is a minor until he has completed his eighteenth year unless, before the completion of the eighteenth year, a guardian has been appointed for his person or property or both by court of Justice, or before the completion of the eighteenth year, the Court of Wards has assumed superintendence of his property, in both the cases minority continues until the person has completed his twenty-first year. Though he may have completed 18 years, the effect of appointment is not nullified by virtue of subsequent death of the guardian or the cancellation of order of guardianship prior to attainment of majority

According to section 26, "*a minor may draw, indorse, deliver and negotiate a negotiable instrument so as to hold all parties, except himself, liable.*" Thus, a minor cannot bind himself by drawing, indorsing, delivering and negotiating an instrument, and the instrument will be valid and binding on all parties except the minor.

Partnership Firm: The partner of a trading firm had an implied authority to draw, accept or negotiate negotiable instruments. But in the case of a non-trading firm a partner cannot do so unless he has an express authority to that effect. In both the cases, however, liability must be incurred in the name of the firm so as to bind all the partners of the firm.

Insolvent: An insolvent does not have the contractual capacity to draw, make, accept or indorse any negotiable instrument which would make his estate liable. He can, however, validly indorse an instrument of which he is the payee or indorsee to a holder-in-due-course.

Agent: A person who is competent to make, draw, or accept a negotiable instrument himself may also do so through an agent. An agent can execute a negotiable instrument, so as to bind the principal, only in the capacity for which he has been specially and expressly authorised. Mere authority to carry on business or to make and receive payments does not amount to authority to negotiate instruments.

Company : A joint stock company or a corporation can be a party to a negotiable instrument if it is authorised so by its Memorandum or Articles of Association. However, a trading joint stock company has an implied power to draw, accept or negotiate negotiable instruments.

Legal Representatives : Legal representative of a deceased person can deal with the negotiable instrument belonging to the deceased to the extent as the deceased could have done. He should limit the liability to the extent of the assets inherited by him from the deceased. However, by adding the words such as "without recourse" or "without recourse to me personally" to his signature, a legal representative can avoid his personal liability.

Alien Enemies: An alien enemy is a person who is resident in a country with which the Government has declared war. A bill drawn to or indorsed by an alien enemy cannot be enforced even after peace is concluded.

20.7.3 Liability of Various Parties

As you know, a contract with a **minor** does not create a legal contractual relationship between the parties. It is simply void. Therefore, negotiable instruments made or drawn or accepted by minors do not bind them. They are not precluded from denying their liability on the ground of want of capacity to contract, even against bonafied holders for value. Subsequent ratification by a person on attaining the age of majority, a transaction entered into while he was still a minor does not form a valid contract to maintain a suit. The property of a minor (not the minor as a person) is liable for debts arising out of 'necessaries' supplied to the minor.

The position of a **lunatic** is similar to that of a minor. A **married woman** is competent to enter into contract. She can enter into contract and render herself liable to the extent of her separate property. This Act also exempts husbands from liability for the debts of their wives incurred before marriage.

When a person is adjudicated as **insolvent**, his entire property including bills of exchange, promissory notes and other negotiable instruments pass to the Official Assignee or Official Receiver. Therefore, he loses power of disposal over his property and he becomes incompetent to sue and incapable of being sued in his own name.

An **agent** who signs his name to a negotiable instrument without disclosing the name of the principal, or without indicating that he is signing as agent, or that he does not intend thereby to incur personal responsibility, is liable personally on the instrument, except to those who induced him to sign upon the belief that the principal only would be held liable (section 28). Study the two signatures presented below and understand the difference:

i) (Sd) XXXXX
Prakash
Partner
Prakash & Co., Madras-2

ii) For and on behalf of
Prakash & Co. Madras-2
Prakash (Sd) XXXXX
Partner

The first signature is an example in which Mr. Prakash will be held personally liable, whereas in the second signature there is an indication that he is signing as an agent (the partner being an agent of the partnership firm). Where a promissory note is executed by an agent there must be a clear suggestion or indication on the face of the note that the principal is the real debtor. An undisclosed principal cannot he sued. Where an agent signs in excess of his authority or without the authority of the principal, he is not personally liable on the instrument although he is liable to be proceeded against deceit or breach of authority.

A **legal representative** of a deceased person who signs his name to a promissory note, bill of exchange, or cheque is liable personally thereon unless he expressly limits his liability to the extent of the assets received by him as such (section 29).

Cheek Your Progress C

1. Mr. Raman signed a pronote as "Raman, Agent of Mr. Ravindran". Is Raman personally liable?

   ....

   ....

   ....

2. Among the following persons state with reason who can be held personally liable on an instrument?

   a) An agent signing without disclosing the principal.

      ....

   b) A minor signing a note for necessaries.

      ....

   c) A partner signing on behalf of the firm.

      ....

   d) A director signing on behalf of his company.

....

3. Differentiate between authority and capacity.

....

....

....

....

....

4. What is the liability under an instrument payable to an alien enemy?

....

....

....

....

....

20.8 HOLDER

The 'Holder' of a promissory note or bill of exchange or cheque means a person entitled in his own name to the possession of that instrument. He also has the right to receive or recover the amount due thereon from the parties to the instrument. Where the note or bill or cheque is lost or destroyed, its holder is the person who was entitled to be so at the time of such loss or destruction (section 8). The term 'Holder' does not include a person who though in possession of the instrument, has not the right to recover the amount due there on from the parties thereto. It is. therefore, clear that in order to be a holder a person must satisfy the following two conditions

a) He must be entitled to the possession of the instrument in his own name.

b) He must be entitled to recover the amount due on the instrument from the parties liable under the instrument.

The holder of a negotiable instrument can give title to any person honestly acquiring it. It is the very essence of a negotiable instrument that the person in possession of it may he treated as having authority to deal with it. unless something is known to the contrary.

A benamidar is a person who has simply lent his name as the real owner. The Act does not recognise such a practice and, therefore, the person whose name is mentioned, whether real or **benami,** is to he held the holder.

The significance of the 'holder' also lies in the fact that the Act states that payment of the amount due on a negotiable instrument' must in order to discharge the maker or acceptor, be made to the 'holder' of the instrument (section 78). The holder, therefore, is the only person who can sue upon the instrument, and can give a valid discharge for it.

20.9 HOLDER IN DUE COURSE

20.9.1 Who is a Holder in Due Course?

Section 9 defines "holder-in-due-course as any person who for consideration became the possessor of a promissory note, bill of exchange or cheque if payable to bearer, or the payee or indorsee thereof, if payable to order, before the amount mentioned in it become payable and without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title"

From the above definition, the essential qualifications of the holder in due course may be stated as follows:

1) It is necessary that the holder should have acquired the instrument for valuable consideration and in good faith. The consideration for the note or bill should be lawful. The title of a person who negotiates a bill or a note is defective when, for instance, he obtains the instrument or acceptance thereof by fraud, duress, force, fear or other unlawful means or for illegal consideration. No person can claim title to any negotiable instrument through a forged endorsement except in the case of a banker making a payment in due course.

2) It is necessary in the case of an instrument payable to bearer that the holder in due course is in possession of it.

3) The holder must have obtained the instrument before maturity. Once an instrument payable before a fixed period of time reaches its maturity, it has exhausted its life and is no more negotiable. An instrument payable on demand is current at least as long as no more negotiable. The law of limitation is applicable in the case of a promissory note. The banks insist that a cheque should be encashed within three months of the date of its issue.

4) The instrument should be complete and regular on the face of it. It is the duty of every person who takes a negotiable instrument to examine its form for if it contains any material defect, he will not become a holder-in-due-course.

5) The holder should have received the instrument in good faith. There are two possible methods of ascertaining whether a person has good faith or not. One method is testing the person's intentions or motives and the other method is to find out whether he took due care and caution.

   To sum up, if a person is to be called or treated as a holder-in-due-course, he must show:

   a) that he became the possessor of the promissory note. bill of exchange or cheque, if payable to bearer **:** i) before the amount mentioned in it became payable; and ii) without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title: or

   b) that he became the payee or indorsee of the promissory note, bill of exchange, or cheque, if payable to order : i) before the amount mentioned in it became payable; and ii) without having sufficient cause to believe that any defect existed in the title of the person from whom he derived his title.

A holder who derives his title from a holder in due course has the rights of a holder in due course.

20.9.2 Privileges of a Holder in Due Course

Every holder is deemed **prima facie** to be a holder in due course. Thus, the responsibility of providing his title does not lie on him. It is for the defendant to prove it. A holder in due course has all rights and power of a holder and in addition holds the bill free from any personal defect of title of his immediate predecessors. The holder in due course of a promissory note can recover the amount of the promissory note from the maker and the payee, irrespective of their respective liability as between themselves.

For example, A, the holder of a Bill, indorses it to B, who is a minor (therefore cannot he made liable). The Bill is stolen from B by C who forges B's indorsement and sells the Bill to D for value. D is a holder-in-due-course and is entitled to sue A and all parties prior to A such as the drawer, the acceptor and all prior indorsees, if any. He can also sue C but not B. This means that D holds the bill free from the defect in title caused by C's theft and forgery.

In an inchoate stamped instrument, wherein, for instance, when the drawee fraudulently fills up a higher amount than what was intended by the drawer (but sufficiently covered by the stamp put on the instrument) and disposed of for value without anybody suspecting the fraud, the holder in due course is protected.

The acceptor of a bill of exchange, as against the holder in due course, cannot say that the other parties to the bill were fictitious.

The party liable to pay an instrument, cannot as against a holder in due course, contend that he had lost the instrument or that it was obtained from him by means of an offence or fraud, or for an unlawful consideration.

A holder who receives an instrument from holder in due course gets the rights of the holder in due course, even if he had knowledge of the prior defects, provided that he was not a party to them.

Check Your Progress D

1. In order to get duly discharged, to whom the payment of the amount due on a negotiable instrument must be made.

   ....

   ....

   ....

   ....

2. State with reasons whether the following persons can be considered as holder in due course.

   a) The assignee of a promissory note.

      ....

      ....

b) The donee of a negotiable instrument.

....

....

c) The debtor indorses and hands over to his creditor a negotiable instrument in discharge of his pre-existing debt.

....

....

3. Differentiate between a holder and a holder in due course.

....

....

....

20.10 LET US SUM UP

A written document which creates a right in favour of some person and which is freely transferable is a negotiable instrument. The Negotiable Instruments Act 1881 deals with three specific classes of negotiable instruments, viz., promissory note, bill of exchange and cheque. The Act does not consider other kinds of instruments which have an element of negotiability in them. Easy negotiability is the unique feature of the negotiable instruments. Negotiability is made possible by delivery or indorsement and delivery. Indorsement is done by signing, by conversion, on the backside of the instrument. The Act lays down certain presumptions in respect of negotiable instruments. These presumptions are said to prevail unless the contrary is proved.

When the instrument appears like both a bill of exchange and promissory note, its ambiguity can be cleared by opting to take it either as a bill or as a note. It is in the option of the holder to treat it as either. But once this option is exercised, it cannot be altered later. Incomplete instruments can gain currency when the blanks in them are duly filled in.

Capacity to contract by minors, agents, legal representatives, partnership firm, company, insolvent, etc., are determined by the Law of Contract. Holder of a negotiable instrument is a person who possesses the instrument in his own name and has given the consideration and also has the right over it. A holder in due course is one who has obtained the instrument by paying the consideration value and is not aware of any defect in the transaction prior to his possession. He is protected and, therefore, gets a better title than the holder.

20.11 KEY WORDS

Ambiguous Instrument: An instrument drawn incompletely in such a way that it can be taken either as a bill of exchange or promissory note.

Benamidar: A person who has lent his name in the place of a real owner.

Drawer: A person who writes and signs an instrument. He directs to pay in the case of a bill and cheque, but the maker of a note undertakes to pay. He is also known as maker.

Indorsee: The transferee or the person in whose favour the instrument has been indorsed.

Indorsement: The signature of the indorser, usually on the backside of the instrument with or without the name of the transferee.

Indorser: The maker, drawer, payee or indorsee who may indorse an instrument. The indorser of a bill has the nature of a new drawer.

Holder: A person who is entitled in his own name to the possession of a negotiable instrument and to receive or recover the amount thereon.

Holder in Due Course: A person who has obtained the negotiable instrument on payment of consideration and in good faith.

Hundi: A bill of exchange drawn in an oriental/Indian language.

Inchoate Instrument: An incomplete instrument with a blank space to be filled.

Instrument: A legally recognied piece of paper in writing used for transfer of money.

Negotiable Instrument: An instrument which is transferable by delivery or indorsement and delivery.

Negotiation : The process by which the transferee of a negotiable instrument becomes a holder of it.

Payee : The person who is to receive the money stated in an instrument.

20.12 ANSWERS TO CHECK YOUR PROGRESS

A) 4. a) ii b) iii c) iv

B) 1. Ambiguous instrument

2. Being an inchoate instrument, it is valid.

3. By filling in the blanks. It carries authority to fill up.

4. The holder can exercise his option and treat it either as a bill of exchange or promissory note.

5. It was duly stamped

6. No. There cannot be any new presumptions other than those stated in the Act.

C) 1. Personally liable as he has not indicated that he is signing on behalf of the principal.

2. a) personally liable b) personally not liable

c) personally not liable d) personally not liable

3. It cannot be enforced

D) 1. To the holder

2. a) Not a holder in due course

b) Not a holder in due course

c) Not a holder in due course

20.13 TERMINAL QUESTIONS

1) Describe the general characteristics of negotiable instruments.

2) What are the legally permitted presumptions in respect of negotiable instruments?

3) Explain the law relating to ambiguous and inchnate instruments.

4) Discuss the capacity and liabilities of the minor and an agent in drawing an instrument.

5) Differentiate between the holder and a holder in due course.

6) Who a is holder in due course? Explain his privileges.

Note :	These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your own practice only.

UNIT 21 PROMISSORY NOTE, BILL OF EXCHANGE AND CHEQUE

Structure

21.0 Objectives

21.1 Introduction

21.2 Promissory Note

- 21.2.1 Essential Characteristics
- 21.2.2 Some Illustrations

21.3 Bill of Exchange

- 21.3.1 Essential Characteristics
- 21.3.2 Some Illustrations
- 21.3.3 Distinction between a Bill of Exchange and a Promissory Note
- 21.3.4 Types of Bills

21.4 Hundies

21.5 Cheque

- 21.5.1 Distinction between a Cheque and a Bill of Exchange
- 21.5.2 Crossing of a Cheque
- 21.5.3 Post-dated Cheque
- 21.5.4 Protection to Paying Banker and Collecting Banker
- 21.5.5 Refusal of Payment by Bank

21.6 Payment in Due Course

21.7 Maturity of Negotiable Instruments

21.8 Let Us Sum Up

21.9 Key Words

21.10 Answers to Check Your Progress

21.11 Terminal Questions

21.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the meaning and implications of promissory note, bill of exchange, hundi and cheque;
- identify different types of bills and hundies;
- identify the features that distinguish one instrument from the other;
- discuss the meaning and implications of crossing; and
- describe the law relating to payment on cheque by banks and the extent of their protection.

21.1 INTRODUCTION

In Unit 20 you have studied the meaning and characteristics of a negotiable instrument, law relating to ambiguous and inchoate instruments, and capacity and liabilities of various parties. You have also learnt that the Act deals with three types of instruments, viz., promissory note, bill of exchange and cheque, which you have learnt in brief. In this unit we will discuss each of these three instruments in detail. You will study the meaning, implications and distinctive characteristics of each of these three instruments. You will also study about 'hundi' which is not within the purview of the Act but is in practice in Indian business.

21.2 PROMISSORY NOTE

As you know, section 4 defines a promissory note as *an instrument in writing (not being a bank-note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument*. This definition describes the essential characteristics of a promissory note. It also makes it clear that it is not a currency or a bank note which has almost all the characteristics of a promissory note but should not be treated as a promissory note.

21.2.1 Essential Characteristics

The essential characteristics of the promissory note, in the light of the above definition, may be listed as follows

1) It must be in writing, which obviously means that an oral promise will not make a promissory note.

2) It contains an unconditional and express undertaking (an unconditional promise).

   The maker of the note undertakes or promises to pay, and such an undertaking must be unconditional.

   In real life situations people help each other by lending money. A 'receipt' or 'chit' may also be obtained from the borrower at that time. A receipt is an acknowledgement but it cannot be a promissory note. If a receipt issued contains both an acknowledgement and an unconditional promise to pay, it is treated as a promissory note. For example, in a receipt it is stated 'we have received the sum Rs. 9,000/- in cash from Mr. X. This amount will be repaid on demand.' This may be treated as a promissory note. The undertaking referred to here is an unconditional one. The maker, for example, cannot write 'I promise to pay Mr. X Rs. 500 as soon as he delivers the goods.' There should be no uncertainty in the promise. For example, 'I promise to pay to Mr. X Rs. 500 as and when I find it convenient' cannot make it a promissory note.

3) The promise must be for paying a certain sum of money. There cannot be a promissory note for anything other than money. The amount must be definite. For example, one cannot write 'I promise to pay Rs. 1000 and some interest thereon'.

4) The maker must sign. Signature is meant to authenticate the instrument. It also means writing a person's name by the person himself.

5) The note is to be made payable:

   i) only to a certain person; or

   ii) to the order of a certain person; or

   iii) to the bearer of the instrument; or

   iv) only to, or to the order of, a certain person, or

   v) only to a certain person, or to the bearer of the instrument.

   A promissory note cannot be made payable to the maker himself. A note made payable only to a particular person is also a promissory note but will not be negotiable. It must contain, along with the payee's name, the words 'or order'. Payable to 'bearer' is valid but RBI Act section 31 restricts private parties issuing notes payable to bearer. Bearer promissory notes are, therefore, not found in practice.

6) The time for payment is 'on demand' or after a definite period of time as may be stated in the promissory note.

7) Omission of the date will not invalidate unless it is to be proved at what time it is to be paid. The place of signature and signatures of two witnesses are also found in practice, though they are not insisted upon by law for ensuring the validity of the note.

8) In addition to the requirements as per the definition, stamp is necessary as per the requirements of the Indian Stamp Act, 1899. A promissory note can be stamped either with adhesive stamps or engrossed on a stamp paper of proper value. The law requires the cancellation of such stamp which may be done by the maker by writing his name across the stamp or initials with the date of his writing or in any other effectual manner.

21.2.2 Some Illustrations

The nature of a document is determined very much by its contents, and merely the description or its form alone cannot change its character or legal effects. The mere description of an instrument stating that it is a promissory note, also cannot make it a promissory note, if it fails to satisfy the various statutory requirements given in the definition. Illustrations provided in the Act itself will be relevant at this point. Some illustrations to show how a promissory note may be drawn in different forms and at the same time fulfilling the requirements of law may be helpful for drawing a valid promissory note. Study the following illustrations carefully:

'A' signs instruments in the following terms:

1) 'I promise to pay B or order Rs. 500'.

2) 'I acknowledge myself to be indebted to B in Rs. 1,000 which I promise to pay on demand, for value received'.

3) 'Mr. B, IOU, Rs. 1,000'.

4) 'I promise to pay B Rs. 500 and all other sums which shall be due to him'.

5) 'I promise to pay B Rs. 500, first deducting thereby any money which he may owe me'.

6) 'I promise to pay B Rs. 500 seven days after my marriage with C'.

7) 'I promise to pay B Rs. 500 on D's death, provided D leaves me enough to pay that sum'.

8) 'I promise to pay B Rs. 500, and to deliver to him my black horse on 1st January next'.

In the above illustrations, instruments 1 and 2 are promissory notes but the rest are not. In instruments 3 to 8 the maker promised to pay subject to some conditions. Hence, not to be treated as valid promissory notes. For your understanding, specimens of varied forms of valid promissory notes are presented below. Study them carefully and note the difference.

Specimen 1

New Delhi
10 March 2019

Rs. 50,000/-

On demand I promise to pay Mr. X or order the sum of Rupees Fifty Thousand with interest at 6 per cent per annum for value received.

Stamp
Mr. Y (Sd/- on stamp)

To
Mr. X
New Delhi

---

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Specimen 2

New Delhi
10 March 2019

Rs. 50,000/-

On demand I promise to pay Mr. X the sum of Rupees Fifty Thousand only.

Stamp
Mr. Y (Sd/- on stamp)

To
Mr. X
New Delhi

Specimen 3

New Delhi
17 March 2019

Rs. 50,000/-

Two months after date I promise to pay Mr. X the sum of Rupees Fifty Thousand only.

Stamp
Mr. Y (Sd/- on stamp)

To
Mr. X
New Delhi

Specimen 4

New Delhi
10 March 2019

Rs. 50,000/-

Three months after date I promise to pay Mr. X or the bearer the sum of Rupees Fifty Thousand only

Stamp
Mr. Y (Sd/.. on stamp)

To
Mr. X
New Delhi

Specimen 5

New Delhi
10 March 2019

Rs. 50,000/-

Three months after date I promise to pay Mr. X or the bearer the sum of Rupees Fifty Thousand only

Stamp
Mr. Y (Sd/ on stamp)

To
Mr. X
New Delhi

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21.3 BILL OF EXCHANGE

As you know, according to section 5, *a bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a sum of money only to, or to the order of, a certain person, or to the bearer of the instrument.*

The section also clarifies that mentioning the time of payment, or payment in instalments after the lapse of a certain period, or payment after the occurrence of a specific and definite event will not make it a conditional promissory note or bill of exchange. The mention of the definite rate of foreign exchange, (the prevailing official rate of exchange) or rate of interest will be taken as the certain amount.

Misspelt and misnamed person or a person mentioned by designation will not invalidate the document and will be within the meaning of 'certain' person as given in sections 4 and 5.

21.3.1 Essential Characteristics

In order to operate as a valid bill of exchange, the instrument must satisfy the following conditions:

1) It must be in writing.
2) It must contain an unconditional order directing a certain person to pay.
3) It must be signed by the drawer.
4) The drawer must be a certain person.
5) The payee must be a certain person, or the bearer of the instrument.
6) The drawee must be a certain person.
7) The amount ordered to be paid must be certain.
8) The order must be to pay money only.

For the purpose of the Indian Stamp Act, many instruments are treated as bills which are not bills of exchange as defined in this Act. A **hundi** is also treated as a bill of exchange under the Indian Stamp Act sections 2(2) and 2(3).

21.3.2 Some Illustrations

The bills may be drawn in different forms incorporating the essential requisites discussed above. Some such forms are provided below. These forms are used within the country — all parties being within the country and the money mentioned is in the local currency. Foreign bills are taken up later in this unit.

Illustrations of Inland Bills

Specimen 1

New Delhi
l0 March 2019

Rs. 50,000/-

On demand I promise to pay Mr. X or order the sum of Rupees Fifty Thousand with interest at 6 per cent per annum for value received.

Stamp
Mr. L Kumar (Sd/- on stamp)

To
Mr. R.B. Singh
New Delhi

Specimen 2

New Delhi
10 March 2019

Rs. 20,000/-

Sixty days ‘after date pay, to my order the sum of Rupees Twenty Thousand.

Stamp
Mr. L. Kumar (Sd/- on stamp)

To
Mr. R.B. Singh
Allahabad

Specimen 3

New Delhi
l0 March 2019

Rs. 30,000/-

Three months after date pay to bearer the sum of Rupees Thirty Thousand for value received.

Stamp
Mr. L. Kumar (Sd/- on stamp)

To
Mr. R.B. Singh
Allahabad

Specimen 4

New Delhi
l0 March 2019

Rs. 50,000/-

Three months after date pay to bearer the sum of Rupees Thirty Thousand for value received.

Stamp
Mr. L. Kumar (Sd/- on stamp)

To
Mr. R.B. Singh
Allahabad

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Specimen 5

New Delhi
10, March 2019

Rs. 40,000/-

On demand pay to Mr. Ram Kumar or order the sum of Rupees Forty Thousand for value received.

Stamp
Mr. L. Kumar (Sd/- on stamp)

To
Mr. R.B. Singh
Allahabad

Demand Drafts: A demand draft is an order to pay money drawn by one office of a bank upon another office of the same bank, or upon an office of a different bank for a sum of money payable to order on demand, when the order is on another branch of the same bank, it is really a cheque but is nevertheless ordinarily called a draft. When a draft is issued on another bank, it has all the characteristics

of a bill of exchange (except that it is not stamped and not accepted) as defined by this section. Even if it is drawn upon another branch of the same bank, it can be treated as a bill of exchange as the conditions stated in this section are satisfied. However, a demand draft is nothing more or less than a negotiable instrument governed by the provisions of this Act, and on the face of it, the obligations it creates are nothing more than ordinary debts.

21.3.3 Distinction between a Bill of Exchange and a Promissory Note

1) In a promissory note, the maker unconditionally undertakes to pay, whereas in a bill of exchange or 'hundi', the maker gives an unconditional order directing a certain person other than himself to pay.

2) The maker of a bill of exchange is called a drawer and the person thereby directed to pay is called the drawee. The liability of the maker of a promissory note is absolute, because he unconditionally binds himself to pay, whereas the obligation undertaken by the drawer of a bill is only conditional, since he becomes only a surety for payment by the drawee.

3) The maker of the promissory note becomes the principal debtor, as he accepts the primary liability to pay. According to the tenor of a bill of exchange, it is only when the drawee fails to pay that the drawer would be liable as surety. An instrument on which the word '**hundi**' is mentioned may be either a promissory note or a bill of exchange. The word '**hundi**' on the stamp does not determine the character of the document. To determine the character of the document, the court will look to the provisions of the document itself.

4) A bill of exchange requires three parties : a drawer. drawee and payee. It is possible that the same person may fill in the place of the drawer and drawee or acceptor. A promissory note requires two parties — both being distinct and different persons.

21.3.4 Types of Bills

Bills may be classified into certain types as follows

Genuine Trade Bill: When a bill is drawn, accepted or endorsed for consideration, it is a genuine trade bill. 'A' sells goods to 'B' on credit and 'A' owes the same amount of money to 'C'. Accordingly, 'B' agrees to pay after 3 months time. To conclude the transaction, A draws a bill on B directing B to pay the money after 3 months to C. This bill is backed by consideration and it is based on a genuine transaction.

Accommodation Bill: A is in need of Rs. 5,000/-. He approaches his friend B for borrowing the amount. B is not in a position to lend but he suggests that A should draw a bill on B which he would accept. Accordingly, 'A has drawn the bill and 'B' accepted it. 'A' in turn got the bill discounted with his banker and took

the money. On due date, 'A' would pay Rs. 5,000 to 'B' to enable him to meet the bill. This bill is arranged to accommodate A. This is an accommodation bill. (Banks, now-a-days normally do not discount these kinds of bills.)

Fictitious Bill: When the name of the drawer or the payee or both is fictitious in a bill, the bill is called a fictitious bill. When both the drawer and the payee of a bill are fictitious persons, the acceptor is liable to a holder in due course if the holder in due course can show that the signature of the supposed drawer and that of the first indorser (payee) are in the same handwriting.

Documentary Bill and Clean Bill: When documents of title to the goods or other documents, e.g., invoice, insurance policy, etc., are attached to the bill, such a bill is called **documentary bill**. Such documents are delivered to the buyer only on acceptance or payment as desired by the drawer of the bill. When no document relating to the goods (for the transaction of which the bill of exchange is being drawn) is attached to the bill, it is called a **clean bill**.

Escrow : When a negotiable instrument is delivered conditionally or for a special purpose as a collateral security or for safe custody only, i.e., not for the purpose of transferring absolutely the property therein, it is called escrow. As between immediate parties, when an instrument is delivered, conditions agreed upon are fulfilled. The liability to pay in case of an escrow does not arise if the conditions agreed upon are not fulfilled, or the purpose for which the instrument was delivered is not satisfied. This, however, does not affect the rights of a holder in due course (section 46).

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Bills in Sets: A bill is sometimes drawn in more than one original copy especially when such copies are required by various parties as in a foreign trade transaction. Such bills are said to be 'bills in sets'. The implications of this kind of bill are as follows:

a) Each copy (called part of the bill) of the bill is equally good and once it is accepted or paid, the other parts or copies become ineffective.

b) Each part of a bill in a set must be numbered and must contain a provision that it shall continue to be payable only so long as the other parts remain unpaid.

c) Each part must contain reference to the other parts. The drawer must sign each part of the bill and deliver. All the parts of the whole set need not be accepted.

d) When a person accepts or indorses different parts of the bill in favour of different persons, he and the subsequent indorses of each part are liable on such parts as if these parts were separate bills.

e) When two or more parts of a set are negotiated to different holders in due course, he who first acquires title to his part is deemed to be the true owner of the bill. He is entitled to (i) possession of all other parts, and (ii) claim the money represented by the bill.

Specimen forms of foreign bills (bills in sets)

Specimen 1

London
15 March 2019

£10,000/-

Three months after sight of this first of exchange (second and third of the same tenor and date unpaid) pay to the order of Messers Bombay Import and Export Company Limited, Mumbai, the sum of Pound Sterling ten thousand only, value received.

Stamp
London Trading Co. Ltd.
(Sd/- on stamp)

To
M/s India Machinery Company
Mumbai

The bill is drawn by the London Trading Company directing India Machinery Company of Mumbai to pay £10,000 to M/s Bombay Import and Export Company. The first part is shown here. The second part of a similar bill is shown below:

Specimen 2

London
15 March 2019

£5,000/-

Three months after sight of this second of exchange (first and third of the same tenor and date unpaid) pay to the order of Mr. Banerjee, Kolkata, the sum of Pound Sterling five thousand only, value received.

Stamp
A.B. Smith
(Sd/- on stamp)

To
M/s India Machine Tools Company
Kolkata

21.4 HUNDIES

Hundi is a bill of exchange drawn by Indians in an oriental or vernacular language of India. Hundies have been in existence in India from very ancient times and are governed by different usages in different parts of the country. The custom or usage in a certain area may be to allow interest on hundies drawn and payable so many days after sight. By mercantile usage in some places, a drawer who has accepted a hundi orally is held liable on the instrument. A hundi as accepted by the drawer is assignable without any regular form of indorsement. A hundi, though a negotiable instrument, is not necessarily a bill of exchange as defined in this Act.

Types of Hundies

Some distinct types of hundies are discussed below:

Shahjog Hundi: A hundi is payable to respectable holder (a man of financial worth in the bazaar) but it is not a hundi payable to bearer. In some respects it is similar to a cheque crossed generally which is payable only to or through some banker and not only the person in whose favour it was drawn can demand payment on its strength but also his indorsee, provided that the later is a respectable holder.

Nam Jog Hundi : It is a hundi which is payable to the party named in the bill or his order, The bill may also be accompanied by a descriptive note about the role of the party in whose favour it is granted.

Dhani Jog Hundi: It is meant to be payable to the Dhani or owner — a holder or bearer-owner.

Jokhmi Hundi : It refers to a hundi which is drawn on or against goods shipped on the vessel mentioned the hundi and implies a certain rick involved in the shipping of goods. They are payable only when the goods arrive safely.

Jawabee Hundi: A hundi which is in the nature of a letter or recommendation to a banker for payment of a particular amount to a particular person.

Zikri Hundi : It is a hundi accepted for honour under what is called a Zikri Chit (or letter of protection) without being protested. It is furnished to the holder by some prior party to the hundi on the hundi being refused acceptance. or when a refusal is likely to occur. It is addressed to some person residing in the town where the hundi is payable. The acceptance is given in writing on Zikri Chit.

Darshni Hundi : It is payable at sight and is negotiable. It may be sold at par or at premium or at discount.

Miadi Hundi: A hundi which is payable after a specified period of time. Loans are usually advanced by bankers on the security of such hundies. It is also usual to deduct interest in advance for the period upto the due date.

Check Your Progress A

1) A promissory note is stamped and signed with the words, "I promise to pay Mr. X or order the sum of Rs. 1 ,000 with interest thereon'.

   a) Is this note valid?

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   b) What rate of interest can be charged?

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2) What is the liability of a drawer in a bill of exchange?

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3) The payee's name mentioned in a bill is that of a non-existent person. How do you treat this instrument?

4) State whether the following statements are True or False

   i) Stamp is not essential for a valid promissory note.

   ii) A bill of exchange can be in the form of an oral promise.

   iii) Hundies are not governed by the Negotiable Instruments Act.

   iv) Signature of the maker is essential for a valid promissory note.

   v) Bills in sets are used in foreign trade transactions.

21.5 CHEQUE

As you know, '*a cheque is a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand*'. Further the expression includes electronic image of truncated cheque and a cheque in the electronic form.

A 'Cheque in the electronic form' means a cheque which contains the exact mirror image of a paper cheque, and is generated, written and signed in a secure system ensuring the minium safety standards with the use of digital signature (with or without biometrics signature) and asymmetric crypto system.

A "truncated cheque" means a cheque which is truncated during the course of a clearning cycle, either by the clearing house or by the Bank whether paying or receiving payment, immediately on generation of an electonic image for transmission, substituting the further physical movement of the cheque in writing.

The cheque is, therefore, a kind of bill of exchange. It must be signed by the maker (drawer); must contain an unconditional order for payment of a certain sum of money, to or to the order of a specified person, or to the bearer; and must specify the banker (bank) upon whom it is drawn. Thus, the cheque should not have any condition attached for making the payment. An instrument in the form of a receipt ordering the bank to pay the sum mentioned 'provided the receipt from at foot hereof is duly signed, stamped and dated' is not a cheque as it imposes a condition on the order to pay. (More can be understood when a cheque is distinguished from a bill of exchange later in this unit.) However, banks by their own regulations honour a cheque only if the cheque form issued by banks themselves are used. Thus, there is very little discretion that the individual can exercise in writing the cheque.

A banker's cheque (demand draft) is something unique since it is a cheque drawn by a bank payable by itself. A demand draft is almost similar to a cheque but the differences between the two are that i) the draft is drawn by one bank against another bank/bank's own branch but not by private individuals, and ii) the draft cannot be so easily countermanded as a cheque, either by a person purchasing

it or by the bank to which it is presented. It is more like an appropriation of what is treated as ready-money in the hands of the banker. Ordinarily the relationship between the holder of a demand draft and the issuing bank is that of a creditor and debtor. The issue of a demand draft by one office upon another of the same bank is only convenient method of remitting the amount covered by the draft.

21.5.1 Distinction between a Cheque and a Bill of Exchange

You have studied the meaning of a bill of exchange and a cheque separately. Now you should know the distinction between these two instruments. The differences are as follows:

1) The cheque is always drawn on a bank while a bill can be drawn upon an individual as well as a bank.

2) The cheque is always payable on demand immediately without any period of grace, while a bill, unless payable on demand, is entitled to three days of grace. Since a cheque is. payable instantly on demand, the law casts a duty on the payee to present the cheque for payment within a reasonable time. Three months from the date of issue is the practice now.

3) A cheque does not require an acceptance. It also does not require a stamp as is the case with a bill.

4) A cheque can be drawn payable to bearer on demand, whereas a bill cannot.

5) A cheque can be revoked by countermanding of payment. A bill of exchange cannot be countermanded.

6) A banker is entitled to statutory protection in certain cases with regard to payment of cheques. No such protection is available to the drawee or acceptor of a bill of exchange.

7) The provisions of the Act as to 'crossing' are exclusively applicable to cheques. (Other instruments analogous to a cheque are banker's drafts and dividend warrants and they may also be crossed.)

8) All cheque forms are issued by banks themselves and no other form is honoured by them whereas individuals may still have their own forms of bills of exchange and promissory notes.

21.5.2 Crossing of a Cheque

You must be aware that cheques can be either open or crossed. Open cheques are those which can be paid over the counter of the bank. When two parallel lines are drawn on the left hand top corner of the cheque, it is called crossing, and such a cheque is called a crossed cheque. A crossed cheque cannot be encashed directly at the counter. It is to be deposited in an account with a bank and the payment is made to the banker. The Act recognises two types of crossing of cheques and prescribes the responsibilities of parties dealing with crossed cheques (sections 123 to 133). *Where a cheque bears across its face an addition of the words 'and company' or any abbreviation thereof, between two parallel transverse lines, or of two parallel transverse lines only, either with or without the words 'not negotiable' that addition shall be deemed to be a*

crossing and cheque shall be deemed to be crossed generally (section 123). Look at figure 21.1 carefully and study how general crossing is done.

Crossing of a Cheque

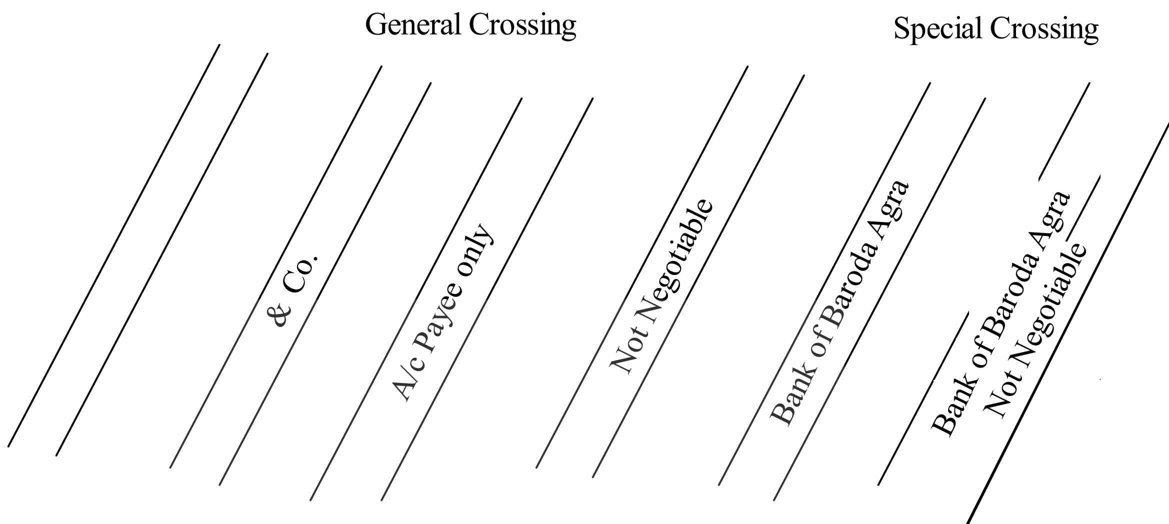

Fig. 21.1

Where a cheque is crossed generally, the banker on whom it is drawn shall not pay it otherwise than to a banker (section 126). Therefore. the holder may get the cheque collected through his/some other bank.

When the name of a banker, either with or without the words 'not negotiable' is written, it is **special crossing**. The transverse parallel lines may or may not be used in this kind of crossing. The special feature is the writing of the name of a banker. Study Figure 21.1 carefully to understand special crossing. Where the cheque is crossed specially, the banker on whom it is drawn shall not pay it otherwise than to the banker to whom it is crossed, or his agent for collection (section 126). Thus, in the use of special crossing the paying banker is to honour the cheque only when it is presented through the bank mentioned in the crossing, or an agent of such bank, i.e., another banker acting as agent.

'Account Payee' crossing which is very much in practice, may be made both under general crossing as well as special crossing. The effect of such crossing is that the collecting banker should credit the amount to the account of the payee only. Not negotiable crossing has some more significance. A person taking a cheque crossed generally or specially, bearing in either case the words 'not negotiable' shall not have, and shall not be capable of giving a better title to the cheque than that which the person from whom he took it had. In short, though such cheques are transferable, the transferee cannot become a holder in due course.

The object of 'not negotiable' crossing is to afford protection to the holder or drawer of a cheque, because even if such a cheque gets into wrong hands and from there it is transferred to a holder in due course, the true owner will not lose his claim against such an indorsee. Thus, an indorsee of such a crossed cheque should not accept the cheque unless he knows the indorser and his title fully well.

Crossing may be done at the time of issue or even after the issue in the following ways (section 125):

1) Where a cheque is uncrossed, the holder may cross it generally or specially.

2) Where a cheque is crossed generally, the holder may make it a special crossing by adding the name of the banker with or without the words 'not negotiable'.

3) Where the cheque is crossed generally or specially, the holder may add the words 'not negotiable'.

4) Where a cheque is crossed specially, the banker to whom it is crossed may again cross it specially to another banker, or his agent for collection.

Crossing becomes material part of the cheque and any alteration except those listed above require authentication. **All the above provisions relating to crossing are applicable to drafts also (section 131.A).**

21.5.3 Post-dated Cheque

Normally cheque is drawn and delivered to the payee on the date on which it is drawn. Sometimes, a future date is given thereby implying that the drawer wants the cheque to be cashed on or after the date which is stated in the cheque.

A cheque is not invalid by the reason that it is ante-dated or post-dated or is dated on a public holiday. A post-dated cheque may be treated as a bill payable at a future time, though it can be negotiated beforehand and becomes on the date it bears a bill payable on demand and hence a cheque.

Where a post-dated cheque is accepted conditionally and it is honoured, the payment for the purposes of the law of limitations can only be the date which the cheque bears and cannot be the date on which it was actually handed over. Negotiability is also not affected by the post-dating of a cheque.

21.5.4 Protection to Paying Banker and Collecting Banker

Negotiability of the cheque and various other possibilities of misuse make the position of the banker somewhat difficult in terms of making payment to discharge the liability in the cheque. Both the collecting banker and the paying banker are involved in this. Hence the Act provides special protection to these bankers under certain circumstances.

Protection to Paying Banker

A paying banker is one who pays the money on a cheque on behalf of his customer. The Act protects the paying banker under the following circumstances:

1) In the case of order cheque, the paying banker is discharged from liability if he makes payment of an order cheque to the payee or the apparent indorsee thereof in good faith and without negligence even though subsequently it may turn out that such an indorsement was forged (section 85). For example, a cheque drawn ' payable to A's order (not crossed) has indorsement upon it and gets paid in due course. The banker is protected if he has acted with care and in good faith on his part. If in the same case, for example, the drawer's signature was found forged, the banker will not be protected because the banker is supposed to recognise the correct signature of his customer who was the drawer. The protection applicable to order cheques is also applicable to bank drafts. If a draft is lost, for example, it may be presented by someone who is not entitled to be the holder and there may be a forged indorsement. In such cases, the purchaser of the draft may ask the bank to be on its guard against presentation by a wrong person.

2) In the case of a cheque originally issued as a bearer cheque, subsequent indorsements which are in the nature of restricting or excluding further

indorsements may be ignored by the paying banker and payment in due course can be made.

Protection to Collecting Banker

A collecting banker is one who receives the payment of a crossed cheque on behalf of his customer. If the title in the crossed cheque is defective, then only the question of his involvement or liability arises. According to the Act he will have no liability if he has acted: i) in good faith, ii) without negligence. iii) received the payment on behalf of a 'customer' and not on his own behalf, and iv) the customer was the bank's own customer. This protection is restricted to crossed cheques only. When one person deals with the money of other person, it should not be construed as 'conversion' or misappropriation and their protection is important. A conversion is a wrongful interference with goods, by taking, using or destroying them violating the owner's right of possession.

21.5.5 Refusal of Payment by Bank

The relationship between the banker and customer is said to be primarily that of the debtor and creditor. It is, therefore, the duty of the banker to honour the cheques (make payment on them on demand) of the customer when he has sufficient funds applicable for the payment of such a cheque (section 31). The banker has to pay damages for wrongful payment or loss arising out of the dishonour. Similarly, he must refuse payment of his customer's cheques only under circumstances when he will not become liable for the payment. If he has not refused payment where he should have, he has to hear the loss by himself. In some cases he can recover the loss from the wrong payee if he is traceable. First the cases in which he must refuse payment may be listed.

In the following cases, the banker must refuse payment of a cheque:

1) When the customer countermands payment, i.e., issues instructions to the bank not to honour ('stop payment') a particular cheque issued by him, the banker is bound to comply with such instruction. The countermanding order should have been given to the banker with sufficient time.

2) When the bank receives a **Garnishee** order i.e. a prohibiting order by any court attaching the money in the customer's account, payment must be refused. In this case he cannot recover from the payee who gets payments of an otherwise valid cheque.

3) When the banker receives a notice of the death of his customer or when his customer has been adjudged insolvent or has become insane, the banker must refuse payment as his authority to pay on behalf of such customers comes to an end. He must get a fresh authority on those accounts. An payment made after a due notice is not good against the drawer, nor is the banker entitled to a refund from the payee, who gets payment of an otherwise valid cheque.

4) When the banker receives a notice of assignment of his credit balance from a customer, he must refuse payment of the cheques drawn by the customer.

5) When the banker comes to know of the defect in the title, or when there is a material alteration in the cheque or the signature of the drawer does not tally with the specimen signature kept by the bank, the banker must dishonour such cheques.

6) When the customer has lost the cheque and has informed the loss to the banker, the banker in turn must dishonour the cheque.

There are some-occasions where the banker may refuse payment but still makes the payment at his discretion. On some occasions the question of who will bear the loss, damages arising out of a wrong refusal will be decided by the court by taking into account the facts of the case. These occasions are listed below:

1) Payment on post-dated cheque presented before the actual date on which it is written to be payable.

2) Payment when funds in the customer's account are insufficient to meet the amount payable against the cheque. Sometimes, the funds might have been there but they are kept for some other authorised purpose and, therefore, not applicable for the cheques presented.

3) Payment when the cheque is not presented within a reasonable time, i.e., within three months after the date of issue as is the practice now. Such cheque is treated as **stale** cheque. He may honour the **stale cheque** after getting confirmation by the customer.

Check Your Progress B

1. What is crossing of a cheque?

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2. Differentiate between general crossing and special crossing.

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3. Is a post-dated cheque valid and negotiable?

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4. A bearer cheque is issued to A' who indorses it to 'B'. B again indorses to 'C' who presents for payment. Who can cross this cheque?

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5. Are the provisions of crossing applicable to bank drafts?

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6. Distinguish between a cheque and a draft.

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7. State whether the following statements are **True** or **False**:
   i) Crossing is always necessary for a cheque to become valid.
   ii) Post-dated cheque can be encashed at the counter of a bank at any time.
   iii) In special crossing, the name of a banker is written.
   iv) The life of a cheque is three months from the date of issue.
   v) A paying banker cannot refuse the payment of a cheque.
   vi) A draft cannot be indorsed.

21.6 PAYMENT IN DUE COURSE

The payment in due course refers to payment of the amount due under a negotiable instrument. A payment in due course, as defined in the Act, operates as a valid discharge of the instrument against the holder. Accordingly, section 10 of the Act lays down the essentials of payment in due course, as follows:

1) The payment should be in accordance with the apparent tenor of instrument. A payment of post-dated cheque before maturity is not according to the tenor of the instrument.
2) The person to whom it is made should be in possession of the instrument.
3) The payment should be made in good faith without negligence and under circumstances which do not afford a reasonable ground for believing that the person to whom it is made is not entitled to receive the amount. The payment must be made in money only unless the holder agrees to accept payment in any other way.

Where 'A' executes a promissory note in favour of 'B' and the amount is payable to B's order, a payment by A to C, who is B's son who is not in possession of the note, is not a payment in due course. Again, when payment is made on a forged cheque, it is not a payment in due course. A banker cannot charge the customer with any money with which he has parted without the customer's authority.

21.7 MATURITY OF NEGOTIABLE INSTRUMENTS

Sections 23 to 25 of the Act lays down the rules according to which the maturity of a negotiable instrument can be decided. According to section 22 **the maturity of a promissory note or bill of exchange is the date at which it falls due.** But, three days of grace shall be allowed in the case of all instruments (note and bill) other than those that are expressed to be payable on demand. A cheque or a bill of exchange when payable on demand is not entitled to any days of grace. In the case of a **hundi**, the days of grace will depend on the local custom. Days of grace are calculated by excluding the day on which the amount falls due and three days are calculated consecutively without any deduction for holidays between the first and the third day. In case an instrument is payable in instalments, every instalment is entitled to three days of grace. Ordinarily the instrument is presented before that date is considered invalid. The holder however becomes entitled to sue before maturity in the event of insolvency of drawer or drawee.

If a promissory note or a bill of exchange is made payable after a stated number of months after date or after sight or after a certain event, it becomes payable three days after the corresponding date of month after the stated number of months (section 23). If the month in which the period would terminate has no

corresponding day, the period is held to terminate on the last day of such a month. For example, a bill dated 30 January 1989 is made payable one month after date. The date of maturity falls due on 3 March 1989. In the above case, the day on which the instrument is drawn or presented for acceptance or sight, or the day on which the event happens, is to be excluded (section 24). If a bill payable thirty days after sight is presented for sight on 1st March 1989, it will fall due on 3 April 1989. When the day on which a promissory note or bill of exchange matures is a public holiday, the instrument is deemed to be due on the next business day (section 25). Sundays and other days declared by the Central Government by notification in the Official Gazette are public holidays.

To sum up, days of grace are allowed on all instruments and (bills and notes) expressed to be payable on a specified day or at a certain period after date or after sight. No days of grace are allowed for a cheque or bill payable on demand or at sighs or presentment or to which no time for payment is specified.

Payment of Interest (Sections 79 and 80) : The Act lays down that when the interest is specified in the promissory note or bill of exchange, the interest shall be calculated at the rate specified, on the amount of the principal money due thereon, from the date of the instrument until tender or realisation of such amount, or until such date after the institution of a suit to recover such amount as the court directs. When no interest rate is specified in the instrument, the rate of interest will be 18 per cent per annum. This will be notwithstanding any oral agreement between the parties. Finally when the party charged is the indorser of an instrument dishonoured by non-payment, he is liable to pay interest only from the time that he receives notice of the dishonour.

Check Your Progress C

1. What do you mean by payment in due course?

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2. What do you mean by the maturity of a negotiable instrument?

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3. What is the grace period in the case of bills and promissory notes?

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4. State whether the following statements are **True** or **False**

   i) When the interest rate is not specified in the instrument, 18% per annum is permitted by the Act.

   ii) Payee of a cheque is entitled for claiming the interest.

   iii) There is no maturity date for cheque.

   iv) All types, of bills are entitled for the days of grace.

21.8 LET US SUM UP

A promissory note contains an unconditional undertaking whereas a bill of exchange as well as cheque contains an unconditional order. The promissory note requires two parties, viz., the drawer or maker and the drawee. The bill of exchange requires three parties, viz., drawer, drawee (acceptor when he accepts) and payee. In a cheque the drawee is always the banker but no acceptance is required as a cheque is payable always on demand. Bills and notes payable after a certain time have a period of grace. Promissory note and bills are stamped and signed. Cheques do not require stamps. There are different forms by which promissory notes and bills of exchange are written. Hundi has come to be recognised as equivalent to a bill of exchange and the prevailing custom in the bazaar govern it.

Crossing of a cheque is basically of two types, viz., general crossing and special crossing. Crossing imposes a restriction on the negotiability of the cheque. It is a caution to the banker that the sum mentioned in the cheque must be credited only to an account holder.

The paying banker is protected when he pays against on an irregular/forged indorsement or order cheque and the collecting banker is protected when he acts in good faith without negligence and receives on behalf of his customer. The banker must refuse payment when there is countermanding, or court's order, or death or insolvency, or notice of assignment or he knows that there is a defect in the title or told about the loss of a cheque. The banker may refuse or honour using his judgement and facing a risk when he pays against a post dated cheque or with inadequate funds or when not properly presented, or on stale cheques.

Payment in due course refers to payment of the amount due under a negotiable instrument to discharge and conclude the claim under the instrument. Payment in due course operates as a valid discharge of the instrument against the holder. The Act also lays down certain essentials of payment in due course.

The maturity of a promissory note or bill of exchange is the date at which it falls due. Days of grace are allowed on all instruments (bills and notes) expressed to be payable on a specified day or at a certain period after date or after sight. No days of grace are allowed for a cheque or bill payable on demand or at sight or presentment or to which no time for payment is specified.

21.9 KEY WORDS

Bills in Sets : Bills of exchange drawn in more than one part used mostly in foreign trade transactions.

Countermanding Payment : An instruction by the customer to his bank to 'stop payment' on the cheque issued by him.

Darshani Hundi : A hundi payable at sight.

Days of Grace: Three days permitted after the date when a bill or note becomes payable.

Dhani Jog Hundi : A hundi payable to the holder or owner.

Documentary Bill : Bill backed by documents of title to goods.

Escrow : A negotiable instrument used as a collateral security or for safe custody only.

Fictitious Bill : A bill with one or more fictitious names.

Garnishee Order : Court's order to a bank attaching a customer's account.

General Crossing of Cheque : Two transverse lines across the face of a cheque with or without certain words like 'A/c payee only'.

Maturity Date : The date when an instrument falls due for payment. Three days of grace are added for instruments payable after a certain date.

Miadi/Muddati Hundi : A hundi payable after a specified time.

Nam Jog Hundi : A hundi payable to the party named therein.

Payment in Due Course : Payment resulting in discharge of the liability in an instrument.

Postdated Cheque : Cheque dated and payable on a future date.

Shah jog Hundi : A hundi payable to a person of high credit worthiness in the trade.

Special Crossing : Name of the bank written in the crossing with or without the transverse lines across the face of a cheque.

Zikri Hundi : A hundi accepted for honour under what is called a **zikri chit.**

21.10 ANSWERS TO CHECK YOUR PROGRESS

A) 1. a) yes valid b) 18%

4. i) False ii) False iii) Truei v) True v) True

B) 7. i) False ii) False iii) True iv) True v) False

vi) False

C) 4. i) True ii) False iii) True iv) False

21.11 TERMINAL QUESTIONS

1) Explain the characteristics of a valid promissory note. Give examples.
2) What are the essential characteristics of a bill of exchange?
3) What are the different types of bills?
4) Compare and contrast a bill with a hundi.
5) Briefly describe the various kinds of hundies.
6) Explain the distinction between a promissory note and a bill of exchange.
7) Explain the characteristics of a valid cheque.
8) Differentiate between a bill and a cheque.
9) Discuss the common features among promissory note, bill of exchange and cheque.
10) What is crossing of a cheque? Explain various types of crossing on a cheque.
11) What is payment in due course?
12) To what extent the paying and collecting bankers are protected by the law?
13) When can a bank refuse payment on a customer's cheque?

Note : These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University for assessment. These are for your own practice only.

UNIT 22 NEGOTIATION

Structure

22.0 Objectives

22.1 Introduction

22.2 Negotiation and Assignment

22.3 Modes of Negotiation

- 22.3.1 Delivery
- 22.3.2 Indorsement
- 22.3.3 Negotiation Back

22.4 Liability of Various Parties

- 22.4.1 Liability of the Drawer of a Bill
- 22.4.2 Liability of the Drawee of a Cheque
- 22.4.3 Liability of the Maker of a Note and Acceptor of a Bill
- 22.4.4 Liability of Indorser
- 22.4.5 Liability of Prior Parties to Holder in Due Course

22.5 Lost and Stolen Instruments

22.6 Instruments Obtained by Fraud

22.7 Forged Instruments and Forged Indorsements

22.8 Let Us Sum Up

22.9 Key Words

22.10 Answers to Check Your Progress

21.11 Terminal Questions

22.0 OBJECTIVES

After studying this unit, you should be able to

- differentiate between assignment and negotiation;
- explain the requisites of negotiation by delivery;
- describe the requisites of negotiation by endorsement and delivery;
- discuss the meaning of negotiation back;
- explain the nature of liabilities of various parties like the drawer, drawee, indorser, acceptor, etc.
- state various implications of instruments when they are lost or stolen, forged, and obtained by fraud or for unlawful consideration.

22.1 INTRODUCTION

As you know, one of the essential features of the negotiable instruments is easy negotiability. Negotiability means transfer of an instrument. Negotiation when

done in a way not recognised by the law, may create complications in the rights and liabilities of the various parties. Hence, it is necessary for you to know the requisites of a legally valid negotiation and other effects relating to negotiation. In this unit you will study the difference between negotiation and assignment, modes of negotiation, meaning of negotiation back and the liabilities of various parties. You will also study the implications when the instruments are forged/lost or stolen, obtained by fraud or for unlawful consideration.

22.2 NEGOTIATION AND ASSIGNMENT

The ownership of a negotiable instrument can be transferred in two ways: i) by negotiation, and 2) by assignment. Although negotiation and assignment result in the transfer of a right or ownership, these two terms are different. **Negotiation** means transfer of an instrument from one person to another so as to constitute that person the holder of the instrument (section 14). **Assignment** means transfer of ownership of a negotiable instrument by means of a written and registered document under the provisions of the Transfer of Property Act.

In order to be negotiable, an instrument should satisfy two conditions: 1) it must be in a form which is recognised by law for being sued upon by the holder, and 2) it must be transferable by custom of trade.

As stated above, negotiation is not the only means by which an instrument can be transferred. A bill of exchange or a promissory note may be transferred by assignment. The Act recognises the transfer of negotiable instruments for consideration other than by negotiation, e.g., by a registered sale deed. The transfer of a promissory note by a separate registered instrument is valid. An assignment of a negotiable instrument under the Transfer of Property Act, 1882 must always be in writing and the assignee must take the instrument subject to all equities which arise between the party liable and the assignor.

The difference between negotiation and assignment are as follows:

1) Negotiation for the purpose of transfer is relevant in the case of negotiable instruments only whereas assignment is done mainly in the case of other documents and may be done in respect of a negotiable instrument also.

2) Consideration is normally presumed in the case of negotiation whereas it has to be evidenced/proved in the case of assignment.

3) In a transfer by indorsement, if the maker/debtor/payee of the instrument is not given any notice, he will be still liable on maturity. An assignment does not bind the debtor unless notice of assignment has been given by the assignee to the debtor and the debtor in turn, expressly or impliedly, has assented.

3) Assignment is done always by writing, usually by a separate document (e.g., a sale deed) or also on the same instrument. But negotiation of a negotiable instrument can be affected by simple delivery or indorsement followed by delivery.

22.3 MODES OF NEGOTIATION

As you know, there are two modes of negotiating a negotiable instrument. Instruments payable to bearer can be transferred by mere delivery whereas instruments payable to the order of a person are transferable by indorsement and

delivery. Thus, the two modes of negotiation are: 1) delivery, and 2) indorsement and delivery. Let us now understand these two modes in detail.

22.3.1 Delivery

Section 47 states that "*subject to the provisions of section 58, a promissory note, bill of exchange or cheque payable to bearer is negotiable by delivery thereof* ". "*Exception: A promissory note, bill of exchange or cheque delivered on condition that it is not to take effect in a certain event, is not negotiable (except in the hands of a holder for value without notice of the condition) unless such event happen*s."

Examples:

a) A, the holder of a negotiable instrument payable to bearer, delivers it to B's agent to keep it for B. The instrument has been negotiated.

b) 'A' is the holder of a negotiable instrument payable to bearer. The instrument is in the hands of A's banker, who is at the time also the banker of 'B'. 'A' directs the banker to transfer the instrument to B's credit in the banker's account with B. The banker does so, and accordingly now possesses the instrument as B' agent. The instrument has been negotiated and 'B' has become the holder of it.

Instrument Payable to Bearer: Section 47 deals with the negotiation of an instrument payable to bearer. The expression 'instrument payable to bearer, includes not only an instrument which is expressed to be so payable. but also one which is indorsed in blank, though originally payable to order. Even if the blank indorsement is followed by an indorsement in full, the instrument continues to be payable to bearer, as regards all parties prior to the indorser in full.

Section 47 has to be read subject to the provisions of section 58 of this Act, which lays down the circumstances under which a holder becomes disentitled to recover on the negotiable instrument or to negotiate it (you will study this later in this unit). Section 47 lays down that an instrument payable to bearer may be negotiated by mere delivery without the formality of an indorsement, and the person to whom such instrument is delivered becomes the holder and entitled to sue in his own name. The two requirements that have to be fulfilled before a document can be considered negotiable have already been noted.

Position of a Transferor by Delivery: Where the holder of a bill payable to bearer negotiates it by delivery without indorsing it, he is not liable on the instrument.

By negotiating a bill, it is presumed that the transferor being a holder for value confirms to his immediate transferee that the bill is what it purports to be, that he has a right to transfer it and at the time of transfer he is not aware of any fact which renders it valueless. The transfer by delivery of negotiable instrument payable to bearer amounts to sale of the instrument just like a sale of goods, and the liabilities of the transferor are like those of a vendor of goods. Therefore, he is liable to the immediate transferee, like the seller of goods for breach of the warranties which are implied in the sale of goods. He is presumed to assure that the instrument that he transfers is not a forged one, that it is unaltered and is what it purports to be on the face of it. If anything, such as the figure of the amount of a bill transferred by delivery, turns out to have been altered before delivery and

the amount is increased by such alteration, the immediate transferee is entitled to recover from the transferor the difference between the amount paid and the original amount of the note.

22.3.2 Indorsement

In order to operate as a negotiation, an indorsement must comply with the following conditions:

1) It must be written on the bill itself and be signed by the indorser. The simple signature of the indorser on the bill, without any additional words, is sufficient. An indorserment written on a slip of paper attached to the instrument is deemed to be written on the bill itself.

2) A partial indorsement (an indorsement which purports to transfer the bill to two or more indorsees severally) does not operate as a negotiation of the bill. It must be an indorsement of the entire bill.

3) Where a bill is payable to the order of two or more payees or indorsees who are not partners, all must indorse, unless the one indorsing has authority to indorse for the others.

4) In a bill payable to order, where the payee or indorsee is wrongly designated or his name is misspelt, he may indorse the bill as therein described, adding his proper signature.

5) Where there are two or more indorsements on a bill, each indorsement is deemed to have been made in the order in which it appears on the bill until the contrary is proved.

6) An indorsement may be made as blank or special indorsement. It may also contain terms making it restrictive.

Kinds of Indorsements : Indorsement may be classified as follows:

1) **Indorsement in blank:** In this type of indorsement, the instrument consists of only the signature of the indorser (section 16). You should note that there is no difference between an instrument payable to the bearer and an instrument indorsed in blank. In both the cases the property will pass by mere delivery of the instrument. An indorsement in blank is also known as **general indorsement**.

2) **Indorsement in full :** This is defined by section 16 of the Act. In addition to the indorser's signature if there is a direction to pay the amount to or to the order of a specified person, it is called 'indorsement in full'. Such an indorsement is generally made in the form of "Pay to X, or order" or "Pay to X" followed by the signature of the indorser. An indorsement in full is also known as **special indorsement**.

   Section 16 does not insist on any specific form of words to be used for an indorsement in full. It is sufficient if the words used can be properly construed as a direction of the nature mentioned therein. Thus, an indorsement in the following form on the back of a promissory note was held to be valid indorsement in full: "I have this day received in cash from you Rs. 5,300 made up of Rs. 5,000 being principal due under this note and of Rs. 300 interest accumulating upto date, and assigned to you this note with power to recover the amount due under it by showing the same".

The indorsement on a pronote reads as follows, "this note has been made over to Mr. X on 31st March", the note is signed by the payee, and the note so indorsed was delivered to the indorsee. This indorsement could be construed as a direction to pay the amount of the note to the person named in it and is an indorsement in full. An indorsement may not contain the actual words of direction, but if it contains what is equivalent to a direction to pay to the indorsee, it is said to contain a direction to pay within the meaning of section 16. However, the acknowledgement of receipt of payment is in no way an indorsment (full blank) as defined in this section.

3) **Restrictive indorsement:** "*The indorsement of a negotiable instrument followed by delivery transfers to the indorsee the property therein with the right of further negotiation but the indorsement may, by express words, restrict or exclude such right, or may merely constitute the indorsee an agent to indorse the instrument or to receive its contents for the indorser or for some other specified persons" (section 50).*

B signs the following indorsements on different negotiable instruments payable to bearer:

i) "Pay the contents to C only".

ii) "Pay C for my use".

iii) "Pay C or order for the account of B".

iv) "The within must be credited to C".

v) "Pay C".

vi) "Pay C value in account with the Oriental Bank"

vii) "Pay the contents to C, being part of the consideration in a certain deed of an assignment executed by C to the indorser and others.

Study the indorsements carefully. You must note that the indorsements (i) to (iv) exclude the right of further negotiation by C. The indorsements (v) to (vii) do not exclude the right of further negotiation by C.

According to section 50 the indorsee stands in the shoes of the indorser, unless the indorsement is recalled. The instrument can be recalled at pleasure and the indorser recalling, in case the amount under the instrument indorsed for collection had not been collected, can maintain suit on the basis of note without the same being reindorsed to him. Under this section, the indorsement of a negotiable instrument followed by delivery transfers to the indorsee the property therein with the right of further negotiation. But the section provides that the indorsement may, by express words, restrict or exclude such right, or may merely constitute the indorsee as an agent to indorse the instrument or to receive its contents for the indorser or for some other specified person. Where the indorsement itself purports to assign the promissory note expressly for the purpose of collection of the amount, the indorsement has the effect merely of constituting the indorsee an agent of the payee.

4) **Partial indorsement :** An indorsement which purports to transfer to the indorsee only a part of the amount payable, or which purports to transfer, the bill to two or more indorsees severally, is called a **partial indorsement**. A partial indorsement is invalid (section 56). However, there is an exception to this general rule. Where an instrument has been paid in part, the fact of

the part payment may be indorsed on the instrument and it may then be negotiated for the residue. For example, it may be indorsed by writing 'pay A or order being the unpaid residue of the bill'.

5) **Conditional indorsement:** Conditional indorsement limits or negatives the liability of the indorser. Conditional indorsement is different from restrictive indorsement. A conditional indorsement has no effect upon the negotiability of the instrument. It only qualifies the liabilities of the indorser. While a restrictive indorsement places restrictions on the negotiability of the instrument indorsed, an indorser of a qualified indorsement cannot absolve himself from the liabilities of a transferor.

Section 52 explains the possibility of indorsement 'without recourse'. A person may draw or indorse a bill without incurring personal liability. The drawer of a bill and any indorser may insert therein any express stipulation : 1) negating or limiting his own liability to the holder, and 2) waiving as regards himself some or all of the holder's duties. Thus, an indorser may express in his indorsement that it is made with the qualification that he shall not be liable on default of acceptance or payment by the drawee. Such qualified indorsement may be made by annexing in French the words '**sans recours**' or in English "**without recourse to me**" or any equivalent expression. But any stipulation limiting the liability of the party making it must appear on the instrument itself. Otherwise it will only be effectual between the immediate parties or a transferee without value, and will not avail against a holder in due course.

An indorser, by his indorsement, can impose a condition which may either be a condition **precedent or a condition subsequent**. In the case of condition precedent, the indorser acquires no right to maintain an action for the recovery of the amount until the condition is satisfied. In the case of the condition precedent, the right of the indorsee is entirely lost if the condition is fulfilled. In all such cases, the instrument is transferred subject to the same conditions to every subsequent holder. Thus, if the indorsement is: "to pay A or order, if a certain ship arrives within a year", then the right to receive payment is absolute and irrevocable if the ship so arrives. Where a note is indorsed 'pay to A or order, if he arrives at twenty one years of age, or if he is living when it becomes due", it is an indorsement with a condition precedent. If the event becomes impossible of performance or the conditions specified are not fulfilled, the indorsee gets no title to the bill, and cannot sue the indorser or any prior party thereto.

But, if the bill is indorsed "pay to A or B or order, unless before payment I advise you to the contrary", it is an indorsement with a condition subsequent, and the title of the indorsee is defeated if, before payment the acceptor of the note is advised not to pay. Where a condition, instead of appearing in an indorsement, is inserted in the body of the bill itself, it affects the negotiability of the instrument; it may delay or even entirely destroy its negotiability. The indorser is entitled to make a qualified indorsement as well. In such cases. the indorser may enable the indorsee to maintain an action on the instrument without taking any liability on himself.

Who can negotiate : Every sole maker, drawer, payee or indorsee or all of several joint makers, drawers, payees or indorsees of a negotiable instrument, if the negotiability of such instrument has not been restricted or excluded (mentioned in section 50), may indorse and negotiate the same (section 51). For example. a bill is drawn payable to A or order. A indorses it to B, the indorsement not

containing the words 'or order' or any equivalent words, B may negotiate the instrument.

Section 51 states that if the negotiability of an instrument has not been restricted or excluded as mentioned in section 50, then : a) every sole maker, drawer, payee or indorsee, or b) all of several joint makers, drawers payees or indorsees of the negotiable instrument may indorse and negotiate the same. But a maker or drawer cannot indorse or negotiate an instrument, unless he is the holder thereof.

In order to effect a valid indorsement of a negotiable instrument, the indorsement must be made by the holder and strictly follow the description given in the instrument. So, where the holder is a firm, only the firm can transfer the note by indorsement.

22.3.3 Negotiation Back

In some cases, an indorser, after he has negotiated an instrument, again becomes its holder before its maturity. On such occasions the instrument is said to be **negotiated back to the holder**. In such cases there are some intervening indorsers and indorsees.

If a bill or note is negotiated back to a prior party, he cannot enforce payment of the instrument against an intervening party to whom he was previously liable but can enforce it against any intermediate party to whom he was not liable. Thus, if A, a holder of a bill, indorses it to B without consideration, and B indorses it to C for value, and C again indorses it to D without consideration, and the bill eventually comes back into the hands of A. Now A can enforce it against B but not against C or D.

Check Your Progress A

1. A promissory note is drawn by A, the payee being B. Then B has transferred it by indorsement in favour of C and C in turn in favour of D. Explain whether the drawer be given notice as and when the transfers were made?

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2. An instrument is drawn payable to "Mr.X or order". Subsequently it was indorsed in blank. Is this payable to bearer? Explain.

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3. An instrument is signed on its back with words "Assigned to X". State whether it is a valid indorsement or not.

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4. What is the effect of indorsement done with the words “without recourse to me”?

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5. Differentiate between conditional indorsement and restrictive indorsement?

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22.4 LIABILITY OF VARIOUS PARTIES

You have studied in Unit 21 about various parties to a bill of exchange, promissory note and cheque. Now you should study the liability of various parties.

22.4.1 Liability of the Drawer of a Bill

Section 30 gives the holder of a dishonoured bill a right of action against the drawer. In addition to the drawer, the acceptor and the intermediate indorsers are also liable to the holder. But a drawee who has not accepted the bill is not liable. This means that the plaintiff cannot get a personal decree against persons who are not parties to the instrument and with whom there is no privity of contract in relation to the plaintiff.

The contract of the drawer of a bill, unlike that of the acceptor, is only a conditional contract. The drawer only undertakes to pay the amount of the bill in case of dishonour either by non-acceptance or non-payment. So, there is no demand or debt until the bill is dishonoured. But when the bill is dishonoured and notice of dishonour given (whatever may be the real account between the drawer and the drawee), the drawer becomes immediately liable to the holder for the amount. The drawer undertakes that the bill would be accepted by the drawee within a reasonable time within the business hours, provided it is presented at the place of business or the usual residence of the drawee. Of course, the drawer is not a surety for acceptance, because the drawee does not become liable until he accepts. Therefore, unless and until the drawee accept the bill, there is no debt for which drawee can be held responsible. It means that there is no principal for whom the drawer can stand surety. Therefore, when there is no acceptance, the liability of the drawer is as a principal debtor under an implied contract of indemnity. His undertaking is conditional only, and his liability does not arise unless: a) the instrument is dishonoured by non-acceptance or non-payment, and b) he gets notice of it.

Where a bill is stolen in transit and presented to the drawee and the drawee pays it without detecting the forgery of indorsement, the drawer’s liability is discharged and he ceases to be liable.

When the drawee is declared as insolvent, the holder may treat the bill as disnonoured without presenting it for acceptance and may sue the drawer before the date of maturity.

Section 30 requires that the notice of dishonour should be given to the drawer,

to give the holder a cause of action. With the notice of dishonour the liability of the drawer could arise because even where a bill has been stolen in transit but paid by the drawee without detecting forgery of the indorsement, the drawer is discharged. The purpose of notice is to make a person aware of fact, and hence a suit should not fail on the narrow technicality that facts regarding notice have been imperfectly stated in the plaint.

22.4.2 Liability of the Drawee of a Cheque

In the case of a cheque, the drawee (bank) having sufficient funds of the drawer in the account, must pay the cheque when duly required to do so. In default of such payment , the drawee must compensate the drawer for any loss or damage caused by such default.

Where the cheque is for an amount greater than that in the hands of the banker, the banker is under no obligation to honour the cheque, not even to the extent of money in his hands. However, it is different in case if there is a contract (as in the case of an over-draft) between the banker and the customer to honour the cheque even without sufficient funds. Consequently, it has been held that a banker's obligation to honour his customer's cheque may be extended by an agreement to allow the customer to overdraw to a certain limit. But, such agreement should be supported by a valid consideration, and in the absence of any such agreement, a banker is not liable for dishonouring his customer's overdrafts.

Relation between Banker and Customer: In the absence of any contract to the contrary, the relation between a banker and customer is that of a debtor and creditor. Money paid into account of customer, even though by mistake, becomes amount of the customer, and the bank cannot reverse the entry of credit nor can it pay back the amount to the person having deposited it. The case is different where money is handed over to bank for remitting it to another place, but the bank does not transfer it on that day, but suspends payment the same day. In such cases, the money remains as property of the person depositing it and make him entitled to preferential treatment.

Liability of Banker for Wrongful Payment of Cheques: A banker, who pays away a customer's money without the customer's authority, cannot debit the customer with the amount so paid.

Liability of Banker to Holder: There is no direct contract between the holder of a cheque and the banker on whom the cheque is drawn. A cheque does not operate as an assignment of funds which a customer may have in the hands of a banker. When a cheque is dishonoured, the remedy of a holder of the cheque is against the drawer and the banker is not liable to the holder.

Cheques sent for Realization: When a customer deposits a cheque with his banker for realization, the banker is only an agent of the customer for collection. Before actually realising the money of that cheque, if the bank credits the amount of that cheque to his customer, such entry in the pass book will show that the bank is a debtor to the customer to the extent of the amount thus credited. Later on the banker can prove that the entry was a mistake, unless, on the belief of such entry, the customer has changed his position. If the customer has changed his position on the belief of such entry, the bank may be stopped from pleading that it is not liable for the amount of such entry.

Duty of Banker regarding Bills: When a customer accepts a bill payable by his bankers, it is an authority to the banker to pay it. In the case of a cheque, he is protected against the consequences of a forged indorsement, whereas in the case of a bill he is not. In the absence of special agreement, there is no obligation for the bank to accept his customer's bills nor he is bound to pay a bill other than cheque drawn on him by the customer.

Compensation for Dishonouring a Cheque: Where a banker dishonours a cheque without any justification, he is liable to the drawer and not the payee. Thus for a wrongful dishonour of a cheque the drawee is liable to the drawer and not to the payee. The amount of compensation recoverable by the drawer of a cheque from the bank in case of dishonour is not limited to the actual pecuniary loss sustained by reason of the dishonour.

22.4.3 Liability of the Maker of a Note and Acceptor of a Bill

"*In the absence of a contract to the contrary, the maker of a promissory note and the acceptor before maturity of a bill of exchange are bound to pay the amount thereof at maturity according to the apparent tenor of the note or acceptance respectively, and the acceptor of a bill of exchange at or after maturity is bound to pay the amount thereof to the holder on demand. In default of such payment as aforesaid, such maker or acceptor is bound to compensate any party to the note or bill for any loss or damage sustained by him and caused by such default*".

Liability of Maker of a Promissory Note: Section 32 deals with the liability of the maker of a promissory note and of the acceptor of a bill of exchange. By executing a promissory note in favour of a certain person the maker of the note becomes a debtor and his liability for the whole amount is absolute. Where the maker of an instrument payable on demand, before any demand is made by the payee, pays its amount without getting the instrument back, and the note is indorsed by the payee to a third person who has no knowledge of the fact of payment, the indorsee is entitled as a holder in due course, to sue the maker of the instrument.

Drawee not Liable until Acceptance: The liability of the drawee arises only when he accepts the bill. The holder cannot sue the drawee for refusing to accept. In the event of dishonour by non-acceptance, the holder can proceed only against the drawer and previous indorsers.

Liability of an Acceptor: The liability of the acceptor of a bill of the maker of a note is absolute and unconditional. By accepting the bill, the acceptor agrees that he will pay according to the tenor of his acceptance. Similarly, the maker of a note, by making it, agrees that he will pay according to its tenor. The acceptor and the maker being the parties primarily liable on the bill or note, their liability is absolute, and no notice of dishonour is necessary to charge them.

The acceptor of a bill and the maker of a note are the principal debtors, and presentment for payment is not necessary to charge them. Their liability is independent of presentment. A drawee of a bill is under no legal obligation to accept the bill and thereby incur liability. So long as he does not accept a bill, no liability attaches to him.

Distinction between Liability of Drawer, Acceptor and Maker: Though both the maker of a promissory note and the drawer of a bill are both creditors, the nature of their liability differs. The liability of the maker of a promissory note, like that of the acceptor of a bill, is unconditional. The liability of the drawer of a bill, like that of an indorser, is conditional and it arises in the event of the bill being dishonoured. The acceptor of a bill and the maker of a promissory note have similar engagements. The acceptor of a bill, by accepting the bill, undertakes that he will make payment according to his acceptance. Similarly, the maker of a pronote, by making it, undertakes that he will pay it according to its tenor. As already stated, both the maker and the acceptor are the parties primarily liable under the note or the bill. The liability is absolute and unconditional, and is not dependent on any notice of dishonour. The liability of the acceptor is not affected by reason of the death or insolvency of the drawer. His liability is also not affected by the fact that he is unable to receive goods owing to the intervention of war in respect of which we gave his acceptance in the instrument.

Parties to Suits: The question may arise as to who are the proper parties to a suit brought for indemnification on a negotiable instrument. Section 32 declares that, in the absence of a contract to the contrary, the maker of a promissory note and the acceptor before maturity of a bill of exchange are bound to pay the amount thereof at its maturity according to the apparent tenor of the note or bill. In default of such payment, such maker or acceptor is bound to compensate the party to the note or bill for any loss or damage sustained by him and caused by such default. Section 37 of the Act states that the maker of a promissory note or cheques, the drawer of a bill until acceptance, and the acceptor of a bill are liable thereon as principal debtors, and the other parties thereto are liable thereon as sureties. Section 38 provides that, as between the parties so liable as sureties, each prior party is also liable thereon as a principal debtor in respect of each subsequent party. As between the maker and indorser, the indorser is liable as a surety, the maker being liable as principal debtor. Therefore, if a holder realises money from the indorser, the indorser can proceed against the maker as principal debtor liable to indemnify him.

22.4.4 Liability of Indorser

"*In the absence of a contract to the contrary, whoever indorses and delivers a negotiable instrument before maturity without, in such indorsement, expressly excluding or making conditional his own liability, is bound thereby to every subsequent holder in case of dishonour by the drawee, acceptor or maker to compensate such holder for any loss or damage caused to him by such dishonour, provided due notice of dishonour has been given to, or received by, such indorser as herein after provided. Every indorser after dishonour is liable as upon an instrument payable on demand"* (section 35).

The application of this section is confined to instruments which are indorsed before maturity, and since a promissory note is payable on demand only at maturity, this section does not apply to such an instrument.

After the dishonour, the indorser is liable upon an instrument payable on demand because his liability is similar to that of the maker. It is clear that the liability under this section arises out of indorsement and not on the instrument. But to create the indorser's liability, mere indorsement is not enough. It must be accompanied by

delivery of possession. The right of the indorsee to sue is dependent on the indorsement, which forms part of the cause of action, and which confers jurisdiction upon the court where the indorsement is made, to entertain and try the case against the indorser and drawer. If a person delivers a bill to another without indorsing his own name upon it, he does not subject himself to the obligation of law and cannot be sued upon the bill either by the person to whom he delivers it or by any other.

22.4.5 Liability of Prior Parties to Holder in Due Course

Every prior party to a negotiable instrument is liable thereon to a holder in due course until the instrument is duly satisfied (section 36). The expression "prior party" means the maker or drawer, the acceptor and the intervening indorser. The acceptor would be a "prior party" within the meaning of this section though he has signed the acceptance after the bill has come into the hands of the holder in due course.

An indorser will not be liable under this section to a holder in due course, if he has, by express words in the indorsement, excluded his liability on the instrument.

This section lays down that every party to a negotiable instrument preceding the holder in due course is liable to him until it is satisfied or discharged. The holder of a bill can bring an action as if he were an agent for all or any of the persons who are parties to it, and this right vests in him by virtue of the inclorsement in his favour.

A negotiable instrument can always be negotiated until it has been paid up or satisfied. But where payment is made before maturity and such payment is not shown on the instrument, it may still be negotiated, because such payment cannot be considered as payment in due course. An instrument before payment or satisfaction can always be negotiated, except by the maker of a note or the drawer or acceptor of a bill, at or after maturity.

Check Your Progress B

1. A draws a bill on B payable 3 months after sight. It passes through X, Y, and Z on negotiation even before acceptance. On presentation by Z, B refuses to accept. Now who are liable to Z?

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2. In case of dishonour. to whom is the indorser of a negotiable instrument before maturity liable?

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3. Who is not a "prior party" as per the law?

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4. A cheque drawn by A payable to B and indorsed to C has been dishonoured by the bank. What is the remedy to the holder?

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22.5 LOST AND STOLEN INSTRUMENTS

Lost Instruments

The following rules are applicable when a negotiable instrument is lost:

1) Where a bill of exchange has been lost before its maturity, its holder may request the drawer to give him another bill of the same tenor. The drawer in turn may request the holder to give security to indemnify him against all persons in case the bill alleged to have been lost is found again. If the drawer on request refuses to give such duplicate bill, the holder may have to obtain it by means of a suit (section 45A). The right to obtain a duplicate of lost instrument is also applicable to the holder of a promissory note or a cheque.

2) In case of loss of a negotiable instrument, the holder should inform all parties liable on it and should also give public notice by advertisement in some local newspaper to caution against its misuse.

3) If the holder could not obtain a duplicate copy, on maturity he should make an application to the person liable to pay on the lost instrument for payment of the amount due thereon. Although the payer is entitled to refuse payment till the instrument is delivered to him, he may make the payment after getting a written undertaking from the payee to indemnify him against any further claim thereon. In case the payer insists on delivery of the instrument and refuses to pay otherwise, then payment can be sought through court on similar undertaking to indemnify (section 81).

4) The finder of the lost instrument gets no title to it and cannot sue the party liable thereon for its payment. The rightful holder (the true owner) is entitled to get back the instrument from him. But if the finder obtains payment of the instrument, it being a bearer document, the payer (i.e., the maker, acceptor or drawee) will be discharged from his liability if he makes a payment in due course. The true owner, however, will be entitled to recover the amount from the finder (sections 58 and 82).

5) As the finder of the lost instrument does not get the title to it, he cannot lawfully transfer it. If that instrument is a bearer instrument or one indorsed in blank, the founder may negotiate it to a holder in due course. In such a case the holder gets a good title to it and can obtain payment from the party concerned (section 58). The true owner cannot take possession of the same from such a holder in due course, and can claim damages from the finder, if traceable.

6) In case the finder transfers an order instrument by making a forged indorsement, even a bonafide transferee for value gets no legal title to it, and, therefore, he is not entitled to sue on the instrument. Forgery can confer no title, and, therefore, the indorsee cannot be a holder in due course. If the party liable to pay on the instrument makes the payment to the indorsee who holds it under a forged indorsement, he shall continue to be liable to the true owner. (Protection has, however, been given by law to a paying banker in such a case).

Stolen Instruments

The position in case of a stolen negotiable instrument is almost the same as in the case of a lost instrument, with the difference that on being traced, the thief is open to criminal prosecution while a finder is not. Here also, the thief does not acquire any title to the instrument and the true owner can sue him for the recovery of the instrument or the money he has received from the maker, acceptor or drawee. But if the thief transfers a bearer instrument to a holder in due course, such a holder gets a good title to it (section 58).

22.6 INSTRUMENTS OBTAINED BY FRAUD

The person who obtains the instrument by fraud, cannot claim payment against any party thereto, nor can he retain the instrument against the true owner. The term 'fraud' has not been defined in this Act but can be found from section 17 of the Contract Act.

Fraud vitiates all agreements and transactions. The law sets itself against fraud to the extent of breaking through almost every rule sacrificing every maxim and getting rid of every ground of opposition which may be presented, so as to prevent it from succeeding. This principle is applicable to debts evidenced by hundies, promissory notes or other negotiable instruments, if the facts show that the loans were contracted on the fraudulent misrepresentation made by the debtor to a creditor.

If a person obtains an advance of money on a hundi on untrue representations, knowing them to he untrue and also knowing that without them he could not have got the money, the lender is entitled to rescind the contract evidenced by the hundi and to sue at once for the amounts advanced even before the due date of the hundi. Similarly, a person who has been fraudulently induced to sign a bill or note is entitled to repudiate it as soon as he has discovered the fraud and before he has derived any benefit therefrom. When he repudiates the instrument, it cannot be enforced against him by any person other than a holder in due course or a person deriving title from such holder.

Fraudulent misrepresentation will be a good cause for rescinding a contract and will be a good defence to an action on a negotiable instrument and the person defrauding will not be entitled to recover.

Though a defence of fraud cannot be set up against a holder in due course or a holder deriving title from such holder, still, if it could be shown that a person without negligence on his part was induced to sign an instrument, he would not be liable even to a holder in due course. If a man who cannot read has a written contract (e.g., a bill of exchange) falsely read over to him and the contract written differs from that pretended to be read, the signature on the document is of no force; because he never intended to sign the document on which the signature was found.

22.7 FORGED INSTRUMENTS AND FORGED INDORSEMENTS

Forgery is the fraudulent making or alteration of a writing to the prejudice of another man's right. The indorsement through which a holder in due course claims must he genuine. This principal is of universal application. A forged indorsement is not considered as an indorsement. If a bill or note be negotiated by means of a forged indorsement, a person claiming under that indorsement, though he may be a purchaser for value in good faith, cannot claim the right of a holder in due course. There is a vital distinction between defect in title and no title at all, the later being the case where the indorsement is forged. The payee of a certain hundi not payable to bearer, who employed a broker for sale was induced by him to indorse the hundi in favour of X. The broker then successively forged the indorsement of X and of some fictitious persons, and sold the hundi to Y. Later Y realised the amount from the drawee. In a suit by the payee against the broker and Y for the amount of the hundi, held, that the plaintiff was entitled to a decree against both. Though Y is a bonafide purchaser for value, he was not a holder in due course and could not escape liability.

Estoppel : A forged signature cannot be validated by ratification, but a person may, by his conduct, be precluded from setting up that his signature or the signature of any other person is a forgery.

Check Your Progress C

1. A draws a promissory note payable to B for the money payable by him. The note is not delivered to B but is lost and found after the death of A. The note is then delivered to B. Who should be held liable on the note?

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2. An indorser has excluded his personal liability on an instrument. Is he liable on the instrument?

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3. A has obtained money on a note by making an untrue representation, knowing well that it is untrue. The note is payable 3 months after the date of its making. What action can be taken by the drawee if he comes to know of the fraud?

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4. What is the effect of a forged indorsement?

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22.8 LET US SUM UP

The ownership of a negotiable instrument can be transferred in two ways: 1) by negotiation, and 2) by assignment. Negotiation refers to the transfer of an instrument from one person to another so as to constitute that person the holder of the instrument. Assignment refers to the transfer of ownership in an instrument by means of a written and registered document under the provisions of the Transfer of Property Act.

There are two modes of negotiating an instrument. Instruments payable to bearer can be transferred by mere delivery whereas instruments payable to the order of a person are transferable by indorsement and delivery. There are different types of indorsements viz., 1) indorsement in blank, 2) indorsement in full, 3) restrictive indorsement, 4) partial indorsement, and 5) conditional indorsement.

In some cases, an indorser, after he has negotiated an instrument, again becomes its holder before its maturity. In such cases, it is said that the instrument is negotiated back to the holder. If an instrument is negotiated back to a prior party, he cannot enforce the payment of the instrument against an intervening party to whom he was previously liable but can enforce it against any intermediate party to whom he was not liable.

The drawer, the acceptor and the indorsers who are the various parties involved in an instrument have their liabilities defined by the Act. The nature of liability (as a primary debtor or as a surety) and the conditions subject to which it arises (on delivery, acceptance, on having sufficient funds, etc.) are discussed in detail. The case of stolen instruments, forged instruments and those obtained by fraud raise the basic question of legal validity of the instrument. In the case of loss of an instrument notice to the concerned parties helps to safeguard against the misuse.

22.9 KEY WORDS

Assignment: Transfer of the ownership and other rights by writing a separate deed.

Forgery: Fraudulent making or alteration of a writing to the prejudice of another person's right.

Negotiation Back: The process of negotiation in which an indorser, after one or more indorsements have taken place, becoming an indorsee.

22.10 ANSWERS TO CHECK YOUR PROGRESS

A) 1. Not necessary because the law regarding indorsement does not require it.

2. Yes, this becomes payable to bearer.

3. It is a valid indorsement.
4. It avoids the personal liability of the indorser.

B)
1. A, B, X and Y are liable to Z.
2. To all subsequent holders.
3. Maker or drawer
4. To sue A only

C)
1. No body can be held liable since the note was not delivered after making.
2. He is liable to the prior parties.
3. Suit can be filed immediately even before maturity.

22.11 TERMINAL QUESTIONS

1) Examine the differences and similarities between a negotiation and assignment.
2) Explain the requisites of a valid negotiation made by a simple delivery.
3) Explain the requisites of a valid negotiation made by indorsement and delivery.
4) Discuss the nature of liabilities of a drawer of a bill, note and cheque.
5) Discuss the nature of the liability of a drawee of a cheque.
6) Explain the liabilities of various parties to instruments.
7) Discuss the liabilities of various parties: a) when an instrument is stolen, and b) When an instrument is forged.

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Note : These questions will help you to understand the unit better. Try to write answers for them. But, do not submit your answers to the University for assessment. These are for your own practice only.

UNIT 23 PRESENTMENT AND DISCHARGE

Structure

23.0 Objectives

23.1 Introduction

23.2 Presentment for Acceptance

- 23.2.1 Rules Regarding Presentment for Acceptance
- 23.2.2 Types of Acceptance
- 23.2.3 Effect of Non-presentment for Acceptance
- 23.2.4 Acceptor for Honour

23.3 Presentment for Payment

- 23.3.1 Rules Regarding Presentment for Payment
- 23.3.2 When Presentment is Unnecessary?
- 23.3.3 Payment for Honour

23.4 Dishonour by Non-acceptance and Non-payment

- 23.4.1 Dishonour by Non-acceptance
- 23.4.2 Dishonour by Non-payment
- 23.4.3 Rules Regarding Notice of Dishonour
- 23.4.4 Noting and Protesting

23.5 Discharge from Liability

23.6 Effect of Material Alteration

23.7 Let Us Sum Up

23.8 Key Words

23.9 Answers to Check Your Progress

23.10 Terminal Questions

23.0 OBJECTIVES

After studying this unit, you should be able to:

- explain the valid methods of presenting a bill for acceptance and for payment;
- state the types of acceptance;
- explain what leads to dishonour by non-acceptance as well as dishonour by non payment;
- describe the actions called noting and protesting after dishonour;
- describe how the liability in an instrument is discharged; and
- explain the effect of material alteration in an instrument.

23.1 INTRODUCTION

You have already studied in detail the nature of the three types of negotiable instruments and the law relating to negotiation of an instrument. For complete

understanding of the Act, you have to study two aspects : 1) the law relating to presentment for acceptance as well as for payment, and 2) how normally one is discharged from the liability arising out of the instrument. In this unit you will study these two aspects in detail. You will study the prescriptions regarding how and when presentment for acceptance and presentment for payment is to be made, what amounts to dishonour by non-acceptance and dishonour by non-payment, noting and protesting after dishonour, how the liability in an instrument is discharged and the effect of material alternation in an instrument.

23.2 PRESENTMENT FOR ACCEPTANCE

Presentment means placing the negotiable instrument before a drawee. Presentment is done for any of the following three purposes 1) for acceptance, 2) for sight, and 3) for payment. Now in this section we shall discuss presentment for acceptance.

Among the three negotiable instruments (i.e., bill of exchange, promissory note and cheque), it is only the bill of exchange that can be presented for acceptance. It is not necessary in all cases to present a bill of exchange for acceptance before presenting it for payment. Presentment of a bill for acceptance is necessary only in two cases: (1) where a bill is payable after sight, (in order to assure the responsibility for payment on maturity of the instrument), and (2) where a bill expressly stipulates that it shall be presented for acceptance before it is presented for payment. In other cases, presentment for acceptance depends upon the discretion of the payee to take it to the drawee for acceptance. Thus, where a bill is payable at a fixed period after date or on the happening of a certain event, the holder may or may not, as he thinks fit, present the bill for acceptance, though in the majority of cases the bill will probably be presented. Neglect to present cannot affect the liability of the parties to the holder, in case the bill is dishonoured by non-payment. It is necessary that the person who has to pay the bill shall have accepted it, in order to complete a legal formality. It can be negotiated even before acceptance and in such cases, the holder may sue upon it as a holder in due course.

In cases where presentment is essential, in the absence of proof of presentment, no claim can succeed. It is also open to the parties to contract themselves out of the obligation of presenting the bill. They may stipulate in the bill that payment is to be made without acceptance. It has further been repeatedly held in connection with bills payable on demand or bills payable on a fixed date that presentation is not compulsory but only optional. However, it is advisable that the bill is presented for acceptance so that, on its acceptance, the holder obtains an additional security of the acceptor. In case the drawee refuses to accept, the holder can give notice of dishonour and sue the drawer immediately without waiting for the date of maturity of the bill.

23.2.1 Rules Regarding Presentment for Acceptance

Presentment by whom to be made : Section 61 says that presentment for acceptance should be made by the person entitled to demand acceptance. This means that the bill should he presented by the holder, or by somebody else on behalf of the holder. In the case of a bill payable at sight, both presentment for acceptance and presentment for payment are combined into one, and therefore the person entitled to present it for acceptance. If, however, a bill is presented

by a person who is not entitled to demand acceptance, but the instrument is accepted by the drawee, such acceptance will be deemed to have been made for the benefit of the person really entitled to the bill. Presentment for acceptance can also be made by the holder, or through his authorised agent.

Time for presentment: A bill payable after sight must, if no time is specified therein for presentment, be presented for acceptance within a reasonable time after it is drawn. If the bill itself specifies a period for presentment, it must be presented within that period. In the case a bill of which presentment for acceptance is optional, if the holder chooses to present it for acceptance, he may do so at any time before payment.

Effects of non-presentment: In the case where presentment is essential but presentment is not made, the liability on the bill or note is discharged and also action is not maintainable in respect of the consideration. Where a suit is filed by the indorsees of a bill against the indorser and the drawer and presentment for acceptance is not established the plantiff's suit is liable to dismissal.

In the case of a bill of exchange payable at sight, the law does not necessarily require it to be presented by the holder to the drawee for acceptance. If the holder does not elect to present the instrument for acceptance but merely presents the same for payment and the drawee makes default, notice of dishonour to the drawer must be given under section 30 of the Act in order to make him liable.

Presentment for acceptance when excused : Presentment for acceptance is excused, and the bill may be treated as dishonoured by non-acceptance in the following cases:

a) Where the drawee is a fictitious person, or is a person incompetent to contract.

b) The drawee cannot found even after a reasonable search.

c) Where, although presentment has been irregular, acceptance has been refused on some other ground.

If a bill is transferred to a holder at so short a time before maturity that presentment is impossible, it will be excused only as regards the liability of the party so transferring. The holder's obligation to present the bill for acceptance is not gone, even if the drawer requests the drawee not to accept the bill, if presented. Similarly, a holder is bound to make presentment for acceptance, even if the drawee has become insolvent. But, if a drawee once refuses to accept when the bill is presented to him, he cannot oblige the holder to present it to him again, even if he promises that it will be accepted by him.

Place of presentment: Presentment for acceptance may be made to the drawee at any place. If, however, the place of presentment for acceptance is definitely mentioned in the instrument, it must be presented at that place. In case the maker of a promissory note does not reside at the place specified in the note and the instrument is in possession of the person in whose favour it was executed, no presentment is necessary. If no place for presentment is specified, then the bill should be presented at the drawee's usual place of business or residence.

Proof of presentment: The burden of proving presentment is on the plaintiff. In a case, where presentment is necessary, presentment should be definitely proved in order to enable a party to recover his claim on it.

Promissory note payable at a certain period after sight : Where a promissory note is made payable after sight, presentment of it for sight is necessary in order to fix the maturity of the instrument. The expression "after sight" on a bill of exchange means after acceptance or protest for non-acceptance, and not after a mere private exhibition to the drawee. If a promissory note is made after sight, it means that payment is not to be demanded till it is again exhibited to the maker.

Drawee's time for deliberation : "The holder must, if so required by the drawee of a bill of exchange presented to him for acceptance, allow the drawee forty-eight hours (exclusive of public holidays) to consider whether he will accept it" (section 63).

Delay may be excused, where it has been occassioned by circumstances over which the holder of the instrument had absolutely no control such as declaration of war, obstructing the transmission of the instrument by the holder for payment, or a declaration of a moratorium, illness of the holder, or even loss of the instrument.

23.2.2 Types of Acceptance

Acceptance may be classified into two types:

1) General Acceptance

2) Qualified Acceptance

General Acceptance

An acceptance which assents without qualification to the order of the drawer is called general acceptance. In general acceptance the drawee accepts the liability to pay the amount as mentioned in the bill in full, without any condition or limitation. Drawee accepts according to the apparent tenor of the bill.

Qualified Acceptance

A qualified acceptance in express terms varies the effect of the bill as originally drawn. In the case of qualified acceptance, the drawee accepts the bill subject to certain conditions, conditions as to time, place, event, amount, drawees, etc. may be added to the acceptance. These conditions make the acceptance qualified.

The holder of a bill is not bound to take a qualified acceptance. Where the acceptance is qualified, he may, at his option, treat the bill as dishonoured, and after giving due notice of dishonour sue the drawer and prior indorsers. If, however, he chooses to take a qualified acceptance, he must be careful to secure the assent of all the prior parties, because all prior parties are discharged unless they give their consent to the qualified acceptance. The drawer or an indorser of a bill undertakes that the drawee on presentment will accept the bill and make payment at its maturity, and, in default, the drawer or the indorser, as the case may be, will pay up the amount of the bill. If the holder, against such a contract of the drawer or the indorser, accepts a qualified acceptance, he varies the contract and, therefore, all the parties prior to him are discharged, unless they give their consent to such qualified acceptance.

As between the drawee and the holder, if the drawee is in contract with the drawer that he will accept; his refusal will make him liable to damages, which may be either to the face-value of the bill, or even to the market value thereof.

Qualification of acceptance must be clearly expressed. An acceptance will not be treated as a qualified acceptance unless the qualification is expressed in the clearest language. To qualify an acceptance, the acceptor must do so on the face of the bill in clear and unequivocal terms by plain and intelligible language, in such a manner that any person taking the bill cannot fail to understand that it was accepted subject to an express qualification.

Classification of Qualified Acceptance: Qualified acceptance may be classified in the following lines

1. Conditional acceptance,
2. Partial acceptance,
3. Qualified as to place,
4. Qualified as to time,
5 Made by someone or more of the drawees. but not by all.

1) **Conditional Acceptance :** A conditional acceptance is one which makes payment by the acceptor dependent on the fulfilment of a condition therein stated. The following are instances of conditional acceptances:

   i) Accepted payable when cash is received for the cargo of the ship.

   ii) Accepted payable when goods consigned to someone are sold.

   iii) Accepted payable on giving up a bill of lading. In this case, it was held, that though the acceptance was a conditional acceptance, the acceptor could not be discharged by not handing over the bill of lading to him on the day the bill fell due.

   The holder, in all such cases, will be entitled to treat the bill dishonoured if he chooses to take such acceptance he should give notice of the nature of the acceptance to all parties. If the condition does not appear on the face of the instrument, it will not affect an innocent indorsee for value and if such acceptance is taken on a separate place of paper, it will bind only the immediate parties.

2) **Partial Acceptance :** A partial acceptance is "an acceptance to pay partly only of the amount for which the bill is drawn". For example: by a bill drawn for Rs. 1,270 if accepted for Rs. 1,000, it is partial acceptance. If a holder takes acceptance only to part of the amount due on the bill, it discharges the prior parties who do not give their consent to such acceptance.

3) **Qualified as to Place:** A local acceptance is "an acceptance to pay only at a particular specified place" The emphasis is on the word "only" as "an acceptance to pay at a particular place is a general acceptance unless it expressly states that the bill is to be paid there only and not elsewhere." Thus, an acceptance in the form "accepted payable at X & Co.", is a general acceptance; but an acceptance in the form "accepted payable at X & Co., and not elsewhere" is a qualified acceptance.

4) **Acceptance qualified as to time:** An acceptance can be made qualified as to time, if the drawee, while accepting, says that the amount due will be paid not at the time mentioned in the instrument but at any other time, whether sooner or later. This, without doubt, means to varying the contract and hence, unless there is a consent, prior parties to the instrument stand discharged.

5) **Acceptance made by someone or more of the drawees but, not by all :** An acceptance made by someone or more of the drawees but not by all is also a qualified acceptance. In case of persons, not partners. acceptance must be made by all of them. If any of them refuses to accept, the holder has a right to treat the bill as dishonoured. But, in case of partnerships, acceptance by one is considered acceptance by all.

23.2.3 Effect of Non-presentment for Acceptance

In the absence of presentment, where presentment is not dispensed with, not only the drawer and all indorsers are discharged as against the holder but also no action is maintainable in respect of the consideration. Where a suit is filed by the indorsees of a bill against the indorser and the drawer, and presentment for acceptance is not established, the plaintiffs suit is liable to dismissal.

In the case of a bill of exchange payable at sight, the law does not necessarily require it to be presented by the holder to the drawee for acceptance. If the holder does not elect to present the instrument for acceptance but merely presents the same for payment and the drawee makes default, notice of dishonour to the drawer must be given under section 30 of the Act in order to make him liable.

23.2.4 Acceptor for Honour

As you know, a bill can be accepted only by drawee. But, when a bill of exchange has been noted or protested for non-acceptance or for better security, any person who is not already liable on the bill, may, with the consent of the holder, accept the bill for the honour of any party (section 108). **This is called the acceptance for honour** and the person who accepts is called the acceptor for honour. Any person who is not liable on the bill can accept for honour. Even the drawee, though he may have refused to accept the bill generally, may accept it for the honour of any party thereto.

The Act provides that a bill can be accepted for honour only with the consent of the holder. The holder has the option to take or refuse such acceptance, and cannot be compelled to take it whether he likes it or not. The holder, as soon as the bill is dishonoured for non-acceptance, becomes entitled to maintain an action against all the parties who are liable to him on the bill. If he gives his consent to acceptance for honour, he waives his right of immediate action against the parties liable to him.

The person desiring to accept for honour is expected to write on the bill that the acceptance is under his hand and he should also declare in writing that he accepts to protest for the honour of the drawer or of a particular person whom he names or generally for honour. Law does not prescribe any particular form of such acceptance. If the requirements stated above are fulfilled, the acceptance is valid, Such acceptance may be written across the bill or on any part of the bill. "Accepted supra protest" or Accepted S.P." or "accepted supra protest for the honour of H.B. for Rs………" will suffice.

Rights and liabilities of acceptor for honour: The party accepting for honour is placed in the shoes of the party for whose honour he intervenes, both as regards his liability to subsequent parties and his rights against the antecedent parties, and, in addition, can recover against such party himself. A person accepting for honour is entitled to recover from the person for whose honour he accepts, even though the acceptance be given without the order, or the knowledge of the person for whose honour it is given.

A bill cannot be accepted for honour, unless it has been noted or protested for non acceptance or for better security. **The Question of Acceptance for honour does not arise in case of promissory notes or cheques.**

Check Your Progress A

1. A bill is drawn on B payable 60 days after the date of the bill. B accepts stating that it is payable after 60 days after acceptance. Is this a valid acceptance?

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2. When the presentment for acceptance is excused and the bill is treated as dishonoured?

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3. What is the provision in the Act when presentment for acceptance is essential but the presentment is not made?

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4. When the presentment for acceptance is not necessary?

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5. Is presentment for acceptance necessary for a promissory note payable after a certain period?

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23.3 PRESENTMENT FOR PAYMENT

Section 64 states that the instrument must be properly presented for payment. The object of presentment is to give the concerned party an opportunity to pay. Moreover, except in the case of a promissory note payable on demand and which is not payable at a specified place, presentment must be made in order to make the maker liable. Until such presentment, no right to sue arises.

The exception to this section 64 lays down that, in the case of promissory note payable on demand at specified place, the note should be presented at that place in order to charge the maker thereof unless the presentment is otherwise excused; but, if the note is not payable at a specified place, the presentment of the note is not necessary. From the exception to section 64 it is made clear that presentment is necessary if the promissory note, payable on demand, is payable at a specified place. By presentment for payment, a holder does not thereby warrant the genuiness of the bill. A drawer or indorser who is discharged from his liability on a bill is also discharged from his liability on the consideration thereof.

The provisions relating to presentment under the Act are applicable to *hundies* and other instruments in oriental language; but they are subject to such local usages as may be proved to exist.

23.3.1 Rules Regarding Presentment for Payment

In order to constitute a valid presentment for payment, the document must be actually presented so as to enable the person presenting, to deliver it forthwith on payment to him. Briefly, due presentment for payment means presentment: (i) on the proper day, (ii) at the proper hour, (iii) by the proper person, (iv) at the proper place, (v) to the proper person, and (vi) in the proper manner. Let us study these rules in detail.

1) **Presentment to whom :** Section 64 must be read with section 75. If the party has been declared an insolvent, presentment may, be made to him or his assignee, as the holder chooses. If there are several makers, drawees or acceptors, not being partner and no place of payment is specified, presentment must be made to all of them.

   Presentment of a promissory note is not necessary when the payment of the promissory note is to be made at the place of the creditor but presentment of a promissory note or bill of exchange is necessary when the payment is to be made at the place of the debtor.

2) **Effect of non-presentment :** The drawer and indorsers in the case of bills and cheques and only the indorsers in the case of notes, are discharged on default of presentment. This is due to the fact that their liability is conditional, and if the condition is not fulfilled, the liability is discharged. It is a well-recognised rule of law that a discharge of the principal is discharge of the surety; the contract or engagement of the surety being but an accessory to the principal's agreement terminate with it.

3) **Waiver of presentment:** Presentment may be waived expressly or impliedly. There may be an express waiver by stipulation inserted in the bill.

   A waiver may be implied in the conduct of the party, as when a man with notice of the failure or undue delay in presentment, promises to pay the bill, or makes or promises to make a partial payment on account.

Presentation for payment is necessary in order to charge the "other parties" i.e., parties other than the holder. This expression must be interpreted to exclude from its ambit also the maker of a cheque. There is a distinction between 'maker' and 'drawer'. The word maker is used in relation to all the three types of negotiable instruments (namely, promissory note, a bill of exchange and cheque), while the word drawer is used only in relation to a bill-of-exchange and a cheque.

Where a promissory note is expressed to be payable on demand, but no place of payment is specified in it, the phrase, "on demand" in the note is a mere technical expression meaning that payment ought to be made immediately or at once. It does not imply a condition that a demand should be made before action is brought. The action itself is a sufficient demand.

4) **Specified place :** If the place of presentment is specified, the obligation to pay arises at that on such presentment. In other words, the place specified for payment must be equivalent to an address. The maker must be able to find the addressee by the exercise of reasonable diligence. If the maker or drawee or acceptor of a negotiable instrument has no known place of business or fixed residence and no place is specified in the instrument for presentment for acceptance or payment, such presentment may be made to him in person wherever he can be found (section 71).

5) **Hours of Presentment :** Presentment for payment must be made during the usual hours of business, and, if at a banker's place, it should he within banking hours (section 65).

6) **Presentment of instruments payable otherwise than on demand :** Section 66 refers to two classes of instruments not payable on demand: (1) those that are payable at a specified period after date, and (2) those that are payable at a specified period after sight. But such instruments must be presented for payment at maturity. There may be instruments not payable on demand besides those specified above (e.g., bills payable on the lapse of a certain period after the happening of a specified event). In such a case, presentment will depend on the circumstances of the case.

7) **Presentment of cheque to charge any other person :** A cheque must, in order to charge any person except the drawer, be presented within a reasonable time after delivery thereof by such person (section 73).

23.3.2 When Presentment is Unnecessary?

The general rule is that a negotiable instrument must be presented for payment to the maker, acceptor or drawee, by or on behalf of the holder to charge the other parties to the instrument with liability. Section 76 enumerates exceptions to this general rule. It specifies the circumstances in which presentment for payment is altogether dispensed with. But, there are also circumstances which, without delay in making presentment, will excuse delay in making it. Delay in making presentment for payment is excused, when the delay is caused by circumstances beyond the control of the holder, and not due to his default, misconduct or negligence. For example, owing to the prevalence of war in the place where the bill was payable, the holder could not present it at maturity, hence delay in presentment was held excusable. But, when the cause of delay ceases to operate, presentment must be made with reasonable diligence. Section 76 enlists the following exceptional

situations where presentment for payment is unnecessary and the instrument will be taken as dishonoured. These are listed in clauses (a) to (d) of section 76.

a) **Intentionally prevents :** If the maker, drawee or acceptor intentionally prevents the presentment of the instrument or he closes the business place during business hours on a working day or when the instrument is made payable at a specific place, he fails to come there or he could not be found even after a due search.

b) **Waiver :** Presentment is unnecessary as against the party sought to be charged therewith if he has agreed to pay notwithstanding non-presentment.

c) **Payment after maturity :** No presentment for payment is necessary as against any party if, after maturity, with knowledge that the instrument has not been presented, he makes a part payment on account of the amount due on the instrument. Proof of such a part payment or promise to pay is necessary. Similarly, a promise to pay the amount due there on can also be made.

d) **As against the drawer:** As against the drawer, presentment is not necessary, if he cannot suffer any damage for want of presentment. When the drawer has no funds, belonging to himself in the hands of the drawee, neither notice of dishonour nor presentment for payment within a reasonable time is necessary.

23.3.3 Payment for Honour

Corresponding to acceptance for honour, there are specific provisions regarding payment for honour. Acceptance for honour is relevant in the case of bills only and not for promissory notes. If a person accepts a promissory note for honour, he does so at his own risk, because he cannot acquire any right of action against the party for those honour the pronote is accepted or even against any other party to the instrument.

In order, that a payment for honour may operate as such, it is necessary to satisfy three conditions: (I) the bill must have been previously noted or protested for non-payment, (ii) the person paying or his agent, must declare before Notary Public the party for whose honour he pays, and (iii) such declaration must be recorded by the Notary Public.

A payment for honour may be made by any person, whether he is liable as a party to the bill or not. Thus, the drawer, the drawee or an indorsee, may pay for the honour of a party liable on the bill. Even a stranger may make a payment for honour. It is not necessary that the payment should be made, at the request of the party for whose honour it is made.

It is necessary that, before payment for honour can be made, the instrument should be protested for non-payment. Such protest is made a condition precedent on the ground that if payment is made before such protest, it will be considered that the payment is made on behalf of the acceptor, and therefore, the payer for honour will lose his rights and claims against the drawer, and the indorsers.

The payer for honour is entitled to recover the amount on the strength of the title of the holder. He can recover from the party for whose honour he pays all sums so paid, with interest thereon and also all expenses properly incurred in making such payment.

These provisions have no application to a "drawee in case of need" of a bill of exchange.

23.4 DISHONOUR BY NON-ACCEPTANCE AND NON-PAYMENT

23.4.1 Dishonour by Non-acceptance

A bill can be dishonoured by non-acceptance in several ways, as discussed below:

1) If a bill is presented to the drawee for acceptance and he does not accept it within 48 hours from the time of presentment for acceptance, the bill is considered to have been dishonoured. If there are two or more drawees (and they are not partners of a firm) and the bill is accepted by one or some of them only, the holder is entitled to treat it as dishonoured. He can also treat such a bill as accepted, but such acceptance is a qualified acceptance, and therefore, he cannot charge the prior parties, unless they give their assent to such an acceptance. But, if the drawees are all partners of a firm, acceptance by anyone of them is taken as an acceptance by all the partners of the partnership.

2) If a bill is given a qualified acceptance, the holder can treat it as dishonoured. The holder can also take such acceptance as in order, but if he does so, all prior parties, unless they give their assent to such acceptance, are discharged.

3) A bill is considered dishonoured by non-acceptance, if the drawee cannot be found after reasonable search.

4) It is also considered dishonoured for non-acceptance, if the drawee is incompetent to enter into a valid contract. When a drawer draws a bill, he impliedly undertakes that the drawee is a person competent to contract. If the holder finds that the drawee is incompetent to contract, he need not make presentment for acceptance and can treat the bill as dishonoured.

5) A bill is also considered dishonoured for non-acceptance if the drawee is a fictitious person. No presentment for acceptance in such a case is possible, because the drawee given in the instrument does not exist.

6) A bill is dishonoured for non-acceptance, where the drawee has either become insolvent or is dead. In such a case presentment for acceptance to the assignee or the legal representative of the deceased drawee is optional with the holder.

23.4.2 Dishonour by Non-payment

"A promissory note, bill-of-exchange or cheque is said to be dishonoured by non-payment when the maker of the note, acceptor of the bill or drawee of the cheque makes default in payment upon being duly required to pay the same" (section 92).

The provision of this section dealing with dishonour by non-payment are applicable to bill of exchange payable at sight or on demand. There may be dishonour by non-acceptance of a bill payable on demand, though presentment for acceptance is not required by law in such a case.

If notice of dishonour is not given to drawer and indorsers, it will discharge them all from liability not only on the bill but also with regard to the original consideration. In the absence of a contract to the contrary, the indorsee of a promissory note is not liable when he has no notice of dishonour.

This section 92 must be read with section 76, which specifies the circumstances in which the holder of a bill or note may treat it as dishonoured, without presenting for payment.

23.4.3 Rules Regarding Notice of Dishonour

Section 93 deals with cases of dishonour of negotiable instruments, either by non-acceptance or by non-payment. The law requires that notice of dishonour should be given either by the holder or by some party liable on the instrument. Promptness in giving notice is required to enable the drawer of a bill and the indorser to safeguard himself from further loss in the hands of the drawee or the acceptor, and also to enable parties to take necessary steps to recover the amount from all the parties liable to them. Even in cases, where an instrument payable on demand is indorsed after dishonour, notice of dishonour by non-acceptance or non-payment is absolutely necessary to make the parties liable.

Notice of dishonour by non-payment: Where a bill is dishonoured by non-acceptance and due notice of dishonour is given, it shall not be necessary to give notice of a subsequent dishonour by non-payment unless the bill in the meantime, has been accepted. But, where a bill has not been dishonoured by non-acceptance there is no cause of action until dishonoured by non-payment.

Dishonour by non-acceptance: Whenever the drawee refuses to accept a bill duly presented to him for acceptance, the bill must be treated as dishonoured, and the notice of dishonour must be given in accordance with the Act. But, where a bill is dishonoured by non-acceptance and notice of dishonour is not given, the rights of a person who becomes a holder in due course subsequent to the omission to give notice are not prejudiced by the omission. **The rules for giving notice of dishonour are the same whether the dishonour by non-acceptance or by non-payment.**

Notice by whom: Notice of dishonour must be given by the holder or by a party liable on the instrument. A notice given by a stranger is not valid.

Notice to whom: Notice of dishonour must be given to all parties other than the maker or acceptor who are sought to be made liable, or to their duly authorised agents. If a party entitled to notice has been declared an insolvent, notice may be given to his assignee. Similarly, if the party has died, notice may be given to his legal representative. Notice to drawer is not dispensed with by reason of the fact that the drawee has declared that he could not pay the bill and that the drawer must take it up.

A formal notice is necessary to bind the parties and mere knowledge on the part of the party is sought to be bound is ineffective without such notice. Consequently, it has been held that the fact that a party is already aware of the fact that the instrument in question has been dishonoured does not disentitle him to a notice from the holder. Mere demand does not amount to a notice. Hence, where the payee of a **hundi** meets the drawer after maturity and demands payment, it cannot be said to amount to a notice. Nor can asking for a duplicate of a lost bill be deemed a notice of dishonour. But an intimation that the instrument is

unpaid coupled with a request for payment or speedy attention to the matter is a valid notice. **Notice means the actual notification of the dishonour of bill by non-acceptance or by non-payment.**

Form of Notice: A notice of dishonour may be given in any form fulfilling the requirements of the law (section 94). It may be oral or written or partly oral and partly written, and may be given in any terms which sufficiency identify the instrument and inform the party to whom it is given that the instrument has been dishonoured by non-acceptance or non-payment and that he will be held liable thereon.

Effect of omission to give notice: Except in case in which notice is dispensed with under-section 98, a drawer or an indorser to whom due notice of dishonour is not given is discharged from liability on the instrument.

When notice of dishonour is unnecessary : Notice of dishonour is not necessary in the following circumstances:

a) When it is dispensed with by the party entitled thereto

b) In order to charge the drawer when he has countermanded payment.

c) When the party charged could not suffer damage for want of notice.

d) When the party entitled to notice cannot, after due is, for any other reason, unable without any fault of his own to give it.

e) To charge the drawers when the acceptor is also a drawer.

f) In the case of a promissory note which is not negotiable.

g) When the party entitled to notice, knowing the facts, promises unconditionally to pay the amount due on the instrument (section 98).

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Check Your Progress B

1. A draws a bill on B and C writes on it as accepted. Is this acceptance valid?

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2. Under which circumstances presentment for payment is unnecessary and the instrument will be taken as dishonoured?

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3. When the party making payment for honour is entitled to the rights of the party for whose honour he intervenes?

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4. What is the effect when the notice of dishonour is not given?

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23.4.4 Noting and Protesting

Noting

When a promissory note or bill of exchange has been dishonoured by non-acceptance or non-payment, the holder may cause such dishonour to be noted by a Notary Public upon the instrument, or upon an paper attached thereto, or partly upon each.

Thus, noting is recording of the presentment of the instrument for acceptance or for payment and its dishonour by non-acceptance or non-payment. It is done by a person (e.g. a Magistrate) officially designated for this purpose and it serves as the authentic and legal proof of presentment and dishonour. While noting, the Notary Public records the date of dishonour, the reason assigned for such dishonour and the Notary's charges. Noting must be done within a reasonable time after dishonour.

Advantage of noting: Noting is useful as a legal evidence and has the following advantages:

1) If noting is done within a reasonable time, protest if required in an instrument may be drawn later on (Sec. 104-A).

2) A bill of exchange can be accepted for honour even after noting, though no protest is drawn up (Sec. 108).

3) A bill of exchange may be paid for honour after noting and the payer need not wait for protest (Sec. 113).

4) A Notary, being a person conversant in such transactions, is qualified to direct the holder to pursue the proper conduct in presenting the bill, and may, upon a trial, be a useful witness of the presentment and dishonour.

5) By the noting, the presentment and dishonour of the bill can be traced easily at any time by reference to the register or protest book reserved in the Notary Office. Another advantage in noting is that a copy can, at any time, be obtained from the Notary Office, if the original is lost.

Protest

Protest is a formal certificate issued by the Notary public to the holder of the bill on his demand the Certificate contains all the relevant particulars. This Certificate evidences the dishonour.

Both 'noting' and 'protesting' are compulsory in the case of foreign bills and are optional in the case of inland bills. Noting, unless followed by protest, does not afford any evidence of presentment or dishonour, even though it may contain the full name of the Notary Public.

Immediately upon the dishonour of a bill, the holder acquires a right of action against the drawer or maker and the indorsers. In order to avail himself of this

right, he must (unless excused for giving due notice of dishonour) cause it to be protested, and get all the events noted, on the day of dishonour. Protest is compulsory particularly in the case of foreign bill.

Besides, a protest affords satisfactory evidence of dishonour to the drawer, who, from his residence abroad, might experience a difficulty in making proper inquiries on the subject, and be compelled to rely on the presentation of the holder.

Besides the protest for non-acceptance and for non-payment, the holder may protest the bill for better security. Protest for better security is made where the acceptor becomes bankrupt, or insolvent or suspends payment before the bill falls due. In such cases, the holder may cause a Notary to demand better security, and on its being refused, the bill may be protested, and notice of the protest may be sent to an antecedent party.

Contents of a Protest: Section 101 enumerates the contents of a protest:

1) A protest is required to contain either the instrument itself or a literal transcript (a copy) of it and of everything written or printed thereupon The Section makes no provision when the bill is lost or cannot be had by the holder.

2) The protest is required to contain the name of the party at whose request it is made. It must also contain in the name of the person upon whom demand of payment or of acceptance is made. If the drawee or the acceptor (on whom demand of payment or of acceptance is made) is not present himself, it is always safe to mention the name of the person in charge on behalf of the drawee or the acceptor upon whom demand is made.

3) The protest must also contain the reason given by the drawee or acceptor for non-acceptance or non-payment or refusal to give better security. The protest must also clearly mention whether the demand is made by the Notary Public himself or by the clerk. If the drawee or the acceptor makes no answers, or if he cannot be found at his usual place of business or residence, such fact must also be mentioned in the protest. Normally, greater weight is attached, if the protest is made by the Notary Public himself, because he is a public officer and thereby enjoys credibility.

4) It is also necessary that the time of demand and dishonour should be mentioned in the protest, otherwise it will not be possible to ascertain from it whether the bill was duly dishonoured. Protest can be made later, if nothing is done within a reasonable time.

5) It is further essential that the signature of the Notary should appear on the protest. Though no seal of the Notary is required under the provisions, in practice protests are made under the Notary's official seal, and the courts take judicial notice of the seal of a Notary Public.

Section 102 lays down that, in cases where notes and bills are required to be protested, notice of protest and not notice of dishonour is to be given. In case of foreign bills, all parties liable in respect thereof against whom the holder intends to proceed are entitled to the notice of protest.

A notice of protest need not contain a copy of the protest. It is enough, if the party to whom notice is issued is informed that the bill has been dishonoured by non-acceptance or non-payment and has been protested.

23.5 DISCHARGE FROM LIABILITY

In the case of negotiable instruments, the term discharge from liability has two connotations : 1) discharge of one or more parties from liability in respect of a negotiable instrument, and 2) discharge of the instrument itself. The discharge of an instrument is one thing and is different from discharge of a party from liability under it. The discharge of the instrument results in extinguishment of all rights of action under it and puts an end to its negotiability. Therefore, if after its discharge, an instrument comes into the hands of a holder in due course, he acquires no right under it and he cannot bring a suit on the foot of it. On the other hand, when only a particular party is discharged, the instrument continues to be negotiable with the liabilities of undischarged parties attaching thereto. Thus, the discharge of one or more parties to an instrument does not discharge the instrument.

The maker, acceptor or endorser of a negotiable instrument is discharged from liability in the following ways:

1) **Discharge by Cancellation :** The holder of a negotiable instrument may deliberately cancel the name of any of the parties liable under that instrument with the intention to discharge him from the liability. A party whose name has been cancelled is discharged from liability to the holder who has cancelled his name, and to all other persons who derive their title from him. The proper and safe mode of cancellation is to draw the pen through the name so as to leave it legible.

   In order that a cancellation may be valid, it must be intentional. If it is done under a mistake or without the authority of the holder or without the intention of discharging the party, it is not operative.

2) **Discharge by Release:** When the holder of an instrument releases any party to the instrument by any method other than cancellation, the party so released is discharged from liability. But release of one of joint parties will not release all. A promisee can only dispense with the performance of the promise by a voluntary conscious act. (A mere omission to assert his rights or insist upon his rights cannot amount to dispensing with, within the meaning of Sec. 63, Contract Act) Even negligence to assert his rights cannot amount to dispensing with, though in certain cases it might result in estoppel. A dispensation may be express or implied by conduct if it is consistent with the continuance of the original right. Releases may certainly be effected by agreement between parties. A promisee may, by his kindness excuse the promisor from performance of his obligations.

3) **Discharge by Payment:** When payment of money due on a negotiable instrument is made in due course to the person legally entitled to receive it, the maker/indorser/acceptor of that instrument is discharged from liability. In the case of instrument payable to bearer or indorsed in blank, such maker, acceptor or indorser should make payment in due course of the amount due thereon. Thus, where the maker executes a pronote in favour of the promisee and the amount is payable to the promisee's order, a payment made by the maker to the promisee's adopted son or to his father, does not discharge the maker from liability, as the note is not payable to bearer and also the payment cannot be said to have been made in "due course".

A promissory note may be discharged by cash payment or by a fresh note and when once discharged, the original note ceases to be in force, even against a signatory who did not execute the fresh note.

4) **Discharge by Operation of Law :** The law relating to negotiable instruments being only a branch of the law of contract, the principle of general law also apply to negotiable instruments and, hence, they are discharged in ways other than those contemplated by the present Act, e.g., by becoming time barred under the Limitation Act, by the debtor being adjudicated insolvent, or by merger of one debt into another, or where the acceptor of a bill becomes the holder of it at or after its maturity.

5) **Discharge by Allowing Drawee more than Forty-eight Hours to Accept:** "If the holder of a bill of exchange allows the drawee more than forty-eight hours, exclusive of public holidays, to consider whether he will accept the same, all previous parties not consenting to such allowance are thereby discharged from liability to such holder" (section 83).

6) **Discharge in the case of Cheques :** If the holder of a cheque presents the cheque after a reasonable time, the liability of the drawer stands discharged, and the holder in due course becomes a creditor of the bank in respect of the amount of the cheque and a set-off is available in respect of such amount. If the bank on whom the cheque is drawn becomes insolvent before the cheque is presented, the drawer would be discharged to the extent of loss suffered by him by the bankruptly of the banker. But if the banker remains solvent and the holder proves that the drawer has suffered no loss the drawer will remain liable to the holder.

The drawer of a cheque must prove two facts: (1) the drawer had sufficient money in deposit in the bank deposit in the bank in his account to honour the cheque, and (2) he had suffered actual loss or damage on account of non-presentment of the cheque within a reasonable time. The liability of the drawer is discharged to the extent of the loss or damage suffered by him by the neglect of the holder. If the drawer had sufficient funds with the bank to meet the cheque at the time when the bank failed, he will be discharged in full.

For example, A draws a cheque for Rs. 1,000 and when the cheque sought to be presented, the bank has funds to meet it. The bank fails (becomes insolvent) before the cheque is presented. The drawer is discharged but the holder can proceed against the bank for the amount of the cheque.

If the funds were not sufficient for the payment of the cheque on the date when the bank went into liquidation, the drawer will be discharged only to the extent of the amount which he had in the bank at the time for honour of the cheque. If, however, the bank fails before the cheque could be presented within a reasonable time, the drawer will not be discharged at all.

The above provision applies only to the drawer of a cheque and not to an indorser. To charge an indorser, the cheque must be presented for payment within a reasonable time after delivery of it by him. In default of such presentment, the indorser would be altogether discharged.

Under Section 85 a banker who pays (a cheque payable to order) in due course a cheque drawn upon him is protected. This is so even if the indorsement of the payee is forged. The payment is a discharge of the drawer.

Bank is not liable for loss of cheque or draft in transit when sent by post because the post office is not an agent of the addressee bank unless the addressee had asked for despatch by post but not otherwise.

Drafts drawn by one branch of a bank on another payable to order: “Where any draft, that is an order to pay money, drawn by one office of a bank upon another office of the same bank for a sum of money payable to order on demand, purports to be indorsed by or on behalf of the payee, the bank is discharged by payment in due course” (Section 85-A)

23.6 EFFECT OF MATERIAL ALTERATION

A change which alters the legal identity or business character of the instrument, or which may affect the contract in the instrument is **Material Change/Alteration.** The main effect of a material alteration is that it makes the instrument void.

Material change arises not only where a certain thing which is already written has been altered or erased, but also a new insertion. In a promissory note, subsequent to its execution, the words, “The proprietor of the Karthika Stores” were inserted above the signature and below the date. It was held that the alteration was a material alteration rendering the instrument unenforceable.

An alteration can be called material alteration it should be such that it alters, or attempts to alter, the character of the instrument, and affects, or is likely to affect, the contract, which the instrument contains or is evidence of. Even as alteration of the one of the clauses of the instrument containing a penal action is a material alteration.

Material alteration : Any material alteration of a negotiable instrument renders the same void as against anyone who is a party thereto at the time of making such alteration and does not consent thereto, unless it was made in order to carry out the common intention of the original parties.

Alteration by indorsee : Any such alteration, if made by an indorsee, discharges his indorser from all liability to him in respect of the consideration thereof.

Alteration of date: If the date of a bill or note is changed without the consent of the prior parties, it amounts to a material alteration.

Alteration of time of payment : If alteration is made in the time of payment (for example if a bill payable three months after date is changed into a bill payable three months after sight), it is a material alteration, and it discharges all the parties to the bill.

Alteration of place of payment : An alteration regarding the place of payment is certainly a material alteration within the meaning of the section.

Alteration of sum payable : An alteration in the amount of sum payable (e.g., where a bill for Rs. 100 is altered into a bill for Rs. 200 is a material alteration.

Alteration in indorsement: If words are added to a bill of exchange with blank indorsement, so as to convert them into special indorsements, there is said to be a material alteration.

Alteration of parties : The addition of a new party to an instrument amounts to a material alteration within the meaning of this section.

Converting a non-negotiable instrument into a negotiable instrument, by adding the words "or order" "or bearer" amounts to material alteration. If out of the words "to order or bearer", the words "or bearer" are struck out, or the word "bearer" is substituted for "order" in an indorsement, it makes the instrument void. **But the substitution of the word "order" for "bearer" has been held to be not a material alteration.**

An alteration, effected with the consent of the parties does not affect the validity of the instrument. The cancellation or erasing of the name of a maker is a material alteration. Affixing stamps beside the signature and cancelling the same by drawing two parallel lines on it instead of signing on it does not amount to material alteration.

Instances of alterations which are not material:

a) Conversion of instrument payable to order into one payable to bearer.

b) The elimination, of the words "or order" from an indorsement would not be a material alteration.

c) Where an alteration seems only to state explicitly what was already clearly implied in the document and what the law would infer from it, such an alteration is immaterial and does not vitiate the instrument. A maker of pronote will not be discharged from his obligation to pay it, because the holder has put in writing on the note what the law would have supplied.

d) The addition of the words "on demand" to a note in which no time or payment is expressed is not a material alteration.

Effect of material alteration: A party, who is in custody of an instrument is bound to preserve it in its original state, because any material alteration in the instrument will vitiate it. If it is materially altered, all persons who were parties to it at the time of alteration and did not consent to it will be altogether discharged from liability under that instrument. They will not be liable even to a bonafide purchaser of the instrument having no notice of the alteration. But an instrument, which is materially altered, is not absolutely void. It is only against those who did not consent to the alteration, and can be enforced against those who consented to the alteration or made the alteration, and also against those who, became parties to the instrument subsequent to the alteration.

Effect of alteration on liability: According to section 8 an alteration of a negotiable instrument affects the liability of such persons only who were parties to the bill before the alteration was effected and does not affect the persons who became parties subsequent to the alteration. The reason is that an acceptor who accepts an altered bill or an indorser who indorses after alteration cannot be prejudiced by the altered, is not absolutely void. It is void only against those who did not consent to the undertakes to pay the amount of the instrument, according to the tenor of the instrument as it stands at the time when the acceptance or, indorsement is made.

Section 89 gives protection to a person who pays an altered bill or note or cheque which does not appear to have been materially altered and pays so in good faith. Such a paying person is discharged from liability. In order to claim the protection given by this section it is, however, necessary that the alteration should not be apparent and that payment must be made in due course, i.e., according

to the apparent tenor of the instrument in good faith and without negligence to a person in possession of the instrument under the circumstances which do not afford a reasonable ground for believing that he is not entitled to receive payment. When these conditions are satisfied, the payer would not only be discharged from all liability on the instrument but can also debit the person on whose account the payment was made with the amount paid. Thus, where a person draws a bill or cheque for Rs. 100, and a holder without the consent of the drawer alters the figure 100 into 1,000 and makes the instrument look like a bill or cheque drawn for Rs. 1,000 and the alteration is not apparent, the drawee or banker who pays the bill or cheque in good faith and without negligence is entitled to debit the drawer with Rs. 1,000.

Check Your Progress C

1. The maker is discharged from liability to a holder of instrument by
   a) Cancellation only
   b) Release only
   c) Payment only
   d) Any of the above
2. A valid discharge of a promissory note takes place when
   a) only when payment is made by cash,
   b) when payment is made by cash or issue of a fresh note.
   c) only when the instrument becomes time barred.
   d) only when the holder fails to get payment within 48 hours of presentment.
3. A bank is not liable for loss of a cheque in transit when sent by post because
   a) the bank insists on personal presentment.
   b) the post office is not an agent of the bank.
   c) the bank is specifically protected by law.
   d) the transit through post office is not a recognised mode of presentment.
4. Which one of the following alteration is not a material alteration so as to make it a void instrument?
   a) change in the place of payment (with in the country).
   b) change in the name of the maker.
   c) affixing stamps besides signature and cancelling them by two parallal lines.
   d) out of the words “to order or bearer” the words “or bearer” are struck out.

23.7 LET US SUM UP

Presentment means placing the negotiable instrument before the drawee. Presentment is done for any of the following three reasons : 1) for acceptance,

2) for sight, and 3) for payment. Bills payable after sight are those that require presentment for acceptance. All instruments require presentment for payment. Non-acceptance can amount to dishonour. There are certain rules regarding the presentment for acceptance and presentment for payment. Acceptance may be either general or qualified. An acceptance which assents without qualification to the order of inland bills-but nevertheless they serve as authentic proof. Notice of dishonour by non-acceptance is necessary in all cases. There can be protest for better security.

On a dishonour by non-acceptance it is necessary in the case of a foreign bill to get it noted and protested by a Notary Public. Noting and protest are optional in respect of inland bills-but nevertheless they serve as authentic proof. Notice of dishonour by non-acceptance is necessary in call cases. There can be protest for better security also. There can be an acceptor for honour.

Presentment for payment is essential in all cases. The presentment should be made to the proper person at the proper place and time and in proper manner.

The maker, acceptor or indorser of an instrument is discharged by cancellation, by release or by payment. A material alteration in the instrument will make it void.

23.8 KEY WORDS

Acceptor for Honour: Any party, other than the acceptor, who gives acceptance for the honour of the drawer or a particular indorser.

Drawee in Case of Need : The person (who is mentioned by the drawer or even an indorser) who should be approached in case of dishonour by the acceptor/ drawee.

General Acceptance: An acceptance without qualification to the order of the drawer.

Material Alteration : Unauthorised alteration that makes the instrument void.

Noting: Recording of the presentment of the instrument for acceptance or for payment and is dishonour by a Notary Public.

Payment for Honour : Payment made by drawer, the drawee or an indorsee or even a stranger paying for the honour of a party liable on the bill — after the instrument is protested for non-payment.

Protesting : Certificate issued by the Notary Public to the holder.

Qualified Acceptance: An acceptance is qualified in terms of making a conditional acceptance.

23.9 ANSWER TO CHECK YOUR PROGRESS

A) 1. It is a valid acceptance at the option of the holder

5. Presentment for acceptance is optional

B) 1. A valid acceptance because C is a stranger.

C) 1. d) 2) b 3) b 4) c

23.10 TERMINAL QUESTIONS

1) When is presentment for acceptance (a) necessary, and (b) not necessary? What are the effects of non-presentment for acceptance?

2) State the rules regarding presentment for acceptance.

3) Who is an Acceptor for honour? Explain his rights and duties?

4) What is dishonour by non-acceptance and non-payment? What should be done by the holder on such dishonour?

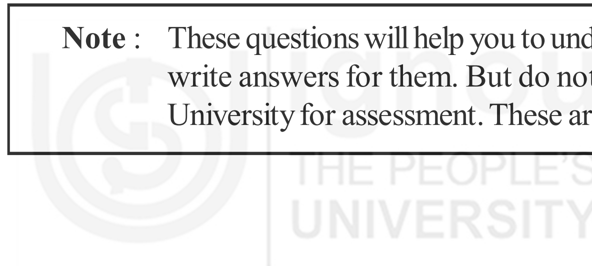
5) What is noting and protesting? Why should it be done?

6) How much a party is liable in an instrument discharged from such liability?

7) Explain the rules regarding proper presentment for payment. When is such presentment not necessary?

8) What is a material alteration in an instrument? Give examples of what are material alterations and what are not.

Note : These questions will help you to understand the unit better. Try to write answers for them. But do not submit your answers to the University for assessment. These are for your own practice only.



SOME USEFUL BOOKS (BUSINESS LAW)

1. M. C. Kuchhal, and Vivek Kuchhal, Business Law, Vikas Publishing House, New Delhi.

2. Avtar Singh, Business Law, Eastern Book Company, Lucknow.

3. S. N. Maheshwari and SK Maheshwari, Business Law, National Publishing House, New Delhi.

4. G. K. Kapoor Business Laws, Scholar Tech Press, New Delhi.

5. P. C. Tulsian and Bharat Tulsian, Business Law, McGraw Hill Education.

6. Sharma, J. P. and Sunaina Kanojia, Business Laws, Ane Books Pvt. Ltd., New Delhi.

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