Unconscionable Clauses in Construction Contracts

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It is often alleged by contractual agencies that conditions contained in contracts, more particularly construction contracts, are drafted by the employer in such a manner that these lean heavily in favour of the employer and against the contractual agencies. It is also alleged that the contractual agencies have no option but to sign on the dotted lines otherwise they will be out of job. On the other end of the spectrum are cases where the very same contractors impose strict and harsh conditions on their sub-contractors and when Real Estate Builders impose one-sided conditions in contracts entered into with people who wish to buy properties in their ventures.

It is no doubt true that the contractual agencies, in order to secure a contract, do not weigh the pros and cons of the stipulations contained in the bid documents at the time of bidding. It is done only when, during the course of execution of the work, they realize that certain terms and conditions of the bid documents are unjust, unfair and unworkable. But then, by that time, it is too late. Another issue, which calls for consideration is as to why an experienced contractor, who has executed a number of jobs for any particular organization, fully knowing the contract terms and conditions, bids for works in such an organization and, that too, time and again.

Numerous countries have wrestled with the issue of unconscionable clauses *vis a vis* the rights of Employers. Questions are often raised that if courts or arbitrators start entertaining such issues and start declaring certain terms of the contract as void, then development works and constructional activities would come to a grinding halt. The argument that when a party signs a contract with eyes wide open it cannot later be allowed to make a *volte* face and complain that the contract was unconscionable or unfair, also has a lot of merit. Another point that needs to be examined is: Can it be said that a huge contracting agency employing hundreds of technical and legal personnel can sign a contract and later, when disputes arise, raise a contention that the contract clauses are unreasonable? Such a situation would beg the question: Has the contract become unconscionable and unfair overnight?

Courts in India have often favoured this argument and held that after having voluntarily agreed to execute the work on the terms and conditions contained therein, it is too late in the day to allege that the same are unfair or unconscionable. Where a party, without any coercion, fraud, misrepresentation or undue influence, willingly accepts of his own accord a clause in a contract which provides that the arbitrator may be an employee of the employer, it cannot turn round and say that the clause is unconscionable **(1)**. The Courts will not, on that account, release the parties from their own bargain, however

improvident it may consider it, so long as the Court is satisfied that the party or parties knew or ought to have known what kind of bargain he or they were entering into. **(2)**

On the other hand, numerous countries have enacted laws and instituted Commissions to enquire into this aspect of law in order to protect their citizens against contracts and contractual terms which are palpably unconscionable. Some of the said laws and Commissions are as follows:

- Unfair Contract Terms Act, 1977 in the United Kingdom
- Uniform Commercial Code of the United States, Section 2.302
- Standard Contracts Law in Israel.
- Ontario Law Reform Commission, 1987
- Report of the New Zealand Law Commission, 1990
- Report of South African Law Commission, 1998
- Report of the Law Commission of England and Scotland (2004)
- Discussion Paper of the Standing Committee of Officers of Consumer Affairs, Victoria (Australia), 2004
- Interim Report of the British Columbia Law Institute, 2005.

In India also, the subject has been hotly debated over the years and the Law Commission, through its 103rd Report (1984) and 199th Report (2006), has *suo motu* published findings on this issue and recommended changes in the existing laws to guard against unconscionable clauses of contract. But so far nothing has fructified and the Legislature has not acted upon any of the said reports.

Existing laws in India

The Indian Contract Act, 1872 provides certain measures to protect citizens against unfair terms of contract:

- Sections 15, 16, 17, 18, 19, 19A of the Act deal with 'voidable contracts' i.e. if the transactions are vitiated by 'coercion', 'undue influence'', 'fraud', 'misrepresentation', then that agreement is voidable.

- Sections 10, 20, 23, 24, 25, 26, 27, 28, 29, 30 and 56 of the Act deal with 'void' agreements. These Sections deal with agreements which are void because of absence of consideration or due to mutual mistake, unlawful consideration, or are agreements in restraint of marriage, or in restraint of trade, or in restraint of legal proceedings, or agreements which are uncertain, or by way of wager or impossible of performance.

Section 16 of the Act: Section 16(1) defines when a contract is said to be induced by undue influence. Section 16(2) states that a person is deemed to be in a position to dominate the will of another (a) when he holds a real or apparent authority over the other or where he stands in a fiduciary relation to the other; or (b)where he makes a

contract with a person whose mental capacity is temporarily or permanently affected by reason of age, illness or mental or bodily distress.

Section 16(3) states that where a person who is in a position to dominate the will of another, enters into a contract with him, and the transaction appears, on the face of it or on the evidence adduced, to be unconscionable, the burden of proving that such contract was not induced by undue influence shall be upon the person in a position to dominate the will of the other.

Section 23 of the Act: This Section states that "The consideration or object of an agreement is lawful, unless – it is forbidden by law; or is of such a nature that, if permitted, it would defeat the provisions of any law; or is fraudulent; or involves or implies injury to the person or property of another, or the Court regards it as immoral or opposed to public policy."

Though the Section does not speak of 'unconscionability' as one of the grounds, however, the last part of Section 23 declares that no man can lawfully do that which is opposed to public policy. The Indian Contract Act does not define the expression 'public policy' or what is meant by being 'opposed to public policy' but some of the decided cases do broadly define the expression 'public policy" as follows:

The orthodox view on public policy was explained by Subba Rao, J. **(3)** in the following terms:-

> "Public policy or the policy of law is an elusive concept. It has been described as an "untrustworthy guide", "variable quality", "unruly horse", etc; the primary duty of a court of law is to enforce a promise which the parties have made and to uphold the sanctity of contracts which forms the basis of society; but in certain cases the court may relieve them of their duty on a rule founded on what is called the public policy…… though it is permissible for the courts to expand public policy and apply them to different situations, it should be invoked in clear and incontestable cases of harm to the public; though the heads are not closed and though theoretically it may be permissible to evolve a new head under exceptional circumstances of a changing world, it is advisable in the interest of stability of society not to make any attempt to discover new heads in these days."

A later judgment **(4)** has given a wider meaning to the expression by holding:

> "Public policy is not the policy of a particular Government, it connotes some matter which concerns the public good and public interest. The concept of what is for the public good or in the public interest or what would be injurious or lawful to the public good or the public interest has varied from time to time. As new concepts take the place of old, transactions which were once considered against public policy are now being upheld by the courts and similarly where there has been a well-recognized head of public policy, the courts have not shirked from extending it to new transactions and changed circumstances and have at times

not even flinched from inventing a new head of public policy. It is thus clear that the principles governing public policy must be and are capable on proper occasions of expansion or modification. If there is no head of public policy which covers a case, then the court must in consonance with public conscience and in keeping with public good and public interest declare such practice to be opposed to public policy."

Section 28(b) of the Act: Section 28(b) as amended through amendment to the Contract Act in 1997 provides that: "Every agreement which extinguishes the rights of any party thereto, or discharges any party thereto from any liability, under or in respect of any contract on the expiry of a specified period so as to restrict any party from enforcing his rights, is void to that extent." The above amendment has been followed in a number of cases wherein it has been held that clauses imposing a restricted time limit for invocation of arbitration are void to that extent **(5)**.

Concept of unconscionability

There are two forms of unconscionability: procedural and substantive.

1. **Procedural Unconscionability:**

   A contract or a term is procedurally unfair if it has resulted in an unjust advantage or unjust disadvantage to one party on account of the conduct of the other party or the manner in which or the circumstances under which the contract has been entered into or the term thereof has been arrived at by the parties. (Recommendation of Law Commission of India, 199th Report)

2. **Substantive Unconscionability**

   A contract or a term thereof shall be treated as unfair if the contract or terms thereof are by themselves harsh, oppressive or unconscionable. (Recommendation of Law Commission of India, 199th Report)

   If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result. (Uniform Commercial Code (Act 174 of 1962), Section 2.302)

Instances of courts striking down unfair clauses

Where the transactions are totally unconscionable, the courts in India have unhesitatingly come out with a heavy hand to nullify such dealings. For example, when one party is in an exceptionally strong and commanding position and the other, a really weak party, enter into an agreement for transfer of a property for a consideration which

is palpably low and grossly inadequate, and even a common man will not hesitate for a moment to comment that the weaker party has been totally duped. In such a case the courts will not permit the strong party to push the weaker party to wall.

Penal clauses: Courts in India have set aside clauses of contract, where the clauses are clearly penal in nature. Law is well-settled that a penal stipulation to pay the sum agreed on breach of contract cannot be enforced. Agreed liquidated damages, if it be enforced, must be the result of a "genuine pre-estimate of damages." They do not include a sum fixed *in terrrorem* covering breaches of contract of many varying degrees of importance, the possible damages from which bear no relation to the fixed sum, and which obviously have at no time been estimated by the contracting parties **(6)**. Similarly, if the court finds that the real purpose for which a stipulation has been incorporated in the contract is that by reason of its burdensome or oppressive character it may operate *in terrorem* over the promisor so as to drive him to fulfill the contract, then the provision will be held to be one by way of penalty. **(7)**

Variation clauses: One sided clauses providing for unlimited variation in quantities and unfair interpretation of variation clauses have been set aside by the Courts by holding that the Engineer-in-charge cannot require a contractor to execute additional work without any limit and that a reasonable limit should be placed on the quantity of additional work, which the contractor may be required to execute at the rate stipulated for the main work under the contract. The court upheld the decision of the arbitrator to follow the practice prevalent in the Central Public Works Department in this regard **(8)**. Thus, even if the power to order extras may appear to be unlimited, it is in fact, limited to ordering extras up to a certain value. **(9)**

In a recent judgment, it has been held that when a contractor bids in a contract, he has to offer reasonable rates for the works which are both difficult to perform and other works which are not that difficult to perform. Every contractor tries to balance his rates in such a manner that the employer may consider his offer reasonable. In that process the contractor tries to get a reasonable margin of profit by balancing the more difficult (and less profitable items) and the less difficult (and more profitable items). His bid is, normally, a package. If the employer is permitted in law to make variations upwards and downwards — even if it be up to a limit beyond which market rates become payable — then the interpretation of the clause must be one which balances the rights of both parties. For example, if the plus and minus variations go beyond 25% and are made in a manner increasing the less profitable items and decreasing the more profitable items, and if the net result of the contract is to be the basis then it may work out that the contractor could be made to perform a substantially new contract on the same contracted rates. **(10)**

Award of escalation for delay despite non-existence of escalation clause: A clause in a contract debarring the contractor from claiming escalation in rates has been construed to be limited only upto the stipulated period of contract and not beyond. **(11)**. Even in the absence of an escalation clause in a contract, the courts have allowed compensation in the form of escalation in prices on the ground that once it is found that

delay in execution of the contract due to the conduct of the employer, it was liable for the consequences of the delay, namely, increase in prices.**(12)**

Clauses prohibiting Interest: The courts have held that a clause in a contract providing that: "No claim for interest or damages will be entertained by the Government with respect to any money or balance which may be lying with the government or may become due owing to any dispute, difference or misunderstanding between the Engineer-in-charge on the one hand and the contractor on the other hand or with respect to any delay on the part of the Engineer-in-charge in making periodical or final payment or in any other respect whatsoever", would not debar an arbitrator from granting interest during the pendency of the reference if, in his discretion, he considers it appropriate to award it. **(13)**

No claim certificates: Where a clause in a contract provides that a contractor has to submit a no claim certificate before any payment is made it him, the courts have held that such a clause would not debar him from getting his claims adjudicated upon through arbitration if the undertaking was given under undue influence **(14)**. The circumstances in which a no-claim certificate was issued has been held to be of utmost importance. When a contractor makes huge investments, he cannot afford not to take from the employer the amount under the bills for various reasons which may include discharge of his liability towards the banks, financial institutions and other persons. In such a situation, the employer holds an upper hand and normally refuses to release the money unless a "No-Demand Certificate" is signed. The maxim, *necessitas non habet legem*, i.e. necessity knows no law has been recognized by the courts in construction contracts and it has been held that a person may sometimes have to succumb to the pressure of the other party to the bargain who is in a stronger position. **(15)**

Clause permitting one party to change terms of contract: Under the general law of contracts, once the contract is entered into, any clause giving absolute power to one party to override or modify the terms of the contract at his sweet will or to cancel the contract — even if the opposite party is not in breach, would amount to interfering with the integrity of the contract. **(16)**

Thus, from the above, it is evident that in certain circumstances, a contractor can be protected when it is apparent that there was undue and unfair pressure. For example, an employer threatens encashment of a bank guarantee which had been given by the contractor in order to secure mobilization advance, simply because the progress of work is not accelerated. The purpose of such a bank guarantee is not linked with the progress. Remedy available to the employer is to levy liquidated damages or, in the alternative, to serve a show cause notice on the contractor as to why the contract be not terminated.

Instances of courts upholding one-sided clauses

As against the above judgments, in which one-sided clauses of contract have been read down or distinguished, in a number of judgments, the courts have come out in favour of clauses which are unfair.

Prohibition on award of damages for delay: The courts have upheld the applicability of Clause 11 of the MES standard form of contract and held to be a clear bar to any claim for compensation for delays, in respect of which extensions have been sought and obtained. **(17)** Similarly, Clause 59 of the A.P. Standard Specifications, which states that no claim for compensation on account of delays or hindrances to the work from any cause would lie except as therein defined, has been upheld. **(18)**

One-sided arbitration Clauses: Fairness in adjudication process, undoubtedly, is a *sine qua non* for doing justice between the parties. In almost all the Public Works Departments all over the country, the arbitration clause speaks of adjudication of disputes between the parties by a serving officer of the same Department and even of the Officer of the Circle under whose supervision the work was executed. This does not seem to be fair for the simple reason that a serving officer, who is usually a Superintending Engineer, having been assigned the task of arbitration, would hardly be expected to be impartial since he is answerable to his seniors and looks forward to his promotion.

In order to be fair and impartial, the arbitration clause should be drafted in such a manner which leaves the adjudication of disputes in the hands of an officer who had not been connected with the work. Where an arbitration clause provided for adjudication of disputes by Superintending Engineer, Public Works Department "unconnected with the work", it was held to mean that the officer appointed should be one unconnected with the particular works contract in relation to which the dispute has arisen between the parties and does not relate to the Department concerned dealing with the works contract in question. **(19)**

A party will not be permitted in law to lie by and participate in the arbitration proceedings and, if it suits its purpose, then attack on the ground of irregularity. In this connection, RUSSELL states:

> "The strongest line of conduct and the strongest form of protest for a party to adopt or make is to retire from the proceedings, but such a course, when a party is brought or tied to a particular Tribunal, is obviously extremely dangerous, because he may ultimately find, when he has moved to set aside the Award made against him, that the irregularity of which he complained is not sufficient to upset the Award. The obvious course therefore is for a party complaining of irregularity to protest against the irregularity and to continue to conduct his case in the proceedings before the Arbitrator under such protest. The other alternative is to submit to the irregularity and forego any rights he may have to object to the Award on that ground when it is made, for he cannot lie by and then object to the Award if it is against him." **(20)**

The 1996 Act has laid great stress on independence and impartiality of an arbitral tribunal. Sensing that in-service officers of the departments cannot be as independent and impartial as is envisaged in the 1996 Act, the Supreme Court in a very recent case has held that provision in the contract for appointment of serving officer of one party as arbitrator needs to be reviewed in view of the resistance it brings from the other party when disputes arise and also in view of the emphasis on independence and impartiality stressed in Sections 13 and 14 of the Act. Government, statutory authorities and Public Sector Undertakings have been advised to think of phasing out such arbitration clauses to encourage professionalism in arbitration. **(21)**

A beginning has been made and it is expected that it would not be long before Government, semi-government and Public Sector Undertakings would come forward with positive step and appoint such persons as arbitrators against whom there cannot be any allegation of being partisan. The foregoing decision of the Supreme Court is certainly a step in the right direction. In fact, such a decision was long overdue. Fairness in arbitration was eroding so fast that even those propagating arbitration had started losing faith. If the arbitrators were to act at the dictates of their superiors or were to be more loyal than the king himself, then it would be better to say good-bye to the arbitral system and take recourse to courts.

Need to formalize the law

The judicial trends noticed above, clearly indicate a divergence of views amongst the judgments. On the one hand are the progressive judgments striking down unfair clauses, whereas on the other hand are judgments strictly interpreting one-sided conditions of contract. Hence, there is a need and necessity to formalize the law through an enactment so as to prevent contradiction in judgments and law and in order to protect the citizens against unfair terms even in commercial contracts. In this regard the recommendations of the Law Commission are very pertinent:

The Law Commission of India in its 103rd Report suggested that an additional Section 67A be added to the Indian Contract Act, which may read as follows:

> "67A. (1) Where the Court, on the terms of the contract or on the evidence adduced by the parties, comes to the conclusion that the contract or any part of it is unconscionable, it may refuse to enforce the contract or the part that it holds to be unconscionable.
>
> (2) Without prejudice to the generality of the provisions of this Section, a contract or part of it is deemed to be unconscionable if it exempts any party thereto from – (a) the liability of willful breach of contract, or (b) the consequences of negligence."

The Law Commission of India in its 199th Report headed by Mr. Justice M. Jagannadha Rao enlarged significantly the scope of unconscionable clauses and suggested the following major changes:

- Definition: The Commission distinguished between 'procedural unfairness' and 'substantive unfairness' (Sections 5 and 12 of proposed Bill)

- Power to Arbitral Tribunals: The Commission recommended that jurisdiction to declare a contract or a clause thereof as unconscionable should be exercised not only by the Courts but also by the Arbitral Tribunals and Consumer Forums. (Sections 2(b), 16 and 17 of proposed Bill)

- Procedural unfairness: In Section 6 of the proposed Bill, the Commission details the circumstances of procedural unfairness as follows:

    (a) The knowledge and understanding of the promisee in relation to the meaning of the terms thereof or their effect;

    (b) The bargaining strength of the parties to the contract relative to each other;

    (c) Reasonable standards of fair dealing or commonly accepted standards of dealing;

    (d) Whether, or not, prior to or at the time of entering into the contract, the terms were subject to negotiation or were part of a standard terms contract;

    (e) Whether or not it was reasonably practicable for the party seeking relief to negotiate for the alteration of the contract or a term thereof or to reject the contract or a term thereof;

    (f) Whether expressions contained in the contract are in fine print or are difficult to read or understand;

    (g) Whether or not, even if he or she had the competency to enter into the contract based on his or her capacity and soundness of mind, he or she (i) was not reasonably able to protect his or her own interests or of those whom he or she represented at the time the contract was entered; (ii) suffered serious disadvantages in relation to other parties because he or she was unable to appreciate adequately the contract or a term thereof or their implications by reason of age, sickness, physical, mental, educational or linguistic disability, emotional distress or ignorance of business affairs.

(h) Whether or not independent legal or other expert advice was obtained by the party seeking relief;

(i) The extent (if any) to which the provisions of the contract or a term thereof or their legal or practical effect were accurately explained by any person, to the party seeking relief;

(j) The conduct of the parties to the contract in relation to similar contracts or courses of dealing to which any of them had been party; or

(k) Whether a party relied on the skill, care or advice of the other party or a person connected with the other party in entering into the contract.

- Substantive unfairness: In Section 13 of the proposed Bill, the Commission laid out various guidelines to judge if a contract or its terms are substantively unfair:

(a) Whether or not the contract or a term thereof imposed conditions which are (i) unreasonably difficult to comply with, or (ii) are not reasonably necessary for the protection of the legitimate interests of any party to the contract;

(b) Whether the contract is oral or wholly or partly in writing;

(c) Whether the contract is in standard form;

(d) Whether the contract or a term thereof is contrary to reasonable standards of fair dealing or commonly accepted standards of dealing;

(e) Whether the contract, agreement or a term thereof has resulted in a substantially unequal exchange of monetary values or in a substantive imbalance between the parties;

(f) Whether the benefits to be received by the disadvantaged party are manifestly disproportionate or inappropriate to his or her circumstances;

(g) Whether the disadvantaged party was in a fiduciary relationship with the other party; or

(h) Whether the contract or a term thereof
  (i) requires manifestly excessive security for the performance of contractual obligations; or
  (ii) imposes penalties which are disproportionate to the consequences of a breach of contract; or
  (i) denies or penalises the early repayment of debts; or

(ii) entitles a party to terminate the contract unilaterally without good reason or without paying reasonable compensation; or
(iii) entitles a party to modify the terms of a contract unilaterally.

- Restriction of liability: The Commission provided for exclusion or restriction of liability if a clause is substantially unfair. It was recommended that a contract would be substantially unfair and void if it:

  (a) excludes or restricts liability for negligence;

  (b) excludes or restricts liability for breach of express or implied terms of contract without adequate justification. (Section 9 of proposed Bill)

- Choice of law: In respect of provisions in various contract stipulating that the disputes would be governed by laws of other countries, the Commission in Section 11 of the proposed Bill provided as follows: "Where a contract contains terms applying or purporting to apply the law of a foreign country, despite the contract being in every respect wholly unconnected with the foreign country, such terms shall be deemed to be substantively unfair."

- Option to affected party: Section 19 of the proposed Bill provides that where a contract is procedurally unfair, the aggrieved party has an option to insist that the contract or term shall be performed, and that he should be put in the position in which would have been if the conduct, manner or circumstances did not permit the disadvantage term to form part of the contract.

- Burden of Proof: Regarding burden of proof, the Commission recommended that insofar as "procedural unfairness" was concerned, some 'unfair advantage' or 'unfair disadvantage' to one party ought to be proved. But, insofar as "substantive unfairness" was concerned, it could lead to unenforceability without it being simultaneously unfair procedurally. (Section 14 of the Act)

- *Suo motu* power: The court (including a consumer forum and an arbitral tribunal) has been vested with *suo motu* powers to enquire into substantial unfairness even if not so pleaded by the parties. (Section 16 of the proposed Bill)

- Reliefs that can be granted: The court has been empowered to provide the following reliefs:

  (a) Refuse to enforce the contract or the term thereof;
  (b) Declare the contract or any term thereof void;
  (c) Vary the terms of the contract so as to remove the unfairness;
  (d) Refund of the consideration or price paid;
  (e) Order payment of compensation or damages;
  (f) Issue permanent injunction;
  (g) Issue mandatory injunction; or

(h) Any other relief which the interests of justice require. (Section 17 of the proposed Bill)

- Exemptions: In Section 18 of the proposed Bill certain exemptions have been provided for:

(a) contracts and relations between employers and workmen under the labour laws in force;
(b) public employment under the Central Government or a State Government or their instrumentalities or under local authorities;
(c) employment under public sector undertakings of the Central Government or a State Government;
(d) employment under corporations or bodies established by or under statutes made by Parliament or State Legislatures;
(e) contractual terms in respect of which measures are provided in international treaties or agreements with foreign countries to which the Central Government is a signatory.

Conclusion

The Supreme Court in a number of landmark judgments has struck down unreasonable clauses in contracts of employment. **(22)** While doing so, however, it has been expressly stated in these very cases that the principle of arbitrariness cannot be extended to 'commercial contracts' in the same manner as it is extends to terms imposed unilaterally by a statutory employer on its employee. It is the need of the hour that the above principles of law laid down for employment contracts should be followed even in construction contracts and that the recommendations contained in the 199th Report of the Law Commission should be followed and a law enacted to safeguard the interests of the construction industry against unfair clauses of contract.

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