

### 3

## Elements of a Contract

In this chapter, we discuss the requirements in order to have a valid contract. We will look at the difference between a legally-binding agreement and an *agreement*. In other words, how and when does an agreement become a contract?

An agreement is legally enforceable (*i.e.*, considered a *contract* by the law) if the agreement contains all of the following elements:

- the parties all have the intention to create a legal relationship;
- there must be consent or agreement;
- there must be consideration for the agreement or else the agreement should be made under seal;
- the terms of the agreement are certain; and
- the parties to the agreement have the capacity to enter the agreement.<sup>1</sup>

The first three requirements will be presented immediately below. The last two requirements will be discussed later in Chapter Four and Chapter Five respectively.

#### A. Intent

To have a valid contract, the parties must have the intention to create a legally-binding relationship. In other words, the parties must intend the agreement to be enforceable in court. This is a major difference from an agreement, such as a social agreement. In some agreements, such as a social agreement between friends to have lunch together, the parties may not have the intention of suing in court should the other party fail to

show up for lunch. How is the intention to be legally bound determined to be present or absent in an agreement?

Intention is determined objectively from the circumstances, including the nature of the words used or the conduct of the party making the offer. In commercial transactions, there is an assumption that the agreement is intended to be legally binding. In social or domestic situations, unless the parties state otherwise, the law presumes that such agreements are not intended to be legally binding. In the case of *Balfour v Balfour* [1919] 2 KB 571, there was an agreement between spouses for the payment of a monthly allowance to the wife (who remained in England because of medical reasons while the husband worked overseas). The wife attempted to enforce this promise. The court found this agreement to be legally unenforceable as it was a domestic agreement. The court presumed that the parties did not intend to create a legal relationship. In the case of *Jones v Padavatton* [1969] 1 WLR 328, the court held that family agreements were dependent upon the parties' good faith to keep the promises made and that the parties did not intend to make legally-binding agreements.

### B. Agreement

Once we have determined whether the parties to an agreement intend to be legally bound by that agreement, we need to examine whether the parties had come to any agreement. Note that some individuals would prefer to reverse the order of our review, that is to determine firstly, whether there were any agreement before deciding whether the agreement is legally-binding. This can be done as this particular order is flexible. What is important is that all of the above elements of a contract are present before finding that there is a legally-binding agreement.

There must be a legal agreement between the parties to a contract before one party can enforce another party's promise. "Agreement is usually reached by the process of offer and acceptance ... the law requires that there be an offer on ascertainable terms which receives an unqualified acceptance from the person to whom it is made."<sup>2</sup> To determine the existence of a contract and the content of its terms, courts have used this approach to determine the precise words and conduct constituting offer and acceptance. Some courts are willing to be flexible where the words and conduct are unclear. These courts would look at all the circumstances at the time of the agreement to determine whether a contract was formed. However, for certain particular agreements, such as contracts under seal, identification of offer and acceptance is not necessary.

We, too, will use this offer-and-acceptance approach. Contracts under seal are comparatively less frequently used, so we firstly will concentrate on offer-and-acceptance and discuss contracts under seal in a later section. We start with the topic of *offer* below.

#### i. Offer

An *offer* is a promise to do (or not to do) something in the future. An offer is also a display of willingness to enter into a contract on specified terms, made in such a way that a reasonable person would expect acceptance to result in a legally-binding contract.<sup>3</sup> Thus, once an acceptance of an offer is made, a contract exists between the parties.

The party making an offer is the *offeror* (also referred to as the *promisor*) and the party to whom this offer is made is the *offeree* (also referred to as the *promisee*). An offer can be made expressly, *i.e.*, by definite spoken or written words. An offer can also be made impliedly, *i.e.*, by conduct or by law. An example of an implied contract by conduct: a bus pulls up to the bus stop. You get on the bus and pay the specified bus fare. By conduct, you and the bus company have entered into a legally-binding agreement (exceptions to creating a legally enforceable agreement will be discussed later). No words need be spoken or written in this example. One instance of an implied contract by law would involve contract terms imposed by law rather than negotiated by the parties.

An offer must be made with the intention that upon acceptance, the offer becomes binding. Once the offer becomes binding, there is offer and acceptance, *i.e.*, consent or agreement by the parties to a contract.

When determining whether an offer had been made, one should identify 'an expression of willingness to contract on certain terms made with the intention that it shall become binding as soon as it is accepted by the person to whom it is addressed.' The person effecting such expression is the offeror even though he may not have initiated the contact.

It is difficult at times to determine which statements or which acts constitute an offer. It is particularly difficult where the parties are indiscriminate with the use of words. The test of an offer is the intention of an expression and not the words used.<sup>4</sup>

Thus, a statement will not be an offer if it is merely intended to supply information.

## Contents

This chapter is concerned with the contents or provisions of a contract. In other words, the obligations and responsibilities of the parties in the legally-binding relationship based upon those provisions will be discussed.

### A. Certainty of Terms

Recall the earlier discussion concerning the elements of a legally-binding agreement. One of these requirements for a contract is *certainty*. In other words, a contract requires sufficient details before the agreement can be enforced legally. A contract cannot contain too many unknown features affecting matters such as quantity, price, place of delivery, time of delivery, payment methods, etc. This section discusses the need for certainty of terms in order to have a legally enforceable agreement.

The parties to a contract undertake obligations and obtain certain rights as defined in the provisions of their contract. These provisions may be expressed or implied. These provisions, however, must not be so vague, uncertain or ambiguous that a court is unable to apply them. Otherwise, the contract is void for uncertainty. The general rule is that the courts will interpret a contract according to the parties' intentions at the time the contract was made.

The general rule is that, if the terms of an agreement are so vague or indefinite that it cannot be ascertained with reasonable certainty what is the intention of the parties, there is no contract enforceable at law. This may happen in two ways: a clause may be devoid of any meaning or have such a wide variety of meanings that it is impossible to say which of them is intended.

...



The courts, however, do not expect commercial documents to be drafted with strict precision; the court will look at the document as a whole ... in construing an agreement, a court should not hold a provision to be void for uncertainty unless it cannot resolve the ambiguity ... Finally, it should be remembered that the degree of uncertainty in an agreement is a factor which may go to the question of whether or not the parties intend to create legal relations.<sup>1</sup>

The case of *Professional Associates v Polytek Engineering Co Ltd* [1986] HKLR 20 involved the issue of the existence of a contract between an architectural firm and several companies proposing a hotel construction project in the People's Republic of China. The joint venture company responsible for the actual construction project had yet to be created and the approval of mainland officials had yet to be obtained. The Hong Kong High Court, in finding the existence of a contract, discussed the element of certainty by referring to the case of *Scammell and Nephew Ltd v HC and JG Ouston* [1941] AC 251. The Hong Kong High Court stated at page 34:

that in order for a contract to be binding the terms must be so definite that no further agreement is necessary between the parties to render them certain ... As a matter of law the contract price must be certain. But certainty may be achieved by more than one route. The common and simple alternative is for an express fixed contract sum to be stipulated. However, the contract price is equally certain if instead of an express fixed sum, a formula is agreed upon under which the contract price may be ascertained, without further agreement by the parties.

## B. Contractual Provisions

The provisions of a contract define the obligations and the rights of the parties to that contract. "Assuming that a contract has been validly created, it is necessary to consider the extent of the obligations imposed on the parties by the contract. In order to do this, the exact terms of the contract must be determined and their comparative importance evaluated."<sup>2</sup> Thus, as discussed in the preceding section, the provisions of a contract must be sufficiently certain or definite so as to be enforceable in court. Moreover, a contract's provisions may be placed into several categories.

The provisions of a contract are frequently disputed as each party claims a different interpretation of a particular provision. If the interpretation of a particular provision is not in dispute, the category

of the provision might determine the type and amount of recovery an injured party may receive or the consequences a party may face for failing to honour its legal obligations. For example, assume that Alice, a very rich tai-tai, enters a shop seeking a refrigerator for a new designer home on the Peak into which Alice will move in 30 days. In 35 days, Alice will host an open-house party to show off her new home to her rich and influential friends. After long discussions with the sales consultant, Alice enters into a contract with a shop for the purchase of a black Sub-Zero® brand of refrigerator for Alice's new home. What was said during those discussions? Did the sales consultant make any statements (known as *representations*) which influenced Alice's decision to buy the Sub-Zero® rather than a Samsung® refrigerator? Did any portions of the discussions between Alice and the sales consultant become part of the contract? What are the consequences if the shop:

- delivers a yellow and purple coloured model?
- delivers a black Samsung refrigerator?
- delivers a black, Sub-Zero refrigerator that has a scratch on the side which will be hidden once the refrigerator is installed in the cabinetry?
- delivers the correct product later than agreed?

### i. Expressed and Implied Terms

Terms of a contract may be expressed or implied. An *express term* is an expressed promise which forms an integral part of the contract. Even such a simple concept can have difficulties on application:

[W]here there is such a contractual documentation, it by no means follows that that document will contain all the terms agreed between the parties. Leaving aside the possibility of implied terms, there may be (1) express oral terms, for most contracts may be made wholly or partly by word of mouth; or (2) a collateral contract.

Where there is a contractual document, the question whether the agreement between the parties contains additional, or even contradictory, oral terms is one of fact, to be decided by extrinsic evidence. Once all the express terms of a contract have been ascertained, their meaning is a matter of construction.<sup>3</sup>

An *implied term* is a term which the parties intended and which they would have included expressly if they had thought about this question of its inclusion at the time of contracting.<sup>4</sup>

## Vitiating Factors

The ways in which an otherwise legally-binding agreement may be set aside (*vitiated, i.e., made void or voidable*) are discussed in this chapter.<sup>1</sup> The grounds for vitiating a contract commonly centre on whether there was any genuine agreement, *e.g.*, did a party actually know what it was doing; or, did a party have any real choice? Thus, this generally concerns a party's ability to enter knowingly and voluntarily into a legally-binding agreement, *i.e.*, whether there was a "meeting of the minds" of the parties. These grounds, which centre on the required elements of capacity and consent, will be discussed first. There are other grounds and these will be presented at the end of this chapter.

### A. Capacity

This refers to the legal ability, competency or fitness of a party to knowingly enter and be bound by a contract. Here, *party* may refer to a natural person, *i.e.*, an individual or a group of individuals. *Party* may also refer to a legal person, *i.e.*, a legal entity such as a company. A party to a legally-binding agreement must have the ability under the law to enter into a contract.<sup>2</sup> Without the ability to enter into a legally-binding relationship, the party is considered to lack capacity. The general rule is that the law presumes everyone has the capacity to make a contract unless falling within one of the following legal categories:

- a minor;<sup>3</sup>
- a person who is mentally disturbed;<sup>4</sup> or
- a person who is intoxicated.

A minor may enter into a contract. The other party to this agreement, however, takes a risk that the minor may not fulfil the contract where it is for non-essential goods or for money, *i.e.*, the contract is voidable at the option of the minor. In Hong Kong, an exception exists under section 46 of the *District Court Ordinance* (Cap 336).<sup>5</sup> This section provides that infancy (below 18 years old) is no defence to a debt less than \$60,000. However, where a contract concerns land, company shares, partnership, or is of a similar long-term or continuing nature, that contract is voidable at the minor's option before reaching the age of 18 and for a reasonable time afterwards.<sup>6</sup>

A person intoxicated at the time of making a contract may lack the capacity to understand or appreciate the obligations of that legally-binding agreement. Thus, this person might not have the necessary ability and/or willingness to enter into a contract. Being intoxicated does not automatically make a person incapable of entering into contracts. A person claiming intoxication at the time of contracting bears the burden of proving two elements:

- (a) intoxication to the level that prevented full appreciation of the nature of the contract and of the person's act in entering the agreement at the time; and
- (b) the other party reasonably knew that the intoxicated person was unable to act in a reasonable manner.

Similarly, to vitiate a contract on the grounds of mental disability, a person of unsound mind, through his guardian or legal representative, must prove either that:

- (a) this individual was too mentally incompetent to understand the nature and consequence of entering the contract at the time; or
- (b) the execution (*e.g.* signing) of the contract was an uncontrolled reaction to a mental illness, and the other party had reason to know of this condition.

Capacity may also refer to the authority of a legal person, in particular a company, to enter into contracts. A company's capacity to contract is determined by its Memorandum of Association and its Articles of Association. A company may, but is not required to, state its objects in its Memorandum of Association. If the objects are stated, the company's power is limited by its objects. If the company enters into a contract which is outside its stated objects and if the other party has actual knowledge of

the circumstances, the contract would be invalidated. The other party is not considered to know of a company's capacity to contract merely because the objects are stated in the Memorandum and kept by the Registrar of Companies.<sup>7</sup>

## B. Lack of Genuine Consent

We have discussed that to have a valid, legally-binding agreement, the parties must have the ability to enter into the contract and be able to understand the contract's obligations. Another essential requirement for a valid contract is that the parties freely agreed to accept the terms and the obligations of that agreement. In short, the parties must be able to understand the contract provisions and be able to agree to the provisions. Where this consent is not genuine, *i.e.*, is not freely and voluntarily given based upon full and accurate knowledge of the contract's provisions, there might not be a valid, legally-binding agreement. Situations which might prevent a party from exercising its own free will, *i.e.*, genuine consent, are presented below.

When reading this section concerning genuine consent, keep in mind the situation of tai-tai Alice and the Sub-Zero® refrigerator for her new home on the Peak mentioned in Chapter Four section B. What representations were made by whom to whom? What was said? Was any statement(s) relied upon in making a decision? Was the relied upon statement(s) true?

### i. Misrepresentation – Generally

Misrepresentation is where a party is enticed to enter into a contract by a factual statement, upon which it relied, and the statement was untrue.<sup>8</sup> If the party suffered damage from its reliance on that statement, remedies may be available under several situations; these will be discussed later.<sup>9</sup> First, however, let us discuss the requirements of misrepresentation. These elements can be found in the definition of *misrepresentation*: a false statement of fact which causes the recipient to enter into a contract with the person making the statement.

- **Falsehood:** the statement must not be correct or true. Although a statement was made both honestly and reasonably, the statement may still be a misrepresentation if it is inaccurate.<sup>10</sup>
- **Statement:** this element may consist of written words, oral statements or conduct. For example, in the case of *Spice Girls Ltd v Aprilia World Service BV* [2000] EMLR 478 the court found an implied representation



that the girl group would stay together as a singing group for the duration of the advertising contract. However, as the group knew of the pending departure of one of its members, which would affect continuation of the advertising contract, the court found there had been misrepresentation on the part of the Spice Girls even though the group had said nothing.

- There is a general rule that silence will not impose liability. One exception is where there is concealment of a fact. This concealment may be considered to be the same as saying that there is no defect. "Covering dry rot in a house so as to conceal its existence is equivalent to a 'statement' that the house is free from dry rot."<sup>11</sup> Another exception to the general rule concerns full disclosure. If a person begins to speak, the disclosure needs to be full and frank. In the case of *Dimmock v Hallett* (1866) 2 Ch App 21, the buyer of land wanted to know whether the farms on that land were leased. The seller said "yes", which was true but the seller failed to state that all the tenants on that land had been told to leave.<sup>12</sup> In this instance, the statement is literally true but is also false in the overall circumstances. The reason for this is because the statement implies other facts which are misleading or false (e.g., that there will be rent from the tenants).
- Another exception to the rule is where silence amounts to a failure to correct a previous statement. The case of *With v O'Flanagan* [1936] Ch 575 concerned the sale of a medical practice. At the beginning of negotiations, the doctor stated that his practice was worth £2000 per year. By the time the negotiations ended, the practice was worth much less due to the doctor's illness. The court found the doctor's failure to disclose the change to be misrepresentation.
- There is one final exception to the general rule concerning silence. This exception is known as *uberrimae fidei* (of the utmost good faith).<sup>13</sup> Situations requiring *uberrimae fidei* are usually imposed by law and concern fiduciary matters such as insurance contracts, or contracts between principal and agent, solicitor and client relationships. In situations of *uberrimae fidei*, there is an obligation for full disclosure; silence or partial disclosure is unacceptable.
- Of Fact/Opinion/Intention: a false statement of a fact is misrepresentation. One should note that misrepresentation is limited to untrue statements of fact but not of opinion or intention. There would be misrepresentation of fact where a person pretends to hold an opinion which is not actually held. However, if that person actually

holds such an opinion which turns out to be wrong, the representation would not be misrepresentation. Therefore, a false statement of an opinion, truly held, is not misrepresentation. An opinion may amount to a statement of fact where it can be proved that the person making the statement did not actually hold or believe in that opinion. In the case of *Smith v Land and House Property Corp* (1884) 28 Ch D 7 the seller of a hotel stated that it was leased to "a most desirable tenant" when the seller knew the tenant was frequently late in paying the rent. The court stated that "if the facts are not equally known to both sides, then a statement of opinion by the one who knows the facts best involves very often a statement of a material fact, for he impliedly states that he knows facts which justify his opinion."<sup>14</sup> A statement of intention will not amount to misrepresentation should the intention change. However, a statement of intention, if not sincerely held at the time, would constitute a misrepresentation of an existing fact concerning the speaker's state of mind.<sup>15</sup>

- Inducement: the recipient of the misstatement must have been induced by the misstatement to enter into the contract. There would be no misrepresentation if the recipient did not receive the misstatement; ignored it; or, being aware of its falsehood, entered the contract nonetheless.

In Hong Kong, there is legislation controlling misrepresentation. This legislation is the *Misrepresentation Ordinance* (Cap 284) which is concerned with innocent misrepresentation. Despite this focus, certain sections of this ordinance refer to misrepresentations "other than fraudulent." This reference includes by inference negligent misstatement. Section 2 keeps the remedy of rescission (discussed below) for innocent misrepresentation even where the misrepresentation has become a contract term, or, where the contract has been performed.<sup>16</sup> Section 3(1) provides for damages as a remedy for non-fraudulent misrepresentation, unless the offending party proves that there had been reasonable grounds to believe that the representation was true and that the offending party believed it to be true when the contract was made. This section of the Ordinance, in effect, places the burden of proof upon the offending party to prove no misrepresentation occurred. Section 3(2) permits a court the discretion to grant damages rather than rescission. Damages may be awarded both under sections 3(1) and 3(2), but the award given under section 3(2) shall be taken into account when assessing damages under section 3(1).