Formation of Contracts - Part - 1

by **David Kelly**
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Not all agreements that people enter into are binding in law. Only con- tractual agreements are enforceable through the court system. Such a statement, however, merely raises the question as to what amounts to a contract. There are certain factors which have to be borne in mind when analysing situations to decide whether or not they amount to contracts.

The essential elements of a binding agreement are as follows:

- offer;
- acceptance;
- consideration;
- privity;
- capacity;
- intention to create legal relations;
- there must be no vitiating factors.

The first six of the above factors must be present, and the seventh one absent, for there to be a legally enforceable contractual relationship. In this article I will deal with the first three elements, and will return to the others in later editions of this journal. It is only possible to provide a very basic introduction to these topics, so you will have to supplement this article with further reading in your manuals or textbooks.

Offer

Firstly a point of terminology: the person who makes the original offer is the offeror; the person who receives it is the offeree, although the parties can change roles in the course of their negotiations.

It is a rather surprising fact that students tend to be in such a rush to explain what they know about what are not offers, i.e., invitations to treat, that they tend to ignore the central importance of offers themselves. The offer sets out the terms upon which the offeror is willing to enter into contractual relations with the offeree. The essential thing to emphasise about an offer is that, once it is accepted by the offeree, a legally binding contract has been entered into, and failure to perform what has been promised will result in breach of contract.

The usual definition of an offer is a promise, capable of acceptance, to be bound on particular terms. The first consequence to note from this definition is that the promise to be accepted must not be too vague. The classic case on this point is *Scammel v. Ouston* (1941), in which the court was unable to decide on the precise nature of the offer that was supposed to have been accepted by the plaintiff. Ouston had ordered a van from Scammel on the understanding that the balance of the purchase price could be paid on ‘hire-purchase terms over two years’ but the actual terms of Ouston’s agreement were never actually fixed.

Distinguishing factors of an offer

It is important to distinguish the genuine offer, capable of immediate acceptance, from other statements which are not capable of acceptance. These latter may take the form of:

- **A statement of intention:** this cannot form the basis of a contract, even although the party to whom it was made acts on it. Examples of such may be seen in cases involving letters of comfort, where parent companies state their present intention to support their subsidiaries, but subsequently fail to accept responsibility for the debts of those subsidiaries (see *Kleinwort Benson v. Malaysian Mining Corporation* (1989)).

- **A supply of information:** with regard to the supply of information not amounting to an offer, the classic case is *Harvey v. Facey* (1893), in which it was held that the defendant's telegram, which stated the lowest price he would accept for the sale of some property, was not an offer capable of being accepted by the plaintiff.

- **An invitation to treat is not an offer**, it is merely an invitation to others to make offers.

It follows that an invitation to treat cannot be accepted in such a way as to form a contract and equally the person extending the invitation is not bound to accept any offers made to them. Examples of common situations involving invitations to treat are:

- **The display of goods in a shop window.** The classic case in this area is *Fisher v. Bell* (1961), in which a shopkeeper was prosecuted for offering offensive weapons for sale, by having flick-knives on display in his window. It was held that the shopkeeper was not guilty as the display in the shop window was not an offer for sale but only an invitation to treat.

- **The display of goods on the shelf of a self-service shop.** *In Pharmaceutical Society of Great Britain v. Boots Cash Chemists* (1953), it was held that the display of goods on the shelf was only an invitation to treat and that in law, the customer offered to buy the goods at the cash desk.

- **A public advertisement.** In *Partridge v. Crittenden* (1968), a person was charged with 'offering' a wild bird for sale contrary to Protection of Birds Act 1954, after he had placed an advert relating to the sale of such birds in a magazine. It was held that he could not be guilty of offering the bird for sale as the advert amounted to no more than an invitation to treat.

- **Tenders** (see below).

Offers to particular people

An offer may be made to a particular person or to a group of people or to the world at large. If the offer is restricted then only the people to whom it is addressed may accept it; but if the offer is made to the public at large, it can be accepted by anyone. In *Carlill v. Carbolic Smoke Ball Co.* (1893), the company advertised that they would pay £100 to anyone who caught influenza after using their smoke ball as directed. When Carlill used the smoke ball but still caught influenza she sued the company for the promised £100. Amongst the many defences argued for the company, it was suggested that the advert could not have been an offer as it was not addressed to Carlill. It was held that the advert was an offer to the whole world which Mrs. Carlill had accepted by her conduct.

There was, therefore, a valid contract between her and the company.

Termination of offers

If an offer is accepted (see below) then a contract is formed, but there are other ways in which an offer can be terminated without involving the creation of a legally binding agreement.

- **Rejection of offers**

If a person to whom an offer has been made rejects it, then that is the end of the matter and they cannot subsequently accept the original offer.

A counter-offer, where the offeree tries to change the terms of the original offer has the same effect, as may be seen *Hyde v. Wrench* (1840). Wrench offered to sell his farm for £1,000. Hyde made a counter-offer to buy the farm for £950, which Wrench rejected. Hyde then told Wrench that he accepted the original offer. It was held that there was no contract. Hyde's counter-offer had effectively ended the original offer. A counter-offer should not be confused with a request for information which does not end the offer (see *Stevenson v. McLean* (1880)).

- **Revocation of offer**

Revocation takes place when the offeror withdraws their offer. The offeror may change their mind at any time before acceptance. Once accepted the offer cannot be revoked, but once revoked the offer cannot be accepted (see *Routledge v. Grant* (1828)).

Revocation, however, is not effective until it is actually received by the offeree, but communication of revocation may be made through a reliable third party (see *Dickinson v. Dodds* (1876)). Where the promisor agrees to keep the offer open for a time they can still withdraw it at any time before acceptance, unless, the offeree has provided separate consideration for the offer to kept open. In that situation an option contract has been created and the offeror cannot withdraw the offer before the agreed time.

In relation to revocation of offers it should be noted that, where unilateral contracts are involved, revocation is not permissible once the offeree has started performing the task requested (see *Errington v. Errington* (1952)).

- **Lapse of offers**

It is possible for the parties to agree, or for the offeror to set, a time limit within which acceptance has to take place. If the offeree has not accepted the offer within that period then the offer is said to have lapsed and can no longer be accepted. Even where no set time limit has been placed on accepting the offer it will still lapse after the passage of a reasonable time, depending on the circumstances of the case.

Acceptance

Acceptance is necessary for the formation of a contract. As stated above once the offeree has assented to the terms offered, a contract comes into effect and both parties are bound by the terms offered and accepted. Any acceptance must correspond with the terms of the offer, otherwise the attempt to introduce new terms into the acceptance will operate as a counter-offer and will revoke the original offer.

There are some particular points to bear in mind with respect to acceptance.

- **Knowledge and motive**

No-one can accept an offer that they do not know about, but the motive for accepting is not important as long as the person accepting knows about the offer. Thus in order to claim a reward offered for something, the person performing the requested act must have known about the reward before carrying out the action, but the gaining of the reward need not be the prime reason why they did what they did (see *Williams v. Carwadine* (1883)).

- **Form of acceptance**

Acceptance may be in the form of express words, either spoken or written; but equally it may be implied from conduct as can be seen from *Brogden v. Metropolitan Railway Co* (1877).

- **Communication of acceptance**

The general rule is that acceptance must be communicated to the offeror. As a consequence of this rule, silence cannot amount to acceptance as was seen in the classic case of *Felthouse v. Bindley* (1863).

There are, however, exceptions to the general rule that acceptance must be communicated.

Thus in unilateral contracts, such as *Carlill v. Carbolic Smoke Ball* Co, where the offeror has waived the right to receive communication, acceptance occurs when the offeree performs the required act and they do not have to specifically notify the offeror of their acceptance.

Where acceptance is through the postal service, acceptance is complete as soon as the letter, properly addressed and stamped, is posted. The contract is concluded even if the letter subsequently fails to reach the offeror (*Adams v. Lindsell* (1818)). The postal rule applies equally to telegrams, but it does not apply where means of instantaneous communication are used (see *Entores v. Far East Corp.* (1955)). This means that when acceptance is made by means of telephone, fax, or telex, the offeror must actually receive the acceptance.

It is important to remember that the postal rule will only apply where it is in the contemplation of the parties that the post will be used as the means of acceptance. If the parties have negotiated either face to face, in a shop for example, or over the telephone, then it might not be reasonable for the offeree to use the post as a means of communicating their acceptance and they would not gain the benefit of the postal rule. Alternatively it is possible for the offeror to exclude the operation of the postal rule by requiring that acceptance is only to be effective on receipt (see *Holwell Securities v. Hughes* (1974)). The offeror can also require that acceptance be communicated in a particular manner, but where the offeror does not actually insist that acceptance can only be made in the stated manner, then acceptance is effective if it is communicated in a way no less advantageous to the offeror (see *Yates Building Co v. J. Pulleyn & Sons* (1975)).

Tenders

These arise where one party wishes particular work to be done and issues a statement asking interested parties to submit the terms on which they are willing to carry out the work. In the case of tenders the person who invites the tender is simply making an invitation to treat. The person who submits a tender is the offeror and the other party is at liberty to accept or reject the offer as they please.

The effect of acceptance depends upon the wording of the invitation to tender. If the invitation states that the potential purchaser will require to be supplied with a certain quantity of goods, then acceptance of a tender will

form a contract and they will be in breach if they fail to order the stated quantity of goods from the tenderer.

If, on the other hand, the invitation states only that the potential purchaser may require goods, acceptance only gives rise to a standing offer. There is no compulsion on the purchaser to take any goods but they must not deal with any other supplier (see *Great Northern Railway v. Witham* (1873)).

Consideration

English law does not enforce gratuitous promises unless they are made by deed. Consideration was defined by Sir Frederick Pollock, a definition adopted by the house of Lords in *Dunlop v. Selfridge* (1915), as:

"An act or forbearance of one party, or the promise thereof, is the price for which the promise of the other is bought, and the promise thus given for value is enforceable."

Types of consideration

Consideration can be divided into the following categories:

Executory consideration

This is the promise to perform an action at some future time. A contract can thus be made on the basis of an exchange of promises as to future action.

Executed consideration

In the case of unilateral contracts, where the offeror promises something in return for the offeree's doing something, the promise only becomes enforceable when the offeree has actually performed the required act. Thus if A offers a reward for the return of their lost watch the reward only becomes enforceable once it has been found and returned to them.

Past Consideration

This category does not actually count as valid consideration. Normally consideration is provided either at the time of the creation of a contract or at a later date. In the case of past consideration, however, the action is performed before the promise that it is supposed to be the consideration for. Such action is not sufficient to support a later promise (see *Re McArdle* (1951)).

There are exceptions to the rule that past consideration will not support a valid contract:

- under Section 27 of the Bills of Exchange Act 1882;
- under Section 29 of the Limitation Act 1980 a time barred debt becomes enforceable again if it is acknowledged in writing;
- where the plaintiff performed the action at the request of the defendant and payment was expected, then any subsequent promise to pay will be enforceable (see *Re Casey's Patents* (1892)).

Rules relating to consideration:

- **consideration must not be past:** (see above);
- performance must be legal: The court will not enforce a promise to pay for any criminal act;
- **performance must be possible:** a promise to perform an impossible act cannot form the basis of a contract;
- **consideration must move from the promisee:** if A promises B £1,000 if B gives his car to C, then normally C cannot enforce B's promise, because C is not the party who has provided the consideration for the promise (see *Tweddle v. Atkinson* (1861)).
- **consideration must be sufficient but need not be adequate:** the court will not intervene to require equality in the value exchanged, as long as the agreement has been freely entered into (see *Thomas v. Thomas* (1842) and *Chappell & Co v. Nestle Co* (1959)).

Performance of existing duties

The rules relating to existing duty are as follows:

The performance of a public duty: the performance of public duties cannot be consideration for a promised reward *Collins v. Godefroy* (1831) Where, however, a promisee does more than their duty, they are entitled to claim on the promise (see *Glassbrook v. Glamorgan C.C.* (1925)).

The performance of a contractual duty: the rule, used to be that the performance of an existing contractual duty owed to the promisor could not be consideration for a new promise (see *Stilk v. Myrick* (1809). Some additional consideration had to be provided (see *Hartley v. Ponsonby* (1857)). However, in the light of *Williams v. Roffey Bros* (1990) it now appears that performance of an existing contractual duty can amount to consideration for a new promise in circumstances where there is no question of fraud or duress, and where the promisor receives practical benefits.

The performance of a contractual duty owed to one person can amount to valid consideration for the promise made by another person (see *Shadwell v. Shadwell* (1860)).

Consideration in relation to the waiver of existing rights

At Common Law, if A owes B £10 but B agrees to accept £5 in full settlement of the debt, B's promise to give up existing rights must be supported by consideration on the part of A. In Pinnel's case (1602) it was stated that a payment of a lesser sum cannot be any satisfaction for the whole. This opinion was approved in *Foakes v. Beer* (1884).

However, the following will operate to fully discharge an outstanding debt:

- **payment in kind:** A may clear a debt if B agrees to accept something instead of money.
- **payment of a lesser sum before the due date of payment;**

- **payment at a different place:** as in the previous case this must be at the wish of the creditor;
- **payment of a lesser sum by a third party;**

- **a composition arrangement:** this is an agreement between creditors to the effect that they will accept part-payment of their debts. The individual creditors cannot subsequently seek to recover the unpaid element of the debt;
- **estoppel:** treated separately below.

Promissory estoppel

This equitable doctrine prevents promisors from going back on their promises. The doctrine first appeared in *Hughes v. Metropolitan Railway Co* (1877) and was revived by Lord Denning in *Central London Property Trust Ltd v. High Trees House Ltd* (1947).

The precise scope of the doctrine of promissory estoppel is far from certain. However, the following points may be made:

- It arises from a promise made by a party to an existing contractual agreement (see *W.J. Alan & Co v. El Nasr Export & Import Co* (1972));
- It only varies or discharges of rights within a contract, it does not apply to the formation of contracts and therefore it does not avoid the need for consideration;
- It normally only suspends rights thus it is usually open to the promisor, on the provision of reasonable notice, to retract the promise and revert to the original terms of the contract. (See *Tool Metal Manufacturing Co v. Tungsten Electric Co* (1955)) Rights may be extinguished, however, in the case of a non-continuing obligation, or where the parties cannot resume their original positions;
- The promise relied upon must be given voluntarily (see *D & C Builders v. Rees* (1966)).